

# REGULATING HAWAII'S PETROLEUM INDUSTRY

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PETROLEUM INDUSTRY

FOREWORD

This study was prepared in response to House Resolution No. 174, H. D. 2, which was adopted during the Regular Session of 1995. The Resolution requested the Legislative Reference Bureau to conduct a study to obtain the views of selected state agencies and representatives of Hawaii's petroleum industry in order to assist the Legislature in formulating policies that protect the interests of Hawaii's gasoline consumers. The Resolution sought information and the views of survey participants on a broad range of proposals to regulate Hawaii's petroleum industry. This study reviews each of these proposals in terms of their value to consumers, and explores both regulatory policy options and alternatives to regulation available to state lawmakers.

The Bureau extends its sincere appreciation to all those whose participation and cooperation made this study possible. A list of contact persons, including the names of survey participants and others who helped to contribute to this study, is contained in Appendix B.

Wendell K. Kimura  
Acting Director

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## REGULATING HAWAII'S PETROLEUM INDUSTRY

### Chapter 1 INTRODUCTION

The Eighteenth Legislature of the State of Hawaii, Regular Session of 1995, adopted House Resolution No. 174, H. D. 2 (Appendix A), requesting the Legislative Reference Bureau to conduct a study to obtain useful data and views from selected state agencies and representatives of Hawaii's petroleum industry--gasoline dealers, wholesalers (jobbers), and large oil companies--to assist the Legislature in formulating policies that protect the interests of Hawaii's gasoline consumers. The Resolution specified that the protection of these consumers' long- and short-term interests was to be accomplished by ensuring the: (1) lowest possible gasoline prices; (2) availability of automotive services; and (3) convenient access to retail gasoline outlets. In particular, the Resolution requested the Bureau to obtain information and data from the participants on the following topics:

- (1) The effects of prohibiting franchise agreements from requiring franchisees to purchase all of their gasoline from the franchisor or restraining franchisees from dealing with the franchisors' competitors;
- (2) The effects of limiting the amount of gasoline franchisors require franchisees to purchase from the franchisor;
- (3) The effects of prohibiting gasoline allotment under exchange agreements on the basis of historical market share;
- (4) Measures to ensure the lowest retail gasoline prices for the consumer in the short and long-term;
- (5) Whether price inversion has occurred or is currently occurring in the distribution of gasoline in Hawaii;
- (6) The effects of encouraging the establishment of a public bulk gasoline terminal facility, which could make the importation of gasoline cost

effective and could also lead to a reduction in wholesale gasoline prices;

- (7) The effects of establishing a petroleum regulatory commission having general supervision over all petroleum manufacturers and jobbers in the State with the authority to:
  - (A) Authorize new retail service stations and determine whether they may be operated by a petroleum manufacturer or jobber;
  - (B) Restrict price increases when prices rise above a certain percentage over a benchmark market, as determined by rules adopted by the commission under chapter 91 [the Hawaii Administrative Procedure Act];
  - (C) Decide when a petroleum manufacturer or jobber may convert a retail service station from one operated by a gasoline dealer to one operated by a petroleum manufacturer or jobber, and vice versa;
  - (D) Decide when a petroleum refiner may close a retail service station, to prevent communities from being underserved;
  - (E) Review management decisions of petroleum manufacturers and jobbers regarding infrastructure, strategic planning, and other areas to ensure market compliance; and
  - (F) Review profits for reasonableness in light of the need for petroleum utilities to promote a safe workplace and ensure environmental protection;
- (8) The effects of regulating retail gasoline prices of company-operated retail service stations;
- (9) The effects of requiring manufacturers, terminal operators, and jobbers of petroleum products to file with the State, a tariff listing all prices at which the manufacturer or jobber offers goods or services for sale or lease;

- (10) The effects of prohibiting any terminal operator having excess capacity from refusing to provide terminalling services to any person at the prices published in the tariff that the terminal operator filed with the State;
- (11) The effects of prohibiting manufacturers of petroleum products not only from directly operating retail service stations, but also from franchising them or owning and leasing them to branded dealers (divestiture);
- (12) The effects of establishing a public petroleum products storage authority with power to import, store, and market petroleum products;
- (13) The effects of active enforcement of the Petroleum Industry Information Reporting Act of 1991 and Act 291, Session Laws of Hawaii 1991 (codified as chapter 486I, Hawaii Revised Statutes);
- (14) Measures that could be initiated to reduce the cost of conducting business for independent dealers (i. e., lease rent and environmental regulations);
- (15) The effects of the provision contained in section 486H-10(a), Hawaii Revised Statutes, that allows manufacturers and jobbers to open one company operated retail service station for each dealer operated service station owned by that manufacturer or jobber, up to a maximum of two company owned retail service stations;
- (16) Whether laws in other states prohibit or limit the number of retail service stations that may be opened or operated by wholesalers, producers, or refiners of petroleum products, or their subsidiaries; and
- (17) Whether or not the existing moratorium has resulted in lower gasoline prices for consumers.

#### Survey Participants

House Resolution 174, H. D. 2, requested that the Bureau seek the above information and data from the following persons:

- (1) Petroleum industry participants:
  - (A) The Hawaii Automotive and Retail Gasoline Dealers Association (HARGD);<sup>1</sup>
  - (B) The Hawaii Petroleum Marketers Association (HPMA);
  - (C) Western States Petroleum Association (WSPA);
  - (D) Chevron USA Products Company (Chevron); and
  - (E) BHP Hawaii Inc. (BHP); and
- (2) State government agencies:
  - (A) The Attorney General (AG);
  - (B) The Department of Commerce and Consumer Affairs (DCCA);
  - (C) The Department of Business, Economic Development, and Tourism (DBEDT); and
  - (D) The Public Utilities Commission (PUC).

The Hawaii Automotive and Retail Gasoline Dealers Association has a membership of approximately 175, of which approximately 125 are service stations and the remainder are auto repair shops or suppliers. Of the 125 service stations represented, 86 are three-party oil company franchises, 36 are two-party independents under a supply contract, and three are one-party independents/jobbers.<sup>2</sup>

The Hawaii Petroleum Marketers Association represents fourteen oil wholesalers in the State, which are referred to in chapter 486H, Hawaii Revised Statutes, and in this study as "jobbers".<sup>3</sup> Hawaii's gasoline retail market is served by one large jobber, Aloha Petroleum, which sells gasoline under its own brand, while the remaining jobbers are smaller in size and mostly sell gasoline under the major brands.<sup>4</sup> Aloha Petroleum has contributed to this study on its own initiative.

Western States Petroleum Association is a trade association of oil companies doing business in the Western United States, and functions as an information clearinghouse. The Hawaii Petroleum Resources Group (PRG) was created as a committee within the WSPA to focus on legislative issues that are pertinent to Hawaii. The Association's Hawaii membership consists of Texaco, Shell, Unocal, and Chevron.<sup>5</sup>

Hawaii's petroleum industry is served by five major oil companies, namely, the four Hawaii members of PRG, and BHP Hawaii, which is not a member of the WSPA.<sup>6</sup> Although the WSPA did not contribute to this study under the name of that organization,<sup>7</sup> the positions of the major oil companies are represented by Chevron, BHP, and Shell Oil Products Company (Shell). While Chevron and BHP were specifically named in the House Resolution as participants in this study, Shell contributed to this study on its own initiative.

The names, addresses, and phone numbers, as available, of each of the study participants named in the Resolution and others participating in the survey is contained in Appendix B.

Only two of the four Hawaii government agencies requested to participate in the survey--the Department of the Attorney General and the Department of Business, Economic Development, and Tourism--have actually participated. The Public Utilities Commission refused the request of the House of Representatives to participate in this study, noting that "the Commission has never regulated this industry and, thus, does not possess the information sought by the questionnaire."<sup>8</sup> The Department of Commerce and Consumer Affairs also refused to participate other than to submit copies of an earlier study conducted on behalf of the department regarding consumer and gasoline marketing in the State, stating that "it does not appear that DCCA can add anything further to this inquiry."<sup>9</sup> While the DCCA study is relevant on matters relating to divorcement and gasoline retailing, it is not responsive to most of the remaining questions specified in House Resolution No. 174, H.D. 2.<sup>10</sup> It would appear that the refusal of these agencies to participate indicates that they take no position with respect to any of the issues specified in the Resolution.<sup>11</sup>

#### Methodology, Organization, and Focus of Study

The Bureau's survey questionnaire, a copy of which is contained in Appendix C, requested the information specified in the House Resolution from the persons identified in that Resolution. Due to the broad scope of the study and the potentially large volume of information sought, the questionnaire requested that the study participants submit their responses on sixteen of the seventeen questions in accordance with three staggered deadlines in order to ensure that all materials would be received and compiled in a timely manner.

This study is organized into sixteen chapters. This chapter introduces the study. Chapters 2 and 3 provide background information to assist readers in understanding the issues discussed in the remainder of the report. Chapter 2 provides a brief overview of the petroleum industry generally, while chapter 3 gives an overview of the

petroleum industry in Hawaii.

Chapters 4 through 15 present the views of the petroleum industry and government agencies surveyed with respect to the questions in the Resolution other than question (16), which requested information from the Bureau regarding the laws of other states concerning what is generally referred to as "divorcement" legislation. The following table outlines which of the Resolution's questions are discussed in each chapter:

CHAPTER	QUESTIONS
4	(1) and (2)
5	(3)
6	(4)
7	(5)
8	(6) and (12)
9	(7)
10	(8)
11	(9) and (10)
12	(11)
13	(13)
14	(14)
15	(15), (16), and (17)

Specifically, chapter 4 contains the responses of the survey participants regarding open supply legislation and exclusive dealing. Chapter 5 discusses responses regarding exchange agreements. Chapter 6 reviews measures to ensure the lowest retail gasoline prices. Chapter 7 discusses price inversions. Chapter 8 discusses the proposed establishment of a public bulk gasoline terminal facility and a public petroleum products storage authority. Chapter 9 discusses the proposed establishment of a petroleum regulatory commission. Chapter 10 discusses the effects of regulating retail gasoline prices of company-operated retail service stations. Chapter 11 discusses the filing of tariffs with the State and providing terminalling services. Chapter 12 discusses vertical divorcement, or divestiture. Chapter 13 discusses the Petroleum Industry Information Reporting Act of 1991. Chapter 14 reviews measures to assist independent dealers. Chapter 15 reviews divorcement laws of other jurisdictions and discusses retail divorcement generally.

The survey responses in chapters 4 through 15 are arranged in the following order:

- (1) State government. The government's positions are advanced by the Hawaii Departments of the Attorney General (AG) and Business, Economic Development, and Tourism (DBEDT).

- (2) Gasoline dealers. The positions of Hawaii's gasoline dealers are advanced by the Hawaii Automotive and Retail Gasoline Dealers Association (HARGD).
- (3) Jobbers. The positions of wholesalers of petroleum products are advanced by the Hawaii Petroleum Marketers Association (HPMA) and Aloha Petroleum.
- (4) Oil companies. The positions of the major producers or refiners of petroleum products are advanced by Shell, BHP, and Chevron.

Some of the responses have been edited for length. A discussion section follows the responses, either to provide additional background information or to discuss issues that were not sufficiently addressed by the survey participants.

Finally, chapter 16 reviews various alternatives to regulation and policy options available to legislators with respect to Hawaii's petroleum industry.

There is some degree of overlap among the questions presented in the Resolution. This study therefore reviews those questions together that relate to the same subject matter. In addition, many of these questions ask for the "effects" resulting from certain actions; for example, question number (7) of the Resolution asks for the "effects of establishing a petroleum regulatory commission ...". Because the intent of the Resolution is to provide useful information and data that the Legislature may consider in developing policies that protect the short- and long-term interests of Hawaii's gasoline consumers, the survey requested the participants to respond, whenever possible, along these lines. For example, with respect to question number (7), the survey summarizes participants' responses regarding whether establishing a petroleum regulatory commission would or would not protect the interests of gasoline consumers in this State.

In addition, it is important to note at the outset that the House Resolution requests a compilation and presentation of the views of participants in the petroleum industry in Hawaii and selected government agencies on a variety of loosely related issues. The purpose of this report is to present these views to the Legislature in a reasonably concise, manageable format to allow the Legislature to draw its own conclusions as to the appropriateness of any particular view. This report therefore avoids drawing conclusions as to which of these views are preferable, but rather summarizes the competing policy arguments and presents them from the standpoint of protecting the

interests of Hawaii's gasoline consumers.

#### Use of Terms

For the purposes of this report, except where otherwise noted, the following terms (most of which are used in House Resolution No. 174, H. D. 2) are deemed to have the same meanings as defined in section 486H-1, Hawaii Revised Statutes. That section contains the following definitions:

"Franchise" means:

- (1) Any agreement or related agreements between a petroleum distributor and a gasoline dealer under which the gasoline dealer is granted the right to use a trademark, trade name, service mark, or other identifying symbol or name owned by the distributor in connection with the retail sale of petroleum products supplied by the petroleum distributor; or
- (2) Any agreement or related agreements described in paragraph (1) and any agreement between a petroleum distributor and a gasoline dealer under which the gasoline dealer is granted the right to occupy the premises owned, leased, or controlled by the distributor, for the purpose of engaging in the retail sale of petroleum products supplied by the distributor.

"Gasoline" includes gasoline, benzol, benzine, naphtha, and any other liquid prepared, advertised, offered for sale, sold for use as, or used for, the generation of power for the propulsion of motor vehicles, including any product obtained by blending together any one or more petroleum products with or without other products, if the resultant product is capable of the same use.

"Gasoline dealer" means any person engaged in the retail sale of petroleum products in the United States under a franchise agreement entered into with a petroleum distributor.

"Good faith" means the duty of a gasoline dealer and a petroleum distributor to act in a fair and equitable manner in the performance and in the demanding of performance of the terms and provisions of the franchise. The petroleum distributor shall not impose on a gasoline dealer by contract, rule, or regulation, whether written or oral, any standard of conduct that is not reasonable and of material significance to the franchise relationship.

"Inventory" means any product sold to a gasoline dealer for resale purposes by a petroleum distributor.

"Jobber" means every wholesaler of petroleum products.

"Major brand" means the primary trade name or trademark most commonly associated and identified with a manufacturer's retail service station.

"Manufacturer" means a producer or refiner of petroleum products, or any subsidiary of that producer or refiner. 12

"Motor vehicle fuel" means gasoline, diesel fuel, alcohol, and any mixture of those fuels suitable for use in vehicles registered under chapter 286. 13

"Petroleum distributor" means any person engaged in the sale, consignment, or distribution of petroleum products to retail outlets that it owns, leases, or otherwise controls.

"Petroleum products" includes motor vehicle fuel, residual oils number 4, 5, and 6, and all grades of jet (turbo) fuel.

"Purchase" means any acquisition of ownership.

"Retail" means the sale of a product for purposes other than resale.

"Retail service station" means a place of business where motor vehicle fuel is sold and delivered into the tanks of motor vehicles.

"Sale" means any exchange, gift, or other disposition.

"Secondary brand" means a trade name or trademark, other than a major brand, used to identify a manufacturer's retail service station.

"Unbranded" means an independent retail service station dealer, jobber, heating oil distributor, motor fuel wholesaler, or peddler marketing gasoline or special fuels under its own brand, trade name, or trademark, other than those of a manufacturer, or any subsidiary thereof.

#### Additional Terms Defined

In addition, the following additional terms, as used in this report, are defined as follows:

"Barrel" (of crude oil or petroleum product) is equivalent to forty-two gallons. 14

"Bulk terminal" means a facility used primarily for the storage or marketing of petroleum products, or both, that has a total bulk storage capacity of fifty thousand barrels or more, or receives petroleum products by tanker, barge, or pipeline. 15

"Company-operated retail service station" means a retail service station owned and operated by a manufacturer or jobber. 16

"Crude oil" means a mixture of hydrocarbons that exists in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface-separating facilities. Domestic crude oil is produced in the United States or from its outer continental shelf; foreign crude oil is produced outside of the United States. 17 "Sour crude" is crude oil containing sufficiently large quantities of sulfur and sulfur compounds as to require chemical treatment for removal. 18 "Sweet crude" is crude oil containing so little sulfur as to render unnecessary chemical treatment for the removal of sulfur or sulfur compounds. 19

"Dealer-operated retail service station" means a retail service station owned by a manufacturer or jobber and operated by a qualified gasoline dealer. 20

"Dealer tank wagon price" or "DTW price" means the wholesale price a dealer pays to a supplier for gasoline delivered in bulk to the dealer's outlet. Typically, the delivery is by tank truck and the transaction takes place between a dealer and a refiner or jobber. The dealer tank wagon price may be higher than the total of the unbranded (rack) price since it may often include the price for gasoline, transportation costs, and the value of the brand name including additive package. 21

"Divestiture" or "vertical divorcement" means the divestment of a vertically integrated oil company of all or a portion of its major operations.

"Divorcement" or "retail divorcement" means the prohibition of a producer or refiner from directly operating a retail service station. 22

"Downstream" generally means starting with one stage of a sequential production process and encompassing all subsequent stages. 23 More specifically, "downstream processing" refers to the upgrading of distillation products into materials suitable for blending into motor

gasoline. 24

"Economies of scale" means decreases in the cost of production from any type of plant which are associated with increases in the size of the plant. 25

"Exchange agreement" means an agreement allowing a party ("A") that does not refine gasoline in one locality to obtain the gasoline it needs from another party ("B") that does refine gasoline in that locality, in exchange for providing B with the gasoline it needs in areas in which B does not refine gasoline. For example, a hypothetical exchange agreement would permit Shell, which does not refine gasoline in Hawaii, to obtain gasoline from Chevron, which does refine gasoline locally, in exchange for providing Chevron the gasoline it needs in areas in which Chevron does not refine gasoline, but Shell does. 26

"Feedstock" means the use of crude oil, residual fuel oil, and refined petroleum products for processing in a petrochemical plant. 27

"Independent dealer" means a firm that is engaged in the retail sale of petroleum products that is neither controlled by nor in a partnership with a major oil company. 28

"Lessee dealer" means an independent marketer who leases the station and land from a supplier and has the use of tanks, pumps, signs, etc. The lessee dealer typically has a supply agreement with a refiner or distributor and purchases products at dealer tank wagon prices. 29

"Major oil company" means a vertically integrated oil company that refines and distributes oil and owns retail service stations. 30

"OPEC" means the Organization of Petroleum Exporting Countries, consisting of Algeria, Equador, Gabon, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, Venezuela, and the neutral zone between Kuwait and Saudi Arabia, which has organized for the purpose of negotiating with oil companies regarding matters of oil production, prices, and future concession rights. 31

"Open dealer" means an independent marketer who owns the station or land of a retail outlet, and has use of tanks, pumps, signs, etc. The open dealer typically has a supply agreement with a refiner or a distributor and purchases products at or below dealer tank wagon prices. 32

"Open supply" legislation would permit retail dealers to buy gasoline from more than one supplier (i.e., from sellers other than the refiners who lease them their stations) and sell that gasoline through the

leased outlet. 33

"Price competition" means the attempt by a seller to increase sales by lowering its own price in relation to its competitors' prices. 34

"Price discrimination" occurs when a seller obtains different rates of return from the same product from different groups of customers. 35

"Price elasticity" refers to the percentage change in demand for a product for each percentage change in price. 36

"Price inversion" or "wholesale price inversion" means a market anomaly in which the price jobbers pay to oil refiners for quantities in bulk becomes higher than the retail price available from branded retail outlets. 37

"Pump prices" are prices charged by retail gasoline outlets. 38

"Rack price" means the wholesale price to nonbranded independent marketers and jobbers, typically set at a terminal or refinery rack. 39

"Spot price" means a transaction price concluded "on the spot", i. e., on a one-time, prompt basis. The transaction usually involves only one specific quantity of product, in contrast with a term contract sale price, which obligates the seller to deliver a product at an agreed price and frequency over a certain period. 40

"Terminal" or "terminalling" means the receipt of gasoline for storage into a terminal facility, including pipelines; storage of gasoline; delivery of the gasoline as directed by the distributor into a tanktruck, vessel, or pipeline; maintenance of inventory records and other records of account; quantity and quality testing of the gasoline; volume measurement; and pipeline throughput services. 41

"Terminal facility" means storage tanks and other appurtenant equipment, including pipelines, where gasoline will be commingled with other products of similar quality. 42

"Throughput" means the volume of crude oil, unfinished oil, and natural gas liquids refined during a specified time period. 43

"Underground storage tank", "tank", or "UST" means any one or combination of tanks (including pipes connected thereto) used to contain an accumulation of regulated substances, and the volume of which (including the volume of the underground pipes connected thereto) is ten per cent or more beneath the surface of the ground. 44

"Upstream" generally means starting with one stage of a sequential production process and encompassing all prior stages. 45

"Vertical integration", in the case of a major oil company, means the ownership or control of all phases of the production of petroleum products, including the drilling, pumping, refining, distribution, and resale of the petroleum products by a person, firm, partnership, or corporation, from the well to the gasoline pump. 46

"Vertically integrated oil company" means an oil company controlling all phases of petroleum production and sale from the well through distribution to dealers. 47

### Scope of Study

The oil industry, both in the United States mainland and in Hawaii, has been the subject of numerous investigations and studies. House Resolution No. 174, H.D. 2, seeks the views of the petroleum industry and state government on a wide range of complex issues, all connected to the petroleum industry, but in many instances otherwise unrelated. Previous studies have focused solely on one or two of these topics. For example, two recent studies in Hawaii are devoted entirely to retail divorcement legislation and its impact on gasoline retailing and consumer prices. 48 Hawaii's Attorney General recently engaged the services of a professional economist specializing in petroleum markets to provide assistance in one aspect of its investigation on gasoline pricing in the State. 49 Other states have delegated selected issues, such as divorcement and open supply legislation, to special task forces or legislative study committees and their staff. 50

This study does not purport to be, and should in no way be viewed as, definitive with respect to any of the topics specified in the Resolution. Rather, this study reviews relevant literature regarding each such issue and reports the viewpoints of the industry and state government as requested in the Resolution. Efforts have been made to unify the diverse issues specified in the Resolution and discuss them in the context of the wholesale and retail gasoline industries in the United States and Hawaii, as applicable, focusing on information that the Legislature may consider useful in formulating policies to protect the interests of Hawaii's gasoline consumers.

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## Endnotes 1

1. This organization was referred to in the Resolution as the "Hawaii Retail Gasoline Dealers Association".
2. Letter to researcher from Richard C. Botti, Executive Director, Hawaii Automotive and Retail Gasoline Dealers Association, dated July 20, 1995.
3. The members of the HPMA are as follows: Akana Petroleum (Hilo), Alii Petroleum (Honolulu), Aloha Petroleum (Honolulu), B & E Petroleum (Kaneohe), Big Island Petroleum (Kailua-Kona), Diamond Head Petroleum (Honolulu), Garlow Petroleum (Honolulu), Hawaii Petroleum (Hilo), Kauai Petroleum (Kapaa), Kewalo Marine Service (Honolulu), Maui Oil (Kahalui), Maui Petroleum (Kahalui), Pacific Petroleum (Honolulu), and Senter Petroleum (Kailua). Telephone interview with Alec McBarnet Jr., Vice-President of the Hawaii Petroleum Marketers Association, August 23, 1995, and letter to researcher from the Hawaii Petroleum Marketers Association, postmarked September 7, 1995.
4. See Walter Miklius and Sumner J. LaCroix, *Divorcement Legislation and the Impact on Gasoline Retailing in the United States and Hawaii* (Honolulu: University of Hawaii, January 20, 1993) at 56.
5. Letter to researcher from David Young, Public Affairs Manager, Chevron U. S. A. Products Co., and Chairman of the Hawaii Petroleum Resources Group, dated September 20, 1995.
6. See Miklius and LaCroix at 56.
7. The Bureau's survey was forwarded to WSPA's general offices in California, from which it was distributed to all WSPA companies doing business in Hawaii. In a letter to this researcher, the chairman of WSPA's Hawaii Petroleum Resources Group stated that: "WSPA itself has no analytical capacity nor an extensive legal staff. From our experience in answering your survey, I can assure you that the time, expertise and effort necessary to provide you with answers would be far beyond the association's capacity." Chevron and Shell therefore responded individually. Letter to researcher from David Young, *supra* note 5.

8. Letter from Yukio Naito, Chairman of the Public Utilities Commission, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated June 2, 1995.
9. Letter memorandum from Kathryn S. Matayoshi, Director of Commerce and Consumer Affairs, to Wendell K. Kimura, dated June 8, 1995.
10. See Julia E. Schoen, *The Consumer and Gasoline Marketing in Hawaii: The Impact of Direct Retailing of Motor Fuel by Refiners and Distributors on the Consumer* (Honolulu: Hawaii Department of Commerce and Consumer Affairs, 1992 (interim study) and 1993 (final report)). For example, the Resolution requests the views of the Department on the effects of establishing a public bulk gasoline terminal facility, a petroleum regulatory commission, and a public petroleum products storage authority, none of which are addressed in the Department's study.
11. The position of the Public Utilities Commission with regard to the implementation of the Petroleum Industry Information Reporting Act of 1991 (chapter 486I, Hawaii Revised Statutes) is reported in chapter 13.
12. Although the definition of "manufacturer" in section 486H-1, Hawaii Revised Statutes, refers to specific manufacturers in existence on January 1, 1992, for purposes of chapter 486H, Hawaii Revised Statutes (gasoline dealers), that definition has been amended to refer to manufacturers generally.
13. Chapter 286, Hawaii Revised Statutes, relates to highway safety.
14. MacAvoy, Paul W., ed., *Federal Energy Administration Regulation: Report of the Presidential Task Force* (Washington, DC: American Enterprise Institute for Public Policy Research, 1977) at 177.
15. United States, Department of Energy, *The Motor Gasoline Industry: Past, Present, and Future* (Washington, DC: Jan. 1991) at 54 (hereinafter "DOE (1991)").
16. Haw. Rev. Stat., §486H-10(a), as amended by Act 238, Session Laws of Hawaii 1995. The term implies that the retail outlet is under the direct control of a major oil company which is able to set the retail product price and directly collect all or part of the retail margin. The term also

includes retail outlets being operated by salaried employees of the oil company or its subsidiaries and affiliates, and may involve personnel services contracted by the oil company. See definition of "refiner-operated retail outlet" in David J. Teece, "Vertical Integration in the U.S. Oil Industry", in Vertical Integration in the Oil Industry, Edward J. Mitchell, ed., (Washington, DC: American Enterprise Institute for Public Policy Research, 1976) (Appendix 1: Definitions Used in the Federal Energy Administration's Refiner/Importer Historical Report on Petroleum Products Distribution) at 184.

17. DOE (1991) at 54.
18. MacAvoy (1977) at 189.
19. Id.
20. Haw. Rev. Stat. §486H-10(a), as amended by Act 238, Session Laws of Hawaii 1995.
21. Massachusetts, Open Supply and Divorcement Task Force, Report Concerning House Bills H861 and H4490 Currently Before the Joint Committee on Energy (Boston: Aug. 11, 1993) at 1 (hereinafter, "Mass. Task Force"); Hawaii, Department of the Attorney General, An Investigation of Gasoline Prices in Hawaii: A Preliminary Report (Honolulu: Sept. 1990) at 6 (hereinafter, "AG (1990)").
22. Hawaii, Department of the Attorney General, Gasoline Prices in Hawaii: The Impact of Oil Company Divorcement on Consumer Prices (Honolulu: 1993) at 1 (hereinafter, "AG (1993)"); Hawaii, Department of the Attorney General, The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices (Honolulu: 1994) at 19 (hereinafter, "AG (1994)").
23. MacAvoy (1977) at 181.
24. DOE (1991) at 53.
25. MacAvoy (1977) at 181.
26. AG (1994) at 4-5; AG (1990) at 11; see also Nancy D. Yamaguchi and David T. Isaak, Hawaii and the World Oil Market: An Overview for Citizens and Policymakers (Honolulu: East-West Center Energy Program, August 1990) at 73-74.

27. MacAvoy (1977) at 181.
28. Mass. Task Force at 1.
29. Teece (1976) at 183-184.
30. Mass. Task Force at 1.
31. DOE (1991) at 55.
32. Teece (1976) at 184.
33. United States, General Accounting Office, Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products (Washington, DC: March 1993) at 127; Arizona, Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Petroleum Producer Retail Divorcement, Final Report (Dec. 1988) (App. A) at 17.
34. AG (1990) at 7.
35. See generally Herbert Hovenkamp, Federal Antitrust Policy: The Law of Competition and its Practice (St. Paul: West Publishing Co., 1994) at 262-263 and 516-531; see also Graham Bannock, R. E. Baxter, and Evan Davis, The Penguin Dictionary of Economics (London: Penguin Books, 1987) at 322-323.
36. MacAvoy (1977) at 186.
37. Jeffrey L. Spears, "Note: Arguments For and Against Legislative Attacks on Downstream Vertical Integration in the Oil Industry," 80 Kentucky L. J. 1075 at 1078 (Summer, 1992); see also AG (1993) at 26.
38. MacAvoy (1977) at 187.
39. Mass. Task Force at 1-2.
40. DOE (1991) at 55-56.
41. See House Bill No. 1652, introduced in the Eighteenth Legislature 1995, State of Hawaii, at 5 (lines 11-17).
42. Id. at 5 (lines 18-20).
43. MacAvoy (1977) at 189.

44. Hawaii Revised Statutes §342L-1. The definition in section 342L-1 further provides that the term does not include any of the following:
- (1) Farm or residential tank of one thousand one hundred gallons or less capacity used for storing motor fuel for noncommercial purposes;
  - (2) Tank used for storing heating oil for consumptive use on the premises where stored;
  - (3) Septic tank;
  - (4) Pipeline facility (including gathering lines) regulated under:
    - (A) The federal Natural Gas Pipeline Safety Act of 1968, Public Law 90-481, as amended; or
    - (B) The federal Hazardous Liquid Pipeline Safety Act of 1979, Public Law 96-129, as amended;
  - (5) Surface impoundment, pit, pond, or lagoon;
  - (6) Storm water or wastewater collection system;
  - (7) Flow-through process tank;
  - (8) Liquid trap or associated gathering lines directly related to oil or gas production and gathering operations; and
  - (9) Storage tank situated in an underground area (such as a basement, cellar, mineworking, drift, shaft, or tunnel) if the storage tank is situated upon or above the surface of the floor.
45. MacAvoy (1977) at 190.
46. Tenn. Code Ann., §47-25-602(10) (1994); see also Black's Law Dictionary, 5th ed. (St. Paul, MN: West Publishing Co., 1979) at 1401.

47. See Tenn. Code Ann., ñ47-25-602(11) (1994).
48. See AG (1993); Miklius and LaCroix (1993).
49. AG (1994) at 13.
50. See, e.g., Arizona, Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Petroleum Producer Retail Divorcement Final Report (Dec. 1988); Massachusetts, Open Supply and Divorcement Task Force Report Concerning House Bills H861 and H4490 Currently Before the Joint Committee on Energy (Boston: Aug. 11, 1993); Virginia General Assembly, Report of the Joint Subcommittee Studying Divorcement and Representative Offering for Inclusion in the Virginia Petroleum Products Franchise Act (Richmond: 1991).

Prior to the adoption of House Resolution No. 174, H. D. 2, an earlier bill request that the Bureau study the issues contained in the Resolution in consultation with other agencies and over a longer period of time was deleted in conference committee. Senate Bill No. 487, later codified as Act 238, Session Laws of Hawaii 1995, would have required the Bureau to study divorcement and the other issues specified in the House Resolution "in consultation with the attorney general, the department of commerce and consumer affairs, the department of business, economic development, and tourism, the public utilities commission, and any other appropriate government agencies" and to "consult with representatives of the refining oil companies, nonrefiner oil companies, lessee dealers, open dealers, and jobbers". Under that bill, the Bureau was to submit an interim report to the Legislature prior to the convening of the Regular Session of 1996, and a final report prior to the 1997 Regular Session. See Senate Bill No. 487, S. D. 1, H. D. 1, ñ5 (1995). That section, however, was deleted in the C. D. 1 version of that bill, according to the Conference Committee Report, since "further study of this issue is not necessary". See Conference Committee Report No. 128 with respect to Senate Bill No. 487, C. D. 1, dated April 28, 1995.

# REGULATING HAWAII'S PETROLEUM INDUSTRY

## Chapter 2 PETROLEUM INDUSTRY, GENERALLY

The issues raised in House Resolution No. 174, H. D. 2, cover a wide range of topics relating to the petroleum industry--from divorcement to exchange agreements to the establishment of a petroleum regulatory commission. While seemingly unrelated, many of these issues are connected in a broader sense to proposals for increased government intervention in the activities of vertically integrated oil companies in the operation of their downstream (retail) facilities. In essence, these proposals seek to impose limitations on the major oil companies doing business in Hawaii through increased governmental regulation of these facilities, ostensibly to ensure the viability of small independent stations while at the same time maintaining lower gasoline prices for Hawaii's consumers.

This chapter reviews relevant literature on the oil industry in terms of this broader perspective in order to give an overview of some of the underlying issues raised in the Resolution. This report, however, is not intended to be a comprehensive analysis of these issues; for a more thorough examination, the reader is referred to the sources cited in the endnotes to this chapter and the bibliography in Appendix L. In particular, this chapter briefly reviews vertical integration, oligopolies, gasoline retailing, oil and gasoline prices generally, and relevant federal legislation.

### Vertical Integration

The oil industry in the United States is composed of nearly seventeen thousand firms ranging from small open dealers to large corporations. While most companies operate within one level of the oil industry, i. e., exploration and production, refining, transportation, or marketing, many oil companies are integrated to some extent into other upstream or downstream businesses, for example, from small dealers owning several service stations and a fuel truck to large multinational corporations that are integrated in all levels.<sup>51</sup> Despite the longstanding coexistence of both large and small oil industry operators, however, critics frequently cite the degree of vertical integration of the larger oil companies as evidence of

"intolerable market concentration and power". 52

Historically, the degree of animosity directed at vertically integrated oil companies has been significant:

Vertical integration in the petroleum industry has ... become a malignant force for harnessing monopoly power and for transmitting it to markets which would otherwise be workably competitive. So long as the present structural arrangement persists, workable competition in refining and marketing will always be frustrated. Many of the independents as well as integrated oil companies having a low degree of crude-oil self-sufficiency have been squeezed out of existence. Furthermore, the future for many of the remaining independents does not look bright. The petroleum industry is becoming more concentrated in the hands of those vertically integrated oil companies having strong crude-oil positions. If the petroleum industry is permitted to continue to administer artificially high crude-oil prices, competition in the industry will become still more limited. 53

Antitrust policy has also been traditionally hostile toward vertical integration (especially when one of the market levels involved is subject to monopoly), as well as toward vertical mergers, despite their "extraordinary potential for creating efficiency and limited threat of economic harm...". 54 The state of Tennessee, in enacting legislation regulating petroleum products, specifically cited vertical integration in the petroleum industry as inhibiting competition and tending to result in higher prices for those products:

The purpose of this part is to regulate vertical integration of the petroleum industry in Tennessee, it being the conclusion of the general assembly that vertical integration tends to operate in restraint of free trade and inhibits full and free competition and therefore tends to increase the price of petroleum and related products and services.... 55

What is vertical integration? Do vertically integrated oil companies contribute, directly or indirectly, to lower or higher prices at the gasoline pump? Vertical integration is the ownership or control of the network of production and distribution of goods from raw materials to sale to the ultimate consumer. 56 A firm may be viewed as vertically integrated

whenever it performs some function for itself (within that industry) that could otherwise be purchased on the market.<sup>57</sup> With respect to oil companies, vertical integration may be defined as the ownership or control of all phases of the production of petroleum products, including the drilling, pumping, refining, distribution, and resale of petroleum products, from the well to the gasoline pump.<sup>58</sup> A fully integrated oil company would be involved in oil exploration and production, transportation of crude oil and petroleum products, refining crude oil, and marketing refined products. Horizontal integration, in contrast, involves increasing degrees of market concentration within a market segment, such as the merger of two firms in the same business.<sup>59</sup>

A firm may integrate vertically in one of three different ways: by entering a new market on its own (e.g., a refiner opening a new retail service station), by acquiring another firm that is already operating in the secondary market (e.g., a refiner acquiring an existing service station), or by entering into a long-term contract with another firm, under which the two firms coordinate certain aspects of their behavior (e.g., a refiner entering into an exclusive dealing contract with a retailer, who agrees to purchase all of the retailer's gasoline from that refiner). In addition, a firm can integrate vertically in two different directions: "forward" integration occurs when a firm integrates in the direction of the end-use consumer, as when an oil refiner acquires its own retail service station; "backward" integration occurs when a firm integrates into a market from which it would otherwise obtain some needed raw material or service, for example, a retail service station acquiring a refinery.<sup>60</sup>

Generally, vertical integration by contract may involve "interbrand" or "intra-brand" restraints:<sup>61</sup>

Interbrand distribution restraints limit the way downstream firms can use brands made by someone other than the firm imposing the restraint, usually by tying arrangements and exclusive dealing. A tie-in or tying arrangement is a sale or lease of a product or service on the condition that the buyer will take a second product or service as well.<sup>62</sup> An exclusive dealing arrangement is a contract pursuant to which a buyer promises to buy its requirements of one or more products exclusively from a particular seller.<sup>63</sup>

Intra-brand distribution restraints regulate a dealer's sales of a single brand without creating limitations on its sales of brands made by other suppliers. One broad category of intra-brand restraints is vertical price fixing, or resale

price maintenance (RPM), under which the manufacturer or supplier regulates the price at which a product is resold by independent dealers. The second category is vertical nonprice restraints. The most common of these are vertical territorial division, under which a supplier regulates the location or sales territories of its distributors or retailers; another vertical nonprice restraint is the customer restriction, which limits the classes of buyers with whom a distributor or other reseller may deal.

A supplier may use a combination of both interbrand and intrabrand restraints. Intrabrand distribution restraints are governed by section 1 of the Sherman Act; interbrand distribution restraints are covered under section 3 of the Clayton Act as well.

Generally, firms integrate vertically not in order to become monopolists and earn monopoly profits, but to reduce costs, which, in competitive markets, are passed on to the consumer. In essence, vertically integrated firms are efficient, it may be argued, and enable firms to save money in a variety of ways. Under this analysis, most instances of vertical integration should be legal under the antitrust laws.<sup>64</sup> The following efficiency arguments have been advanced in favor of vertical integration:<sup>65</sup>

(1) Production cost savings. Vertically integrated firms are able to take advantage of technologies unavailable to firms that are not vertically integrated, thereby resulting in savings in production costs.

(2) Transaction cost savings. Integrating vertically also potentially reduces transaction costs, i.e., the costs of relying on the marketplace; the costs of negotiating, drafting contracts, and planning for sufficient supplies in a market containing many self-interested actors can be riskier and more expensive than arranging transactions internally.<sup>66</sup>

(3) Market power held by other firms. A firm that is forced to deal with a monopolist or cartel may save money by integrating vertically into the market level in which the monopolist or cartel is located. A vertically integrated firm always obtains integrated inputs at the marginal cost of producing them, as it would in perfect competition. If forced to deal with a monopolist, however, a non-integrated firm must pay production costs plus any additional markup the monopolist might add because of its monopoly position. Vertically integrating allows a firm to avoid dealing with the monopolist or cartel.

(4) Optimum product distribution. Vertical integration can also facilitate other efficiency savings by ensuring that the firm's product

will receive sufficient promotion, distribution, and sales services:

For example, a refiner of gasoline might increase sales by assuring retail customers that the quality of its product and of the service given by retailers is uniformly high across the country. The refiner can make such an assurance, however, only if it has substantial control over the gasoline retailers themselves. One way the refiner can obtain such control is by building and operating its own retail stations. Another very common way is by means of elaborate franchise contracts that permit the retailers to retain their identity as separate firms while being substantially controlled by their larger supplier. 67

However, some instances of vertical integration may be seen as anticompetitive. The following are some of the perceived dangers to competition from vertical integration: 68

(1) Increased market power. Increased market power is not a likely consequence of vertical integration, it is argued, because the monopolist of any single distribution level generally can obtain all monopoly profits available in a given distribution chain.

(2) Barriers to entry. Vertical integration can make it more difficult for new firms to enter a market if the integrating firm has a very large share of the market. For example, if a monopolist widget manufacturer has acquired all of the independent widget fabricators, there would no longer be independent firms left at either production level. Any firm desiring to enter either level would have to enter both simultaneously, or it would have no one with which to deal. However, vertical integration creates a true barrier to entry only if the need for two-level entry makes entry into the market more expensive than it would be otherwise. 69

(3) Price discrimination. A firm may vertically integrate to facilitate price discrimination, i. e., when a seller obtains two different rates of return on two different sales. Price discrimination enables a firm to maximize its profits regarding different groups of customers instead of finding an "average" profit-maximizing price. Only a firm with a certain amount of market power can engage in price discrimination, since it will be earning monopoly profits from those sales in which its profits are highest. For example, a monopoly manufacturer of widgets that has two different groups of customers with different demands for widgets may make more money by selling widgets for 50 cents at a retail store, and for \$1.00 at concessionaires at public events, rather than by finding a profit-maximizing price somewhere

between 50 cents and \$1.00. However, under certain circumstances, the Robinson-Patman Act may prevent the firm from selling the same product to two classes of buyers at two different prices.<sup>70</sup>

(4) Rate regulation avoidance. Price-regulated firms may integrate vertically into unregulated markets to "cheat" on a regulatory scheme.

(5) Cartels. Cartel members may vertically integrate in order to discourage cheating on the cartel agreement.

### Oligopolies

In addition to vertical integration, another important feature of gasoline markets, both in the U.S. mainland<sup>71</sup> and in Hawaii,<sup>72</sup> is that they are oligopolies--markets in which prices and other factors are controlled by a few sellers. Oligopolies, which are "the most dominant industrial market structure within the nation's economy",<sup>73</sup> are not in themselves illegal, so long as new competition is free to enter and compete in the market, and no violation of antitrust laws occurs if the oligopoly simply persists as a result of natural market conditions. However, a seller's practice of keeping competition out of the market or conspiring with other sellers to fix market prices will violate the antitrust laws.<sup>74</sup>

Pricing in an oligopoly is influenced both by the limited number of competitors and their interdependence:

Because their numbers are small, sellers in an oligopoly perceive that their interdependent action will be more profitable than independent action. Interdependence suggests that each seller takes into account the actual or potential market reactions of competitors before output or price decisions are made.

If one seller were to increase output and reduce price in order to capture more sales, other producers in the oligopoly would follow suit and, if the first price change is not concealed, the reaction would be swift. A price cutter would gain little. Accordingly, the incentive to price-compete is reduced. Likewise, unless a price increase were coordinated among all members of the oligopoly, there would be no rational incentive to undertake it, since consumers would buy from the sellers that did not increase price. Reaction, coordination, and strategic behavior are, therefore, important elements of oligopoly behavior.<sup>75</sup>

Although price competition is reduced in an oligopoly, nonprice competition--including quality improvements and advertising--may take place, but may be subject to the same limitations as price competition.<sup>76</sup> Oligopoly pricing is a concern from an antitrust perspective since it may not be based on competitive factors but rather on coordinated pricing actions, whether from tacit or overt collusion.<sup>77</sup> In general, the greater the interdependence among firms in an oligopoly, the more the market may result in monopolistic conduct.<sup>78</sup>

Allvine and Patterson (1972) argue that oligopolistic pricing, including market interdependence and the avoidance of price competition, occurs in the petroleum industry;<sup>79</sup> Moreover, while the petroleum industry in the United States is not as concentrated as other oligopolistic industries that appear to be workably competitive, they argue that the presence of vertical integration frustrates potentially workable competition at the retail level:

While the gasoline market does tend to behave like a classic oligopoly, the petroleum industry is not nearly as concentrated as many other industries which seem to be workably competitive. There are probably just too many gasoline sellers, and the geographic distribution of their shares of the market is too uneven for price competition to be completely suppressed as it is in those oligopolistic industries dominated by fewer than one-half dozen sellers. Without the presence of vertical integration, there is reason to believe that at least the retailing of gasoline could be workably competitive from a practical standpoint. Competitive self-restraint among twenty to thirty firms is likely to breakdown as each jockey for competitive advantage. Even sporadic price competition among this many sellers would serve to keep prices and margins in line, rewarding the innovators and the efficient and disciplining the laggards and the inefficient. However, vertical integration is very much present in the industry, and its presence effectively frustrates this potentially workable competition at retail for a number of reasons. Because it frustrates retail competition, vertical integration strengthens the tendency of a marginally oligopolistic market to behave as a classic textbook example of oligopoly at its worst.<sup>80</sup>

Others, however, contend that people are quick to blame rising oil

prices following market disruptions on oil company collusion, although other equally plausible explanations exist. Lee (1991), for example, maintains that price rises following the Iraqi invasion are equally well explained by efficient market operation as by tacit collusion:

Politicians professing outrage at the rapid, dramatic post-invasion rise in petroleum prices often cite the rise itself as "economist evidence" supporting the inference of tacit collusion. But these price rises comport at least as well with the efficient operation of a market as with tacit collusion. The invasion created considerable uncertainty about the supply of crude oil and petroleum products in the near future. With a shortfall threatened, the right to buy these goods in the near future became more valuable to some consumers. These consumers, and those expecting to supply them, bid up the price of these rights. In order to compete for petroleum supplies, current consumers had to bid up spot prices. All of this occurred rapidly because the petroleum market efficiently impounds information into prices. As a result, this market allocates products over time far more optimally than could any group of government functionaries. Prices rose dramatically not only because the threatened oil reservoirs were relative large, but more importantly, because they were relatively cheap to produce. Replacing some of the output of the threatened oil reservoirs with increased production from others would necessarily put producers to far more cost. To induce producers to incur these costs, consumers had to bid up prices accordingly. 81

Lee concluded that "the available evidence ... provides almost no support for the inference of collusion." 82

### Gasoline Retailing

Gasoline retailing may be viewed as involving a principal (the refiner) and an agent (the station manager) in a vertical context. 83 Most retail outlets are built by the refiner, who selects station location, gasoline sales capacity, and other services, such as automotive or convenience store services, choosing these characteristics to maximize station profit given local supply and demand conditions. The refiner also designs the contract, usually making a take-it-or-leave-it offer to potential managers, to induce the manager to use the manager's best efforts in areas preferred by the refiner:

Within the constraints imposed by the contract and given the characteristics of the station, the operator chooses the retail price and effort level that maximizes downstream profit. Final demand for station output (gasoline and other products or services) is assumed to increase in quality and decline in price. The station manager can exert sales and service effort that increases quality. Effort is costly for the manager and she or he will not, in general, choose the level that is optimal from the refiner's point of view without some contractual restraint. Similarly, the manager's unconstrained choice of retail price will not be the price the refiner would have chosen. The purpose of the vertical contract is to induce the manager to make choices preferred by the refiner, either by directly specifying outcomes or providing incentives that align the interests of the manager with those of the refiner. 84

Three types of contractual arrangements are used in gasoline retailing: company-owned, lessee-dealer, and open-dealer. Company-owned contracts approximate full vertical integration at one extreme, while open-dealer contracts approximate trade between independent firms at the other; between these two are lessee-dealer contracts which constitute a type of franchise agreement: 85

(1) Company-owned contracts. At stations operated under company-owned contracts, the refiner owns all of the capital, employs the manager as a salaried employee, and maintains ownership of the gasoline until it is sold to consumers, and therefore may set the retail price. This is the only contractual form under which the refiner may set retail prices; courts have consistently held that refiners may not set the retail price at any station not operated by an employee. 86

(2) Lessee-dealer contracts. At stations operated under lessee-dealer contracts, the refiner owns the land and capital, and sets the wholesale price and an annual rental fee; the manager is self-employed. The contract allocates some quality control to the refiner and usually specifies a minimum volume of gasoline the manager must purchase. Although contractual requirements are enforced by the threat of lease termination and nonrenewal, the federal Petroleum Marketing Practices Act was enacted to protect lessee-dealers and defines the circumstances under which a dealer can be terminated or not renewed. 87 The net effect of that Act was to give dealers more latitude to take actions that increased dealer profits at the expense of joint dealer-oil company profits: "Since the Act increased the cost of

franchising, it provided incentives for companies to use company- owned stores more frequently."88

(3) Open-dealer contracts. At stations operated under open-dealer contracts, the refiner controls the wholesale price but has no investment in the station and does not charge a rental or franchise fee. The station manager owns the land and capital, and generally makes decisions over service quality and retail price. Managers, however, cannot sell gasoline supplied by another refiner in pumps identified with the contracting refiner. As in lessee-dealer contracts, open-dealer contracts frequently include a minimum purchase requirement, but the only penalty for failing to meet this requirement is termination of the supply relationship.

Generally, retailers obtain their gasoline from a refiner either directly or indirectly. These supply arrangements ultimately influence the price of gasoline in the supply chain. In the direct distribution system, a refiner sells or supplies branded gasoline, i. e., gasoline marketed under the refiner's trademark, to its company-operated stations or lessee dealers, or unbranded gasoline to open dealers. In the indirect distribution system, refiners sell branded or unbranded gasoline to independent distributors, who in turn sell the gasoline to consumers through their own retail stations or resell the gasoline to other retailers. 89

### Oil and Gasoline Prices

The pricing of gasoline raises issues of both national and international importance.<sup>90</sup> According to a 1993 United States General Accounting Office (GAO) analysis of the pricing of crude oil and petroleum products, wholesale and retail prices of gasoline and other refined petroleum products are based largely on crude oil prices. Domestic prices for oil have been linked to world oil prices since their decontrol by late 1981. However, the GAO found that the world price of crude oil is not necessarily related to its production or acquisition costs, but to the following factors:<sup>91</sup>

- (1) OPEC. Because of the Organization of Petroleum Exporting Countries' large low-cost crude oil reserves and excess production capacity, crude oil prices are influenced by members' decisions affecting the world's oil supply.
- (2) Scarcity. Crude oil is a scarce and valuable resource; since it can only be replaced at a higher cost once current reserves are depleted, the price of crude oil

compensates the owner for its scarcity.

- (3) Lack of substitutes. In the short term, there are a lack of substitutes for crude oil, and there are no economically viable substitutes for gasoline.
- (4) Seasonal demand. Crude oil prices are affected by seasonal demand, especially for gasoline and heating oil due to higher demand in the summer and winter months, respectively.

Although Yamaguchi and Isaak (1993) note that OPEC has little control over world oil pricing,<sup>92</sup> the importance of OPEC's influence on the world's supply of crude oil cannot be understated. Most of the world's crude oil is situated in OPEC countries, and OPEC retains almost all of the world's estimated excess production capacity. While OPEC no longer sets crude oil prices, it does set voluntary production quotas for member countries in order to maintain a target price for oil, and member countries' decisions regarding oil supply still have a significant impact on world oil prices.<sup>93</sup>

Despite the political instability of the oil-producing Middle East region, others predict that oil demand will grow moderately in response to strong growth in developing countries; production capacity should also grow, principally in OPEC countries where the main reserves exist; and oil prices, while remaining somewhat volatile in the short run, should remain fairly stable over the longer term, in a range of \$20 to \$25 per barrel in 1991 dollars through the year 2010. A principle reason given for these projections is that Saudi Arabia and its Persian Gulf oil allies will be able to exert a controlling influence on OPEC policies, given these countries' strong interest in avoiding another oil disruption, which would endanger prospects for a growing long-term market for their oil, as well as political and security risks for themselves.<sup>94</sup> Nevertheless, "another sizable oil disruption has to be rated a possibility, simply because so much of the world's oil needs, a growing proportion in fact, is supplied from an area of chronic political volatility--the Middle East."<sup>95</sup> A large net shortfall in supply from a political upheaval in the Middle East "would cause a disproportionately large jump in the price of oil--a response dictated by the inelastic demand for oil in the short run."<sup>96</sup>

During market shocks, moreover, prices for crude oil, including gasoline held by local service stations, rapidly adjust to reflect the current market value, even if the oil or gasoline was produced or acquired at a lower or higher cost.<sup>97</sup> In addition, many industry representatives and consumers believe that retail gasoline prices rise quickly when crude oil prices rise during a market shock, but are slow to

reflect price decreases. While the GAO's model of price adjustment in the gasoline market shows some evidence that this occurs, but only under certain circumstances, other models have found evidence that retail prices of gasoline adjust more slowly to falling crude oil prices or wholesale gasoline prices, or both. Factors accounting for this asymmetry at the retail level include uncertainty about decreases in crude oil and wholesale prices during market shocks, retailers' knowledge of consumers' psychology and buying patterns, and the short-term inelasticity of the demand for gasoline. 98

Under normal market conditions, however, the GAO found that prices for gasoline and other petroleum products are fundamentally determined by the price of crude oil; competition in the petroleum products markets and threats that OPEC may raise prices for crude oil tend to keep the prices of crude oil and petroleum products in line with each other. 99 However, wholesale prices are also affected by seasonal demand and supply arrangements. Increased demand for gasoline during the summer generally leads to higher wholesale gasoline prices during those months; during periods of higher anticipated demand, prices increase as distributors build up their inventories. 100 A recent study further found that, apart from crude variations, short-term variations in resale gasoline prices "are mainly a function of the prior month's spread, the time of year, and the supply demand balance--not demand by itself or supply, but the relationship between the two." 101

According to the GAO, short-term variations in wholesale prices are also affected by the type of supply arrangement between the buyer and seller under normal market conditions. Gasoline and other petroleum products may be bought and sold at wholesale in the futures, spot, and contract markets. Daily movements in wholesale prices for petroleum products on the futures market serve as the basis for negotiations regarding prices in the other two markets. Different types of dealers may pay one or more wholesale prices, either spot prices or one of three contractual prices, namely, branded rack, unbranded rack, and dealer tankwagon prices: 102

(1) Spot prices. These prices are generally lower and more volatile than contract prices; there is no binding contract between the buyer and seller, so buyers on the spot market are free to shop around for the lowest price. Although the spot market accounts for a small portion of domestic gasoline sales, spot prices and futures prices strongly influence contract prices by providing the daily competitive signals that serve as a basis for setting contract prices.

(2) Contractual prices. Under a contract, which is based on a prearranged pricing formula, buyers pay premiums for the security of having a guaranteed supply of gasoline.

- A. Rack prices. Rack prices are paid by distributors and dealers for gasoline supplied by refiners at the refiner's wholesale terminal, or "rack". These prices are generally higher than spot prices under normal market conditions because of the relative certainty of supply and stability. Branded rack prices are paid by distributors for gasoline supplies from major refiners selling under their trademark. Unbranded rack prices are paid for gasoline supplies largely from independent refiners. Branded rack prices tend to be higher than unbranded rack prices because the former include a premium for the recognized brand name, while the latter are for generic gasoline; branded gasoline contracts, while less flexible, also guarantee a more secure supply than unbranded gasoline.
  
- B. Dealer tankwagon (DTW) prices. DTW prices are paid by lessee dealers and some open dealers to suppliers (refiners or distributors) for branded gasoline delivered at the dealers' outlets; DTW prices, which are set by suppliers and include the cost of transporting the gasoline to outlets as well as other premiums, are generally less volatile and higher than spot and rack prices. The contractual agreement between the dealer and supplier provides for a minimum purchase, allowing the dealer little flexibility to shop around for lower prices, but affording greater stability of these prices and security of supply, even during periods of constrained supplies and volatile prices.

(3) Transfer prices. Transfer prices are internal prices at which distributors or refiners supply gasoline to their company-owned and -operated retail service stations.

In addition, the GAO found that, also under normal market conditions and in the short term, retail gasoline prices are influenced by the extent of competition within a local market:

Typically, a gasoline retailer closely watches the pricing by other retailers within the vicinity and keeps the retail price competitive so as to preserve market share and profitability. Moreover, the fewer the retail stations that are equally accessible to motorists within a given vicinity, the more likely the chance that retail prices will be, on average, higher

than in areas with more competitors. A gasoline distributor with whom we spoke claimed that rural outlets can more easily pass on any increases in wholesale costs because there is less competition than in urban areas.

According to some oil industry representatives and experts, there is often "price leadership" in the marketplace. One retailer in a given area may adopt an aggressive pricing strategy by frequently changing prices, and other retailers in the area will generally tend to follow that retailer's lead. For example, as some industry representatives and experts pointed out, a typical price leader may choose to lower prices in an attempt to increase market share, and an integrated oil company owning large domestic reserves of crude oil may lower prices at company-owned and -operated stations in an attempt to move large volumes of gasoline. 103

The GAO further noted that retail gasoline prices often do not reflect daily fluctuations in wholesale and crude oil prices: "This 'stickiness' of the retail price can occur for a variety of reasons, including the fact that some retailers will generally delay a price change until it is initiated by another retailer within the local market." 104

Federal and state excise taxes also form a large component of the retail price of gasoline. These taxes are basically a highway user's fee; because they have traditionally been levied on a per unit basis (usually a fixed number of cents per gallon), more frequent users pay more in gasoline taxes than do less frequent users. 105 While revenues collected from gasoline taxes vary depending on the amount of the levy and the quantity of gasoline sold, the average combined federal and state taxes nearly doubled during the 1980s, from 12.7 cents per gallon in 1981 to 24.4 cents per gallon in 1989. These tax increases, which were made in part because of diminishing tax revenues and increasing highway construction and maintenance costs, had a significant impact on the retail price of gasoline. From 1978 to 1981, gasoline taxes as a percentage of the average retail price of gasoline dipped sharply due to the abrupt increase in gasoline price during that period. Since 1981, however, gasoline taxes have increased as a component of retail gasoline prices; by the end of the 1980s, gasoline taxes were proportionally higher than before the 1979-1980 oil crisis. 106

#### Federal Legislation

Petroleum Marketing Practices Act (PMPA). The PMPA<sup>107</sup> was intended to protect gas station franchise owners from arbitrary termination or nonrenewal of their franchises with large oil companies and gasoline distributors, and to remedy the disparity in bargaining power between parties to gasoline franchise contracts.<sup>108</sup> That Act, inter alia, specifies the grounds for termination and nonrenewal of a franchise relationship. The Act prohibits major oil companies from terminating dealers unless the location is uneconomical for the lessor, the site is being converted to other uses, the lessor is leaving the local market, the parties cannot agree on a new contract after good faith negotiations, or the dealer has violated its contract with the lessor.<sup>109</sup>

Antitrust laws. The Sherman, Clayton, Robinson-Patman, and Federal Trade Commission Acts are intended to protect the competitive process at all levels of distribution and apply to the petroleum industry.

The Sherman Act,<sup>110</sup> which was enacted in 1890, contains two main provisions: section 1 of that Act prohibits contracts, combinations, and conspiracies in restraint of trade or commerce, and section 2 prohibits monopolies, or attempts, combinations, or conspiracies to monopolize any part of the trade or commerce.<sup>111</sup> The courts have construed this Act to preclude only those contracts or combinations that unreasonably restrain competition.<sup>112</sup> Hawaii has also enacted laws regarding monopolies and restraint of trade.<sup>113</sup>

The Clayton Act,<sup>114</sup> which was enacted in 1914 to supplement and improve enforcement under the Sherman Act, prohibits price discrimination, tying arrangements<sup>115</sup> and exclusive dealing contracts, and certain mergers and acquisitions where the effect may be to substantially lessen competition or tend to create a monopoly.<sup>116</sup>

The Federal Trade Commission Act,<sup>117</sup> also enacted in 1914, created the Federal Trade Commission which may restrain conduct considered harmful or potentially harmful to competition. Although not defined as an "antitrust law" for purposes of federal statutes, this Act applies to anticompetitive practices that may fall short of violating either the Sherman or Clayton Acts.<sup>118</sup>

The Robinson-Patman Act,<sup>119</sup> section 1 of which amended section 2 of the Clayton Act,<sup>120</sup> was enacted in 1936 to curb anticompetitive price discrimination.<sup>121</sup> The Act prohibits certain instances of differential pricing, that is, charging different buyers different prices for goods of like grade and quality.

Trademark Act. Supplier trademarks are protected by the Lanham Act,<sup>122</sup> which is designed to protect both the public and the trademark owner. The Act prevents the copying of the supplier's trademark or

symbol, thereby preventing others from passing off their products as those of the supplier and encouraging competition by preserving good will and investment in product quality and promotion. 123

Proposed federal legislation. In addition, bills have been introduced in recent years that have proposed retail divorcement, open supply, and anti-price inversion measures on the national level. The Attorney General's 1993 report on the impact of divorcement on consumer prices reviewed several of these bills, which were introduced in the 102d Congress (1991 - 1992), but which were not enacted into law. 124

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Endnotes 2

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54. Herbert Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice* (St. Paul, MN: West Publishing Co., 1994) at 334, 341.
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56. Black's Law Dictionary, 5th ed. (St. Paul, MN: West Publishing Co., 1979) at 1401.
57. Hovenkamp (1994) at 329.
58. Tenn. Code Ann. §47-25-602(10) (1994).
59. Spears (1992) at 1076 n. 6; Graham Bannock, R. E. Baxter, and Evan Davis, *The Penguin Dictionary of Economics*, (London: Penguin Books, 1987) at 270. For a discussion of

the application of the 1982 Merger Guidelines issued by the Antitrust Division of the United States Department of Justice (relating to horizontal mergers) and the role of terminal facilities in the wholesale distribution and marketing of gasoline, see G. A. Hay and R. J. Reynolds, "Competition and Antitrust in the Petroleum Industry: An Application of the Merger Guidelines" in *Antitrust and Regulation: Essays in Memory of John J. McGowan*, ed. Franklin M. Fisher (Cambridge, MA: MIT Press, 1985) at 15-42. The Antitrust Division issued revised guidelines 1984 and, with the FTC, again in 1992, which also apply to horizontal mergers. For a discussion of the 1992 guidelines and vertical mergers, see Hovenkamp (1994) at 346-349.

60. Hovenkamp (1994) at 329-330.
61. See *id.* at 351, 384, 393.
62. Closely related to tying is reciprocity. Reciprocity, or reciprocal dealing, is the sale or lease of a product on the condition that the seller purchase a different product from the buyer, or when a buyer conditions its purchase of one product on the sale of one of its own products to the seller. See *id.* at 381-384.
63. For further discussion of exclusive dealing, see notes 23 to 29 and accompanying text in chapter 4.
64. Herbert Hovenkamp, *Antitrust Black Letter Series*, 2d ed. (St. Paul, MN: West Publishing Co., 1993) at 135.
65. See generally Hovenkamp (1993) at 133-139.
66. See also Roger D. Blair and David L. Kaserman, *Law and Economics of Vertical Integration and Control* (New York, NY: Academic Press, 1983) at 11-27; Wesley J. Liebeler, "Integration and Competition" in *Vertical Integration in the Oil Industry*, ed. Edward J. Mitchell (Washington, DC: American Enterprise Institute for Public Policy Research, 1976) at 7-18.
67. Hovenkamp (1994) at 334. Vertical price fixing (resale price maintenance), however, is *per se* illegal. *Id.* at 138, 175. See also David J. Teece, "Vertical Integration in the U.S. Oil Industry" in *Vertical Integration in the Oil Industry*, ed. Edward J. Mitchell (Washington, DC: American

- Enterprise Institute for Public Policy Research, 1976) at 105-154.
68. See Hovenkamp (1994) at 336-341; Hovenkamp (1993) at 139-142; see also Liebler (1976) at 20-32; Teece (1976) at 154-168.
  69. "For antitrust purposes, a barrier to entry is some factor in a market that permits firms already in the market to earn monopoly profits, while deterring outsiders from coming in." Hovenkamp (1994) at 39; see also Blair and Kaserman (1983) at 42-44.
  70. See also *infra* text accompanying notes 69 to 71; see generally 15 U.S.C. section 13; Richard A. Posner, *The Robinson-Patman Act: Federal Regulation of Price Differences* (Washington, DC: American Enterprise Institute for Public Policy Research, 1976); Blair and Kaserman at 120.
  71. Allvine and Patterson (1972) at 211.
  72. Hawaii, Department of the Attorney General, *An Investigation of Gasoline Prices in Hawaii: A Preliminary Report* (Honolulu: Sept. 1990) at 7 (hereinafter, "AG (1990)").
  73. Kenneth M. Parzych, *Public Policy and the Regulatory Environment* (Lanham, MD: University Press of America, 1993) at 15.
  74. *Id.* at 7-8. The upstream and downstream petroleum industries may alternatively be characterized as a "successive oligopoly"--one in which two oligopolistic industries are vertically related and market power is distributed asymmetrically among firms in the two industries: "The upstream firms (suppliers) have the market power to decide price (quantity) of intermediate products. Taking the input price as given, the downstream firms have market power over consumers." Other forms of oligopoly are "bilateral oligopolies", in which the upstream and downstream firms bargain over the price of the intermediate products, and "mixed oligopolies", in which "the welfare-maximizing public firms and profit maximizing private firms co-exist in the same industry." Changqi Wu, *Strategic Aspects of Oligopolistic Vertical Integration*, *Studies in Mathematical and Managerial Economics*, vol. 36, ed. Herbert Glejser and Stephen Martin (Amsterdam: North-Holland, 1992)

at 9. See also Parzych (1993) at 15-16.

75. E. Thomas Sullivan and Jeffrey L. Harrison, *Understanding Antitrust and its Economic Implications*, Legal Text Series, 2d ed. (New York, NY: Matthew Bender, 1994) at 32, 256.
76. See *id.* at 32-33: "Even if interdependence results in price rigidity in oligopolistic markets, nonprice competition in the form of advertising, quality improvements, or pre- or post-point-of-sale service may take place. Each form of nonprice competition, however, may be subject to the same limits as price competition. For example, quality improvements may be quickly duplicated, giving the innovator only a temporary advantage. Moreover, each form of nonprice competition has a cost which will be a restraining force on its use or on the minimum price of the product."
77. See Parzych (1993) at 18-19:

Tacit collusion, which most approximates oligopolistic industry behavior, reflects an awareness or recognition among rival firms that forceful price competition would be ruinous to the individual firms and the entire industry. Continued price cutting would not substantially increase sales and ultimately would lead to a rapid deterioration in revenues and profitability. Thus, while firms do not in a recordable way communicate their interest or willingness to maintain comparable price levels, it is instinctively clear that they must avoid competing among each other on the basis of substantial differences in price. This inferred awareness, without concrete evidence of a conspiracy, is tacit collusion.

Ultimately, the net result and impact of this form of industry behavior is similar to what would occur if the firms had formally, with prior arrangement, overtly agreed to fix prices. In both instances, consumers are denied meaningful differences in price and ultimately elect to purchase a product for other reasons. Overt collusion, which implies a contrived arrangement among competitors to manipulate and distort market conditions, is illegal. Uniformity of selling prices, attributable to a conscious and arranged effort among rival firms to avoid price competition, is a per se violation of law.

In striking contrast, the same market impact, arrived at through an implied awareness (tacit collusion), is not a readily accepted violation of law. This question of inferential conspiracy has been judicially tested on a number of occasions without a definitive interpretation having evolved. While it may not appear to be very competitive when firms pursue parallel pricing behavior, it has not become a consistently interpreted violation without concrete evidence or strong circumstantial evidence.

78. Sullivan and Harrison (1994) at 33. The question is whether this market interdependence constitutes an agreement or combination in violation of section 1 of the Sherman Act, or whether the behavior is natural and rational in view of the market structure. *Id.* at 134. Section 1 of the Sherman Act makes unlawful "[e]very contract, combination ... or conspiracy in restraint of trade." 15 U.S.C. section 1.

79. Allvine and Patterson (1972) at 212-213:

The major oil companies will generally refrain from price competition and exhibit leadership in establishing relatively high and stable prices. The economic theory of markets in which there are oligopolistic competitors accurately predicts that the prevailing gasoline price will be set at or near the price posted by one of the dominant sellers. Experience also shows that in any market consisting of a small number of dominant sellers, the implicit understanding that a price cut can and will be met by all other large sellers, effectively serves to deter frequent or aggressive price competition.

80. *Id.* at 214.

81. Mark R. Lee, "Oil Price Shocks, Antitrust and Politics: The Supply of Petroleum and the Demand for Regulation," 15 S. Ill. U. L. J. 529, 535 (1991) (footnotes omitted).

82. *Id.* at 536.

83. See Andrea Shepard, "Contractual Form, Retail Price, and Asset Characteristics in Gasoline Retailing," *Rand J. of Econ.*, vol. 24, no. 1 (Spring 1993) at 60:

Gasoline retailing is an example of a principal-agent problem in a vertical setting. It is natural to view the station manager, who sells gasoline to the final consumer, as the agent and the refiner..., who supplies gasoline to the station, as the principal. The station itself is an asset in which both parties may have some investment. The contract that governs the relationship between the principal and the agent specifies how the investment is to be shared and how the asset is to be managed.

84. Id.
85. See id. at 61-62 and n. 7.
86. For a discussion of resale price maintenance in the courts, see Hovenkamp (1994) at 417-426; Sullivan and Harrison (1994) at 151-166.
87. See infra text accompanying notes 57 to 59.
88. Walter Miklius and Sumner J. LaCroix, Divorcement Legislation and the Impact on Gasoline Retailing in the United States and Hawaii (Honolulu: University of Hawaii, Jan. 20, 1993) at 41-42.
89. United States, General Accounting Office, Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products (Washington, DC: March 1993) at 41-42 (footnotes omitted) (hereinafter, "GAO (1993)"). For a discussion of marketing strategy developments since decontrol, including the economics of gasoline marketing, traditional pricing strategies, distribution strategies, and outlet choice, see United States, Department of Energy, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers (Washington, DC: March 1984) at 33-46 (hereinafter, "DOE (1984)").
90. While this section examines some of these issues, this study, for the most part, does not undertake an analysis of the international petroleum market or world events influencing the dependence of the United States on petroleum imports, national energy policy, the history or politics of oil and gasoline regulation in the United States, or national security or environmental quality concerns. For discussions of these and related topics, see generally United States, Department of Energy, The Motor Gasoline

Industry: Past, Present, and Future (Washington: Jan. 1991) (hereinafter, "DOE (1991)"); United States, Department of Energy, The U. S. Petroleum Industry: Past as Prologue, 1970 - 1992 (Washington: Sept. 1993) (hereinafter, "DOE (1993)"); Edward R. Fried and Philip H. Trezise, Oil Security: Retrospect and Prospect (Washington, DC: The Brookings Institution, 1993); Joseph P. Kalt, The Economics and Politics of Oil Price Regulation: Federal Policy in the Post-Embargo Era (Cambridge, MA: MIT Press, 1981); H. A. Merklein and W. P. Murchison Jr., Those Gasoline Lines and

How They Got There (Dallas: Fisher Institute, 1980); Franklin Tugwell, The Energy Crisis and the American Political Economy: Politics and Markets in the Management of Natural Resources (Stanford, CA: Stanford University Press, 1988); and GAO (1993). For a discussion of gasoline prices in Hawaii, see notes 39 to 56 and accompanying text in chapter 3.

91. See GAO (1993) at 4-5, 48, 55.
92. See Nancy D. Yamaguchi and David T. Isaak, Hawaii and the World Oil Market: An Overview for Citizens and Policymakers (Honolulu: East-West Center Energy Program, Aug. 1990) at 21 (emphasis in original):

OPEC does not control the price of oil. Since 1973, no one has been able to control the price of oil. The oil companies are as baffled as the consumers, and have lost literally billions of dollars on seemingly reasonable investments that turned bad because of sudden changes in the price of crude. There were signs in the late 1980s that the market was beginning to stabilize, and some hope that the 1990s might see something approaching a sensible market, with prices high enough to encourage conservation and development of alternative resources, but not so high as to cause a world recession. The invasion of Kuwait may have destroyed that possibility, and the 1990s may be as volatile as the 1970s and 1980s.

93. GAO (1993) at 5.
94. Fried and Trezise (1993) at 86-87.
95. Id. at 87.

96. Id.

97. GAO (1993) at 6:

Oil prices change quickly to reflect actual or potential changes in the scarcity and value of crude oil and petroleum products. Crude oil prices respond faster to oil market shocks today than they did before the 1980s, when most oil was purchased in the contract market. Currently, information about events that can cause an actual or potential change in the supply of and demand for oil is quickly translated into price changes on the international futures exchanges. Transactions in the other pricing markets will also immediately reflect the price changes in the futures market that were induced by the market shock.

98. According to the GAO (1993), "[i]ndustry officials and experts and these other modelers point to several factors that may help explain why retailers may be slow to pass along decreases in their costs. For example, if price decreases at the crude oil and wholesale levels are perceived to be temporary, sellers may be disinclined to lower retail prices; consumers may become accustomed to the higher price; and consumers may not force prices down by aggressively shopping for the lowest price." Id. at 7; see also id. at 72-73.

99. Id. at 45.

100. Id. at 48-49.

101. John Zyren, "What Drives Motor Gasoline Prices?", *Petroleum Marketing Monthly* (Washington, DC: Energy Information Administration, June 1995) at xxii. The gasoline spread is the difference in gasoline price over crude. See id. at xv.

102. See GAO (1993) at 48-52; see also Philip E. Sorensen, *An Economic Analysis of the Distributor-Dealer Wholesale Gasoline Price Inversion of 1990: The Effects of Different Contractual Relations*, manuscript (April 1991) at 3-6.

103. GAO (1993) at 55-56 (footnote omitted).

104. Id. at 56 (footnote omitted).

105. DOE (1991) at 31; see also chapter 16 for further discussion

of taxation.

106. *Id.* at 31-32.
107. 15 U.S.C. §2801 et seq. (1995).
108. See, e.g., *DuFresne's Auto Service, Inc. v. Shell Oil Co.*, 992 F.2d 920, 925 (9th Cir., 1993); see also John D. Burns and Gregory A. Chaimov, "Repairing the Irreparable Harm Standard in Petroleum Marketing Practices Act Injunction Cases," *Franchise L.J.*, vol. 11, no. 1 (Summer, 1991) at 3.
109. See Miklius and LaCroix (1993) at 41; see generally 62B Am. Jur. 2d Private Franchise Contracts §§659-726 (1990).
110. 15 U.S.C. §1 et seq. (1995).
111. 15 U.S.C. §§1, 2 (1995).
112. Arizona, Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Petroleum Producer Retail Divorcement, Final Report (Dec. 1988) (hereinafter, "Arizona Report") at 13.
113. See Haw. Rev. Stat. chapter 480.
114. 15 U.S.C. §12 et seq. (1995).
115. Tying arrangements exist when a seller states that the seller will sell a product or service (the tying product) only if the consumer agrees to purchase another product or service (the tied product). See Hawaii, Legislative Reference Bureau, *The Hawaii Antitrust Act*, Report No. 8 (Honolulu: 1961) at 23-26.
116. Arizona Report at 13.
117. 15 U.S.C. §41 et seq. (1995).
118. Arizona Report at 13.
119. See 49 Stat. 1526 (1936).
120. 15 U.S.C. §13 (1995).
121. See Posner (1976) at 1-2.

122. 15 U. S. C. §1051 et seq. (1995).
123. Arizona Report at 24; Andrew D. Smith, "Comment: Trademark Law: Equity's Role in Unfair Competition Cases," 13 U. Haw. L. Rev. 137, 141 (Summer 1991).
124. See Hawaii, Department of the Attorney General, Gasoline Prices in Hawaii: The Impact of Oil Company Divorcement on Consumer Prices (Honolulu: 1993) at 25-27. In particular, the Attorney General discussed the following bills:

The Motor Fuel Consumer Protection Act (S. 790) would have enacted divorcement by prohibiting producers or refiners from operating any motor fuel service station in the United States. The bill would have allowed producers or refiners to own all or part of the assets of a service station so long as the producer or refiner did not engage in the business of selling motor fuel at the station through any employee, agent, or other person acting under the control or supervision of the refiner or producer. In addition, this bill would have enacted an open supply requirement, which would have imposed a seventy percent cap on the monthly retail sales of gasoline that a producer or refiner could require a retail dealer to purchase, and would have forbidden a producer or refiner from restraining the amount of fuel that a dealer could purchase.

The Petroleum Marketing Competition Enhancement Act (S. 2041; H. R. 2966) would have prohibited refiners from engaging in price inversion, i. e., from supplying gasoline to their wholesale customers at a higher price than offered at their own company-operated retail stations less an amount for the company's cost to operate at retail. The bill also would have prohibited refiners from engaging in price fixing, i. e., from entering into any scheme or agreement to set, change, or maintain maximum retail prices of motor fuel, except with respect to the refiner's retail sales at its direct operated outlets.

The Motor Fuel Marketing Competition Act (S. 2043) would have prohibited price inversion and price fixing similar to that provided in the Petroleum Marketing Competition Enhancement Act, and further

would have prohibited supply discrimination by a refiner against established customers in favor of its own directly operated outlets during periods of short supply.

A fourth bill reviewed by the Attorney General, the Petroleum Marketing Competition Enhancement Practices Act, which was developed as a compromise measure near the end of the 102d Congress, was apparently never introduced. That bill would have prohibited refiners from practicing price inversion and would have enacted an open supply provision. In addition, the bill would have given the Justice Department and state attorneys general both criminal and civil enforcement authority, and allow persons injured in their business or property, including competitors, to sue for treble damages and injunctive relief.

## REGULATING HAWAII'S PETROLEUM INDUSTRY

### Chapter 3 PETROLEUM INDUSTRY IN HAWAII

The pricing of gasoline in Hawaii has received a significant amount of attention in recent years. The Hawaii Attorney General has been investigating gasoline prices in the State since 1989, shortly after the Exxon Valdez oil spill, culminating in three reports on the subject to date.<sup>125</sup> In addition, the Hawaii Department of Commerce and Consumer Affairs has recently concluded a study of gasoline marketing in Hawaii,<sup>126</sup> while a recent University of Hawaii study has documented divorcement legislation and its impact on gasoline retailing in the United States and Hawaii.<sup>127</sup> Earlier reports following the 1973 oil embargo reviewed gasoline prices in the State,<sup>128</sup> measures to manage a gasoline shortage in Hawaii,<sup>129</sup> and replacement and alternative fuels, including ethanol and methanol, to serve as substitutes or additives to gasoline.<sup>130</sup>

Despite the numerous studies on gasoline and related issues, however, there is little consensus among the large oil companies, wholesalers, dealers, and state agencies on what appropriate legislative responses, if any, are necessary to ensure a stable supply of low-cost gasoline to Hawaii's consumers. Before reviewing these often divergent views (in chapters 4 to 15), it is necessary to review some of the factors that influence the price of gasoline in Hawaii. In particular, this chapter discusses the State's dependence on oil and vulnerability to disruptions, the gasoline industry in Hawaii and reasons for the decline in the number of lessee and open dealer service stations, the pricing of gasoline in Hawaii, and relevant Hawaii legislation.

#### Hawaii's Dependence on Oil

Hawaii is heavily dependent on imported oil. This is in part due to the State's lack of indigenous fossil fuels, relatively high fuel oil consumption for electric power generation and lack of economically competitive alternative energy sources, and an economy dominated by tourism, agro-processing, and the military, making transportation the State's largest energy consuming sector.<sup>131</sup> These and other factors, including Hawaii's geographic isolation and lack of overland access to energy sources, render Hawaii unique among the fifty states with respect to its reliance

on imported oil and vulnerability to supply disruptions.<sup>132</sup> The State Energy Resources Coordinator has identified the following factors as contributing to the State's energy vulnerability:<sup>133</sup>

- (1) Market disruption. Hawaii is dependent on imported oil for over ninety-two percent of its energy needs. "This makes Hawaii the most vulnerable state in the nation to the disruption of its economy and way of life in the event of a disruption of the world oil market or rapid oil price increases."<sup>134</sup>
- (2) Declining reserves. Forty percent of the State's oil comes from Alaska and the remainder from the Asia-Pacific region. The export capabilities of these sources of supply are expected to decline by approximately fifty percent by the year 2000. These factors will probably increase the Hawaii's dependence on the oil reserves of the politically unstable Middle East.<sup>135</sup>
- (3) Geographic location. The long distance from the United States Petroleum Reserve in Louisiana and Texas, together with the declining number of U. S. flag tankers that are capable of transiting the Panama Canal, make timely emergency deliveries problematic, thereby further rendering the State vulnerable to supply disruptions in a crisis.
- (4) Environmental fragility. Energy production from fossil fuels is the major source of global and local air pollutants; petroleum shipping and handling present risks to the State's fragile marine habitats and coastal resort areas.

Hawaii also has a relatively high demand for oil, reflecting the growing energy demands of the Asia-Pacific region generally.<sup>136</sup> Although Hawaii's demand for petroleum products is comparatively small at "130-140 thousand barrels per day--as opposed to 1.6 million barrels per day in California... Hawaii's population is much smaller than California's", and, as mentioned earlier, Hawaii's per capita demand is second only to Alaska and far exceeds the per capita demand in the United States as a whole.<sup>137</sup> Moreover, during periods of supply curtailment, the need to ensure basic public emergency services to safeguard the public safety, health, and welfare, including police and fire protection, hospital and ambulance services, utility emergency services, water supply, and other areas, may compete with the need

to maintain Hawaii's economy and employment levels, including the continued operations of industry, commerce, transportation, construction, government, the military, and agriculture.<sup>138</sup>

Interisland shipments of oil are also vulnerable. Following the grounding of the Exxon Valdez in Alaska's Prince William Sound in March 1989, together with several smaller oil spills from tankers near United States shores, increasing attention was focused on tanker safety, oil spill prevention, and protection of coastal areas. The Oil Pollution Liability and Compensation Act of 1990 significantly increased liability for large and small vessels that the federal government could impose in the event of an oil spill. In addition, that Act allowed unlimited liability against tanker owners where gross negligence or willful misconduct was involved, and reserved to the states the right to impose their own unlimited liability requirements.<sup>139</sup> Hawaii retained this unlimited liability provision. As a result, the major oil companies that marketed heavy fuel oil to the neighbor islands--PRI (BHP), Chevron, and Unocal--decided to discontinue or limit their shipments of this oil in order to minimize their liability risks.<sup>140</sup> In response, the Hawaii Legislature limited liability under the State's environmental response law for a release of heavy fuel oil from a tank barge carrying this oil interisland, citing the "approaching threat to essential public services and the State's economy, including without limitation, the production of sugarcane and the supply or cost of electricity to the neighbor islands".<sup>141</sup>

Several factors, however, may mitigate Hawaii's dependence on imported oil and vulnerability to losses. For example, the United States Department of Energy, in discussing factors in opposition to the establishment of a Regional Petroleum Reserve in Hawaii, observed that Hawaii's refineries have been upgraded to process greater volumes of Alaska North Slope crude oil, making the State less dependent on foreign imports. Moreover, since the 1970s, new supplies of oil have been developed in Asia and the West Coasts of North and South America. Strategic petroleum reserve (SPR) crude oil could also reach Hawaii indirectly through exchange sales, for example, if Gulf Coast oil were exchanged for Alaska oil which was destined for the Gulf Coast; "[t]he SPR oil would replace Alaska oil on the Gulf Coast, and the released Alaska oil would become available for use on the West Coast and in Hawaii."<sup>142</sup>

#### Hawaii's Gasoline Industry

Hawaii's gasoline retail market is served by five major oil

companies (BHP, Chevron, Shell, Texaco, and Unocal), one large jobber selling gasoline under its own brand (Aloha Petroleum), and several smaller jobbers mostly selling gasoline under major brands. Nearly all of Hawaii's gasoline is produced in-state and supplied to these marketers by two refineries, one owned and operated by BHP and the other by Chevron in the foreign trade zone at Barber's Point (Kalaeloa) on Oahu. 143

Hawaii's refineries are of the highest level of complexity, variously referred to as "upgrading" or "cracking" refineries, and produce primarily gasoline, jet fuel, distillates, and heavy fuel oil from crude oil. The presence of advanced (and expensive) cracking technologies in Hawaii's refineries is explained by their use in maximizing jet fuel production. In general, the refineries have been constructed to match the relatively high needs in the State for jet fuel (commercial and military) and gasoline, while producing less diesel and fuel oil than would be expected. 144

Moreover, Hawaii's two refineries, although comparatively small at 53,000 barrels per day (b/d) and 95,000 b/d, are able to compete in the local market against the large 250,000 b/d refineries in California despite the fact that California refineries are closer to the sources of crude oil in both California and Alaska. However, the cost of shipping products from California to Hawaii allows the Hawaiian refiners to import and refine crude more competitively in the local market: "Thus, scale and complexity interact in complex ways with the locational factors of transport costs and local demand patterns; Hawaiian refiners have occupied a somewhat unique geographical niche that is matched in few other locations." 145

Generally, gasoline is marketed to Hawaii's consumers by a fairly simple distribution system. Chevron and BHP store the gasoline that they manufacture in terminals, and sell some in bulk quantities to Shell, Texaco, and Unocal, which in turn store the gasoline in their own terminals. Each terminal consists of several storage tanks, pipelines to a pier or refinery, and dispensing facilities ("racks") where tank trucks fill up with gasoline to deliver to retail service stations. While the main terminal storage facilities are on Oahu, there are also terminal storage facilities on each of the other major neighbor islands. Gasoline is distributed to neighbor island terminals by inter-island barge. Gasoline is distributed on the same island from terminals to retail stations by tank truck. 146

In 1992, the six major marketers in Hawaii (BHP, Chevron, Shell, Texaco, Unocal, and Aloha) supplied 365 outlets. Out of

this number, 63 were supplied through jobbers or commission agents, while 302 outlets were supplied directly. Of these 302 outlets:

- . 177, or 48.5 percent, were operated by lessee dealers;
- . 31, or 8.5 percent, were operated by open dealers;
- . 65, or 17.8 percent, were operated by companies (salary operated); and
- . 29, or 7.9 percent, were commission operated.

In addition, two of the major marketers (Unocal and Shell) did not have any company-operated stations.<sup>147</sup>

#### Changing Market Conditions

Despite conflicting data, the number of retail service stations in Hawaii appears to be steadily decreasing.<sup>148</sup> Miklius and LaCroix (1993) regard as unlikely in Hawaii's retail markets allegations that the rapid decrease in the number of lessee and open dealer stations resulted from predatory pricing by refiners against their lessee dealers,<sup>149</sup> and instead cite the following alternative explanations for the observed decrease in the number of lessee and open dealers and increased importance of company-operated stations:

- (1) Changes in gasoline consumption trends.

The retail gasoline marketing network was built originally in anticipation of a continuation of strong historical growth in gasoline consumption. However, actual gasoline consumption decreased on the United States mainland after the second oil shock of 1979 until 1982, and resumed at a slower growth thereafter. In Hawaii, gasoline consumption declined after 1979 for two years, jumped between 1981 and 1982, and has been growing at a somewhat higher rate than on the mainland since that time.<sup>150</sup> Lower consumption trends in Hawaii have been attributed in part to an increase in the real price of gasoline and the erosion of personal real income.<sup>151</sup> Another reason for declining rates of gasoline consumption was the replacement of older vehicles with more fuel-efficient ones. Changes in automotive technology to improve fuel efficiency included redesign of chassis and body to reduce drag and weight, redesign of the engine and drivetrain, and advances in lubrication to reduce friction on surfaces within engines.<sup>152</sup> Miklius and LaCroix contend that these changes in consumption may be sufficient to account for a contraction in the number of retail outlets.

(2) Changing service station configurations.

In addition, the trend toward large-volume, self-service outlets and the decline in demand for repair and maintenance services, have affected dealer-operated conventional service stations unfavorably. The change in station configuration from conventional bay stations to large-volume, self-service outlets was motivated by such factors as technological innovations making self-service possible, increasing construction and payroll costs, consumer preferences, and the decreased demand for automobile repair and maintenance services. The decline in demand for automobile repair and maintenance services was due in part to improvements in automotive technology that reduced the frequency of required routine maintenance service. This in turn reduced conventional stations' sales of tires, batteries, and accessories (TBA). Improvements in technology also allowed manufacturers to offer extended warranties and increased the complexity of automobiles, requiring specialized expertise and equipment for repairs and maintenance. These trends favored repair and maintenance services by automobile dealers and other specialists, since conventional stations tended to have more general repair expertise, and affected a greater share of lessee dealer-operated stations since they tended to provide more repair services than company-operated stations. Although Hawaii's acceptance of self-service outlets has lagged behind the U. S. mainland, the distribution of station configurations in Hawaii (self-service, convenience store, and conventional stations) is similar to that on the mainland. 153

Self-service technology has also contributed to the growth of convenience store ("C-store") stations. The practice of installing self-service pumps at small C-stores, which was first popularized in the 1960s, increased as C-store owners and independent marketers realized the profit potential of a joint C-store/self-service operation. Although there were only 1,500 C-stores in the United States in the early 1960s, by 1990 the number of C-stores had increased to 71,200, of which 66 percent sold gasoline. 154 Another recent trend in station configurations is the addition of restaurants to C-store stations. For example, McDonald's and Chevron Corporations recently announced the development of co-branded outlets in Hawaii and throughout the West, featuring McDonald's restaurants, Chevron service stations, and convenience stores at selected locations in which both companies operate. Insurers have also recently introduced "automobile managed care" in response to high vehicle repair costs. 155

(3) Effects of governmental regulation.

A. Price and allocation regulations.

The federal Emergency Petroleum Allocation Act of 1973 was enacted to help maintain the historic market share of independent marketers. Pursuant to this legislation, the Department of Energy adopted price and allocation regulations, in effect until 1981, 156 which adversely affected lessee and open dealers on the U. S. mainland by delaying the conversion of dealer-operated, conventional bay stations to self-service stations. From 1971 until 1981, consumers were shifting from full- to self-service, and the costs of operating a conventional station were increasing.

However, a combination of federal price and margin controls and the inability to purchase additional gasoline prevented dealer-operated stations from changing their operations to self-service, although the same supply constraints were not imposed on jobbers. 157

The decontrol of the U. S. gasoline market in January, 1981, allowed gasoline dealers to profit by cutting prices and margins for self-service gasoline, while increasing prices and margins for full-service. Removing regulations also resulted in lower jobber margins and profitability, causing a large number of jobbers to leave the market. Generally, decontrol allowed changes consistent with emerging technology and consumer demands, but which had been constrained by a decade of federal regulations. 158 In addition, decontrol furthered greater economic efficiency in gasoline marketing, contributing to lower gasoline prices during a time of rising gasoline taxes and increasing inflation: "In retrospect, the DOE gasoline regulations appear to have benefitted wholesalers but hurt small retailers.... DOE allocation controls, which accompanied price controls, appear to have impeded the introduction of more efficient marketing operations, which have lowered prices to consumers since decontrol." 159

Miklius and LaCroix note, however, that the decline in the number of dealer-operated stations on the mainland was not observed in Hawaii during this period. They suggest that Hawaii's small retail markets generated less competition than larger U. S. mainland markets, producing larger retail margins which were locked in by price regulations; the large margins in turn allowed increased costs to be absorbed by dealers. Because of the relatively minor role played by independent dealers in Hawaii, there was little pressure to adopt self-service. 160

## B. Environmental regulations.

Miklius and LaCroix cite the cost of complying with new environmental regulations to have been and continue to be the single most important factor affecting gasoline retail marketing.<sup>161</sup> These Environmental Protection Agency regulations--including underground storage tank, financial responsibility, environmental cleanup, and other environmental regulations--are reviewed in chapter 14.

### (4) Changes in lease rents and increasing land values.

Finally, a substantial increase in lease rents and rising land values have contributed to the increased importance of company-operated stations. Citing the high rent increases in a sample of recently renegotiated leases, Miklius and LaCroix maintain that "[a] large number of businesses could not afford to pay land rentals of these magnitudes and gas stations are no exceptions. One should expect the total population of firms doing business in Hawaii as well as the number of gas stations to decrease."<sup>162</sup> These issues are also further reviewed in chapter 14.

## Gasoline Prices in Hawaii

Gasoline prices in Hawaii are among the highest in the United States. If the price of gasoline is considered to include the average pump price plus state and federal taxes, the three states with the highest prices are Connecticut, Hawaii, and Alaska, in that order. Alternatively, if one considers the average pump price excluding taxes, the three states with the highest prices are Alaska, Hawaii, and Connecticut, respectively.<sup>163</sup>

The Attorney General's 1990 report on gasoline prices in Hawaii discussed the following four components that make up the price of gasoline at the pump:<sup>164</sup>

- (1) The cost of crude oil. The cost of crude oil, as discussed in chapter 2, fluctuates depending on a number of variables, including the influence of OPEC members' decisions, the scarcity of crude oil, the lack of substitutes, and seasonal demand.
- (2) The refiner margin. The refiner margin is the difference between the cost of crude oil and the dealer tankwagon price.

- (3) The retailer margin. The retailer margin is the retail dealer's price, before taxes, for self-service gasoline paid for in cash; the dealer includes its land costs, labor, overhead, and profit to the DTW price. Additional fees may be added for payment by credit card or full service. 165
- (4) Fuel and excise taxes. In Hawaii, the federal, state, and county taxes comprise a large portion of the price of gasoline at the pump. For each gallon of gasoline, fuel taxes include a \$0.002 superfund (leaking underground storage tank) tax, a \$0.091 federal fuel tax, a \$0.11 state fuel tax, and county fuel taxes of \$0.165 for the City and County of Honolulu and \$0.088 for the other counties. State excise taxes amount to 0.5 percent on the sale between the oil company and the retail dealer, and 4.0 percent on the sale between the retail dealer and the public.

The Attorney General further noted the following factors that may have the effect of decreasing price competition and lessening competition generally in Hawaii's petroleum industry: 166

(1) Oligopolies. Oahu and each of the Neighbor Islands constitute separate, highly concentrated oligopolistic gasoline markets; the pricing of gasoline in these markets is influenced by the limited number of competitors and their interdependence. 167

(2) Entry barriers. New competition in Hawaii's highly concentrated gasoline markets is hindered by a number of costs and risks, including the high cost of building new terminals to store gasoline that is transported in bulk to the islands, and the risk that the additional gasoline supply would require too great a reduction in price to gain a sufficient market share in Hawaii's retail gasoline market so as to allow a new competitor to remain in business. 168 As noted earlier, Hawaii's high land prices also deter new competition by substantially increasing the cost of doing business for both refineries and services stations. 169 In addition to economies of scale and high land costs, other entry barriers include unrecoverable capital costs, environmental restrictions, and the relatively small size of Hawaii's gasoline market. 170 Hawaii's relatively small gasoline market, however, is compounded by the State's high costs of doing business and the comparative cost-effectiveness of establishing operations in a mainland city. 171 A related factor that tends to decrease price competition in Honolulu as compared to mainland cities is the

geographic layout of Oahu. 172

(3) Inelastic demand. Another factor discouraging price competition in Hawaii is that the demand for gasoline in the State is relatively inelastic. Generally, elasticity measures the responsiveness of sellers and buyers to price changes; when the percentage change in quantity of a product is less than the percentage change in price, demand is said to be inelastic, buyers are not very responsive to price changes, and purchases will not be drastically affected.<sup>173</sup> Demand for a commodity is inelastic when a large price increase may be imposed without a significant loss in sales.<sup>174</sup> Because gasoline is an essential commodity for which there are currently no economically viable substitutes, it is estimated that gasoline consumption will decrease by only 1.3 percent if the price increases by ten percent.<sup>175</sup> Inelastic demand acts as an entry barrier to new competitors in Hawaii's gasoline industry because "total demand will not increase much unless the market price is reduced significantly.... [P]eople who are not driving now because the price of gasoline is too high, probably won't start driving unless the price of gasoline goes down significantly."<sup>176</sup>

(4) Intercompany dealings. The Attorney General noted that even though the major oil companies in Hawaii are supposed to be competitors, they nevertheless deal with each other in many areas: "They exchange gasoline. They share pipelines. They buy and sell additives to and from one another. They provide storage and terminalling services to one another. These dealings, and the interdependence they generate, appear to discourage meaningful price competition."<sup>177</sup> One form of intercompany dealing reviewed by the Attorney General is that of exchange agreements, which generally involve competing companies that agree to structure certain features of supply arrangements, often to deliver products on each other's behalf in order to lower transportation costs. For example, a hypothetical exchange agreement would allow Shell, which does not refine gasoline in Hawaii, to obtain gasoline from BHP, which does refine gasoline locally, in exchange for providing BHP the gasoline it needs in areas in which BHP does not refine gasoline, but Shell does. Arguments in favor and against exchange agreements are discussed in chapter 5.<sup>178</sup>

(5) Vertical networks. The ownership and control of retail marketing facilities in Hawaii by vertically integrated oil companies, although efficient for the companies involved, may further lessen competition in the State. In particular, vertical arrangements in the State's branded distribution system, when considered along with other factors such as high entry barriers

and inelastic demand, contribute to the lack of aggressive price competition in Hawaii. 179

(6) Closed terminals. The Attorney General has noted evidence in which a terminal operator in the State refused to deal with an outsider seeking unused terminal space to store gasoline that would be imported to the U. S. mainland, and concluded that this practice lessens competition by helping local oil companies maintain the status quo of high market concentration and interdependence. 180

### Hawaii Legislation

Divorcement. Hawaii's retail divorcement statute, codified as section 486H-10, Hawaii Revised Statutes, establishes a moratorium on the operation of company-operated retail service stations selling petroleum products under certain conditions until August 1, 1997. In particular, that section allows manufacturers and jobbers to open one company-operated station for each dealer-operated station owned by that manufacturer or jobber that was opened on or after July 31, 1995, up to two company-owned stations. That section also allows manufacturers and jobbers to acquire or construct replacement stations to replace any company-operated stations in existence on July 30, 1993, which have subsequently closed due to the expiration or termination of the station's ground lease, so long as the manufacturer or jobber negotiated in good faith to renew the ground lease of the stations and the stations are located within a one-mile radius of the stations that they replace. 181

Other petroleum laws. Chapter 486E, Hawaii Revised Statutes (HRS) (fuel distribution), requires distributors, including fuel refiners and manufacturers who sell fuel at wholesale or retail, to register with the Department of Business, Economic Development, and Tourism and to file statements with the director regarding fuel refined, manufactured, or compounded and sold or used by the distributor; fuel imported or exported; and other categories during certain reporting periods. Civil penalties may be imposed for failure, neglect, or refusal to register or to file the required statements. Effective July 1, 1996, section 486E-5, HRS, requires that the department adopt rules to require that gasoline sold in the State for use in motor vehicles contain ten percent ethanol by volume. 182

Chapter 486H, HRS (gasoline dealers), contains Hawaii's retail divorcement law, as discussed earlier, as well as provisions

relating to dealer franchises. In particular, that chapter prohibits the wrongful or illegal termination or unreasonable nonrenewal of a franchise agreement by a petroleum distributor, and allows for damages and equitable relief. The chapter also requires written notice of termination, cancellation, or nonrenewal by certified mail at least ninety days in advance of the effective date of that action. Petroleum distributors are prohibited from dictating, forcing, or attempting to set the retail price of any product sold by a gasoline dealer.

Chapter 486I, HRS (petroleum industry information reporting), requires that each refiner, major marketer, oil producer, oil transporter, and oil storer submit to the Public Utilities Commission certain information relating to petroleum and petroleum products relating to their areas of specialty within specified time periods. The Commission, with its own staff and other support staff with expertise and experience in the petroleum industry, is required to gather, analyze, and interpret the information submitted to it, and may conduct random or periodic audits and inspections of suppliers of petroleum products to determine whether they are unnecessarily withholding supplies from the market or are violating applicable laws or policies. The Commission is required to publish annually and report to the Governor and the Legislature a summary, analysis, and interpretation of the information submitted to the Commission.

Copies of the full text of chapters 486E, 486H, and 486I, HRS, are contained in Appendices G, H, and I, respectively.

Environment. Chapter 128D, HRS (environmental response law), defines "oil" as including petroleum and includes oil as a "hazardous substance" under section 128D-1. Section 128D-4 provides for the removal and remedial action of hazardous substances that are released into the environment; section 128D-6 establishes strict liability for costs of removal or remedial action, damages for injury or loss of natural resources, and the costs of health assessments. In addition, section 128D-8 establishes civil penalties, including treble punitive damages for failure to perform actions specified in an administrative order to properly provide removal or remedial action, and section 128D-10 establishes criminal penalties or enhanced civil penalties for knowing releases of hazardous substances.

Chapter 342G, HRS (integrated solid waste management), defines "special waste" in section 342G-1 as including petroleum-contaminated soil, i.e., soil contaminated by a release of petroleum to a degree exceeding levels determined acceptable by

the director of health. Pursuant to section 342G-21, each county is required to prepare an integrated solid waste management plan which, under section 342G-25(b) and 342G-26(e), must include a special waste component that describes the existing waste handling and disposal practices for special wastes, including petroleum-contaminated soil.

Chapter 342H, HRS (solid waste pollution), in section 342H-1, defines "petroleum-contaminated soil" the same as defined under section 342G-1, and, pursuant to section 342H-4.5, prohibits the transportation of this soil without a permit issued by the department of health. Section 342H-4.5 provides an exemption from the permit requirement for the transport of petroleum-contaminated soil to a soil remediation site if the transporter provides written notification in advance to the department and abides by any transportation guidelines set by the department.

Chapter 342L, HRS (underground storage tanks), defines an underground storage tank in section 342L-1 as one or a combination used to contain an accumulation of regulated substances, including petroleum, the volume of which is ten percent or more beneath the surface of the ground. Permit procedures are established under section 342L-4 to obtain permission from the director of health to install or operate a tank or tank system. Variances may be obtained from the department with respect to provisions deemed more stringent than federal rules established under the federal Resource and Recovery Act pursuant to sections 342L-5 and 6. Enforcement of the chapter may be by emergency administrative order to stop a release or other activity presenting an imminent peril to human health and safety or the environment (section 342L-9), civil and administrative penalties (sections 342L-10 and 11), and injunctive relief (section 342L-12). 183

Part II of chapter 342L, HRS (sections 342L-30 to 37), establishes underground storage tank regulations, standards, and financial responsibility requirements. The Department of Health is required to adopt standards applying to underground storage tanks and tank systems pursuant to section 342L-32. The Department is also required by section 342L-36 to adopt requirements for maintaining evidence of financial responsibility for taking response action and compensating third parties for bodily injury and property damage caused by an accidental release, and allows the department to establish the amount of required coverage for particular classes or categories of underground storage tanks or tank systems containing petroleum at not less than \$1,000,000 for each occurrence. 184 Part III of chapter 342L (sections 342L-50 to 53) establishes the department response

program for petroleum releases, including the leaking underground storage tank fund, responses to suspected or confirmed releases, and cost recovery measures.

Chapter 342N, HRS (used oil transport, recycling, and disposal), defines "recycled oil" as oil that is reused or prepared for reuse as a petroleum product, and "used oil" as a petroleum-based oil that has become unsuitable for its original purpose due through use, storage, or handling. Section 342N-4 requires a permit from the Director of Health to discharge waste or construct or modify a used oil management system. Section 342N-30 prohibits new, used, or recycled oil from being discharged or allowed to enter sewers, drainage systems, surface or ground waters, or onto the ground, except for inadvertent, normal discharges from vehicles or equipment, provided that appropriate measures are taken to minimize releases. Section 342N-8 and 9 impose civil and criminal penalties for violations of this chapter.

Tax laws. Section 237-27(b), HRS (general excise tax; exemption of certain petroleum refiners), excludes from the general excise tax law "such part of the petroleum products resultant from the refiner's business as is to be further refined by another refiner, to the extent that the petroleum products resultant from such further refining will be ... included in the measure of the tax on such other refiner ...". Section 237-27.1, HRS (exemption of sale of alcohol fuels), excludes from the general excise tax law all of the gross proceeds arising from the sale of alcohol fuels for consumption or use by the purchaser and not for resale.

Section 243-2, HRS (fuel tax law), requires distributors, including refiners, manufacturers, and importers of liquid fuel, to register with the Department of Taxation and to be licensed by the department. Under section 243-3, retail dealers (those purchasing liquid fuel from a licensed distributor and sell the fuel at retail) must also hold permits from the department. Section 243-3.5 imposes an environmental response tax on each barrel, or fractional part of a barrel, of petroleum product sold by a distributor to a retail dealer or end user other than a refiner.<sup>185</sup> Section 243-4 imposes license taxes on distributors for each gallon of liquid fuel refined, manufactured, produced, or compounded and sold or used by the distributor in the State or imported by the distributor, or acquired from persons who are not licensed distributors, and sold or used by the distributor in Hawaii. Section 234-4 also imposes a license tax with respect to distributors of diesel oil. Both of these license taxes include

amounts designated for the counties, in addition to the county fuel taxes provided under section 234-5.186

Energy planning. Chapter 196, HRS (energy resources), requires the director of business, economic development, and tourism to serve as the energy resources coordinator to formulate plans for the development of the State's energy resources.

Section 201-12, HRS (state program for energy planning and conservation), requires the department of business, economic development, and tourism to develop a program for energy planning and conservation, consisting of short- and long-range planning for the development and promulgation of methods to encourage voluntary conservation of gasoline and other fuels, and development of new or alternative sources of fuels and energy.

Antitrust. Hawaii's antitrust law, chapter 480, HRS (monopolies; restraint of trade), 187 prohibits unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce in section 480-2, and subjects persons violating that section to a civil penalty not exceeding \$10,000 for each violation in section 480-3.1. Section 480-4 further prohibits combinations in restraint of trade, price-fixing, and limitations of production, and section 480-5 prohibits tying agreements that have the effect of substantially lessening competition or tend to create a monopoly in any line of commerce. Section 480-3 provides that chapter 480 is to be construed in accordance with the judicial interpretations of similar federal antitrust statutes. 188

Miscellaneous statutes. Other laws affecting the petroleum industry include county requirements for the leasing of commercial space for the sale of gasoline and petroleum products, 189 procedures for the control, distribution, and sale of petroleum products during a shortage, 190 requirements relating to motor vehicle industry licensing and rentals, 191 measurement standards, 192 and theft of petroleum products. 193

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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Endnotes 3

125. Hawaii, Department of the Attorney General, An Investigation

- of Gasoline Prices in Hawaii: A Preliminary Report (Honolulu: Sept. 1990) (hereinafter, "AG (1990)"); Hawaii, Department of the Attorney General, Gasoline Prices in Hawaii: The Impact of Oil Company Divorcement on Consumer Prices (Honolulu: 1993) (hereinafter, "AG (1993)"); and Hawaii, Department of the Attorney General, The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices (Honolulu: 1994) (hereinafter, "AG (1994)").
126. Julia E. Schoen, The Consumer and Gasoline Marketing in Hawaii: The Impact of Direct Retailing of Motor Fuel by Refiners and Distributors on the Consumer (Honolulu: Department of Commerce and Consumer Affairs, 1992 and 1993).
  127. Walter Miklius and Sumner J. LaCroix, Divorcement Legislation and the Impact on Gasoline Retailing in the United States and Hawaii (Honolulu: University of Hawaii, January 20, 1993).
  128. Hawaii, Department of Planning and Economic Development, Gasoline Prices in Hawaii, 1920 - 1980 (Honolulu: Aug. 8, 1980).
  129. Hawaii, House of Representatives, Special Committee on Energy, Investigation of the Hawaii Gasoline Market (Honolulu: March 1974); Hawaii, Department of Planning and Economic Development, Managing a Gasoline Shortage in Hawaii, 2 vols. (Honolulu: October 1981) (hereinafter, "DPED (1981)").
  130. See, e.g., Hawaii, Department of Planning and Economic Development, Ethanol/Gasohol for Hawaii (Honolulu: Jan. 1980); Robert Schleser, Ethanol Production in Hawaii: Processes, Feedstocks, and Current Economic Feasibility of Fuel Grade Ethanol Production in Hawaii: Final Report (Honolulu: Department of Business, Economic Development, and Tourism, July 1994); Act 199, Session Laws of Hawaii 1994 (authorizing the Director of Business, Economic Development, and Tourism to adopt rules to mandate the use of ethanol in transportation fuel); and Act 219, Session Laws of Hawaii 1994 (authorizing the issuance of special purpose revenue bonds to provide financing for the construction of a demonstration fuel-grade ethanol production plant in the Hawaii). See also United States, House of Representatives, Committee on Energy and Commerce, Subcommittee on Fossil and Synthetic Fuels, Methanol as an

Automotive Fuel (Washington: 1984); United States, General Accounting Office, Federal and State Methanol Fuel Projects, Coordination, and State Tax Incentives (Washington: May 3, 1985); and United States, Department of Energy, Alternatives to Traditional Transportation Fuels: An Overview (Washington: June 1994) (hereinafter, "DOE (1994)"). Replacement and alternative fuels and related alternative energy issues are beyond the scope of this study.

131. A 1995 Legislative Reference Bureau feasibility study on the establishment of a state energy commission outlined the following reasons for Hawaii's reliance on imported oil:

The Hawaiian Islands are volcanic in origin. Therefore, Hawaii has no indigenous fossil fuels such as oil, coal, or natural gas. Unlike the other fifty states, Hawaii must rely almost exclusively upon imported fuel for its energy needs. Furthermore, oil is the source of almost ninety percent of Hawaii's electricity. This is in dramatic comparison to the rest of the nation, where the majority of electricity is generated by coal, followed by nuclear power, natural gas, and hydroelectricity. Oil, on the other hand, generates only three percent of the nation's electricity. ...

Hawaii's oil supplies have historically come from Alaska and producers in the Asia/Pacific region. ... If Alaskan crude is counted as an import also, Hawaii is 100 percent dependent on imports to meet its demand for oil. Hawaii's situation is shared by its Asia-Pacific neighbors Japan, Korea, and Taiwan. However, even if we exclude Alaskan crude and consider imports from foreign sources only, Hawaii's import dependence still ranks above both the United States average and the world average. Hawaii's oil demand per capita (approximately forty barrels per year) far exceeds the per capita demand in the United States as a whole, as well as other imported oil dependent countries such as Japan, Korea, Taiwan, Germany, and France. Among the states, only Alaska boasts a greater demand for oil per capita, due primarily to its long cold winter.

Hawaii's heavy reliance on oil is an outgrowth of its primary economic structure. Although Hawaii's economy has grown considerably during the last decade,

the structure continues to be dominated by tourism, the military, and agro-processing. As one might expect, transportation is the largest energy consuming sector in Hawaii, accounting for 63 percent of petroleum use and 57 percent of total energy consumption. Jet fuel dominates Hawaii's demand, accounting for approximately 35 percent of Hawaii's oil demand, versus 16 percent for United States west coast region states (Alaska, Arizona, California, Hawaii, Nevada, Oregon and Washington), and only 9 percent for the nation. This is attributable to Hawaii's geographic location as a tourist destination and refueling site for military and civilian trans-Pacific flights. Of Hawaii's three lead industries--tourism, the military and agro-processing--only agro-processing contributes to the energy supply through generation of electricity by burning sugar bagasse, a by-product of sugarcane processing, and selling the excess to island electric companies.

Another major difference between Hawaii and the nation as a whole is in fuel oil consumption; at the national level, fuel oil represents only 8 percent of total demand, while in Hawaii the figure is 30 percent. Most of Hawaii's fuel oil is used for electric power generation. In 1992, over 84 percent of Hawaii's total electricity production depended on oil. The nation as a whole used oil for only about three percent of its electricity production. Unlike other states, Hawaii has little by way of competitive fuels and alternative energy resources such as wind, geothermal, biomass, solar, and ocean thermal energy conversion are, for the most part, not able to compete economically with fuel oil at the present time. Other states have many other types of fuel, including natural gas, hydro electric power, coal, and nuclear for use in power generation.

Jan Yamane, Establishing an Energy Commission: A Feasibility Study, Report No. 3 (Honolulu: Legislative Reference Bureau, 1995) at 6-7 (footnotes omitted); see also Nancy D. Yamaguchi and David T. Isaak, Hawaii and the World Oil Market: An Overview for Citizens and Policymakers (Honolulu: East-West Center Energy Program, August 1990) at 41-51; Charlotte A. Carter-Yamauchi, Utility-Financing of Energy Conservation: A Short-Term Approach to Hawaii's Oil

Dependency, Report No. 3 (Honolulu: Legislative Reference Bureau, 1988) at 6-7; Brad S. Petrus, "Decentralized Power Generation: Alternative Energy Exemption from State Public Utility Regulation--In re Wind Power Pacific Investors-III," 8 U. Haw. L. Rev. 227 (Spring, 1986).

132. Hawaii, Department of Planning and Economic Development, Hawaii's Fuel Requirements for Essential Services (Honolulu: Feb. 1983) at 97 (hereinafter, "DPED (1983)"):

Basic to Hawaii's planning outlook is the fact that the State is far more vulnerable to curtailments of its vital energy supply than is any other State. No other State is as dependent for its energy needs on a single source of energy--petroleum. Hawaii, unlike other States, is without overland access to energy sources and without indigenous oil, coal, gas, or significant hydropower resources. No other State is as isolated geographically from its energy sources.

133. Hawaii, Department of Business, Economic Development, and Tourism, State Energy Resources Coordinator's Annual Report 1993 (Honolulu: 1992-1993) at 1.
134. *Id.* at 1 (emphasis added). The Hawaii Legislature has found that "[t]he State of Hawaii, with its total dependence for energy on imported fossil fuel, is particularly vulnerable to dislocations in the global energy market." Haw. Rev. Stat. §196-1(1). The Legislature further found that "adequate supplies of petroleum products are essential to the health, welfare, and safety of the people of Hawaii, and that any severe disruption in petroleum product supplies for use within the State would cause grave hardship, pose a threat to the economic well-being of the people of the State, and have significant adverse effects upon public confidence and order and effective conservation of petroleum products." Haw. Rev. Stat. §125C-1.
135. Hawaii is included in U. S. Petroleum Administration for Defense District (PADD) V. Because of high levels of crude production in Alaska and California, this region is a net-exporter of oil to other U. S. regions. However, oil production in Alaska and California has peaked and is now headed into a period of decline. See Yamaguchi and Isaak (1990) at 41-42; see generally United States, Department of Energy, The Motor Gasoline Industry: Past, Present, and Future (Washington, DC: Jan. 1991) (hereinafter, "DOE

- (1991)") at 22-24; United States. Department of Energy, The U. S. Petroleum Industry: Past as Prologue, 1970 - 1992 (Washington, DC: Sept. 1993) (hereinafter, "DOE (1993)") at 31-38.
136. The Asia-Pacific region's rapid economic growth and increasing population have caused the region's energy demands to grow faster than anywhere else in the world in recent years. Fereidun Fesharaki, Allen L. Clark, and Duangjai Intarapravich, "Energy Outlook to 2010: Asia-Pacific Demand, Supply, and Climate Change Implications," AsiaPacific Issues, Series, no. 19 (Honolulu: East-West Center, April 1995) at 1-2. "The Asia-Pacific region is the only part of the world that has seen major new demand in the world oil market in recent years. Between 1990 and 1993, the region's demand rose by three million barrels per day (mmb/d), which more than offset the declining demand in other regions. The consequent net increase was 0.5 mmb/d in global oil demand." *Id.* at 2.
137. Yamaguchi and Isaak (1990) at 46.
138. DPED (1983) at 15-22.
139. DOE (1993) at 58-59; see also Stephen J. Darmody, "The Oil Pollution Act's Criminal Penalties: On a Collision Course with the Law of the Sea," 21 B.C. Env'tl. Aff. L. Rev. 89 (Fall, 1993). See generally "Heeding the Valdez," Honolulu, vol. 25, no. 9 (March 1991) at 57; Cynthia Kyle, "The States Beef Up Oil Spill Response Plans," *Governing*, vol. 2, no. 12 (Sept. 1989) at 70; Glenn T. Gray, Direct Action Provisions in Other State's Oil Spill Laws, Research Request 92.190 (Juneau: Alaska Legislative Research Agency, March 13, 1992); "Learning the Lessons of the Star Connecticut," *Environment Hawaii*, vol. 1, no. 6 (Dec. 1990) at 1; Hawaii, Department of Health, Report to the Fourteenth Legislature on HCR No. 173 and HR no. 288: Requesting that the Department of Health Test Dispersants, Develop Recommendations on Stockpiling Dispersants, and Establish More Efficient Operating Procedures in the Event of an Oil Spill (Honolulu: 1988); Rose T. Pfund, ed., *Oil Spills at Sea: Potential Impacts on Hawaii*, prepared for the Hawaii Department of Health by the University of Hawaii Sea Grant College Program (Honolulu: 1992); API Task Force Report on Oil Spills (Washington, DC: American Petroleum Institute, June 14, 1989).

140. See Hawaii, Department of Business, Economic Development, and Tourism, [Updated Issue Paper on the U. S. Oil Petroleum Act of 1990 and the Subsequent Discontinuation of Shipments of No. 6 Fuel Oil to the Neighbor Islands by Pacific Resources, Inc.] (Honolulu: Feb. 1992 and March 18, 1992 Addendum). BHP (Broken Hill Proprietary Co. Ltd. of Australia) acquired Pacific Resources Inc. and its refinery in 1989. See also "BHP's Game Plan," Hawaii Business, vol. 34, no. 10 (April 1989) at 25.
141. 1992 Haw. Sess. Laws Act 130, §1. Section 1 of that Act became effective on June 3, 1992 (the date of approval of Act 130), and is repealed on June 30, 1996. Id., section 5. See also 1993 Haw. Sess. Laws Act 29 and 1994 Haw. Sess. Laws Act 209.
142. Bruce W. Wilson, A Review of Factors Relating to the Establishment of a Regional Petroleum Reserve in Hawaii (Honolulu: Department of Business and Economic Development, Nov. 1988) at 66; see also notes 16 to 22 and accompanying text in chapter 8.
143. See Miklius and LaCroix (1993) at 56; DPED (1981) (vol. 2) at 45; AG (1990) at 3-4.
144. Yamaguchi and Isaak (1990) at 29-39; AG (1990) at 3.
145. Yamaguchi and Isaak (1990) at 36-39; see generally id. at 1-41 for a discussion of the oil industry, including the international crude market, oil cartels, refining, and petroleum products.
146. AG (1990) at 4. As noted in that report, Chevron and Shell operate terminals on each major island, while Chevron jobbers operate limited storage facilities at Kawaihae on the Big Island and on Molokai and Lanai. Unocal maintains terminals on Oahu, Maui, and the Big Island, and a jobber on Kauai and at Kawaihae. Texaco operates a terminal on Oahu, and a Texaco jobber operates facilities on the Big Island. BHP operates an Oahu terminal and a small terminal on the Big Island. Aloha maintains an interest in BHP's Oahu terminal, but has no other terminal facilities of its own in the State. Id.
147. Miklius and LaCroix (1993) at 5, 57 and Table 2-5.
148. A 1992 study prepared for the Hawaii Legislature by the

Department of Commerce and Consumer Affairs on the impact of direct retailing of motor fuel by refiners and distributors on Hawaii consumers indicated a trend toward fewer service stations. In particular, that study noted Department of Labor and Industrial Relations figures indicating that there were 342 stations with payroll in 1980, 297 such stations in 1985, and 265 stations in 1990. While these figures do not include gas pumps attached to stores or stations that do not hire outside help, the study noted that this data is representative of the trend towards fewer service stations. Schoen (1992) at 3.

However, according to Miklius and LaCroix (1993), trends in the number of gasoline stations in Hawaii are difficult to establish because of a lack of consistent data series. The number of gasoline stations, as defined by a 1987 United States Census, has declined in the Hawaii since reaching a peak in 1972. However, the Census figures do not include all outlets selling gasoline; rather, they include only service stations that derive more than fifty percent of their revenues from the sale of gasoline. The increase in the number of convenience store ("C-store") outlets that derive more than half of their revenues from other sources has resulted in a serious undercount of service stations. According to the authors of that study, this undercount, because of the substantial increase in uncounted C-store outlets, means that the decline in the total number of outlets selling gasoline was smaller than indicated by the official data. The authors also cite a 1992 American Petroleum Institute estimate that the number of stations in Hawaii has actually increased from 496 in 1977 to 546 in 1987. Miklius and LaCroix (1993) at 3-5 and Table 2-3.

Miklius and LaCroix nevertheless concluded that, at least as defined by the Census, the number of lessee and open dealer gasoline stations in Hawaii has declined since reaching a peak in 1972, although the decline has been smaller in Hawaii than on the U.S. mainland. In addition, until 1981, company-operated stations in the State accounted for a negligible proportion of all stations; since that year, however, there has been a significant increase in the relative importance of these stations. However, the increase in importance of company-operated stations in Hawaii was due primarily to the entry of new marketers rather than the conversion of lessee dealer stations to company operations--namely, the entry of BHP into the market in 1983 and the acquisition of the Circle K chain of C-

store/gasoline stations by Texaco in 1990. Id. at 5.

149. See notes 66 to 74 and accompanying text in chapter 15 for a discussion of predatory pricing.

150. Id. at 17-18, 56-57.

151. See DPED (1981) (vol. 2) at 57, 65:

The rate of inflation during 1973-1980 must be taken into account when looking at the effect of rising gasoline prices on the consumer. In 1973 the cost of living as reflected by the consumer price index was 1.28 times higher than in the base year, 1967. In comparison, the price of gasoline was only 1.12 times higher than in 1967. In the subsequent years from 1974 to 1978, inflation was generally outpacing gasoline price increases, making gasoline less expensive relative to all other goods. In 1979, however, gasoline price increases were large enough to outpace the general rate of inflation, making gasoline more expensive even in real terms (adjusted for inflation). The same was true in 1980. In other words, while all goods and services combined cost 2.28 times what they had in 1967, gasoline cost three times as much as in 1967.

Consumers spend their money on many different goods and services. In 1980 a family of four in Hawaii on an intermediate budget had to spend 123% more than they did in 1970 to maintain their standard of living. But between the same years, average per capita personal income increased only 113%. That means that the cost of living in Hawaii increased more than the income used to cover living expenses. The average consumer therefore was forced to cut back on some expenditures. Gasoline apparently was one of them.

To summarize the gasoline picture from 1970 to 1980, it is evident that although total gasoline consumption in Hawaii over this period increased in absolute terms, the growth in consumption slowed down following the shortages of 1973-74, and actually was negative beginning in 1979 and continuing into 1980 and 1981. Why the declining trend in gasoline consumption? It is very difficult to disentangle all the possible contributing factors. Over the past ten

years, Hawaii had 50% more motor vehicles consuming only 31% more gasoline in total. Gasoline consumption per motor vehicle consequently declined from 579 gal./vehicle in 1970 to 508 gal./vehicle in 1980. Probable reasons include a replacement of old vehicle stock with newer, more fuel-efficient models, and conservation through a decrease in miles traveled per vehicle, with both factors being influenced by the rising price of gasoline. The decline in gasoline consumption in 1979-80, concurrent with significant increases in the real price of gasoline, attest to the impact of gasoline prices on consumption. It is also likely that the erosion of personal real income over the years has had some effect on gasoline purchases.

152. See DOE (1991) at 5-8. However, changing population patterns, including the aging of the population and increases in the number of people living in suburban communities, may account for a somewhat greater demand for gasoline. *Id.* at 41-42; see also DOE (1994) at 20 - 22.
153. Miklius and LaCroix (1993) at 18-21, 24-27, and 57-59. Schoen (1992) also found an increase in company-operated stations and the inability to find qualified workers as two reasons for the decrease in number of conventional service stations. The former reason cites the lower overhead of company-operated stations compared to that of a conventional dealer's station, since company-operated stations' "sole business ... is to sell gasoline and have the customer do the work of pumping the gas." Schoen (1992) at 4. The latter cites the unreliability of workers and greater availability of higher paying work in tourist related businesses. "Not only are the workers not seen as being as reliable as in previous years, but the romance of working at the local service station has faded." *Id.* at 6.
154. *Id.* at 23-24. The major refiners entered the C-store industry relatively late; by 1981, C-store stations accounted for only seven percent of the stations controlled by the eight major refiners. *Id.* at 24.
155. See "McDonald's, Chevron Plan Combined Stores", Honolulu Star-Bulletin, August 1, 1995, at B-4; David Segal, "Managed Auto Care like HMO for Cars," The Honolulu Advertiser, November 23, 1995, at C7. Under managed care for automobiles, "CMOs", or car maintenance organizations, which are patterned after HMOs (health maintenance organizations),

are used to repair vehicles damaged in collisions. In a CMO, drivers who have been in accidents would be required by insurers to select specified repair facilities from a network, rather than obtaining estimates from randomly selected body shops. Insurers negotiate group discounts with these facilities, which permits them to offer lower premiums to consumers. Although drivers would save money under this type of arrangement, they face more limited choices of repair facilities. In addition, a number of states have "anti-steering" laws, which prohibit insurance carriers from dictating where consumers take damaged vehicles for repair.

156. See generally Paul W. MacAvoy, ed., *Federal Energy Administration Regulation: Report of the Presidential Task Force* (Washington, DC: American Enterprise Institute for Public Policy Research, 1977); Joseph P. Kalt, *The Economics and Politics of Oil Price Regulation: Federal Policy in the Post-Embargo Era* (Cambridge, MA: MIT Press, 1981) at 9-23.
157. Miklius and LaCroix (1993) at 21-23, 59.
158. Another consequence of decontrol was a change in refining economics; production of heavy bulk oils was no longer profitable or feasible. As a result, most refineries increased their flexibility and complexity through expansions in downstream processing capacities after 1981. Production of light, transportation-type fuels claimed more of the production from a barrel of crude oil. Another significant change was the addition of downstream capacity to desulfurize and process poorer quality crude oils into lighter products through distillation. See DOE (1993) at 20-21.
159. Robert Fenili, "The Impact of Decontrol on Gasoline Wholesalers and Retailers," *Contemporary Policy Issues*, vol. 3, no. 3, pt. 2 (Spring, 1985) 119, 129; see also H. A. Merklein and W. P. Murchison Jr., *Those Gasoline Lines and How They Got There* (Dallas: Fisher Institute, 1980) at 111-112: "In freezing supplier/purchaser relationships, the gasoline allocation controls have introduced a rigidity that is intolerable in the normally dynamic market process. In the six-year period since the allocation controls were imposed, gasoline marketing has experienced a number of changes. Self-service islands, high-volume outlets, and convenience stores/gas operations have been introduced, but development of these and other new marketing concepts has

been impeded by regulation." (citing a 1979 United States Department of Energy internal memorandum).

160. Miklius and LaCroix (1993) at 59.
161. Id. at 31.
162. Miklius and LaCroix (1993) at 31.
163. Yamaguchi and Isaak (1990) at 52.
164. AG (1990) at 5-7.
165. For a discussion of credit cards in retail gasoline marketing, see United States, Department of Energy, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers (Washington, DC: March 1984) at 111-118; John M. Barron, Michael E. Staten, and John Umbeck, "Discounts for Cash in Retail Gasoline Marketing," Contemporary Policy Issues, vol. X (Oct. 1992), 89.
166. AG (1990) at 7-14.
167. See notes 21 to 32 and accompanying text in chapter 2 for a discussion of oligopolies.
168. AG (1990) at 9-10:

To compete effectively on the wholesale level, you need access to a bulk supply of gasoline, access to terminal storage facilities, and access to a sufficient retail market.

Many factors make it

difficult for new competitors to gain access to such facilities and markets in Hawaii. Not the least of these is the fact that it would not be in the interest of the existing oil companies to supply a new competitor with petroleum products in bulk quantities or with terminal storage. On the other hand, the cost of transporting bulk gasoline to Hawaii and storing it in newly constructed facilities would not only require a new competitor to bear higher capital and operating costs than do the existing companies, but also additional supply might depress the price of gasoline below the price a new competitor would need to make entry profitable. In other words, a new competitor in Hawaii would run the risk of reducing the price of

gasoline to a point that, with the higher costs, he would go out of business! Clearly, in Hawaii, the economies of scale and the self interest of the already established companies work against new competition.

169. Yamaguchi and Isaak (1990) at 56:

Land prices [in Hawaii] are now shockingly high, and therefore the cost of doing business is high. Land prices have a substantial impact on petroleum refining and marketing costs. Refineries themselves take up a large amount of space, and tankage and terminals are land-hungry. The cost of land affects the economics of service stations themselves, which are often located on prime commercial real estate. The effect of land prices on the cost of petroleum is felt at every stage of the process, from the loading pipelines for crude delivery through the refinery, to the parking lots where the tank trucks are parked, to service stations.

170. AG (1990) at Exhibit 12.

171. Yamaguchi and Isaak (1990) at 56:

It is often observed that one reason that there are not more companies present in Hawaii is that it is a small market. This statement needs to be expanded: Hawaii is a small market with very high overheads for doing business. Wyoming, New Mexico, and the Dakotas are also small markets, but wage levels are low, transport is relatively cheap, and land and infrastructure can be acquired for a small fraction of what it would cost in Hawaii. Companies considering entering the Hawaiian market weigh the costs against the possible benefits, and decide that invading the local market would be a poor business venture--the Hawaiian gasoline market of 23,000 b/d is comparable to a medium-sized mainland city, but requires marine facilities, terminals, and a large local administrative staff that would not be needed to expand into a mainland city.

172. Id. at 72: "In most major mainland cities there are dozens of alternate routes that a person might take to get to work, and in the course of travel they will pass numerous gas

stations. Freeway access is typically easier, and most major on-ramp/off-ramp junctures have at least one gas station, and often three or even four. Under mainland conditions, it is far easier to 'shop around,' and price comparisons seem to result in greater price competition."

173. E. Thomas Sullivan and Jeffrey L. Harrison, *Understanding Antitrust and its Economic Implications*, Legal Text Series, 2d ed. (New York, NY: Matthew Bender, 1994) at 14; see also Graham Bannock, R. E. Baxter, and Evan Davis, *The Penguin Dictionary of Economics* (London: Penguin Books, 1987) at 130.
174. AG (1990) at 10.
175. *Id.*; United States, General Accounting Office, *Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products* (Washington, DC: March 1993) at 55.
176. AG (1990) at 10.
177. *Id.* at 10-11.
178. See chapter 5 for a discussion of exchange agreements; see also AG (1990) at 11-12; AG (1994) at 4-13; Yamaguchi and Isaak (1990) at 73-75.
179. See AG (1990) at 12-13:

The oil companies have each constructed elaborate vertical networks for the distribution of gasoline to consumers in Hawaii. They give their gasoline brand names. They lease the service stations to the retail dealers. They condition the supply of their gasoline on the use of their signs, tanks, and other facilities. They arrange promotional programs providing benefits to dealers who meet sales goals. These arrangements may involve important efficiencies that reduce the cost of distributing gasoline in Hawaii.

These arrangements, however, also may have effects that lessen competition. They may exclude potential competitors. A new entrant into the market at the wholesale level would need the assurance of sufficient retail outlets to justify risking the substantial investment that entry into the Hawaii

market would require. But the branded distribution networks of the incumbent oil companies are so extensive that the likelihood of a new entrant constructing an adequate and competitive distribution system of its own seems remote at best. Aloha Petroleum has made the effort. However, it is dependent on Chevron, PRI, and the other incumbents for its supply of gasoline.

These arrangements in the Hawaii market may be yet another factor limiting aggressive price competition. Generally speaking, branding a product indicates that the product can be differentiated from similar products in a substantial way. Gasoline, however, is a relatively homogenous product. It's the price that counts. Gasoline wars are fought over prices. The vertical arrangements that make up the branded distribution systems in Hawaii, however, tend to promote price maintenance rather than aggressive interbrand price competition, especially at the wholesale level. This is because vertical distribution arrangements in a context of a high level of concentration, high entry barriers, and an inelastic demand make price wars very foolish for the industry.... Since sellers in an oligopolistic market are interdependent in their market response, aggressive price cutting would tend to cause a market-wide war. The result would be that everyone would lose--except, of course, the consumers. This may be why, at least in recent memory, there has never been a real price war over gasoline in Hawaii.

180. Id. at 13.

181. Hawaii's retail divorcement statute reads as follows:

ñ486H-10 Prohibition of manufacturer or jobber from operating a service station. (a) From July 31, 1993, to August 1, 1997, no manufacturer or jobber shall operate a major brand, secondary brand, or unbranded retail service station in Hawaii to sell its petroleum products; provided that for each dealer operated retail service station owned by a manufacturer or jobber opened on or after July 31, 1995, that manufacturer or jobber may open one company operated retail service station, up to a maximum of two company owned retail service stations.

For purposes of this subsection:

"Company operated retail service station" means a retail service station owned and operated by a manufacturer or jobber.

"Dealer operated retail service station" means a retail service station owned by a manufacturer or jobber and operated by a qualified gasoline dealer.

(b) For the purposes of this section, the term "to operate" means to engage in the business of selling motor vehicle fuel at a retail service station through any employee, commissioned agent, subsidiary company, or person managing a retail service station under a contract and on a fee arrangement with the manufacturer or jobber.

(c) This section shall not apply to any individual locations operated by any manufacturer or jobber on the effective date of this Act. Nor shall anything contained in this section prohibit a manufacturer or jobber from acquiring or constructing replacement retail service stations to replace any company-operated retail service stations in existence on July 30, 1993, that have subsequently closed due to the expiration or termination of the retail service station's ground lease; provided that:

- (1) The manufacturer or jobber shall negotiate in good faith to renew the ground lease of the retail service stations; and
- (2) The replacement retail service stations shall be located within a one-mile radius of the retail service stations that they replace.

As used in this subsection, "good faith" means an honest and sincere intention to renew the ground lease of retail service stations.

Haw. Rev. Stat. §486H-10, as amended by 1995 Haw. Sess. Laws ch. 238, §2 (effective June 29, 1995). Prior versions of Hawaii's divorce law are contained in 1991 Haw. Sess. Laws Act 295 and 1993 Haw. Sess. Laws Act 329. Copies of

these 1991, 1993, and 1995 session laws are contained in Appendices D, E, and F, respectively.

182. See 1994 Haw. Sess. Laws Act 199, §§2, 5.
183. See also 1995 Haw. Sess. Laws ch. 180, §§30 to 33 (eff. June 14, 1995) and 1995 Haw. Sess. Laws ch. 201, §5 (eff. June 19, 1995).
184. Haw. Rev. Stat. §342L-36(d) (1995).
185. Haw. Rev. Stat. §128D-2(b) (1995) (environmental response revolving fund; uses) provides that revenues generated by the environmental response tax and deposited into the environmental response revolving fund are to be used for oil spill planning, prevention, and remediation, as well as for county used oil recycling programs, and may be used to address concerns related to underground storage tanks.
186. Haw. Rev. Stat. §248-8 (1995) (special funds in treasury of State), establishes the state highway fund, the airport revenue fund, and the boating special fund as three special funds in the state treasury, and provides that all taxes collected under chapter 243 (fuel taxes) in each calendar year, except the county of Hawaii fuel tax, city and county of Honolulu fuel tax, county of Maui fuel tax, and county of Kauai fuel tax, are to be deposited in the state highway fund; provided that all taxes collected under chapter 243 with respect to gasoline or other aviation fuel sold for use in or used for airplanes is to be set aside in the airport revenue fund; and all taxes collected under chapter 243 with respect to liquid fuel sold for use in or used for small boats is required to be deposited in the boating special fund.
187. See Hawaii, Legislative Reference Bureau, The Hawaii Antitrust Act, Report No. 8 (Honolulu: 1961).
188. See text accompanying notes 60 to 71 in chapter 2 for a discussion of federal antitrust statutes; see also Haw. Rev. Stat. chapters 481 (fair trade regulations), 481A (uniform deceptive trade practices act), and 481B (unfair and deceptive practices); Lyle Harada and Randall Sing, "Note: Island Tobacco Co., Ltd. v. R. J. Reynolds Tobacco Co. [63 Haw. 289, 627 P.2d 260 (1981)]: Federal and State Views of Hawaii's Antitrust Laws," 4 U. Haw. L. Rev. 195, 195-206 (1982); Sumner LaCroix, Walter Miklius, and James Mak, "The

New Standards of Unfair Competition: An Economic Analysis of the Du Pont v. FTC Litigation," 9 U. Haw. L. Rev. 457 (Fall 1987); and Edward Kemper, "Unfair and Deceptive Acts and Practices Under Section 480-2, Hawaii Revised Statutes: Revisited," Haw. Bar J. (May 1994) at 7.

189. Haw. Rev. Stat. §56-3 (leasing of space for commercial purposes), allows the county councils to require the finance director of the county to lease space within public off-street parking facilities for use by the lessee for the sale of gasoline and petroleum products, the sale of automobile accessories, automobile repair or service, or any other garage and fueling services.
190. Haw. Rev. Stat. chapter 125C (procurement, control, distribution, and sale of petroleum products), establishes general powers and procedures during a shortage of gasoline or other petroleum products, requires the state energy resources coordinator to adopt rules establishing a petroleum products set-aside system during a shortage, and provides for the preparation of biennial state and county emergency preparedness plans.
191. Haw. Rev. Stat. chapter 437 (motor vehicle industry licensing act), provides in section 437-11(b) (additional requirements for dealer's and auction's license) that the site for the retail sale of motor vehicles may be used for related purposes, including gasoline and oil, storage, parts, and service. Chapter 437D (motor vehicle rental industry) provides in section 437D-14(f) and (g) (fuel charges) that the price per gallon or per liter which is charged for the amount of fuel required to refuel a rental vehicle may not exceed the sum of the locally prevailing retail market price for similar fuel sold at self-service gasoline pumps by commercial gasoline dealers and a reasonable surcharge not to exceed one-half of that retail price; or, if a credit is applicable, the per gallon or per liter amount which is credited may not be lower than the locally prevailing retail market price for similar fuel sold by commercial gasoline dealers.
192. Haw. Rev. Stat. chapter 486 (measurement standards), part II (sections 486-50 to 486-56), establishes standards for petroleum product accounting and inspection, including requirements for price posting by gallon for retail dispensers of gasoline in section 486-52.5, and provides for civil and criminal penalties for violations.

193. Haw. Rev. Stat. §708-832 (theft in the third degree), provides that a person commits the misdemeanor offense of theft in the third degree if the person commits theft of gasoline, diesel fuel, or other related petroleum products used as propellants of any value not exceeding \$200.

REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Chapter 4  
OPEN SUPPLY

Questions (1) and (2) of the Resolution request the views of survey participants on the following issues:

- (1) The effects of prohibiting franchise agreements from requiring franchisees to purchase all of their gasoline from the franchisor or restraining franchisees from dealing with the franchisors' competitors;
- (2) The effects of limiting the amount of gasoline franchisors require franchisees to purchase from the franchisor.

Because questions (1) and (2) of the Resolution are closely related in subject matter and raise many of the same issues, they are discussed together.

State Government

AG: The Attorney General responded to question (1) by noting that prohibiting these types of franchise agreements, while increasing competition between franchisors and competing sellers, would also increase transaction costs and decrease the value of brand names:

Franchise agreements that require franchisees to purchase their requirements from the franchisor have anticompetitive effects and procompetitive effects. The main anticompetitive effect is that such agreements foreclose the franchisee as a customer for a seller in competition with the franchisor. The main procompetitive effect is that such agreements (1) reduce transaction costs of both parties to the agreements, and (2) protect the value of the brand name of the franchisor's gasoline.

Prohibiting such agreements would increase competition between the franchisor and other competing sellers in the market. At the same time, it would increase transaction costs and decrease the value of the brand name as commercial property. 194

The Attorney General stated that question (2) would also produce mixed results:

Placing limits on the amount of gasoline an oil company or a jobber can require a service station to buy appears to be an alternative legislative measure to prohibiting requirements contracts altogether. It would "free" the retail dealer to buy a portion of the dealer's requirements elsewhere. But it would be a kind of "half" measure that would not likely offer any incentive to retail dealers to seek out other suppliers or gasoline suppliers to seek out retail dealers with "remnant" requirements. The transaction costs would likely exceed any possible benefits. However, it might be possible to minimize transaction costs. For example, the measure might authorize dealer purchasing cooperatives. 195

DBEDT: The department responded to both questions (1) and (2) by noting that this practice would not produce "any significant price effects", but that Hawaii's consumers would benefit most from the free market trade of petroleum:

[W]e strongly support free market trade of petroleum in Hawaii. For example, we believe that the Hawaii consumer can be best served by continuing to allow the competitive forces of the free market to work. Over the past few years, we have supported the Attorney General's on-going investigation of petroleum pricing in Hawaii. Nevertheless, no evidence of anti-competitive behavior was reported by the Attorney General in two separate reports on this investigation. 196

The department further noted that the United States General Accounting Office (1993) found that the wholesale and retail prices of gasoline and other petroleum products are largely determined by the market price of crude oil, and that supply arrangements and the extent of local market competition are mostly secondary price determinants. 197

#### Gasoline Dealers

HARGD: In response to question (1), the HARGD maintained that such a prohibition would lead to uncertainties over the integrity of branded gasoline, resulting in the elimination of

franchisees; moreover, the enactment of open supply legislation would ultimately result in oil companies vertically integrating downstream to capture a greater market share of their branded products:

The integrity of the branded fuel would be questionable, and would cause franchisees to be eliminated because dealers would lose the brand name, logo, credit card usage, advertising, and in all probability, rental agreements. Oil companies would not allow this with the investment they have for the purpose of promoting and selling their branded product. Existing contracts prohibit commingling. The [b]rand integrity is the cornerstone of their marketing strategy. This includes additives, credit cards, advertising, and logo, which would be lost.

If the law mandated open supply, extensive modification to lease agreements would be established to assure the dealer would sell the product as an unbranded product. This would lead to vertical integration in order to assure marketshare of the branded product. 198

In response to question (2), HARGD similarly contends that:

[s]maller stations would be required to purchase improvements provided by their oil company supplier. This would include tanks, pumps, and piping. Comingling of fuel would void contracts....

Open supply would require divestiture of assets or oil companies would take over the franchise. Complete assets (property and equipment) alignment would be necessary before an open supply system could operate. 199

#### Jobbers

HPMA: In response to question (1), the HPMA noted that restricting a franchisor's right to sell gasoline through the franchisor's own facility would discourage the building of new facilities:

You have to give consideration to the franchisor who invested capital and took the risk to build the facility to sell his product. It is only fair that he is allowed to capitalize to the fullest extent of his

investment in the franchisor's facility. If there was an opportunity for a non-franchisor supplier of gasoline to solicit the business of all the franchisor branded stations on a direct basis, the incentive to build additional service stations would be removed. Surely a manufacturer/investor would not build a facility if he thought he was not going to be able to sell products through their facility. The restriction of franchisor's rights to sell petroleum products through his own facility is not inducement to build new facilities. 200

With respect to question (2), the HPMA noted that "there is no economic benefit to limit the amount of gasoline a franchisor requires the franchisee to purchase. This limitation would reduce the potential return on investment from a franchisor, there being a disincentive to build more gasoline facilities." 201

Aloha Petroleum: With respect to question (1), Aloha Petroleum also argued that prohibiting or restricting exclusive dealing arrangements would act as a disincentive for franchisors to invest in service stations:

Gasoline franchise agreements are contractual agreements reached between the franchisor and franchisee. Both parties are given the opportunity to read the agreement, understand the terms thereof, and consult with any necessary experts prior to entering into the agreement. In most circumstances, the franchisee does not have the financial capability to independently initiate the business and must rely on the franchisor for this significant financial investment. As an inducement to the franchisor, an agreement is reached whereby the franchisee commits to dealing exclusively with and purchasing all of the franchisee's gasoline from the franchisor. Without this commitment on the part of the franchisee, the franchisor would not be motivated to make the significant financial investment or enter into an agreement with a franchisee. In most instances, it is the franchisor who is taking the greatest risk. Any attempt to prohibit or restrict this contractual agreement would serve as a disincentive for franchisors to invest in gasoline stations. 202

Regarding question (2), Aloha Petroleum stated that

establishing minimum fuel volume requirements is based on an investment analysis of each particular station, and justifies the franchisor's investment in that station:

The franchisor establishes the amount of gasoline that the franchisee is required to purchase so that the franchisor can recoup the significant financial investment that the franchisor makes. Establishing minimum fuel volume purchases allows the franchisor to achieve the financial performance levels projected for the gasoline station and justifies the investment to the franchisor. In determining the minimum fuel volume to be purchased by the franchisee, the franchisor weighs the amount of the financial investment and the volume of gasoline that the franchisor expects the gasoline station to generate. Setting minimum fuel volume requirements is based on an economic investment analysis of the circumstances surrounding that particular gasoline station. If the franchisee is unable to meet the volume limits, the franchisor must make a business decision to work with the franchisee to obtain the desired volume amounts or to find another franchisee who can achieve the established minimum fuel volume amount. 203

#### Oil Companies

Shell: Shell noted that questions (1) and (2) raise the issue of open supply, which has never been implemented and has been opposed as harmful to consumers by the Antitrust Division of the United States Department of Justice, the United States Department of Energy, the Federal Trade Commission, and the Section on Antitrust Law of the American Bar Association. Anticompetitive supply arrangements between petroleum suppliers and their franchisees can be addressed under existing antitrust laws without changing the distribution system in ways that would be detrimental to consumers. In particular, an open supply system would be detrimental to Hawaii consumers for the following reasons:

The "open supply" concept would be harmful to consumers in Hawaii because it would erode the value of suppliers' brands. This would cause suppliers to reduce their investment in retail service stations, quality control, product innovation, and ancillary services. In the long run, there would be fewer service stations, less consistent product quality and less consumer choice. The majority of gasoline

consumers in Hawaii, who have demonstrated that they prefer the consistent quality of major brands, would be either unable to obtain them or able to do so only at higher prices. None of these adverse consequences need take place for consumers to be able to buy unbranded or local-brand gasoline; those alternatives are already available. The long-run outcome of destroying the value of major brands, however, would be that unbranded gasoline of uncertain quality would in most areas be the only product available. 204

Shell further noted that a product's trademark, and the supplier's reputation that it embodies, provides a valuable source of information for consumers since suppliers (of gasoline and other products) do not provide identical products and it is impractical for consumers to evaluate product quality prior to purchase. Consumers consistently demonstrate the value of a product's trademark by their willingness to choose branded products over lower-priced unbranded alternatives. The federal Petroleum Marketing Practices Act further protects consumers' ability to rely on the supplier's trademark as the source of branded gasoline, since that Act allows for termination of a franchise for a dealer's misbranding, mislabeling, or adulteration of gasoline. 205

Shell stated that it did not require its franchisees to purchase all of their gasoline from Shell so long as provisions were made to protect Shell's trademark, prevent consumer deception, and maintain quality control. Shell further stated that it did not require its lessee dealers to purchase any particular amount of gasoline from Shell, provided that they maintained a representative quantity of each grade. Shell's agreements with those dealers who do not lease their stations from Shell include supply arrangements with minimum purchase requirements, but these dealers may enter into supply arrangements with other suppliers. "In sum, the amount of gasoline that Shell's franchisees purchase from Shell is determined by the amount that consumers are willing to buy from the franchisees." 206

Moreover, Shell argued that open supply legislation would decrease Shell's incentive to invest in product improvement:

Shell makes substantial investments to improve its products (for example, by the development of additives with unique qualities), assure stability of supply, maintain a consistent level of product quality, build

retail outlets, and identify its products to consumers through the display of its trademark at its retail outlets. If the "open supply" concept were implemented, the incentive to invest in each of these areas would be significantly diminished. 207

In addition to increasing consumer confusion, devaluing Shell's trademark, and reducing the incentive to invest, Shell maintained that an open supply mandate would result in fewer branded outlets, higher prices, and the domination of Hawaii's market by unbranded gasoline of uncertain quality: "Even though gasoline would be supplied by the same refineries, without a brand system to preserve [suppliers'] incentive to maintain a consistent level of quality throughout the distribution system, quality would likely sink to the lowest possible level. A costly state testing program might have to be established to insure that unbranded gasoline met minimum specifications." 208

BHP: With respect to questions (1) and (2), BHP noted that the franchise agreement is a legally binding contract benefiting both parties to the contract: the franchisee can use the franchisor's branded product, knowledge, marketing support, and, in some cases, assets to conduct business, while the franchisor is able to market its products while maintaining a high quality of service and establishing a recognizable standard on which consumers can rely. Both franchisors and consumers would be hurt by the loss of integrity of the franchisor's branded products:

To the extent that consumers place value in brand recognition or in the proprietary products which are exclusively offered for sale at such franchises they have the benefit of knowing that the same quality of proprietary product which they have purchased and relied on in the past can be obtained at such franchises. To allow franchisees to obtain their products from other suppliers and then market them under franchisor's brand, destroys the very basis for having such agreements in the first place.

Consumers would be negatively impacted for they can no longer rely on the brand under which such products are marketed. The product's value would be severely diminished and confidence within the market place would erode. 209

Furthermore, BHP noted, establishing brand awareness and associating it with a product class is expensive; for example,

over \$200 million was spent changing the name "Esso" to "Exxon":

[F]ranchisers expend large amounts of capital to establish and enhance brand loyalty and product awareness. The franchiser benefits by being able to sell its product and to the extent that such advertising works, the franchisee benefits by being able to sell more of that branded product. If any product is allowed to be sold under a franchiser's trademark, quality assurance could be lost and consumers would be "cheated" in not getting what they expect when buying that brand. 210

Finally, as a result of the implementation of questions (1) and (2), BHP believed that competition and business development in the State would be inhibited, consumers would be left without assurances as to whether the brand they value is in fact the brand they are purchasing, and gasoline prices would be maintained at artificial levels. 211

Chevron: With respect to question (1), Chevron noted that none of its lessee dealers in Hawaii are required to purchase all of their gasoline from Chevron, and maintained that consumers tend to avoid those outlets that sell more than one brand, finding the practice confusing:

Chevron owns 65 motor fuel retail outlets in Hawaii which it leases to Chevron dealers. (Chevron also owns and operates three company-operated Chevron motor fuel retail outlets in Hawaii.) These Chevron dealers are not required to purchase all of their gasoline from Chevron. They are only required to purchase from Chevron and continuously offer for sale all three grades of Chevron gasolines. The dealer is free to install additional pumps and tanks at his own expense to sell competitive gasolines. Chevron's dealer agreements provide that Chevron will not unreasonably withhold its consent to the installation of such additional pumps and tanks. In fact, Chevron has never withheld its consent to the installation of such additional tanks.

Chevron dealers typically do not also sell competitive gasolines because these sales are not economically attractive to dealers. Consumers do not expect to find more than one brand of gasoline at a service station - particularly a service station prominently flying the

Chevron flag. When they do so, they tend to find the situation confusing, have questions about what type of gasoline they are in fact buying, and thereafter avoid the station. The unattractiveness of such sales is demonstrated by the fact that Chevron also supplies 17 service station dealers in Hawaii who own their own stations. Each of those dealers is free at any time without cause to terminate his agreements with Chevron. These dealers are also free to sell competitive gasoline as long as they continue to offer for sale all three grades of Chevron gasolines. All of these owner dealers elect to sell all three grades of Chevron gasolines and not to offer competitive gasolines, because they have determined that it is good business to do so. 212

With respect to question (2), Chevron argued that open supply would abrogate contractual rights and lead to the destruction of brand-name marketing, ultimately resulting in poorer quality products and services for consumers:

Over the last 20 years [innumerable] bills have been introduced in state legislatures throughout the country and in the U. S. Congress which would abrogate an oil company's ability to require that all grades of its gasoline be continuously offered at service stations owned by the oil company and leased to independent dealers. This so-called "open supply" legislation can take a number of forms--usually some form of limitation that the oil company can require no more than 60% or 70% of the gasoline sold at the station be sold under its brand or that the oil company can only insist that one or two grades of its gasolines be sold under its brand. No such legislation has ever been enacted--because upon reflection it is clear that such an abrogation of normal contract rights would be bad for everyone involved--not only consumers and oil companies, but for service station dealers themselves.

Abrogating these contracts would likely lead to the destruction of brand-name marketing. Consumers could no longer be assured that, just because Chevron's flag flew over a service station, all grades of Chevron gasoline were in fact sold there. The value of the brand would be diminished and trademark identification ultimately lost.

The ... stations that Chevron owns and leases to dealers in Hawaii were built by Chevron for the sole purpose of providing an outlet for its products. If Chevron cannot assure that all of its principal products will be offered at those stations, it cannot not [sic] justify the enormous investments represented by these stations. Nor could any other supplier justify these investments. Since brand would mean little, the quality and appearance of service stations would deteriorate. There would be little incentive to spend the time and money necessary to present a uniform, clean, inviting and convenient offering to the public. What would emerge is a mish-mash of unsightly stations.

Destruction of brand-name marketing would ultimately result in poorer quality products and services. Gasoline is a product which the consumer cannot appraise by seeing, tasting or touching. A well-known brand and a responsible company are the best assurances of quality the consumer has. If brand-name marketing ends, suppliers will have no incentive to pursue research or to make better products. As a result, the quality of gasoline will sink to the lowest common denominator. Consumers would lose the option of patronizing stations where they know a determined effort is made to provide high-quality products and services. 213

#### Discussion

Questions (1) and (2) of the Resolution raise the issue of "open supply". Open supply legislation would permit retail dealers to buy gasoline from more than one supplier (i. e., from persons other than the refiners from whom they lease their stations) and sell that gasoline through the leased outlet. 214 While lessee dealers may currently buy gasoline from other suppliers, there are a number of ways that the dealer's original supplier may make it difficult for the dealer to buy gasoline from other suppliers:

Open supply would permit a dealer to buy gasoline from any supplier, and not just the supplier which owns the station and leases it to the dealer (called here the traditional supplier). The gasoline bought from the nontraditional supplier would have to be sold on an unbranded or other basis, unless the traditional

supplier permitted it to be sold under the station's brand name. According to the present law, a lessee dealer has the ability to buy gasoline from any supplier other than its traditional supplier. But the traditional supplier has a number of ways that it can circumscribe the dealer's purchases of some other supplier's gasoline. If the traditional supplier is a branded refiner, then it can require the dealer to install or use separate tanks to prevent the dealer from commingling branded and unbranded gasoline. The branded refiner can require the dealer to post signs that are conspicuous and easily understood to make sure that consumers know that they are not buying the branded refiner's product. The branded refiner can attempt to enforce minimum purchase contracts against the dealer. Thus, while there is nothing in present law that directly states a lessee dealer must buy only from its traditional supplier, there are many ways to make it extremely difficult for a dealer to buy product elsewhere. 215

Franchise agreements that require franchisees to purchase all of their gasoline exclusively from the franchisor, or restrain franchisees from dealing with the franchisor's competitors, referred to in question (1) of the Resolution, are a type of requirements contract or exclusive dealing arrangement. Exclusive dealing contracts are a form of vertical integration by contract.<sup>216</sup> Exclusive dealing is an example of open-ended contracting, i.e., one that allows the parties to reduce their risk and to account for their lack of knowledge concerning the future. Exclusive dealing arrangements may be preferable to vertical integration by ownership, which entails a heavier investment in markets in which others are already specialists and in which there may be adequate capacity, or simple contracts specifying quantity, which may be too inflexible to consider future uncertainties in the market:<sup>217</sup>

The exclusive dealing arrangement stands between the vertical merger and the individual sale as a device for facilitating distribution of a manufacturer's product to the ultimate consumer. Markets are uncertain, some much more uncertain than others. Long-term, flexible contracts can minimize the costs and risks to both parties of dealing with these uncertainties. For example, no retail gasoline dealer knows in advance precisely what its sales will be over some future period. Nor may he have anything

approaching reliable information about the status of his suppliers. Some markets are so uncertain that no reasonable investor will build an outlet unless she has advance assurance of a steady source of supply. If summer travel is brisk, the gasoline retailer needs to know that it can obtain enough gasoline, and relying on the spot market for short-notice purchases can be risky and expensive.

The refiner, by contrast, wants a steady outlet for its product. Customers become accustomed to buying a particular brand at a particular location. A customer's ability to know in advance that a particular station carries a brand he prefers makes the customer better off. The exclusive dealing arrangement gives both refiners and ultimate consumers the advantages of outright refiner ownership of retail stations, but permits the refiner to avoid the high capital costs of investing in stations. The exclusive dealing contract may also provide incentives at the retailer level. If the refiner owns its own stations, the station operator is merely an employee. The independent dealer is a businessman who usually maximizes his profits by selling as much as possible of the refiner's gasoline. 218

However, exclusive dealing has been disapproved under the "foreclosure theory": "For example, if independent gasoline retailers agree to buy all their gasoline needs from one refiner and no one else, the stations are 'foreclosed' from other gasoline refiners for the duration of their contracts."<sup>219</sup> In *Standard Oil Co. of California v. United States (Standard Stations)*,<sup>220</sup> the United States Supreme Court found these types of contracts illegal when they collectively foreclosed 6.8% of the gasoline market to refiner competitors of the defendant.<sup>221</sup> Exclusive dealing contracts may also inefficiently foreclose competition if an upstream firm has a dominant market position and there are limitations on entry into the downstream market.<sup>222</sup>

Proponents of open supply contend that this legislation would accomplish similar objectives to that of divorcement legislation, namely, that it would increase competition in the retail gasoline industry, assure the economic viability of independent service stations, and give dealers greater control over their operations.<sup>223</sup> Moreover, it is argued that dealerships offering generic gasoline could increase their sales volume of branded fuel, because the lower generic gasoline prices may attract more

customers. Increased volume sales may also lower the dealer's rent, since most major oil companies offer volume rental rebates. An open supply system may therefore result in increased availability and choice for consumers. 224

In particular, proponents maintain that open supply may increase competition by increasing the number of alternative suppliers for lessee dealers, thereby allowing dealers to shop around for the lowest prices and pass these savings on to consumers. 225 Open supply may also create pressure on branded refiners to lower their dealer tankwagon price to their lessee dealer if enough lessee dealers choose to buy gasoline from suppliers other than their traditional supplier. 226

On the other hand, opponents maintain that open supply--which is not statutorily mandated in any state 227 --would lead to the demise of the branded marketing system. Refiners lease stations to lessee dealers and rely on them to market their brand of gasoline. If refiners could not rely on their dealers to buy their gasoline, refiners would be forced to find other ways to market their gasoline, including forward integration into company stores or exclusive contractual arrangements with jobbers, which may undermine the branded dealer network. 228

Another issue is quality control. Because the policing requirements of an open supply system would be more difficult and expensive, refiners with valued brands would be able to guarantee their products' quality only if they were sold through refiner-operated stations. Refiners with highly-valued brands would most likely withdraw from the markets involved or eliminate their lessee dealer networks in these markets, since refiners would have less of an incentive to continue making large investments in their lessee dealer networks if they could not contractually guarantee the sale of their products through an efficient distribution system. 229 Consumers would also be worse off, since they may no longer be able to rely on the quality of their preferred brand of gasoline. 230

In addition, open supply may also result in a "free rider" problem. A free rider is a person who is able to take advantage of services offered by another person without paying for them. 231 If a lessee dealer sells gasoline from other suppliers at separate pumps, the unbranded sales receive benefits from the branded marketing network costs without paying for those benefits. 232 From a supplier's point of view, exclusive dealing may prevent interbrand free riding:

Free riding is an important reason why suppliers impose resale price maintenance and other vertical restraints. The free rider would otherwise take advantage of the promotional activities undertaken by another dealer of the same brand. Interbrand free riding occurs when a dealer having an ongoing supply relationship with one supplier sells a second brand at the same location and takes advantage of facilities or goodwill contributed by the supplier of the first brand. For example, when Standard licenses a new gasoline station, it may help the dealer with financing, acquisition and maintenance of equipment, certain amenities such as "free" road maps, and most importantly, the large Standard sign at the top of the station. If the dealer were permitted to pump a second brand of "equally good" discount gasoline--even if it were properly distinguished from the true Standard pumps--neither Standard nor the dealer could segregate all these facilities and amenities supplied by Standard. Invariably, part of Standard's investment would contribute to the sale of a competitor's gasoline. The solution for Standard is to force dealers to sell its gasoline exclusively. 233

Open supply also raises constitutional concerns. One potential challenge is that open supply may be an unconstitutional taking of private property in violation of the Fifth Amendment of the U. S. Constitution and Article 1, section 20 of the Hawaii Constitution. 234 In particular, the major oil companies may contend that open supply would deprive them of the use of their private property (tanks and pumps) without satisfying the public use requirement and without the payment of just compensation. 235 Another potential constitutional challenge is that open supply may create an impairment of contract in violation of Article I, section 10 of the United States Constitution, since that legislation would impose open supply as a contract condition that may be absent from present franchise contracts. 236

In addition, open supply may lead other businesses that are suffering financially to request similar relief from the Legislature, and may have a chilling effect on new industries that are contemplating entrance into the market. 237 Open supply legislation may further result in business conflicts and legal disputes arising from a refiner's liability for violation of various environmental regulations, such as those applying to gasoline vapor pressure and underground storage tank requirements, with respect to unbranded gasoline sold at the refiner's station. 238

Opponents further contend that open supply would lead to consumer confusion: "The dealer's ability to switch back and forth between different suppliers would confuse motorists and would increase the potential for consumer fraud and misrepresentation."<sup>239</sup> Refiners could also be held unfairly liable for defective gasoline that it did not supply but which was sold at its stations.<sup>240</sup> Opponents cite the lack of success of dealers selling both branded and unbranded gasoline as indicative of consumers' preference for branded gasoline.<sup>241</sup>

Finally, the United States Department of Energy (1984) noted that while open supply may enhance competition by increasing alternative suppliers for dealers, it may nevertheless be disruptive by leading "to the demise of the branded lessee dealer network as branded refiners find alternative ways to ensure downstream purchases and to maintain quality control":

Open supply may be beneficial overall if it improves the competitive process and passes along lower prices for consumers. But the costs of open supply may be quite high for a particular segment of the industry, the one that consistently seeks the most protection, and consumers. Lessee dealers usually have been the strongest supporters of open supply. This support is puzzling in light of the potentially heavy cost to the branded lessee dealer network if open supply were adopted. Consumers would be adversely affected through lack of quality assurance and the loss of branded outlets. The Department is aware of the benefits and costs of open supply. While we do not vigorously support open supply, we do not vigorously oppose it either. At best, there is little evidence, empirical or otherwise, to support findings of benefits and costs. Thus, while open supply may enhance competition, and almost certainly not decrease competition, it potentially may be disruptive, causing costly adjustment, equity, and perhaps political problems. The Department would prefer to have more information before formulating a definitive policy.<sup>242</sup>

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Endnotes 4

194. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, Department of the Attorney General, dated July 21, 1995, at 1-2.
195. Id. at 2.
196. Letter from John Tantlinger, Ed. D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated June 13, 1995, at 1.
197. Id.; see United States, General Accounting Office, Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products (Washington, DC: March 1993) (hereinafter, "GAO (1993)").
198. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated July 1, 1995, at 2.
199. Id.
200. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, dated July 7, 1995, at 2.
201. Id.
202. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., September 21, 1995, at 1.
203. Id. at 1-2.
204. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated June 30, 1995, at 1-2.
205. Id. at 2.
206. Id. at 3.
207. Id.

208. Id. at 3-4 (footnote omitted).
209. Letter to Wendell K. Kimura, Director, Legislative Reference Bureau, from Susan A. Kusunoki, Manager of State Governmental Activities, BHP Hawaii Inc., dated July 18, 1995, at 1.
210. Id. at 1-2.
211. Id. at 2.
212. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 1 (emphasis in original).
213. Id. at 1-2 (emphasis in original), citing written comments submitted by the Federal Trade Commission in 1990 in opposition to open supply legislation introduced in the State of Virginia. A copy of these comments was submitted to the Bureau as part of Chevron's "Exhibit 1" in response to the survey. That exhibit consists of a binder containing the following governmental and academic reports with respect to retail divorcement and other issues relating to the sale of gasoline:
1. March 26, 1991 editorial of Honolulu Star-Bulletin opposing S. B. 1757.
  2. Testimony of Federal Trade Commission opposition to 1990 Virginia divorcement bill.
  3. November 1988 review of divorcement legislation by the Maryland Department of Fiscal Services.
  4. Final report, the State of Competition in Gasoline Marketing, U. S. Department of Energy, January, 1981, Executive Summary.
  5. Title page of 1939 Congressional Hearing report on divorcement.
  6. "The Maryland Divorcement Experience Updated": A summary by John M. Barren and John R. Umbeck, Professors of Economics, Purdue University (1986).
  7. April 22, 1985 editorial of New York Times "Let

the Gas Wars Continue. "

8. December 1988 Report of the Arizona Legislature's Joint Study Committee on Retail Divorcement.
9. Statement of William F. Baxter, Assistant Attorney General, Antitrust Division, on federal divorcement legislation, October 21, 1981.
10. Testimony of John H. Shenenfield, Assistant Attorney General - Antitrust Division, in opposition to divorcement legislation in Virginia, January 18, 1979.
11. Barron & Umbeck, A Dubious Bill of Divorcement, January/February 1983.
12. The Effects of Refiner Divorcement on Retail Gasoline Prices in Maryland, 1979-1984, Philip E. Sorensen, Professor of Economics, Florida State University, April 1985.
13. 1991 Study of Divorcement by State of Virginia.
14. March 3, 1987 Study on Divorcement by Washington Attorney General.
15. December 1990 Study of the Retail Gasoline Market in Georgia, Philip E. Sorensen, Professor of Economics, Florida State University.

Although space limitations prevent duplication of the documents included in this exhibit, a copy of the exhibit is on file at the Legislative Reference Bureau and is available for inspection upon request.

214. A recent Massachusetts bill proposing an open supply system provides as follows:

It shall be unlawful for a supplier to, directly or indirectly, prohibit any dealer at a retail outlet it supplies from selling motor fuel which was purchased from sources other than the supplier, even if the supplier leases the underground storage and [dispensing] equipment to the dealer and such equipment is used for the storing and dispensing of motor fuel other than the supplier's branded motor

fuel....

Any service station ... that offers or dispenses motor fuel which was purchased from sources other than the supplier shall not be required to purchase more than sixty per cent of the branded product purchased in the previous calendar year.

Massachusetts House Bill No. 4490 (1993); see Massachusetts, Open Supply and Divorcement Task Force, Report Concerning House Bills H861 and H4490 Currently Before the Joint Committee on Energy (Boston: Aug. 11, 1993) at Appendix C (hereinafter, "Mass. Report (1993)").

215. United States, Department of Energy, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers (Washington, DC: March 1984) at 118 (footnote omitted) (hereinafter, "DOE (1984)").
216. See notes 1 to 20 and accompanying text in chapter 2 for a discussion of vertical integration. Specifically, an exclusive dealing arrangement is a form of interbrand distribution restraint pursuant to which a buyer promises to buy its requirements of one or more products exclusively from a particular seller. See Herbert Hovenkamp, Federal Antitrust Policy: The Law of Competition and its Practice (St. Paul, MN: West Publishing Co., 1994) at 384 and 393. Generally, a requirements contract is one in which one party agrees to purchase that party's total requirements exclusively from the other party. Black's Law Dictionary, 5th ed. (St. Paul, MN: West Publishing Co., 1979) at 294 and 1172. Requirements contracts are usually treated as exclusive dealing in antitrust analysis. Hovenkamp (1994) at 384 n. 1.
217. Hovenkamp (1994) at 388.
218. *Id.* at 386-387 (footnotes omitted). Hovenkamp also notes that exclusive dealing contracts give both parties an economic interest in productive facilities:

For example, the value of a gasoline refinery results from future sales of refined gasoline. By arranging in advance for a steady stream of such sales, the refiner essentially shares the risk of the investment with the gasoline retailers. In general, the more specialized the plant, the greater the risk will be.

If the refiner builds without this assurance, retailers can later take advantage of the refiner's sunk costs and bargain for any price sufficient to cover the variable costs of refining gasoline. As a result, the refiner unsure about future demand is likely to build a smaller refinery than it would if the demand were certain, or else not build at all....

Exclusive dealing arrangements are analyzed under section 1 of the Sherman Act, section 3 of the Clayton Act, and section 5 of the Federal Trade Commission Act. *Id.* at 384. For judicial tests for exclusive dealing, see *id.* at 384-391; *Standard Oil Co. of California v. United States*, 337 U.S. 293 (1949); and *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320 (1961), on remand, 214 F.Supp. 647 (M.D. Terr. 1963). See also Roger D. Blair and David L. Kaserman, *Law and Economics of Vertical Integration and Control* (New York, NY: Academic Press, 1983) at 171-180; and E. Thomas Sullivan and Jeffrey L. Harrison, *Understanding Antitrust and its Economic Implications*, Legal Text Series, 2d ed. (New York, NY: Matthew Bender, 1994) at 176-182.

219. Hovenkamp (1994) at 384.
220. 337 U.S. 293 (1949).
221. Hovenkamp (1994) at 384; see also notes 152 to 165 and accompanying text in chapter 16.
222. *Id.* "As long as new downstream facilities can readily be constructed, effective foreclosure is unlikely. But suppose that geographical location is critical to business survival, and two or three sites for resale locations are substantially better than alternatives. In that case, a dominant upstream firm could 'foreclose' competition--thus making entry more difficult--by entering into exclusive dealing contracts with all of the preferred downstream locations."
223. See Virginia General Assembly, Report of the Joint Subcommittee Studying Divorcement and Representative Offering for Inclusion in the Virginia Petroleum Products Franchise Act (Richmond: 1991) at 5-6 (hereinafter, "Va. Report (1991)"); see notes 60 to 65 and accompanying text in chapter 15 for arguments for and against retail divorcement laws.

224. Mass. Report (1993) at 13.

225. DOE (1984) at 119:

The major benefit of open supply is the increased ability of the lessee dealer to shop around for the lowest priced gasoline and perhaps passing on these lower prices to consumers. Lessee dealers now buy gasoline from their traditional supplier at the DTW [dealer tankwagon] price. If the lessee dealer faces vigorous price competition from other branded and unbranded outlets, the lessee dealer may find that its supplier's DTW price does not permit it to earn a reasonable profit if it tries to meet low street prices. If the lessee dealer can shop around for a better price, then the lessee dealer may have a better opportunity to meet low priced retail competition. The lessee dealer has the option of passing on the lower price to its customers, or keeping the difference between its former DTW price and the open supply price as increased profits, or some combination of the two. Thus, open supply may mean an increased ability on the part of the lessee dealer to increase its profits by competing on price or by increasing its margins.

226. Moreover, open supply "may lead to the demise of the multitiered pricing structure that now exists in the industry. If lessee dealers can buy at the unbranded rack price, it may put sufficient pressure on the traditional supplier to offer comparable prices. Thus prices may sink to the lowest offered in the marketplace, namely the unbranded rack price." *Id.*

227. See Mass. Report at vii.

228. DOE (1984) at 119:

The refiner has considerable investment in the station, and expects a reasonable return on this investment through the gasoline and other products sold at the station. In this way the refiner builds brand identity for which it can charge a premium. The refiner obtains the assurance of certainty that the lessee dealer will buy its product. The refiner places a substantial premium on this certainty. Its refinery operations are geared toward a certain

minimum volume level which are based substantially on meeting the requirements of its marketing network. If refinery operations cannot be maintained at this irreducible minimum, then refining costs escalate to an unreasonable level. Crude acquisition costs also are dependent on the irreducible minimum of refinery operations. In essence, the entire integrated structure of the company relies upon the knowledge that minimum amounts of crude will be processed by the refinery and sold through the marketing network. The efficiency of the integrated structure depends to a great extent on maintaining an optimal level of throughput through the various parts of the structure.

If this balance is disturbed, it ripples through the integrated structure of the company. If the branded refiner no longer can count on its lessee dealers to buy gasoline from it, it must find some other way to ensure that the irreducible minimum is maintained. It can do this by forward integration through company stores, or forward integration through contractual arrangement with jobbers. In other words, the value of the lessee dealer may be diminished to the point where the refiner shifts away from the lessee dealer to some alternate form of marketing. Thus the lessee dealer may be abandoned, while company stores and jobbers increase their position. Open supply, therefore, can lead to the demise of the branded lessee dealer network.

229. Philip E. Sorensen, *An Economic Analysis of the Distributor-Dealer Wholesale Gasoline Price Inversion of 1990: The Effects of Different Contractual Relations* (N. p., April 1991) at 33.

230. DOE (1984) at 120:

Another cost of open supply is decreased or more costly quality control of gasoline. One aspect of branded marketing is the refiner's knowledge that the product sold through its branded marketing network meets certain specifications. The consumer relies upon this assurance when he or she buys product from that branded refiner. The cost of quality control is now borne by the refiner. The refiner can control quality either by using its own refined product or by using some other refiner's product that it can trust

or that it can test. Thus even though a refiner often uses another refiner's product in its stations, the quality of the product can be maintained. For example, gasoline shipped through pipelines must meet certain specifications usually established industry wide. A common practice among refiners is to exchange gasoline with each other at pipeline terminals. Thus company A may be using company B's gasoline in its stations. Company A has the assurance, however, that the gasoline meets certain specifications; otherwise it could not be shipped in the pipeline. Moreover, Company A can test the gasoline on an economical basis, since it is dealing with large batch shipments. Thus quality control can be established and maintained easily throughout the branded marketing network.

With open supply, quality control become more difficult. If the lessee dealer can buy gasoline from any supplier, the traditional supplier no longer can guarantee the quality of the gasoline sold at its station. Quality control now must shift to the lessee dealer. The lessee dealer must accept the quality assurance of its new supplier, or make tests on the gasoline itself. This latter option probably is not cost effective for the lessee dealer, since the tests would be done on much smaller batches and would be more costly. Thus the lessee dealer more than likely would rely upon the quality assurances given by the new supplier. Since the traditional supplier loses control over quality, it now must worry about the value of its brand, since quality problems can have a severe effect upon its brand. Consumers may no longer be able to rely upon the quality of the product coming from particular stations or from particular brands. If this becomes a widespread problem, then the consumer is worse off, since he or she no longer can be secure in buying problem-free gasoline from particular brands. The branded marketing network is adversely affected, since the value of the brand may decrease to zero. Thus, unless quality control can be maintained with open supply, there are substantial costs to the branded network and to consumer confidence.

See also Sorensen (1991) at 33: "Unlike most other branded products, gasoline is not sold in a container or a package. Thus, it would be difficult to assure a consistent level of

quality to the consumer in the absence of restrictions on the dealer's ability to purchase supplies from the alternative sources. . . . The alternative of allowing dealers to buy any gasoline meeting certain technical specifications would provide neither the degree of consumer protection nor the incentive for product improvements of the present branded marketing system. "

231. Herbert Hovenkamp, *Antitrust*, Black Letter Series, 2d ed. (St. Paul, MN: West Publishing Co., 1993) at 181.
232. DOE (1984) at 120.
233. Hovenkamp (1994) at 387 (footnote omitted); see also Sullivan and Harrison (1994) at 150-151.
234. See also notes 25 to 39 and accompanying text in chapter 11.
235. A 1993 Massachusetts study of open supply legislation noted that Massachusetts courts may find that a taking has occurred based on the property as a whole "and the extent to which the regulation has interfered with a property owner's investment-based expectations." *Mass. Report* (1993) at 23, citing *Steinbergh v. Cambridge*, 413 Mass. 736, 742 (1992). That study noted the following costs in determining the investment-based expectations of tank owners:

A major oil company is in the business of selling gasoline. It invests approximately \$70,000 per tank, including installation. Though tanks may be purchased for less (about \$55,000) the majority will install state of the art, double-lined tanks because of liability concerns. . . . Moreover, the tank that is debranded is the one containing regular unleaded gasoline. The majority of gasoline sold by a major is regular unleaded (approximately 65%). Therefore, the owner's tank which is the most profitable will be lost. A very strong argument can be made that loss of this tank, based on the result[ant] economic impact, would affect the owner's investment-based expectations in a substantial way. Further, the owner also invests \$35,000 for a multi-pump dispenser (MPD) which would be utilized to dispense the generic gasoline. The opposing argument would be that the owner is receiving monthly rental payments, along with the sale of two grades of gasoline, and thus, the regulation has not interfered to the extent that a taking results. *Id.*

236. Mass. Report (1993) at 24-28; see also Anthony v. Kualoa Ranch, Inc., 69 Haw. 112 (1987).

237. Mass. Report (1993) at vii.

238. Va. Report (1991) at 7.

239. Id. at 8.

240. Id.

241. Sorensen (1991) at 34:

It should be recognized that most consumers in the U.S. presently have the option of buying "open supply" gasoline from numerous unbranded marketers who sell product obtained from whatever low-priced sources are available on the market. The fact that unbranded gasoline has not gained a majority share of the market is an indication of the preference of most consumers for the guarantee of quality offered by branded marketers.

Dealers who have experimented with dual brands or with branded/unbranded combinations have not been successful, probably for the reason that consumers do not want to buy gasoline in a situation in which there is confusion about the identity or integrity of the product. In addition, thousands of open or contract dealers (who own their own stations and could buy gasoline from anyone in the market) choose instead to sign supply agreements with a single refiner under a branded marketing system. These facts provide strong evidence against the presumed advantages of open supply to dealers.

242. DOE (1984) at 120.

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Chapter 5  
EXCHANGE AGREEMENTS

Question (3) of the Resolution requests the views of survey participants on the following:

(3) The effects of prohibiting gasoline allotment under exchange agreements on the basis of historical market share.

State Government

AG: The Attorney General reiterated its concern noted in its earlier investigation of gasoline prices in Hawaii that the incumbent oil companies in the State use exchange agreements to allocate gasoline manufactured in Hawaii among themselves according to their historic market shares.<sup>243</sup> The Attorney General stated that "[i]t is the Department's view that prohibiting the practice would tend to increase competition at the distributor level." However, drafting enforceable legislation could be met with a potential commerce clause<sup>244</sup> challenge:

The problem is crafting a bill that would be enforceable as a practical matter. One possibility is to prohibit altogether the use of exchange agreements covering petroleum products manufactured in Hawaii. But such a measure might offend the Commerce Clause. The Commerce Clause problem might be overcome by limiting the prohibition to the use of such agreements when the effect may be substantially to lessen competition or to tend to create a monopoly in any line of commerce in any section of the State. The preventive impact of such a measure might be increased by making its violation subject to the criminal penalties in Hawaii Revised Statutes (HRS) §480-16.<sup>245</sup>

DBEDT: The department noted that exchange agreements are used by the petroleum industry primarily for the purpose of efficiency:

It is our understanding that exchange agreements are

used by the petroleum industry primarily for the purpose of efficiently serving the markets of the companies involved in the exchange agreement. For example, instead of Company A paying cash to Company B for X number of barrels of gasoline to be delivered here in Honolulu, Company A may deliver the same number of barrels from it's California refinery to a San Francisco terminal owned by Company B. So, while not a direct response to the question, understanding the principle of exchange agreements as an efficiency mechanism in the market seems to argue against any restrictions of these arrangements between petroleum suppliers. . . . 246

#### Gasoline Dealers

HARGD: HARGD stated that more research needs to be conducted into the nature of exchange agreements:

Since so little is known about how exchange agreements work, we can not answer this question with any authority. Questions should include: What is exchanged for what, where, when, why, and how. Only then can a better understanding of how exchanges work and what effect they have, can be realized. The exchange agreement is at the manufacturing/wholesale level. Retailers are one or two conjectural steps away. A key question is who will gain or maintain the highest level of control? (i.e. supply, price & distribution.) 247

#### Jobbers

HPMA: HPMA expressed its concern that eliminating exchange agreements would ultimately have an anti-competitive effect by driving major oil companies without refineries in Hawaii from Hawaii's market, and would increase exposure to environmental risks:

An exchange agreement is very important for the Hawaii market. It allows a non-Hawaiian refiner, for example: Texaco, Unocal and Shell, to act as a refiner in the Hawaiian market. Hawaii is obviously not a large enough market to have more than two refiners and it is probably questionable whether two refiners are needed in the Hawaiian market. Without the exchange agreement which allows the non-Hawaiian refiner to

purchase product from the local refiner at LA price plus a location differential (which is usually the cost of transporting the product from California to Hawaii), this market could become a duopoly. If exchange agreements were eliminated, some of the non-refiner majors would seriously consider withdrawing from this market. There is also the continued environmental exposure of these companies shipping finished product into the Hawaiian market. The more shipments over the shipping lanes of finished product represent the greatest potential of an environmental catastrophe. Therefore, shipping only crude oil product to Hawaii, and manufacturing it and consuming it in the Hawaiian market is the optimum use of the local refineries. We must remember the refineries are entitled to make a profit. 248

Aloha Petroleum: Aloha Petroleum stated that it was "unsure of the direction of this question": "If the question is addressing a situation where gasoline allotment is being determined based on historical market share, this is not practical and is indeed an unrecommended proposition. To restrict gallonage allotment to historical market share would be to prohibit future growth, would lead to higher gasoline prices to the consumer and ultimately to fewer retail fuel locations in Hawaii." 249

#### Oil Companies

Shell: "Shell does not have, nor does it require, such provisions in any of its exchange agreements relating to Hawaii." 250

BHP: "BHP does not negotiate its supply agreements based on historical market share. Contract volumes are based on the amount which buyers wish to purchase and the amount which the seller is able to provide." 251

Chevron: Chevron similarly noted that it does not enter into exchange agreements on the basis of historical market share:

Chevron has never, and would never, enter into any agreement calling for allocation on this basis. All of Chevron's exchange agreements in the U.S. provide that, if Chevron is unable because of circumstances beyond its control to meet all of its supply commitments, it will allocate available supplies on a fair and

reasonable basis. On the rare occasions when this has occurred, Chevron has allocated (as we believe is customary in the industry) by delivering a percentage of actual deliveries during some prior "base period" when there was no unusual interruption in supplies. 252

#### Discussion

"Exchange agreements" may be one of two principal types. In the first kind, a simple "distribution swap", two or more companies agree to deliver products on each other's behalf, usually to lower transportation costs. 253 Shell, Texaco, and Unocal, which do not refine gasoline in Hawaii, obtain their gasoline from Hawaii's two refiners--BHP and Chevron--under exchange agreements. For example, a hypothetical exchange agreement would permit Shell to obtain gasoline from Chevron in exchange for providing Chevron the gasoline it needs in areas in which Chevron does not refine gasoline, but Shell does. Any differences in quantity are paid at a price negotiated by the parties at the termination of the contract. 254 The second type of exchange agreement involves swaps of one kind of product for a different product, or several types of products for several others, at different locations. These types of exchange agreements make reference to price, usually some external market price, to protect the parties, since different products have different prices and the markets for these products may fluctuate independently. 255

Question (3) of the Resolution asks for data and views of the survey participants concerning the effects of prohibiting gasoline allotment under exchange agreements "on the basis of historical market share." The inclusion of the quoted language, unfortunately, allows for a range of responses. Several respondents took a more narrow reading by focusing on historical market share (Shell and BHP, e.g.), while others reviewed the broader effects of prohibiting exchange agreements generally (AG, HPMA). It is unclear whether the Resolution intended to focus on the narrower or broader issue.

The Legislature already has the benefit of the Attorney General's 1994 study on gasoline prices in Hawaii, which included an extensive review of the pro- and anti-competitive effects of exchange agreements in Hawaii's petroleum market, together with its own analysis, a review of that analysis by the Bureau of Competition of the Federal Trade Commission (which found exchange agreements to be pro-competitive), and the Attorney General's review of the FTC's analysis. 256 As noted earlier, the Attorney

General maintained that exchange agreements lessen competition in Hawaii's gasoline markets. 257

For the purposes of this Resolution, the overriding question is whether Hawaii's consumers would benefit from the prohibition of exchange agreements in the form of lower prices at the gasoline pump. 258 The Attorney General engaged a professional economist to determine whether the incumbent oil companies in Hawaii were earning profits in excess of competitive levels. The Attorney General argued that if profits were excessive, they should attract competitive gasoline from the mainland, in which case the FTC's conclusion that exchange agreements are pro-competitive should be rejected. If, on the other hand, the incumbent oil companies were not earning excessive profits, low-priced mainland gasoline would not enter Hawaiian markets unless the prospect of profits in Hawaii exceeded profits from available investment opportunities elsewhere, nor would non-refiner incumbents be willing to bring their own gasoline to Hawaii rather than buying it from one of the incumbent refiners. In that case, the Attorney General stated its inclination to accept the conclusion of the FTC that exchange agreements are generally pro-competitive. 259

The economist engaged by the Attorney General found that, based on several assumptions outlined in the Attorney General's study, the incumbent oil companies were not earning excessive rates of return in Hawaii through 1992. The economist, however, noted that the average refined product cost in Hawaii would be "significantly less" if petroleum products were imported into Hawaii from Los Angeles, even taking into account transportation costs. However, if gasoline were in fact brought into the State from the mainland, Hawaii's refineries would probably not be able to match the lower price, leading to their closure. 260 Thus, while Hawaii's oil companies were not earning excessive rates of returns, the large difference between Hawaii's high wholesale gasoline prices and the mainland's low-priced wholesale gasoline should nevertheless result in more mainland competitors entering Hawaii's gasoline market. The Attorney General concluded that the reason that non-incumbent mainland gasoline is not reaching Hawaii is either that the business risks are excessive or the incumbents are blocking its entry; and, if the latter, the incumbents must be doing so to protect their investments in Hawaii: 261

[T]he 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.

Yamaguchi and Isaak (1990) would apparently argue for the former explanation, i. e., that the risks of doing business in Hawaii simply do not justify the entry of non-incumbent competitors. Except for those companies which had the foresight to establish themselves in Hawaii's market when land values and construction costs were lower, barriers to Hawaii's markets are sufficiently high, and the prospect of making profits sufficiently low, as to discourage all but the most intrepid--or foolhardy--competitors from taking a chance in Hawaii's petroleum market: 262

[T]here are limited incentives for new oil companies to

enter the Hawaiian market. A number of the mainland majors have investigated the possibility of moving into the Hawaiian market and decided that it didn't make financial sense. Although sales prices are higher here, the cost of doing business is so much higher that the potential for profits is not at all obvious. Chevron and PRI do reasonably well on their business operations in Hawaii, but they are both companies that have been established here for decades, and they acquired most of their facilities and land when Hawaiian real estate and construction costs were much lower. Both companies believed in the growth potential of the Hawaiian economy, and both are now making profits for having the foresight to establish themselves in a market that most companies viewed as being far too small to bother with.

Oil companies are certainly not charities. Because oil is a high cash-flow business, companies tend to push quickly into any market where potential profits are large. The simple fact that additional companies are not pressing into the Hawaiian market is one of the strongest indicators that "excess profitability" is not a feature of the market--though this is not to say that Chevron and PRI have not made handsome profits in Hawaii.

Yamaguchi and Isaak noted that exchange agreements are an obvious place to look for collusive behavior, since they involve competing companies agreeing to structure certain features of their supply arrangements.<sup>263</sup> Nevertheless, while under some circumstances exchange agreements may be used to exclude other competitors from the market, they maintained that exchange agreements do not lead to price-fixing, but instead make collusion on price more difficult.<sup>264</sup> They concluded that while there exist many entry barriers to Hawaii's gasoline market, "[t]o date, however, we have not seen clear evidence that these barriers are the result of anything but the economic geography of the islands."<sup>265</sup>

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243. See Hawaii, Department of the Attorney General, The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices (Honolulu: 1994) (hereinafter, "AG (1994)") at 5-6.
244. See U.S. Const., art. I, ñ8, cl. 3, giving Congress exclusive powers over interstate commerce.
245. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, Department of the Attorney General, dated July 21, 1995, at 2.
246. Letter from John Tantlinger, Ed.D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated June 13, 1995, at 2.
247. Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated July 1, 1995, at 3.
248. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, dated July 7, 1995, at 2.
249. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., September 21, 1995, at 2.
250. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated June 30, 1995, at 4.
251. Letter to Wendell K. Kimura, Director, Legislative Reference Bureau, from Susan A. Kusunoki, Manager of State Governmental Activities, BHP Hawaii Inc., dated July 18, 1995, at 2.
252. Letter from J. W. McElroy, Regional Manager, Chevron U.S.A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 3.
253. Nancy D. Yamaguchi and David T. Isaak, Hawaii and the World Oil Market: An Overview for Citizens and Policymakers (Honolulu: East-West Center Energy Program, Aug. 1990) at 73-74.

254. AG (1994) at 4-5; Hawaii, Department of the Attorney General, An Investigation of Gasoline Prices in Hawaii: A Preliminary Report (Honolulu: Sept. 1990) (hereinafter, "AG (1990)") at 11.
255. Yamaguchi and Isaak (1990) at 74. This type of exchange agreement may be viewed as similar to reciprocal dealing, that is, "the sale or lease of a product on the condition that the seller purchase a different product from the buyer." Herbert Hovenkamp, Federal Antitrust Policy: The Law of Competition and its Practice (St. Paul, MN: West Publishing Co., 1994) at 381. While reciprocal dealing is often viewed as similar to tie-ins under antitrust law, reciprocal dealing may promote efficiency when entered into voluntarily rather than as the result of coercion. *Id.* at 381-384; E. Thomas Sullivan and Jeffrey L. Harrison, Understanding Antitrust and its Economic Implications, Legal Text Series, 2d ed. (New York, NY: Matthew Bender, 1994) at 201.
256. See AG (1994) at 4-13; see also AG (1990) at 11-12. This section briefly summarizes a portion of the Attorney General's analysis. Readers are referred to the original text of the Attorney General's 1994 interim report for a more extensive discussion of these issues.
257. AG (1994) at 9.
258. See also *id.* at 12:

The question is whether prohibiting exchange agreements in Hawaii will lower Hawaii's gasoline prices. If exchange agreements were not used in Hawaii, the cost of wholesale gasoline refined in Hawaii to the non-refiner 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.

259. *Id.* at 11-14.
260. *Id.* at 14.

261. Id. at 16-17.

262. Yamaguchi and Isaak (1990) at 71-72.

263. Id. at 73.

264. See id. at 74-75:

We do not feel that exchange agreements lead to price-fixing. In the case of simple product swaps, price does not enter into the discussion. In the case of more complex exchange agreements, the prices are almost always assessed against some external market price which neither party to the agreement plays a role in setting. This is done for simple protection; neither party would be willing to expose themselves to [market] prices that the other party could influence. Most exchange agreements are linked to prices that anyone would agree are true "free-market" prices.

Exchange agreements do not, in our opinion, lead to collusion on price; indeed, they tend to make this type of collusion more difficult.

265. Id. at 75.

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Chapter 6  
RETAIL GASOLINE PRICES

Question (4) of the Resolution requests the views of the survey participants concerning the following:

- (4) Measures to ensure the lowest retail gasoline prices for the consumer in the short and long-term.

State Government

AG: The most effective measure to ensure low prices, according to the Attorney General, is to maximize competition:

It is the Department's view that the most effective method of minimizing retail gasoline prices is to maximize competition in Hawaii. Any measure that (1) increases the costs of sellers at any level in the petroleum market, (2) decreases the supply of gasoline that a seller may sell in any market in Hawaii or that a buyer may buy in any market, or regulates the import or export of petroleum product into or export from any market in Hawaii, or (3) regulates the price of petroleum product in any market in Hawaii is very likely to be anticompetitive. 266

DBEDT: The department reiterated its support of free-market trade of petroleum products, and also supported funding the PUC:

[W]e believe that the Hawaii consumer can best be served by continuing to allow the competitive forces of the free market to work. Also, we support the Public Utilities Commission's (PUC) monitoring the oil industry as it was empowered to do by the Legislature in 1991 (Chapter 486I, HRS), although to our knowledge, it has yet to be provided the resources required to implement this authority. Nevertheless, acknowledging the importance of the Attorney General's investigation and the PUC's monitoring of petroleum industry data, the essence of our response is to allow the free market to continue to determine gasoline prices both in the near and long-term. 267

## Gasoline Dealers

HARGD: The Association recommended increased regulation of the petroleum industry in the following four points:

- a) Prohibit vertical integration. Profits at the retail level are at minimum levels and continue to deteriorate. Who is causing the margin squeeze and why will provide the key to the short term pricing and long term stability of price. The marketing scheme that involves the dealer does create the truest level of competition and limit direct control of the retail market place by a few major players. If the major oil manufacturers and direct suppliers secure complete control, long term impact on prices would be at the hands of a few very powerful players.
- b) Requiring all gasoline to be nonbranded products, thus establishing generic gasoline would reduce price.
- c) Regulating the marketplace similar to a utility would control prices.
- d) Establishing wholesale price level available to all would provide lower short and long term pricing. 268

## Jobbers

HPMA: The HPMA recommended maintenance of an adequate supply of petroleum products, maximization of competition, and decreased regulation to ensure the lowest retail gasoline prices:

The best way to have the best price for the consumer is to have competition and adequate supply in the market place. The best way to have competition is to have competitors. By restricting competition through legislation and price control, it will limit the competitor and ultimately the consumer. Regulating competition usually limits competition and hurts the consumer. OPEC tried to control competition and failed. Nixon tried to control prices and this also failed. Once petroleum prices were decontrolled (January 1981), the street price went down. This was a function of adequate supply and competition. 269

Aloha Petroleum: Aloha Petroleum also believed that a competitive market would help to ensure the lowest gasoline prices, while such legislative measures as retail and vertical divorcement serve to restrict competition:

A competitive marketplace is the best way to ensure the lowest retail gasoline price for consumers for both short-term and long-term. Competition is healthy. Legislation such as the moratorium which has been in existence for the last four years and is now going to continue for another two years and the concept of [divestiture] only serve to restrict competition instead of enhancing it. Such legislation protects a few large, branded dealers at the expense of the consumer. In other states where similar legislation has been enacted, divorcement and/or divestiture legislation has been implemented to restrict refiners from owning and operating retail gasoline facilities. Jobbers have been excluded from such legislation. Jobbers serve a crucial role in the petroleum market. Historically, jobbers have priced their gasoline slightly below the price offered by the major refiners. Many jobbers do not have major oil company brand name recognition at their retail locations. Keeping retail prices slightly lower than the majors has enabled jobbers to survive in the marketplace and maintain a competitive edge which benefits the consumer. The retail prices offered by Aloha in Hawaii are a reflection of this trend. Including jobbers in legislation such as the moratorium does not benefit the consumer and does not promote lower gasoline prices for either the short-term or long-term. 270

#### Oil Companies

Shell: The key is to reduce government regulation to encourage a freely competitive market:

The primary forces that affect retail gasoline prices are the supply of gasoline, consumers' demand for gasoline, state and federal taxes and the costs of regulatory compliance. Any governmental action that reduced the incentive to supply gasoline, or increased the cost of supplying gasoline, would be likely to increase retail prices.

Encumbering industry participants with increased

regulatory costs, as suggested in Question 7, would be likely to result in higher retail gasoline prices for consumers. "Open supply" measures such as those addressed in Questions 1 and 2 would reduce the supply, and therefore increase the price, of branded gasoline. In an industry that does not exhibit market imperfections requiring economic regulation, a freely competitive market will result in the lowest prices for consumers. 271

BHP: BHP noted the GAO's (1993) finding that, under normal market conditions and in the short run, retail gasoline prices are "influenced essentially by the extent of competition within a local market." 272 However, according to BHP, in the long run, retailers must maintain a sufficient level of profitability and recover costs relating to business operations in order to stay in business. Promoting competition--in part by maintaining an environment that addresses the needs of businesses--may help keep gasoline prices low:

The price of gasoline, like all commodities sold in Hawaii is determined by market size, economies of scale, unrecoverable capital costs, the cost of the crude oil, manufacture's costs, environmental restrictions, land costs and government taxes.

While there are no guarantees to insure the consumer will always receive the lowest price for gasoline, a competitive open market usually allows for lower prices to the consumer. If the state wishes to promote competition, it should look to supporting increased cost-efficiency and cost-effectiveness for businesses by creating an environment which appropriately addresses the common concerns of all businesses. 273

Hawaii's high costs of land, insurance, and skilled labor, as well as high entry barriers and state and local taxes, all contribute to the increased cost of running a business in the State, which are ultimately borne by consumers. 274

Chevron: Chevron similarly argued against government regulation to maintain the lowest gasoline prices:

Chevron believes, and believes that the evidence is uncontrovertible, that leaving prices to be set in the marketplace without government intervention is what leads to the lowest retail gasoline prices for the

consumer in both the short and the long-term.

Exhibit 2 charts retail gasoline prices in the U.S. from 1960 to the present in current dollars. It demonstrates that true gasoline prices are at an all-time low. The point is that the market works and works well. The only aberration is during the period of the 1970's when federal price controls were in effect. As can be seen from the attached chart, during controls consumers paid far higher prices than under free market conditions. 275

#### Discussion

Question (4) of the Resolution encompasses many of the issues discussed elsewhere in this report, including gasoline retail marketing, vertical integration, oligopolies, entry barriers, and other factors impacting on gasoline pricing in Hawaii that were reviewed in chapters 2 and 3. However, as reflected in the responses from the survey participants, the debate over the most effective means of ensuring the lowest retail gasoline prices for Hawaii's consumers centers around the issues of competition and government regulation. The participants representing state government agencies, jobbers, and oil companies generally maintained that in order to maintain low retail gasoline prices, a freely competitive market is essential; and that government regulations, including price controls, divestiture, retail divorcement, and open supply, limit competition and hurt consumers. Only the association representing Hawaii's gasoline dealers maintained that increased regulation was necessary to ensure low gasoline prices, specifically by prohibiting vertical integration, eliminating name-brand marketing, regulating the oil industry as a public utility, and establishing uniform wholesale price levels.

As discussed in chapter 2, the United States General Accounting Office stated that in general, wholesale and retail prices of gasoline and other refined petroleum products are based largely on crude oil prices, and that domestic prices for oil have been linked to world oil prices since their decontrol by late 1981. Retail gasoline prices are influenced by the relative stability of demand for petroleum products and the extent of local competition, in addition to seasonal demand. 276 As noted by BHP, the GAO further found that under normal market conditions and in the short run, retail gasoline prices are "influenced essentially by the extent of competition within a local market." 277

Is there workable competition in Hawaii's gasoline markets? It depends on whom you ask. Gasoline dealers generally maintain that there is insufficient competition, and that market defects justify government intervention. Jobbers and the major oil companies argue just the opposite--that regulation is unnecessary because Hawaii's gasoline markets are competitive. The Attorney General's position lies somewhere in between. While maintaining that there is a lack of effective price competition, partly due to oligopolistic pricing and the use of exchange agreements,<sup>278</sup> the Attorney General considers Hawaii's gasoline markets at the retail level to be "relatively competitive." Nevertheless, the Attorney General does not consider competition at the retail level to be of much assistance to consumers "because the retail margins generally are too narrow to permit price reductions sufficient to overcome consumer preferences for a particular brand, grade, or dealer."<sup>279</sup> Moreover, although retail gasoline prices are higher in Hawaii than on the U. S. mainland,<sup>280</sup> Hawaii's incumbent oil companies have not been earning profits in excess of competitive levels, at least through 1992.<sup>281</sup> In addition, a 1990 East-West Center report noted that no anticompetitive practices in Hawaii's oil industry have been proven,<sup>282</sup> and a 1993 University of Hawaii study found no evidence of predatory pricing in the State's retail gasoline markets.<sup>283</sup>

In addition to the question of whether there is sufficient economic justification for intervention, several other policy issues must be resolved by state lawmakers before imposing regulations on Hawaii's oil industry. These include such questions as whether regulation will lead to better market performance than that which would prevail without regulation, whether the costs of regulation outweigh the benefits, and whether there are public policy instruments that will achieve the intended results more effectively than regulation.<sup>284</sup> Justifications for government intervention in Hawaii's gasoline markets and related policy issues requiring legislative determination are discussed in chapter 16.

Question (4) also makes the tacit assumption that lower gasoline prices are beneficial to Hawaii's consumers. Some question whether this is necessarily the case. Yamaguchi and Isaak (1990) noted that while gasoline prices in Hawaii are among the highest in the nation, "considered from a broader perspective, even Hawaii ... [has] extremely low gasoline prices ... some of the lowest found outside OPEC."<sup>285</sup> They further observed that within the Organization for Economic Cooperation and Development (OECD) countries, the next lowest gasoline prices after the United States were in Canada and Australia, although even these prices

were nearly double the U. S. average, and average European prices are approximately triple those of U. S. prices: 286

A great deal of the difference in prices between the US and the rest of the OECD can be explained by taxes, but the US also has the advantage of a large and efficient refining and distribution system that keeps prices--even Hawaiian prices--lower than elsewhere. From the standpoint of national security and economic stability, our OECD allies have criticized the US for years for keeping oil prices too low. As oil prices began to decline in the mid-1980s, many nations kept prices artificially high by gradually increasing taxes.

Moreover, Yamaguchi and Isaak contend that lower fuel prices encourage overdependence on oil and remove incentives to conserve energy and develop alternative energy sources.<sup>287</sup> Thus, as a policy matter (and counter to the assumptions of House Resolution No. 174, H. D. 2), ensuring the lowest retail gasoline prices may not necessarily be in the long-term best interests of Hawaii's consumers:

Letting fuel prices collapse has removed the incentives for car pooling, mass transit, and energy conservation. The United States is recognized as one of the world's most wasteful nations; demand-side management (DSM) strategies clearly should play a large role in our national energy policy, but much of the momentum for DSM has flagged during the 1980s. It has been clear to most analysts that the low prices would not last, and that the 1990s would see major increases in price; but the signals to the consumers at the pump have been all wrong. If the prices experienced in the early 1980s had persisted, it is likely that Hawaii would now have an effective mass transit system, rather than finding itself discussing one as the prices skyrocket.

Low prices encourage overdependence on oil, and, for the US, that means overdependence on imported oil. The US economy is dangerously dependent on low oil prices; even though countries like Japan are reliant on imports for all of their oil supplies, the higher prices of oil in Japan have encouraged Japanese companies to use oil efficiently. Many countries that are more reliant on imports than the US are far better prepared to meet the economic effects of an oil

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266. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, Department of the Attorney General, dated July 21, 1995, at 2-3.
267. Letter from John Tantlinger, Ed. D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated June 13, 1995, at 2.
268. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated July 1, 1995, at 3.
269. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, dated July 7, 1995, at 2-3.
270. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., dated September 21, 1995, at 2-3 (emphasis in original).
271. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated June 30, 1995, at 4-5.
272. United States, General Accounting Office, Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products (Washington, DC: March 1993) (hereinafter, "GAO (1993)") at 55.
273. Letter to Wendell K. Kimura, Director, Legislative Reference Bureau, from Susan A. Kusunoki, Manager of State Governmental Activities, BHP Hawaii Inc., dated July 18, 1995, at 1-2.
274. Id. at 3.
275. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A.

Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 3. Chevron's Exhibit 2 is appended to this report in Appendix K.

276. GAO (1993) at 4.

277. Id. at 55.

278. See generally Hawaii, Department of the Attorney General, The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices (Honolulu: 1994) (hereinafter, "AG (1994)") at i, 2-13; Hawaii, Department of the Attorney General, An Investigation of Gasoline Prices in Hawaii: A Preliminary Report (Honolulu: September 1990) (hereinafter, "AG (1990)") at 7-13.

279. AG (1994) at 16.

280. For example, a recent survey of gasoline prices in Honolulu found the lowest self-service cash price for regular unleaded gasoline to be \$1.499 per gallon, while the national average price for regular unleaded gasoline was \$1.178 per gallon. "Prices at the Pump", Honolulu Star-Bulletin, September 5, 1995, at D-1. Honolulu stations surveyed were in the general area bordered by King, McCully, Beretania, and Pensacola Streets, and one on Queen Street.

281. AG (1994) at 13.

282. Nancy D. Yamaguchi and David T. Isaak, Hawaii and the World Oil Market: An Overview for Citizens and Policymakers (Honolulu: East-West Center Energy Program, August 1990) at 82: "Whether or not there are any anticompetitive practices in the Hawaii oil industry, (and, as we have noted earlier, none have been proven), the importance to government in monitoring the situation has been undervalued." The Department of Business, Economic Development, and Tourism has also noted that "no evidence of anticompetitive behavior was reported by the Attorney General in two separate reports on this investigation" of petroleum pricing in Hawaii. Letter from John Tantlinger, Ed. D., Energy Planner, Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Acting Director, Legislative Reference Bureau, dated June 13, 1995, at 1.

283. See Walter Miklius and Sumner J. LaCroix, Divorcement Legislation and the Impact on Gasoline Retailing in the

United States and Hawaii (Honolulu: University of Hawaii, January 20, 1993) at 7; see also chapter 15 for a discussion of predatory pricing.

284. Alan Stone, *Regulation and its Alternatives* (Washington, DC: Congressional Quarterly Press, 1982) at 55-59.
285. Nancy D. Yamaguchi and David T. Isaak, *Hawaii and the World Oil Market: An Overview for Citizens and Policymakers* (Honolulu: East-West Center Energy Program, Aug. 1990) at 56.
286. See *id.* at 58.
287. See notes 47 to 60 and accompanying text in chapter 16 for a discussion of energy policy issues.
288. Yamaguchi and Isaak (1990) at 59. The imposition of motor fuel taxes and other legislative measures to reduce gasoline consumption is discussed further in chapter 16.

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Chapter 7  
PRICE INVERSIONS

Question (5) of the Resolution requests the views of survey participants on the following issue:

(5) Whether price inversion has occurred or is currently occurring in the distribution of gasoline in Hawaii.

State Government

AG: The department stated that it had no data on price inversions in Hawaii, but offered the following definition:

The term "price inversion" refers to a distortion of the pricing structure in a market where the manufacturer distributes its product to the retail consumer by direct sales and also through an intermediate independent distributor. When the manufacturer's price at retail is lower than the manufacturer's price to the independent distributor, the event is called a "price inversion." Price inversions are not necessarily anticompetitive. See, e.g., *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990). 289

DBEDT: "We are unaware of this occurring in Hawaii's gasoline market, but refer you again to the reports of the Attorney General." 290

Gasoline Dealers

HARGD: "We do not understand the question[.]. Is the question of price in the distribution of gasoline directed at the wholesale transaction? What is inversion of price? Do you mean selling below cost, offering better prices at company operated stations or at the jobber price level?" 291

Jobbers

HPMA: "Not certain if price inversion has occurred in Hawaii."292

Aloha Petroleum: Aloha Petroleum believed that price inversion is not occurring on the retail level:

Assuming the price referred to in this question is retail pricing, it is our belief that price inversion for the sale of gasoline to the public is not currently occurring on the retail level. However, in the past, price inversion has occurred resulting from worldwide catastrophes, such as the Exxon Valdez incident and the Gulf War. It is during times like these when jobbers such as Aloha, who must rely solely on supply contracts, are impacted by the uniqueness of Hawaii's location and restricted petroleum resources. 293

#### Oil Companies

Shell: "Price inversion, as Shell understands the term, refers to unusual and temporary circumstances in which the price to jobbers at a supplier's terminal is higher than the delivered price to the supplier's dealers. Shell has not experienced these circumstances in Hawaii."294

BHP: "Price inversion has not and is not occurring in BHP's distribution of gasoline in Hawaii."295

Chevron: According to Chevron, price inversions--temporary market phenomena occurring in volatile markets--have not occurred in Hawaii:

Chevron distributes gasoline in a number of ways. Primarily it sells gasoline to independent dealers who operate service stations and in turn sell gasoline to motorists. Chevron also sells to distributors (usually called jobbers in the industry) who in turn sell to retailers (usually in more outlying as opposed to metropolitan areas) and to large commercial and industrial consumers. (Chevron also sells gasoline directly to motorists in Hawaii through 3 company-operated stations.)

Typically, Chevron's price to distributors is less than its price to dealers. But the price at each level of distribution is set by competition. In volatile markets characterized by very rapid increases in

prices--such as the conditions which followed Iraq's invasion of Kuwait in 1990--distributor prices sometimes rise more rapidly than do dealer prices and the normal price relationship may flip-flop or "invert."

Such a "price inversion" is a temporary market phenomenon caused by different supply/demand forces in each market. When such "price inversions" occur they are typically of short duration while the market adjusts to the new circumstances. To the best of Chevron's knowledge, such "price inversions" have never occurred in Hawaii. 296

#### Discussion

There is insufficient information available to conclude whether a price inversion has occurred or is presently occurring in the distribution of gasoline in Hawaii. The following discussion focuses on price inversions generally, including arguments for and against government intervention to prevent or in response to price inversions.

As noted by the Attorney General, a "price inversion" is said to occur when the manufacturer's price at retail is lower than the manufacturer's price to independent distributors. During a price inversion, the usual pricing relationship between the three different wholesale gasoline markets--the spot market, the rack market, and the dealer tankwagon (DTW) market--becomes distorted. 297 Under normal market conditions, spot market prices, which are the most volatile, are lower than rack prices, which in turn are lower than DTW prices, which are generally the most stable. However, these price relationships tend to become upset when unexpected changes occur in supply conditions. One such change occurred in August, 1990, following Iraq's invasion of Kuwait, resulting in the withdrawal of 4,500,000 barrels per day of crude oil from the world oil market and a sharp rise in crude oil and products prices on the spot and futures markets, as well as an increase in wholesale and retail gasoline prices. During August-September, 1990, and again in March-April, 1991, the normal ordering of wholesale gasoline prices was reversed as rack prices (prices paid by jobbers) rose above DTW prices (prices paid by dealers). 298

Advocates of increased regulation contend that price inversions are caused by the intentional activities of oil refiners, and that an inversion itself is indicative of an

anticompetitive spirit on the part of the large oil companies. 299 In response to the 1990 price inversion following the invasion of Kuwait, new legislative proposals regulating gasoline distribution and pricing were introduced in the United States, including those relating to retail divorcement, open supply, and price control. 300

In particular, independent (unbranded) distributors and open dealers claimed that rapidly rising wholesale gasoline prices and the restraints made by major refiners in pricing retail gasoline placed independents at a disadvantage. In addition, many distributors could not pass on these higher costs to consumers due to the restraints made by some majors in setting retail gasoline prices at company-operated stations. Unbranded distributors were forced to decrease their retail gasoline prices to levels set at company-operated stations or risk losing business to these and lessee dealers' stations. 301

On the other hand, free market economists generally maintain that inversions are the result of natural market forces at work, and reflect the differences in contractual relationships existing in wholesale gasoline markets in the United States. 302 They maintain that there is no evidence that refiners engaged in price gouging in 1990, 303 and that the price inversion experienced in that year was a temporary and economically logical price phenomenon that reflected different rates of adjustment to higher spot market gasoline prices around the world, which was historically consistent with previous sharp increases in spot market prices. 304

Moreover, although some distributors did lose money during the price inversion, the GAO (1993) noted the argument that independents, who lack contractual obligations and enjoy greater flexibility in their ability to shop around for the best prices, must bear the risk of temporary price inversions when unexpected changes occur in supply conditions. Unbranded distributors, who buy at the lowest price from the spot and unbranded rack markets and therefore normally enjoy the lowest costs, have given up the protection afforded by a contractual relationship when prices are more volatile. 305 The greater volatility of spot and rack prices than DTW prices in turn reflects the different degrees of contractual protection of each: 306

[T]he buyer who pays rack prices--particularly, unbranded rack prices--has an advantage over the buyer who pays DTW prices in that the former can buy from multiple suppliers, with the flexibility to vary the amount purchased from each. Under negative market shocks, therefore, average rack prices may overshoot

DTW prices because this flexibility weakens the buyers' contractual relationship with individual suppliers.

The DTW price, however, offers the lessee dealer the advantage of having a secure supply and a less volatile price under any market condition. Since the lessee dealer usually sells exclusively the supplier's branded gasoline, the dealer enjoys a stronger contractual bond with the supplier than do buyers who pay rack prices. In addition, major refiners depend on their lessee dealers to market a large volume of their branded retail gasoline. Thus, refiners have a strong incentive to hold down DTW prices relative to other wholesale prices during a negative supply shock.

During the 1990 price inversion, the major refiners shielded their branded distributors and dealers from price increases in the spot market because of strong contractual ties. 307

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Endnotes 7

289. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, Department of the Attorney General, dated July 21, 1995, at 3.
290. Letter from John Tantlinger, Ed.D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated June 13, 1995, at 2.
291. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated July 1, 1995, at 3.
292. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, dated July 7, 1995, at 3.
293. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., September 21, 1995, at 3-4.

294. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated June 30, 1995, at 5.
295. Letter to Wendell K. Kimura, Director, Legislative Reference Bureau, from Susan A. Kusunoki, Manager of State Governmental Activities, BHP Hawaii Inc., dated July 18, 1995, at 3.
296. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 3-4.
297. See text accompanying note 52 in chapter 2.
298. Philip E. Sorensen, An Economic Analysis of the Distributor-Dealer Wholesale Gasoline Price Inversion of 1990: The Effects of Different Contractual Relations (N. p., April 1991) at vii-viii; see also United States, General Accounting Office, Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products (Washington, DC: March 1993) (hereinafter, "GAO (1993)") at 121.
299. Jeffrey L. Spears, "Note: Arguments For and Against Legislative Attacks on Downstream Vertical Integration in the Oil Industry," 80 Ky. L. J. 1075, 1090 (Summer, 1992).
300. Sorensen (1991) at 31-35. See also the Petroleum Marketing Competition Enhancement Act (S. 2041, H. R. 2966), introduced in the 102d U. S. Congress, which would have prohibited refiners from practicing in price inversion, cited in Hawaii, Department of the Attorney General, Gasoline Prices in Hawaii: The Impact of Oil Company Divorcement on Consumer Prices (Honolulu: 1993) (hereinafter, "AG (1993)") at 26.
301. GAO (1993) at 121-124.
302. Spears (1992) at 1090; Sorensen (1991) at x.
303. For example, Sorensen (1991) concluded the following:
  - . Different levels of price volatility are observed in the spot market, the rack market, and the DTW market for gasoline in the U. S. The greater level of price volatility in the rack as compared to the DTW market was the underlying cause of the August-September 1990

DTW-rack price inversion.

- . During the August-September 1990 period, price inversions were experienced in all regions of the country, including states where retail divorcement laws were in effect.
- . The degree of price inversion was inversely related to the size class of refiners; i. e., the largest refiners experienced the smallest degree of price inversion.
- . There is no evidence to support the claim of "price gouging" by refiners during the period of inversion. The analysis shows that major refiners effectively shielded dealers and jobbers from price increases observed in the spot market. The total value of the "price protection" provided to dealers and jobbers by major refiners during the period of inversion was more than \$900 million.
- . Although jobber prices rose above dealer prices during some weeks in August-September 1990, the average spread between the DTW and the rack price actually widened in favor of jobbers over the entire post-invasion time period (including the period of inversion) through January 28, 1991.
- . The analysis supports the conclusion that the DTW-rack price inversion of 1990 resulted from the different economic characteristics of the three wholesale gasoline markets in the U. S. and not from any strategy on the part of refiners to injure one group of wholesale buyers or to favor another. Proposals for legislative remedies such as price controls, open supply, or retail divorcement of refiners are not supported by this evidence.

Sorensen (1991) at vii. Sorensen further noted that branded refiners were forced to adopt supply restrictions or other policies to prevent jobbers from draining their terminals during this period because the refiners were holding their rack prices significantly below the market-clearing price. "Despite many complaints by jobbers about these supply restrictions, there is evidence that some jobbers made considerable profits by brokering gasoline to unbranded customers during this period." *Id.* at ix.

304. See *id.* at viii, x.

305. See GAO (1993) at 124.

306. *Id.* at 125.

307. *Id.*; see also Sorensen (1991) at 3-6; Spears (1992) at 1090-1091.

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Chapter 8  
PUBLIC TERMINAL FACILITY AND STORAGE AUTHORITY

Questions (6) and (12) of the Resolution request the views of survey participants on the following issues:

- (6) The effects of encouraging the establishment of a public bulk gasoline terminal facility, which could make the importation of gasoline cost effective and could also lead to a reduction in wholesale gasoline prices;
- (12) The effects of establishing a public petroleum products storage authority with power to import, store, and market petroleum products.

State Government

AG: With respect to question (6), the Attorney General noted that it had recommended in its 1990 report that a unit of state government be funded to monitor and analyze oil industry data, and that the unit study ways to increase competition, including the establishment of a public petroleum products storage authority. 308 The Attorney General believed that such a facility would lead to lower gasoline prices:

The Department continues to think that a public bulk gasoline facility would tend to increase competition and thus lead to a reduction in prices. Moreover, a public terminal holds out the possibility that it could be managed in such a way as to avoid chaotic flooding of the market that anti-dumping laws seek to prevent. 309

The Attorney General also noted that it had recommended for study the option discussed in question (12) in its 1990 report, and that question (12) "is substantially the same as the proposal at point (6)...."310

DBEDT: With respect to question (6), the department questioned whether the high costs in constructing such a facility would make it cost effective:

This question seems to imply that if the government managed a bulk gasoline terminal in Hawaii, direct

importation of gasoline would lead to reduced wholesale and retail gasoline prices. We know of no study which has produced evidence to support this conclusion. In fact, as the state has pursued a ten million barrel regional petroleum reserve to be built by the U.S. Department of Energy, we have discovered the extremely high cost of such a terminal. Our most recent estimate to construct such a terminal is approximately \$195 million dollars. So, we are unaware of any evidence that would establish the cost-effectiveness of a public bulk gasoline terminal facility. 311

With respect to question (12), the department stated that it was reasonable to expect that the authority would benefit inefficient wholesalers and retailers at the expense of more efficient ones, and ultimately at the expense of taxpayers:

[W]ith no detailed cost-benefit analysis, it is not possible to determine what the true costs to the state would be to operate such a terminal, likewise there is no evidence that such a storage authority would actually contribute to lower consumer prices or increased competition. It is, however, reasonable to expect that such a facility could buoy inefficient wholesalers and retailers and stifle efficient ones who might otherwise be able to operate a storage terminal more inexpensively. This would transfer the burden of paying for the terminal and assuming the risks inherent in operating such a facility (e.g., environmental and financial risks) to the owners of the public terminal, the taxpayers. 312

#### Gasoline Dealers

HARGD: With respect to question (6), the Association noted that such a facility would lead to more competitive wholesale prices:

The wholesale price would become more competitive if another wholesale supplier were able to enter the market using a bulk gasoline terminal facility. Sales would have to be at the wholesale level, unless an acquisition of existing locations were secure, or open supply were instituted circumventing [existing contractual] prohibitions. 313

However, with respect to question (12), the Association noted that unless such an authority was established to maintain an emergency

reserve of petroleum or the private sector could not supply petroleum products through normal distribution channels, an authority would be an inefficient use of public funds:

The state should not be involved in placing financial resources into the supplying of petroleum distribution, unless the private sector is not able to supply product through normal methods of distribution. The state has made attempts in the past to get involved in supplying products or services, and has not been successful. If the state were to be involved in storage of a strategic emergency supply of petroleum for use under emergency circumstances, it would be acceptable. Otherwise, it would not be an effective manner in which to spend government resources.

The effects could range from keeping control of petroleum industry costs based on public competition to refineries utilizing their product for the highest bidder, which may be export.

Another consideration to be addressed is the differential in additives of motor fuels that is currently being used a[s] a marketing strategy to capture or retain market share. With public petroleum products storage, a means of mixing and/or blending additives would be required. 314

Jobbers

HPMA: In response to question (6), the Association argued against the building of such a facility as against free-market principles:

Government should not be in private business and the historical facts are that government would spend more than private industry and the taxpayers would pay for this facility.... [T]urning the Hawaii market into a "dumping ground" and making it totally uncompetitive for the existing oil companies, therefore forcing their exit, would be an error. We in the Hawaiian market want all the players to remain here, to remain competitive without government intervention.

If public terminal means a government operated terminal for the purpose of keeping wholesale prices down, that won't work either. Any commingling of product would eliminate brands. Any averaging of prices at such a

public terminal gives no incentive for a supplier to keep prices lower than what the market dictates. 315

With respect to question (12), the Association argued that several non-refiner marketers in the State would leave the market rather than be encumbered by government regulation, thereby lessening competition and hurting Hawaii's consumers in the long run:

Why should the public sector be spending taxpayers' money to build a (public) facility without the expertise and the private enterprise experience to operate? Government is not profit oriented, which usually means that they are not competitive. Competition is what is beneficial for the consumer. If a non-Hawaiian petroleum operator sees an opportunity by building an additional storage facility, they have all the right in the world to do it. HPMA believes that government should facilitate an operator by expediting permits and creating an environment that would be beneficial for his entry into the market. Potential profit is what attracts an investor. Governments' role is not private enterprise, but instead to facilitate private enterprise for the benefit of the consumer. HPMA believes there is a strong possibility that if a public petroleum storage authority was created, that several of the non-refiner petroleum marketers in Hawaii would leave the market rather than being encumbered by government regulation. This is a situation that HPMA thinks would be disastrous long-term for the Hawaii consumer. We want the major marketers to remain here and to do that they must be able to make a profit without regulation. 316

Aloha Petroleum: Regarding question (6), Aloha Petroleum argued that while a privately operated fuel terminal could benefit Hawaii's petroleum market, a fuel terminal operated by the government would only exacerbate existing problems:

The concept of a privately operated fuel terminal which is open to qualified buyers, could be beneficial to Hawaii's petroleum market. Mainland petroleum jobbers frequently "shop" privately operated fuel terminals which are open to them for the best price available. Such flexibility allows gasoline distributors and jobbers the ability to purchase gasoline at the best price available. A privately operated terminal, open to qualified buyers would introduce competitive

wholesale pricing to the Hawaii petroleum market. However, if the public terminal referred to in the above question means a public terminal operated by the government, it is our opinion that such a proposition would not be beneficial to Hawaii's petroleum market. Government competition with private business has not been successful and would only exacerbate the problems that already exist. 317

In response to section (12), Aloha Petroleum again maintained that while a privately operated facility would be beneficial, a government-operated facility would be "anti-business":

The idea of a privately operated petroleum storage facility open to qualified buyers would appear to be beneficial to the State. Such a facility would enable jobbers and distributors to shop for competitive prices. However, a government operated petroleum storage facility open to the public would be anti-business and therefore not beneficial to the State. Governmental intervention in private business has historically not been advantageous for either party. There are other ways in which government can support a privately operated petroleum facility. For example, the state could make property available to qualified companies to construct a terminal facility if the terminal operation would be as described above. 318

#### Oil Companies

Shell: With respect to question (6), Shell maintained that while such a facility might reduce the cost of importing gasoline to Hawaii, this might not be advantageous, considering the State's adequate refining capacity and inelastic demand for gasoline:

Depending on the level of user charges, the availability of a public terminal facility might help to reduce the cost of importing gasoline into Hawaii. It is not clear that such importation would be economically advantageous, given the presence in Hawaii of refining capacity sufficient to serve demand and the inelastic nature of that demand. Importation of substantial quantities of gasoline into Hawaii might produce such a level of excess supply that prices would decline to a point at which the imported gasoline could not be sold at a profit. 319

With respect to question (12), in the absence of information regarding the intended scope of the operation, Shell assumed that such an authority would market petroleum products at the terminal by trucks and barges and would not also participate in the retail gasoline market, and concluded that the authority would become a financial burden to the State's taxpayers:

Shell's assessment of the impact of such an authority is that it would lose money from operations and become a financial burden to the taxpayers of Hawaii. To the extent that the demand for motor gasoline in Hawaii is currently being met by the State's two refineries, facilities to handle imported gasoline would be redundant and therefore uneconomical. If importation of gasoline into Hawaii made economic sense, one would expect that the private sector would be doing it. The costs of importing gasoline, including acquiring it, transporting it, financing its storage, managing its price risk, building and operating sufficient terminal tankage to contain tanker quantities and managing environmental risks, are quite significant in relation to the small volume of business an importer could anticipate in the face of an adequate supply from the State's two refineries. Consequently, it is difficult to see how the State's consumers would benefit from such a publicly financed authority. 320

BHP: BHP noted that the assumptions made in question (6) were questionable for the following reasons:

a. All current major gasoline suppliers have the ability to import gasoline into the State and store the product in their own terminals constructed at a substantial investment. These suppliers have opted to purchase their gasoline from the two local refineries because it is economically more attractive to do so. Hawaii lacks the advantage of lower-cost pipeline access available to mainland suppliers and therefore proximity to crude sources and refined supplies. Shipping gasoline cargoes to Hawaii requires the supplier to incur high freight, storage and selling costs to move their inventories in the relatively limited Hawaii market. Recent federal and state environmental regulations have also had a negative impact on ability to transport petroleum on the water and have led to a reduction in the number of vessels and increases in freight costs.

b. Who would utilize the terminal? There would be no incentives for current terminal owners/operators to use this facility. All current suppliers have other petroleum products to consider besides gasoline which would necessitate continued operation of their own terminals. This would likely lead to redundant operating costs and place incumbent terminal owners at a distinct competitive disadvantage with any new entrants into the market. These new entrants would have to make no major investment in the state to participate in the market and face significantly lower operating costs. Additionally, a public bulk gasoline terminal facility with multiple users would raise concerns over quality control, exposure to environmental and product liability issues and conflicts over scheduling and logistical difficulties.

c. On average, the Hawaii gasoline market is in balance, with demand being adequately supplied by the two local refineries, eliminating the need to both import and export gasoline out of state. In general, this balance meets the local demand for every petroleum product, with the exception of jet fuel, which requires importation. This delicate balance between supply and demand provides consumers with a reliable, consistent and efficient flow of products at a reasonable cost. Singling out one product such as gasoline in an attempt to lower prices could introduce distortions into the market.... As a result the refiner is required to make a profit over the entire barrel of crude, rather than individual products. Any action which places a product at a different competitive level resulting in a reduction in profit over the entire barrel, would have to be made up by the remaining products.

d. There are numerous other issues which need to be addressed including:

- What would a state of the art terminal cost the State?
- How would such a facility be funded?
- Who would operate and manage the facility?
- Would the state be willing or able to assume liability for such a facility, including but not limited to all demonstrations of financial responsibility, environmental and operating costs?

- What would be the price impacts on other petroleum products?
- Is it an efficient use of in-state energy resources?
- Is it the State's business to enter a market and compete directly with private enterprise, and if so can it be done more efficiently than the current terminaling operations?321

With respect to question (12), BHP stated that this proposal would lessen competition, raise exposure to environmental risks, increase the State's administrative burden of compliance (which would ultimately be passed on to consumers), and discourage investment by the private sector:

The State should not assume a role in an enterprise which is already highly competitive and one which is already being adequately addressed by the private sector. To do so would be an unnecessary burden to the taxpayer and force the weaker, or smaller competitors out of business.

It is unclear where and how the state would acquire its supply. If the state imported product from out-of-state, environmental risk would increase from having product on the water. It would also probably result in an excess supply of gasoline in the state leading to exports, again increasing the exposure to environmental risk, and to price impact on other refined petroleum products. If the supply were acquired locally, it would not make economic sense for the local refineries to store product at a state-owned facility when they own their own facilities.

The state would be subject to the same regulatory requirements and environmental standards governing private industry over the importation, storage, and distribution and marketing of petroleum products. The state's administrative burden of compliance would be increased which would ultimately be passed on to the taxpayer and consumers.

In the short-term, the state may find it necessary to increase taxes to recover capital expenditures and operating costs, adding to the burden to taxpayers; there is no guarantee that prices would be reduced in the long-term instead it creates a probability that

prices would rise. The state does not have the same level of expertise, and incentives, to be an efficient manager and operator of business enterprises that already resides in private industry. Finally, such intervention by the state would discourage investment by the private sector. 322

Chevron: With respect to questions (6) and (12), Chevron argued that taxpayers would likely pay subsidies to make up for government inefficiencies:

The question here is one of cost versus benefit, and whether this is a good use of taxpayer funds... [T]here are already five major wholesalers of gasoline in Hawaii and competition is vigorous. The establishment of a public bulk gasoline terminal could be expected to have a significant effect on the market only if its operation were as efficient or more efficient than the existing distribution systems established by the private sector. Experience has shown that the government usually cannot compete with the private sector without taxpayer subsidies (either direct or hidden) to make up for inherent inefficiencies in the government-run enterprise.

It should be noted that while the Attorney General's 1990 Preliminary Report on the Investigation of Gasoline Prices recommended that the state government study whether such a public terminal should be established, that recommendation was not repeated in the Attorney General's 1994 Interim Report. 323

#### Discussion

Questions (6) and (12) of the Resolution ask for the effects of establishing two public entities--a public bulk gasoline terminal facility and a public petroleum products storage authority. While the specifics of the two are not delineated in the Resolution, presumably the former entity would provide for the actual storage of gasoline in terminals and appurtenant equipment, while the latter would provide the regulatory oversight, not only for storage, but also for the importation and marketing of gasoline and other petroleum products. Question (6) is inherently one-sided in that it suggests the intended outcome of response, i.e., that encouraging the establishment of such a facility "could make the importation of gasoline cost effective and ... lead to a reduction in wholesale gasoline prices". As demonstrated by the responses, the views of all of the participants do not coincide

with this presumption.

This section discusses two issues raised by questions (6) and (12)--the establishment of a regional petroleum reserve and the commerce clause implications of state participation in the marketplace.

### Regional Petroleum Reserve

Question (6) raises the ancillary issue of the establishment of a regional petroleum reserve in Hawaii for the storage of oil as a strategic reserve against supply interruptions.<sup>324</sup> The creation of a central strategic petroleum reserve (SPR) and regional petroleum reserves (RPRs) was provided under the federal Energy Policy and Conservation Act of 1975. Section 157(c) of that Act gave discretionary authority to the U.S. Secretary of Energy to allow for the substitution of oil in the SPR in lieu of oil in the RPRs for purposes of economy and efficiency and without compromising the RPRs' objectives. Since 1975, the U.S. Department of Energy has opposed the creation of a RPR in Hawaii, maintaining that the State's oil security needs are adequately served by the SPR on the Gulf Coast.<sup>325</sup>

Wilson (1988), in a study prepared for the state Department of Business and Economic Development, cited a number of factors in favor of the establishment of a regional petroleum reserve in Hawaii, including protecting the State's economy, ensuring the security of citizens, and providing for the national defense. The State is extremely dependent on petroleum, especially for transportation fuel; however, neither the Gulf Coast nor Alaska will be able to provide energy security for Hawaii in the 1990s, while Pacific Basin supplies will become increasingly in tight supply. Moreover, the study noted, the domestic tanker fleet is inadequate to meet supply disruptions.<sup>326</sup>

One of the factors cited by the Department of Energy against the establishment of a regional petroleum reserve in Hawaii was the comparatively high cost involved. Construction of above-ground steel tanks in Hawaii would cost about \$8 to \$9 per barrel of storage capacity, compared to underground salt dome storage capacity along the Gulf Coast, which cost from \$5 to \$6 per barrel.<sup>327</sup> The cost of acquiring land in Hawaii was not included in the estimate "because land exchanges between the State and the U.S. Government are considered a viable means of obtaining a suitable site for the RPR."<sup>328</sup> While Wilson argued that adding a transportation penalty of \$3 to \$6 per barrel to the lower capital cost of the salt dome storage capacity made the cost of RPR capacity in Hawaii "competitive with the Gulf Coast SPR",<sup>329</sup> an earlier study by the state Department of Planning and Economic Development found that "[a] State-owned contingency reserve

for all public and private petroleum needs would be too costly for the State Government to fund."<sup>330</sup>

As noted earlier, Hawaii is particularly vulnerable to supply disruptions, in part due to its heavy reliance on imported oil and relative geographic isolation.<sup>331</sup> While a public bulk gasoline terminal facility in Hawaii would not take the place of a regional petroleum reserve, it could nevertheless serve as an emergency backup during a supply interruption or shortage. Although expensive, depending on the size and location of the facility, infrastructure costs would most likely be less than that associated with the construction of a regional petroleum reserve. However, unless the facility is situated on public lands, high land values would dramatically increase the cost of such a facility.

#### Commerce Clause Implications

The establishment of a public petroleum products storage authority having the power to import, store, and market petroleum products in accordance with question (12) would unavoidably involve the State as a participant in interstate commerce. Importation would necessarily be from outside of Hawaii, including Alaska and possibly California. Storage would presumably be in the State's public bulk gasoline terminal facility, while marketing of petroleum products would probably be aimed at local independent dealers and distributors. In this scenario, the State itself would own its own petroleum products, terminal, and related resources, and would be involving itself, both directly and indirectly, in both intra- and interstate commerce.

Since the State in this case would not be acting as a market regulator but rather as a market participant engaged in interstate commerce, it would be permitted to favor its own citizens in certain market transactions. In *Hughs v. Alexandria Scrap Corp.*,<sup>332</sup> the United States Supreme Court stated that "[n]othing in the purposes animating the commerce clause prohibits a state, in the absence of congressional action, from participating in the market and exercising the right to favor its own citizens over others."<sup>333</sup> The Court subsequently held in *Reeves, Inc. v. Stake*<sup>334</sup> that when a state or local government enters the market as a participant, it is not subject to commerce clause restraints.<sup>335</sup> Thus, while self-imposed restrictions are usually not economically efficient, nothing in the "dormant" commerce clause prohibits a state from restricting its own purchases or limiting its sales to its own citizens.<sup>336</sup>

While the commerce clause<sup>337</sup> gives Congress exclusive powers to regulate interstate commerce, and the supremacy clause<sup>338</sup> gives federal

legislation enacted under the commerce clause precedence over conflicting state laws, the courts must determine when state legislation affecting interstate commerce is permissible under the "dormant" commerce clause, i. e., in the absence of federal legislation in an area in which the primary power is delegated to Congress.<sup>339</sup> The fact that a state acting as a marketplace participant may favor its own citizens over citizens of other states in certain market transactions does not violate the commerce clause; the state "is simply engaging in a form of welfare. It may be welfare for the rich rather than for the poor, but it is not restricted by the dormant commerce clause":

The selling of state-owned resources to local residents at a lower price [than] the state charges to out-of-state interests is consistent with commerce clause principles because the state is acting as a "market participant"--that is, the residents of the state are bearing the cost of providing a welfare benefit to persons within the jurisdiction. When the state is bearing the cost of providing economic benefits, there is little reason for the Supreme Court to intervene, even though some inefficiency in the marketplace might be created, because the political process within the state should serve as an inner political check on the state's decisions to participate in the marketplace.<sup>340</sup>

However, "the mere fact that the state is 'participating' in the marketplace through the use of its financial or natural resources does not completely immunize its actions from review under the commerce clause."<sup>341</sup> The state does not have the power to allocate a resource it owns in such a way as to discriminate against competition from citizens of other states in local economic interests. When a state regulates the use of materials that the state sells or distributes, the judiciary must decide "whether the regulation is one which results in the residents of the state bearing the cost for providing benefits to various persons within the state's jurisdiction or ... whether the regulation is an unconstitutional shifting of the cost for local benefits to out-of-state persons or interests by improper restrictions on competition."<sup>342</sup>

Thus, although the State's intervention in the market as a participant in the petroleum industry through the establishment of a public petroleum products storage authority and terminal facility may cause inefficiencies in the petroleum products market in Hawaii, the courts are unlikely to intervene if the State favors its own citizens, for example, by limiting its sales of petroleum products to Hawaii citizens. The State cannot, however, unfairly shift the cost for local

benefits to out-of- state persons by imposing improper restrictions on competition.

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308. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, Department of the Attorney General, dated July 21, 1995, at 3, citing Hawaii, Department of the Attorney General, An Investigation of Gasoline Prices in Hawaii: A Preliminary Report (Honolulu: Sept. 1990) at 23 (hereinafter, "AG (1990)").
309. Id.
310. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, dated July 26, 1995, at 4; AG (1990) at 23.
311. Letter from John Tantlinger, Ed. D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated June 13, 1995, at 2-3.
312. Letter from John Tantlinger, Ed. D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated July 26, 1995, at 4.
313. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated July 1, 1995, at 4.
314. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive and Retail Gasoline Dealers Association, dated August 1, 1995, at 3.
315. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, dated July 7, 1995, at 3.
316. Letter to researcher from Alec McBarnet, Jr., Vice President

- of the Hawaii Petroleum Marketers Association, August 14, 1995, at 2 (emphasis in original).
317. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., September 21, 1995, at 4.
  318. *Id.* at 8.
  319. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated June 30, 1995, at 5, citing Hawaii, Department of the Attorney General, The Attorney General's 1994 Interim Report on the \*Investigation of Gasoline Prices (Honolulu: 1994) at 10 ("[T]he non-refiner incumbents could send gasoline to Hawaii.... 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....").
  320. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated July 31, 1995, at 4.
  321. Letter to Wendell K. Kimura, Director, Legislative Reference Bureau, from Susan A. Kusunoki, Manager of State Governmental Activities, BHP Hawaii Inc., dated July 18, 1995, at 3-5.
  322. Letter from Susan A. Kusunoki, BHP Hawaii Inc., to Wendell K. Kimura, Director, Legislative Reference Bureau, August 10, 1995, at 5-6.
  323. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 4, 8.
  324. Member countries of the International Energy Agency agreed to establish an emergency reserve of oil of ninety days of the previous year's imports by 1980; by 1985, the U. S. program sought to maintain reserves of at least one billion barrels. See Thomas C. Schelling, *Thinking Through the Energy Problem* (New York, NY: Committee for Economic Development, 1979) at 28.
  325. Bruce W. Wilson, *A Review of Factors Relating to the Establishment of a Regional Petroleum Reserve in Hawaii* (Honolulu: Department of Business and Economic Development,

Nov. 1988) at vii.

326. In particular, Wilson cited the following points in favor of the establishment of a regional petroleum reserve in the State:

- . A Regional Petroleum Reserve (RPR) should be sited in Hawaii to protect the economy of the State, to ensure the security of the citizens of the State, and to provide for the national defense. Relatively low oil prices would dictate that an RPR in Hawaii be sited and filled with volumes equal to 90 days of consumption as soon as possible.
- . RPRs were enacted under the Energy Policy and Conservation Act (EPCA) of 1975. Section 157(c) conferred discretionary authority on the Secretary of DOE to establish RPRs--in lieu of central SPR storage--in insular or petroleum import-dependent areas of the U. S. Hawaii qualifies on both counts; however, DOE has consistently maintained that it is most economic to serve Hawaii from the central SPR on the Gulf Coasts of Texas and Louisiana or from the diversion of tankers at sea carrying Foreign or Alaskan North Slope (ANS) crude oil.
- . Petroleum represents 90 percent of Hawaii's energy supply, especially transportation fuels. The islands require large volumes of jet fuel for a healthy economy. Endurance time in Hawaii is 30-50 days.
- . Neither the Gulf Coast nor Alaska will provide energy security for Hawaii during the 1990s, and supplies from the Pacific Basin will become increasingly in tight supply.
- . During the 1990s, the "developed world" is expected to become more heavily dependent on imported oil as ANS production begins a precipitous decline. The "swing-producers" for imports into the U. S. will be in the Middle East--especially Saudi Arabia. U. S. import dependence is forecast to rise from 35 percent of total consumption in 1987 to more than 50 percent during the 1990s.
- . By 1994, it is forecast that Hawaii will be totally dependent on imports for its crude oil supply. The

West Coast of the U.S. is expected to import plus or minus one-third of its oil in the late 1990s.

- . The Pacific Basin imports half of its oil from the Middle East. If there is a supply disruption--especially one in the Persian Gulf--the Pacific Basin demand for available Australian and Southeast Asian crude oils will increase dramatically.
- . Figures indicate that U.S. shipping requirements must be met by foreign tankers and the domestic tanker fleet is inadequate to meet disruption scenario demand. There is also a deficiency in the number of small (below 80m dwt) tankers within the domestic U.S. Fleet. *Id.* at v.

327. *Id.* at vii.

328. *Id.* at 83.

329. *Id.*

330. Hawaii, Department of Planning and Economic Development, Hawaii's Fuel Requirements for Essential Services (Honolulu: Feb. 1983) at 59.

331. See notes 7 to 9 and accompanying text in chapter 3.

332. 426 U.S. 794 (1976) (state bounty for scrap automobiles may favor scrap processors with an in-state plant).

333. *Id.* at 810; see John E. Nowak, Ronald D. Rotunda, and J. Nelson Young, *Constitutional Law*, 3d ed. Hornbook Series (St. Paul, MN: West Publishing Co., 1986) at 283; Laurence H. Tribe, *American Constitutional Law*, 2d ed. (Mineola, NY: The Foundation Press, 1988) at 430; Ralph C. Chandler, Richard A. Enslen, and Peter G. Renstrom, *The Constitutional Law Dictionary* (Santa Barbara, CA: ABC-Clio, Inc., 1987) at 357 (vol. 2).

334. 447 U.S. 429 (1980) (state may limit the sale of cement produced at a state owned cement plant to state residents).

335. See Chandler, Enslen, and Renstrom (1987) at 357; Nowak, Rotunda, and Young (1986) at 283; and Tribe (1987) at 431.

336. Nowak, Rotunda, and Young (1986) at 283.

337. U.S. Const. art. I, §8, cl. 3.

338. U.S. Const. art. VI.

339. Nowak, Rotunda, and Young (1986) at 260-261:

The Constitution itself ... does not explicitly articulate the boundaries of this commerce power vested in Congress, particularly when Congress has not spoken. Whether or not the commerce power is exclusive or to what extent concurrent state regulation may coexist in the absence of an articulated Congressional judgment is not textually demonstrable. Moreover, the text of the commerce clause provides no overt restraint of state impingement of interstate commerce in the absence of Congressional legislation. It has been left to the Court to interpret, as inherent in that affirmative grant of power, self-executing limitations on the scope of permissible state regulation.

340. *Id.* at 284 (footnote omitted).

341. *Id.*

342. *Id.*

REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Chapter 9  
PETROLEUM REGULATORY COMMISSION

Question (7) of the Resolution requests the views of the survey participants regarding the following:

- (7) The effects of establishing a petroleum regulatory commission having general supervision over all petroleum manufacturers and jobbers in the State with the authority to:
  - (A) Authorize new retail service stations and determine whether they may be operated by a petroleum manufacturer or jobber;
  - (B) Restrict price increases when prices rise above a certain percentage over a benchmark market, as determined by rules adopted by the commission under chapter 91;
  - (C) Decide when a petroleum manufacturer or jobber may convert a retail service station from one operated by a gasoline dealer to one operated by a petroleum manufacturer or jobber, and vice versa;
  - (D) Decide when a petroleum refiner may close a retail service station, to prevent communities from being underserved;
  - (E) Review management decisions of petroleum manufacturers and jobbers regarding infrastructure, strategic planning, and other areas to ensure market compliance; and
  - (F) Review profits for reasonableness in light of the need for petroleum utilities to promote a safe workplace and ensure environmental protection.

State Government

AG: The Attorney General noted that to the extent question (7) calls for public utility regulation, this proposal may have a

negative impact on consumers:

The Department reads question (7) as asking for comments on the desirability of subjecting petroleum product marketers in Hawaii to public utility regulation. This is a political issue beyond the competence of the Department. However, to the extent that public utilities regulation increases the cost of doing business and/or the cost of government, the Department is of the view that such would tend to have a negative impact on consumers that may or may not be over-balanced by the benefits flowing from public utility regulation. 343

DBEDT: With respect to questions (7)(A) through (D), the department stated that "[a]ny action to establish and enforce price structures does not seem appropriate at this time. Also, there is no proof that artificially determined pricing will support increased competition, or protect the consumer." 344

Citing the GAO's 1993 study, the Department noted that of the five broad types of legislation proposed to address unfair pricing concerns--divorcement, open-supply, anti-price-gouging, below-cost sales, and minimum-markup statutes--discussions with state officials found limited evidence that these laws had any conclusive effect on gasoline prices, and that only five states had enacted petroleum pricing legislation between 1990 and 1991. 345 The department further noted that artificially stabilized gasoline prices could have the opposite of its intended effect in Hawaii, and would in addition require a significant commitment of government resources:

Further, and perhaps most important, governmental action to stabilize petroleum prices can actually backfire by making it financially infeasible for a petroleum company to sell its products at an artificially low price in the regulated area when market forces are causing prices to rise in the rest of the world market. Consider that current world oil consumption is approximately 67 to 68 million barrels of oil per day (one barrel equals 42 U.S. gallons). U.S. oil consumption is approximately 17.5 million barrels a day. Hawaii's petroleum consumption is only about 166,000 barrels per day. Hawaii represents only 0.009% of U.S. consumption and a mere 0.002% of the world market. Accordingly, our small state can have little influence on the global forces affecting

petroleum prices. Also, we would run the risk of serious economic consequences in the event of price spikes like those witnessed in previous oil crises, if we attempted to artificially stabilize prices. The oil companies would simply not find Hawaii's small market with artificially low prices attractive when they can sell their products at higher prices to the rest of the world.

Notwithstanding the market rationale for recommending against establishment of a petroleum regulatory commission, there remains the issue of staffing and providing other resources to such a commission during these fiscally troubled times. For example, the analytical skills and resources required to effectively regulate and provide oversight over petroleum industry management decisions would be enormous by comparison to those required for the PUC to regulate the electric and gas utilities. Skills in economics, chemistry, petroleum logistics, international politics and so forth would be required of a commission's staff. Even the oil companies themselves must pay hundred of thousands of dollars annually for consulting services in these areas that go beyond their own staff capabilities. At the risk of being redundant, competition, not regulations, is what drives the world oil market and the world oil market drives petroleum prices in Hawaii. 346

With respect to questions (7)(E) and (F), the department noted its belief that the Public Utilities Commission has had the authority to conduct this type of monitoring since 1991. 347

#### Gasoline Dealers

HARGD: The Association generally found that the establishment of such a commission would be beneficial by providing stability in pricing and assuring consumers the lowest long-term prices of gasoline:

(7)(A): This would inject a high degree of stability at the retail level of petroleum marketing and could provide a good balance based on the guidelines established for such decisions.

(7)(B): It would provide stability in pricing based on

cost of production. It would also put the commission in a strategic position under emergency situations.

(7)(C): This would provide a balance to any divorcement law by allowing vertically integrated locations where it was felt to be in the best interest of the consumer. Generally speaking, the petroleum supplier is interested in through-put only, and not in other services that have normally been provided by the franchise locations.... [P]lacing the control of conversion within a government agency would provide an alternative to allowing total vertical integration which would result if supplier were competing against supplier.

(7)(D): It would assure convenience to the consumer, but may not address profitability.

(7)(E): [The Association noted that (7)(A) through (D) accomplish (7)(E).]

(7)(F): Increasing environmental costs are having a direct affect at all levels from a profitability point of view. The assurance of reasonable profits at each level in the petroleum industry would assure the consumer the lowest long term price at the pump. 348

#### Jobbers

HPMA: The Association stated that treating the petroleum industry as a public utility would have a negative impact on Hawaii's consumers:

This is nothing more than having the petroleum industry be a regulated utility like electricity or water. Adding a bureaucratic level of government in an industry that is competitive makes no sense. The cost of such a government agency would be high. There are laws in place with regard to antitrust and price fixing which should answer any current concerns. To regulate further would be socialistic and detrimental to competition and other market functions such as supply and demand. For government to authorize new stations, price increases, reasonable profits, or when a jobber can convert to a retail, is contrary to free-market [principles]. It is ... poor logic to think that this will benefit the Hawaiian consumers. 349

Moreover, the Association argued that existing regulations, specifically, the moratorium prohibiting manufacturers and jobbers from operating company stations pursuant to section 486H- 10, Hawaii Revised Statutes, have had a detrimental effect on Hawaii's consumers, while other similarly situated industries in Hawaii remain unregulated:

The moratorium, restricting growth of new company-operated facilities for the last four years, has not benefited the consumer one iota. In fact, the moratorium has created a status quo in the Hawaiian market and has suppressed competition. The same logic could also be applied to the Hawaii retail market. The power marketers, K-Mart's, Wal-Mart's, and Sam's Clubs, ... have hurt the small retailers in Hawaii, but on the other hand have delivered substantial benefits to the consumers of Hawaii. Should the power retailer[s] be restricted in their ability to open new facilities because they threaten the survival of the smaller retailer? We cannot use logic in one industry and not the other one, when it benefits the consumer. The moratorium for the past four years has been a creation of special interests that has lobbied aggressively and vociferously for their perceived benefit and has been contrary to the consumers' benefit. Open competition is what benefits our Hawaii consumers, not restricting market growth. 350

Aloha Petroleum: Aloha Petroleum noted that the establishment of such a commission is unwarranted, since Hawaii's petroleum industry is not a utility, and the incentive to do business in Hawaii would decrease significantly:

The establishment of a petroleum regulatory commission with the powers presented in this question would not be beneficial to ... either Hawaii's petroleum industry or the consumer. Hawaii's petroleum industry is not a utility and should therefore not be treated as such. Existing federal and state regulations significantly restrict the petroleum market. The establishment of a petroleum regulatory commission would unnecessarily increase government cost, intervention and gasoline prices. Furthermore, the powers that would be given to the commission as described in the question would clearly demonstrate an anti-business climate and would significantly decrease the incentive for doing business

in Hawaii. If the legislature's objective is to protect Hawaii's consumers by ensuring the lowest gasoline price possible, then competition is the key and further governmental regulations such as a petroleum regulatory commission would not achieve that objective. If the legislature's goal is to protect a few large dealers, a petroleum regulatory commission would not protect dealers from changes in the marketplace or in consumer buying patterns. 351

#### Oil Companies

Shell: Shell regarded public utility regulation as inappropriate for the gasoline industry, which would impact negatively on consumers:

Economic regulation--as distinguished from health, safety and environmental regulation--benefits the public only where a market for some reason cannot sustain economic competition. For example, in some markets, such as the local distribution of electricity, the cost of operation can be minimized only by production at such a large scale that a single firm can satisfy the entire market demand. In such markets, where prices are unconstrained by competitors, public regulation may be necessary to protect the public from exploitation. But gasoline refining, distribution and retailing are markets in which competition works. In gasoline markets, the regulators are the motorists who choose from which supplier they will buy. The imposition of unnecessary regulatory costs on suppliers in a competitive market will result in either higher prices, a reduced level of products and services provided by market participants, or both.

(7)(A): This form of regulation would increase the cost of entry for new competitors and new retail franchises, which would in turn reduce the number of new outlets and lead to higher prices. The costs and delays of the administrative process would confront anyone who wanted to open a new retail outlet. Moreover, current market participants could increase their potential competitors' costs and lengthen the delays by participating in the administrative process. This would deter some from opening new outlets at all, and increase the costs of those who successfully withstand the process, potentially placing them at a

competitive disadvantage in the market.

(7)(B): The use of governmental administrative procedures to regulate prices could increase the cost of operation and consequently increase prices; tend to stabilize prices at higher levels than would otherwise prevail, with the administratively-set ceiling serving as a floor; or, if the regulated price were too low, diminish suppliers' incentives to invest in service stations, thus reducing the level of services available to consumers. Shell is aware of no evidence that public administrators are better suited than market participants to the task of determining appropriate prices for competitive markets, or quickly adjusting to changing circumstances, so as to avoid these adverse effects.

(7)(C) and (D): The federal Petroleum Marketing Practices Act of 1978 preempts the states' ability to regulate the termination or nonrenewal of retail gasoline franchises. Regulation of the establishment of such franchises would not be in the interest of consumers, as discussed in response to Question 7(A).

(7)(E) and (F): Shell assumes the term "petroleum utilities" was used advisedly here. Questions 7(E) and 7(F) clearly contemplate public utility regulation of what is otherwise a competitive market. This would have all of the adverse effects explained above with reference to economic regulation in general. In addition, such a scheme of cost-plus regulation of profits would appear to create a perverse incentive for suppliers to increase their costs, which would result in higher prices. 352

BHP: BHP similarly viewed regulation of the petroleum industry as ill-advised and suggested the existence of an equal protection problem in view of arbitrary discrimination against manufacturers and jobbers in favor of others: 353

(7)(A): Such authorization represents an unreasonable restriction on the natural competitive forces present in this State. Implicit within this statement is the fact that although a manufacturer or jobber may be prohibited from operating a retail service station, "other" non-regulated entities can. Such a result would have a negative impact on the very competitive

aspects of the marketplace which one assumes such regulation is trying to protect. By prohibiting one class of business from entering the marketplace it establishes an unnatural market monopoly for "others".... There is no rational basis for drawing any type of distinction between manufacturers and jobbers on the one hand and "others" on the other. Such a two tiered distinction is arbitrary and discriminatory.

The need for authorization also assumes that a "commission" would be the best judge as to where a new retail station would be needed. Again, this improperly infringes upon the natural competitive market forces. Such a decision should, rightfully, be left up to the consumer. If a new retail service station opens and is not patronized, then it will ultimately have to close....

(7)(B): Such price restrictions, which apply only to manufacturers and jobbers, would only exacerbate an already skewed market structure which allows "other" entities to function, unencumbered by any regulatory framework. Unregulated entities could easily undercut the regulated market, eventually eliminating manufacturers and jobbers from the marketplace. If manufacturers are no longer able to economically do business in this State, then gasoline would have to be imported and the cost to the consumer would invariably go up. This does not even take into account the major economic impact to the State if one of its major industries were forced to withdraw. Causing a petroleum manufacturer to discontinue to do business in the State would negatively impact, among others, the transportation industry, and power producers.

A barrel of crude oil, when refined, produces more than just gasoline and product prices are, to a large extent, dictated by the value of "all" the products produced from that barrel of crude oil.... It must take into account the other products produced from that same barrel of crude oil, all of which are influenced by global markets and not just this State.

(7)(C): [See responses to (7)(A) and (B).]

(7)(D): One of the basic principles of public utility

law is that the regulated utility is entitled to collect a reasonable price for the service or product which it supplies. If a petroleum refiner is forced to continue to operate a non-profitable service station [then] such loss would have to be made up at other retail service stations. This means that one group of consumers will have to subsidize the gasoline purchases of another consumer group. It would also make those other retail service stations less competitive where they are forced to maintain a reasonable profit margin for not only their operation but others as well. Competition would be hurt, consumers would have to pay higher prices, and if the burden became too great, one competitor would be eliminated from the market.

There is also no [rational] basis to single out petroleum refiners, as opposed to any other person or entity who may own a retail service station. To make such a distinction is arbitrary and discriminatory.

(7)(E): [Establishing] the necessary regulatory infrastructure to adequately perform such a review would be ... costly and unnecessary. The Attorney General's ongoing pricing investigation has found no improprieties which would warrant such an expenditure. Further there are already various anti-trust laws in existence which can be utilized to correct any illegal monopolistic activities.

(7)(F): While a safe work place and protection of the environment are important considerations in any business they are not the only two components of any determination of the reasonableness of profits. There are numerous other considerations which must be taken into account such as capital employed, risk, taxes, regulatory expenses, and property costs. To define the reasonableness of one's profits based solely on whether a safe work place is provided or the environment protected is illogical. 354

Chevron: Chevron similarly regarded public utility regulation of Hawaii's competitive gasoline market as "chaotic and inefficient", and would ultimately lead to higher gasoline prices:

We interpret this inquiry to ask whether the public would be served by public utility regulation of

the gasoline business in Hawaii. We believe it is rather clear that it would not. First, public utility regulation is normally justified only where for one reason or another one company has a natural monopoly--often granted to it by the State. In Hawaii, there are at least five competitors at the wholesale level and hundreds of competitors at the retail level. Attached as Exhibit 3 is a graph showing the changing market shares of the five main competitors in Hawaii over the last 12 years. The fact that these market share are constantly changing indicates a market characterized by vigorous competition.

In this context, public utility regulation would be chaotic and inefficient. It would inevitably raise gasoline prices to Hawaii consumers and interfere with the efficient distribution of gasoline in the state.

Our specific comments on each proposal are set forth below. We note that most of the specific proposals, on their face, are not designed to keep prices down, but rather to protect vested interests from competition in the marketplace. These proposals are intended to prop up the inefficient and would inevitably result in higher prices to Hawaii consumers.

(7)(A): If all new retail service stations must be authorized, then it follows that there will be fewer such stations than under free market conditions. Such decisions will inevitably factor in the desirability of protecting existing retailers from additional competition. This must put upward pressure on prices.

(7)(B): Artificially restricting gasoline prices invariably interferes with the ability of the marketplace to allocate products where they are needed. Artificial price ceilings inevitably result in shortages of product where needed. Generally, the government's response is to control not only prices but also to allocate products among outlets. As demonstrated by the experience in the U. S. government in regulating prices and supplies during the 1970's, this inevitably creates greater and greater distortions--resulting in the long run in higher prices to consumers. If consumers do not immediately pay higher prices as a result of such controls, they pay in other ways--such as waiting in line for the reduced-

price rationed product. Exhibit 2 shows that U. S. consumers have never paid higher prices in real terms than under the price in allocation controls imposed by the federal government during the 1970' s.

Although gasoline costs more in Hawaii than in California, the difference is less on a percentage basis than for most other products....

(7)(C): If a government agency is going to determine who operates a facility owned by another, it is obviously going to base its decision on considerations other than efficiency. Further, the relationship between oil companies and their jobbers and dealers and between jobbers and their dealers is pervasively regulated by the federal Petroleum Marketing Practices Act, 15 U. S. C. 2801, et seq. (the "PMPA"). Section 2802(b)(3)(A) of the PMPA prohibits an oil company from terminating a dealer for the purpose of converting the station to company-operation. Section 2806(a) of the PMPA precludes any state from adopting any law or regulation affecting the termination or nonrenewal of such relationships unless it is exactly the "same" as the federal statute. Hence, in addition to the inadvisability of substituting government judgments for those of the marketplace, there may be constitutional limitations on the state's ability to legislate in this area.

(7)(D): Again, if a refiner may not close an inefficient service station, this is going to result in higher prices throughout the system. We are not aware of any complaints in Hawaii that individual communities are under served. The marketplace responds very quickly with the creation of new stations to accommodate population shifts, new subdivisions, and the like. Again, the question is whether there is any public benefit in requiring the taxpayer subsidize inefficient stations by paying higher prices.

(7)(E): We do not know what is meant by "market compliance." If the government must review investment decisions of oil companies before they are made, the inevitable consequence is simply that (in the long run) fewer investment will be made. Again, this will result in inefficiencies and higher prices.

(7)(F): We read this to mean a requirement that prices not be "too low." This in essence is a government prohibition against vigorous competition. Apparently, the justification would be that additional profits are needed to promote a safe working place and ensure environmental protection. Again, the real effect would be to prop up the inefficient through higher prices. Generally, the approach of the government has been simply to mandate a safe workplace and to mandate environmental protection, leaving the market to seek the lowest possible level of prices which will support these mandated governmental goals.

Chevron believes that consumers are best served if the marketplace is allowed to determine prices and profits. . . . 355

#### Discussion

As noted by several respondents, question (7) proposes regulating Hawaii's petroleum products marketing industry in a manner similar to that of a public utility. Public utilities are those privately owned and operated businesses that regularly supply the public with a commodity or service that is of public need and consequence, including electricity, water, gas, transportation, and telephone service. Generally, the business or service of the public utility is deemed so essential to the general public as to justify the grant of a special franchise for the right of eminent domain or the use of public property, in consideration of which the owners of the business must serve all those who apply, without discrimination. Public utilities are generally regulated as to rates and service as virtual monopolies. 356

In Hawaii, public utilities are regulated by the Public Utilities Commission (PUC), which is placed within the Department of Budget and Finance for administrative purposes. 357 The PUC is generally responsible for regulating all franchised and certificated public service companies providing gas, telephone, electricity, telecommunication, private water and sewage, and motor and water carrier transportation services in Hawaii. 358 The three-member Commission's main objective in carrying out its regulatory function is to ensure that customers of the regulated companies receive efficient and adequate services at fair and reasonable rates, while ensuring a fair return to the regulated companies. 359 While similar in some respects to the PUC, the petroleum regulatory commission proposed in question (7) of the

Resolution would regulate only petroleum manufacturers and jobbers, primarily in the operation of their downstream facilities.

Although the Resolution proposes regulation of the oil industry by an independent commission, it has also been proposed that the oil industry be regulated by the PUC itself. Several bills introduced in recent sessions of the Hawaii Legislature would have required the PUC to assume some regulatory function over oil companies and others involved in the distribution of petroleum products.<sup>360</sup> One recent bill, Senate Bill No. 1900 introduced during the 1995 Regular Session, specifically sought to regulate oil companies as public utilities under the jurisdiction of the PUC. In testifying before the Senate Committee on Consumer Protection regarding that bill, neither the PUC nor the Department of Commerce and Consumer Affairs took a position with respect to that bill. Nevertheless, the PUC suggested a review of the need for regulation and the appropriation of additional resources to allow for the development of expertise in the substantive areas required by the bill,<sup>361</sup> and the Consumer Advocate also noted the need for additional funding.<sup>362</sup> The major oil companies also responded negatively to Senate Bill No. 1900.<sup>363</sup>

Whether regulated by the PUC or an independent commission, the classic economic justification for public utility regulation of an industry lies where the characteristics of that industry are those of a "natural monopoly".<sup>364</sup> In a natural monopoly, economies of scale--i.e., factors that cause the average cost of producing a commodity to drop as output of the commodity increases<sup>365</sup>--are sufficiently high that prices would increase significantly if more firms entered the market:

The most traditional and persistent rationale for governmental regulation of a firm's prices and profits is the existence of a "natural monopoly." Some industries, it is claimed, cannot efficiently support more than one firm. Electricity producers or local telephone companies find it progressively cheaper (up to a point) to supply extra units of electricity or telephone service. These "economies of scale" are sufficiently great so that unit costs of service would rise significantly if more than one firm supplied service in a particular area. Rather than have three connecting phone companies laying separate cables where one would do, it may be more efficient to grant one firm a monopoly subject to governmental regulation of its prices and profits.<sup>366</sup>

While public utility regulation has been the traditional response where a monopoly results from "natural causes," antitrust legislation is the typical response of policy makers when monopoly results from the deliberate design of those engaged in business. 367

However, in those markets where competition is found to be "workable", competition is generally considered to be superior to economic regulation in that competition increases both economic efficiency and consumer welfare:

Economic regulation has generally been limited to a few industries that are either natural monopolies or subject to other kinds of market failure. This practice reflects a faith in the superiority of free, unregulated, competitive markets wherever competition is adjudged feasible and effective. This faith receives support from the teachings of economics as well as from practical experience with economic regulation. Competitive markets are economically efficient. Prices reflect economic costs and guide buyers' choices so that resources are allocated to maximize consumer welfare. 368

Moreover, the rewards and punishments occurring in competition but which are absent under regulation "lead to stronger incentives for competitors to reduce costs, make correct decisions and innovate"; competitive markets are "flexible and responsive to changing conditions; the invisible hand of the marketplace leads the market to adjust to minimize prolonged shortages or excesses":

Competition automatically regulates profits, preventing monopoly returns, yet it rewards the efficient and penalizes the inefficient. Thus, competition achieves regulation's goal of preventing monopoly profits, but, unlike regulation, competition provides a strong profit incentive for efficiency and progress. Because of these virtues, competition is widely viewed as superior to economic regulation in those markets in which competition is workable. 369

Competition is deemed to be workable "if it provides alternatives to the offerings of any one competitor and if these alternative offerings act as a disciplinary force to prevent the exercise of undue market power. That is, the alternatives must provide effective constraints on the seller's ability to charge

supra- competitive prices or offer an inferior service."370

It may be argued that it is rational for voters to prefer a regulatory process to a laissez-faire market system, even at the cost of some loss of efficiency, since the former imposes due process requirements on changes in the existing framework of goods, prices, and market structures; "[t]he result is to give individuals and firms some legal rights to the status quo."371 At the same time, it may be questioned whether increased regulation will improve the general social welfare. Regulatory commissions often become identified with the industries they are required to regulate, thereby appearing to protect those same industries from competition. Moreover, a regulatory commission cannot compel an industry to become more efficient. Regulation should be considered a complement to, rather than a substitute for, competition. 372

The relative value of regulation has also undergone change in the last few decades. Until the 1960s, the prevailing view of regulation was that it sought to provide a degree of protection for consumers from monopolists, or protected producers from the harmful effects of unstable markets. After that time, however, some economists felt that regulation was "ineffective in restraining monopoly power, that regulatory agencies were often captured by industry groups and used as cartel managers, and that regulation introduced potentially serious distortions in the resource allocation process...". 373

While the oil industry is not currently being regulated as a public utility by any state, the threat of dwindling supplies and such other factors as the lack of close substitutes for gasoline, 374 suggest that the "public utility nature" of gasoline and other petroleum products should be taken into consideration in policy decisionmaking, and that the industry should be encouraged to take measures consistent with that description. For example, Gray (1975) noted that the oil industry should be encouraged "to develop plans for distribution and marketing of fuel oil and heating oil and gasoline in the U.S. when supply is short--recognizing the public utility nature these products have assumed; the need for assuring supply of fuel and home heating oil at reasonable prices; and public demand for gasoline supplied reliably and at reasonable prices."375

On the other hand, it is argued that gasoline marketing simply does not fit the requirements of a natural monopoly. 376 In particular, opponents of government intervention cite the failure of federally-imposed allocation and price controls in the 1970s as

an example of the negative consequences of regulation, namely, inefficiency and gasoline shortages, until the decontrol of the gasoline market in January of 1981. Yamaguchi and Isaak (1990) also noted several practical problems associated with government regulation of the price of gasoline. First, it is impossible to regulate only gasoline prices without introducing serious market distortions.<sup>377</sup> Second, there are significant political liabilities associated with the regulation of oil; lawmakers are under constant pressure by various interest groups to subsidize one type of fuel at the expense of another.<sup>378</sup> Finally, they maintain that existing state agencies are understaffed relative to the complexity of the issues involved, and that there is insufficient data necessary to monitor the oil industry in Hawaii.<sup>379</sup>

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REGULATING HAWAII'S  
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Endnotes 9

343. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, Department of the Attorney General, dated July 21, 1995, at 4.
344. Letter from John Tantlinger, Ed.D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated June 13, 1995, at 3.
345. See United States, General Accounting Office, Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products (Washington, DC: March 1993) (hereinafter, "GAO (1993)") at 127-128.
346. *Id.* at 4.
347. *Id.* at 3; see Haw. Rev. Stat. chapter 486I.
348. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated July 1, 1995, at 4.
349. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, dated July 7, 1995, at 3.

350. Id. at 3-4.
351. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., dated September 21, 1995, at 5.
352. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated June 30, 1995, at 6-8.
353. See text accompanying notes 45 to 53 in chapter 10 for a discussion of equal protection.
354. Letter to Wendell K. Kimura, Director, Legislative Reference Bureau, from Susan A. Kusunoki, Manager of State Governmental Activities, BHP Hawaii Inc., dated July 18, 1995, at 5-8.
355. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 4-7 (emphasis in original). Chevron's Exhibit 3, referred to in the text, is appended to this report at Appendix K. Chevron further noted that the prices of virtually all consumer goods are higher in Hawaii than on the U.S. mainland, and that Hawaii is a small market with very high overheads for doing business, citing Nancy D. Yamaguchi and David T. Isaak, *Hawaii and the World Oil Market: An Overview for Citizens and Policymakers* (Honolulu: East-West Center Energy Program, Aug. 1990) at 52-56. Chevron also cited the Attorney General's finding in its 1994 Interim Report that through 1992, Hawaii's refineries have not been earning more than a competitive return on investment. See Hawaii, Department of the Attorney General, *The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices* (Honolulu: 1994) at 13.
356. Black's Law Dictionary, 5th ed. (St. Paul, MN: West Publishing Co., 1979) at 1108-1109; see also Charles F. Phillips, Jr., *The Regulation of Public Utilities: Theory and Practice* (Arlington, VA: Public Utilities Reports, Inc., 1988) at 4-6.
357. Haw. Rev. Stat. §269-2(b).

358. The PUC's basic authority to regulate public utilities is contained in chapter 269, HRS. The PUC's authority to regulate motor carriers is contained in chapter 271, HRS, while the authority to regulate commercial water transportation carriers within Hawaii is found in chapter 271G, HRS. The PUC also has quasi-judicial authority to establish and enforce administrative rules and to set policies and standards.
359. Among the activities performed by the PUC to accomplish this objective are prescribing tariffs, rates, charges, and fees, and determining the allowable rate of earnings in establishing rates; issuing orders and guidelines concerning the general operations and management of utilities; prescribing the service, method, and annual rates of depreciation for utility property; and adopting rules governing the operations, standards, and fiscal management of utilities. See generally Hawaii, Public Utilities

Commission, Annual Reports: Fiscal Years 1991-92 and 1992-93 (Honolulu: July, 1994); Hawaii Revised Statutes chapter 269.

360. See, e.g., Senate Bill No. 1900 and House Bill No. 1652, Eighteenth Legislature, 1995, State of Hawaii; Senate Bill No. 123, Senate Bill No. 559, House Bill No. 66, C.D. 1, and House Bill No. 279, Seventeenth Legislature, 1993, State of Hawaii.

361. In particular, the Commission noted the following:

1. We do not believe that the proposed expansion of the Commission's jurisdiction over oil companies that are doing business in the State should be mandated without a thorough study of the need for the regulation and the Commission's regulatory role with respect to these companies. We would note here that the Commission is unaware of any state that regulates oil companies as public utilities.

2. The regulation of oil companies in the State will undoubtedly increase the Commission's workload. We are unclear at this time of its impact. However, we suspect that the Commission's budget and staffing will have to be increased substantially to develop expertise in the area and to take on the regulation of

the oil companies in the State.

3. The Commission's proposed 1995-1997 budget does not include the assumption of additional regulatory responsibilities, such as those envisioned by this bill. Thus, additional funding will be required to implement this measure.

Testimony of Yuko Naito, Chairman, Public Utilities Commission, before the Senate Committee on Consumer Protection regarding Senate Bill No. 1900 (1995), February 13, 1995, at 1-2.

362. See Testimony of Charles Totto, Executive Director of the Division of Consumer Advocacy, Department of Commerce and Consumer Affairs, before the Senate Committee on Consumer Protection regarding Senate Bill No. 1900 (1995), February 13, 1995, at 1:

[S]hould this bill be passed out of Committee, we respectfully request that a section be added allowing sufficient funding for the purposes of properly executing the mandates of the Consumer Advocate under §269-52[, Hawaii Revised Statutes]. Those duties require us to represent, advance and protect the interests of all utility consumers. We anticipate that participating in rate regulation and other investigations on behalf of consumers of petroleum products will be a monumental undertaking. As a result, funding for staff, consultants and legal counsel from the Department of the Attorney General will be required.

363. For example, the Western States Petroleum Association argued that public utility regulation of the oil industry was unnecessary:

The oil industry, left to manage its business in a free market environment will ultimately provide the consumer with the best products and services at the best value possible. In fact, competition in Hawaii is so great, that it has allowed the industry to improve the efficiency of their operations, upgrade facilities, invest in new technology and offer the consumer more convenience, reliability, and overall quality products and services.

Testimony of Jack K. Suwa, Public Affairs Consultants-Hawaii, before the Senate Committee on Consumer Protection regarding Senate Bill No. 1900 (1995), February 10, 1995, at 1. Similarly, BHP argued that there was no rational justification for regulating Hawaii's oil industry, that regulation would replace natural market forces which could result in artificially higher prices, and that regulation would have a chilling effect on other firms seeking to enter Hawaii's market. See Testimony of George T. Aoki, BHP Hawaii, Inc., before the Senate Committee on Consumer Protection regarding Senate Bill No. 1900 (1995), February 13, 1995, at 1; see also testimony of J. W. McElroy, Chevron USA Products Company, before the Senate Committee on Consumer Protection regarding Senate Bill No. 1900 (1995), February 13, 1995.

364. Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly* (Cambridge, MA: The MIT Press, 1991) at 1-2; see also Phillips (1988) at 45; Alan Stone, *Regulation and its Alternatives* (Washington, DC: Congressional Quarterly Press, 1982) at 68-78; see generally Richard Schmalensee, *The Control of Natural Monopolies* (Lexington, MA: Lexington Books, 1979).
365. Graham Bannock, R. E. Baxter, and Evan Davis, *The Penguin Dictionary of Economics* (London: Penguin Books, 1987) at 129. While it has been argued that economies of scale make larger firms more productive than smaller ones, others contend that economies of scale in production do not vary significantly according to the size of a firm, and that "[t]he continued existence of establishments of many sizes argues that economies of scale in production are not significant." Robert E. Breney and Ed Owens, "A Model for Contemporary Small Business Policy Issues" in *Small Business in a Regulated Economy: Issues and Policy Implications*, ed. Richard J. Judd, William T. Greenwood, and Fred W. Becker (New York, NY: Quorum Books, 1988) at 207 (footnote omitted).
366. Stephen G. Breyer, *Regulation and its Reform* (Cambridge, MA: Harvard University Press, 1982) at 15. For a discussion of justifications for and against regulating natural monopolies, see *id.* at 15-20.
367. Stone (1982) at 74.

368. William R. Hughes and George R. Hall, "Substituting Competition for Regulation," 11 Energy L. J. 243, 245 (1990) (footnote omitted).
369. Id. (footnote omitted).
370. Id. at 245 n. 9.
371. Bruce M. Owen and Ronald Braeutigam, *The Regulation Game: Strategic Use of the Administrative Process* (Cambridge, MA: Ballinger Publishing Co., 1978) at 1-2.
372. Walter Adams, "Can Regulation Curb Corporate Power?" in *Public Utility Regulation: Change and Scope*, ed. Werner Sichel and Thomas G. Gies (Lexington, MA: Lexington Books, 1975) at 15-17:

[F]irst, ... regulatory commissions tend to develop an undue identification with the industries they are supposed to regulate. More often than not, they seem to protect the regulated industries from competition, rather than the public from exploitation. Indeed, it is not too extreme to suggest, as our experience (especially with the ICC) indicates, that what starts out as regulation ends up as protection. The power to license becomes the power to exclude; the regulation of rates, a system of price supports; the surveillance of mergers, an instrument of concentration; the supervision of business practices, a pretext for harassing the weak, the unorganized, and the politically impotent; and the assurance of a needed public service, an excuse for public subsidies and bailouts. Once an industry becomes the government's chosen instrument for effectuating a public purpose, regulation becomes, as Henry Simons saw long ago, "an apology for governmental enforcement of minimum prices and wages at levels higher than monopolies could maintain without the support of law." Regulation becomes the means of officially sanctioning and legitimizing the chosen instrument's performance, no matter how deplorable such performance may be... Once you are wedded to that kind of regulatory scheme, the public is stuck with its chosen instrument.

The second difficulty with regulation is that, at best, it is a negative force for right conduct. A regulatory commission can refuse to approve a price

increase, but it cannot compel its regulatees to lower production costs. The commission cannot compel the scrapping of old plants or the construction of new ones. It cannot force additional expenditures on research and development or command greater progressiveness in innovation and in invention. It cannot penalize management for its incompetence, for its lack of imagination, or for its lack of creativity because it does not have a clear view of what potentially attainable cost reductions are. It has no way, therefore, of stopping the great vice of monopoly, namely, the monopolist's tendency to lead the quiet life and to squander society's treasure in the form of excessive cost. Limiting the monopolist to a fair return may be the essence of the regulatory process, but it does not achieve society's central objective. Put differently, regulation is often a pass-through mechanism for the inefficiency, cost escalation, and lethargy of pampered managements luxuriating in an ambience of governmental permissiveness.

Third, regulation, whatever its short-run, static virtues, is not a substitute for but a complement to competition. That is, it cannot function effectively without some exogenous force to discipline the conservative bias of both regulatees and regulators. Experience shows, especially in transportation, but also in communications, that even peripheral competition plays a more significant role than straight regulation in forcing innovations on bureaucratic managers and their overly permissive guardians.... It is these marginal competitors, operating at the periphery and in the interstices of a regulated industry, who have done so much to demonstrate what innovations are possible, practical, and profitable, and who, more often than not, have suffered regulatory euthanasia for performing that invaluable public service....

What, then, is the solution? Obviously, at least as far as I'm concerned, I think that deregulation, wherever possible, is the answer. That is, in industries which are naturally competitive industries, there really is no excuse for the government's playing a role, because the government will only be a protective device for vested interest. It will be a

mask for privilege, a shield for monopoly. It will not be an agency for the public interest.

See also Schmalensee (1979) at 11-13, discussing economic, political, and administrative conceptions of regulatory failure.

373. Owen and Braeutigam (1978) at 10. Economic theories of regulation include the following:

. Capture theory. The first version of the capture (or economic) theory of regulation is that regulatory agencies, although established to protect the public interest, subsequently become tools of the industry which they regulate. The second version is that these agencies are created to serve the interests of the industries that they regulate in response to industry demands for cartel management. Other tools to effect redistribution include various direct tax and expenditure programs.

. Life-cycle theory. This theory reaches similar conclusions to that of capture theory, i.e., that regulation ends up favoring industry groups at the expense of consumers. Under this theory, short-lived coalitions of consumer interest groups are formed to adopt regulatory legislation to benefit consumers, which, once established, becomes captured by the industry. As the issue wanes in political importance, the consumer interest coalition fades, partly due to the "myth" that the agency is protecting the interests of consumers. The agency, once established, also requires substantial expenditures that tend to benefit lawyers, lawmakers, and consulting economists.

. Bureaucrats and legislators. It has been argued that bureaucrats seek to maximize the total budget of their bureau, and that bureaus exchange a specific output for a specific budget. The latter implies that bureaus hold some monopoly power, by giving the bureau's sponsors (e.g., a legislative appropriations committee), a take-it-or-leave-it choice. In addition, legislators provide facilitation services to their constituents who must deal with the bureaucracy.

. Regulation as contract. Under this theory, regulatory agencies are viewed as analogous to long-

term contracts between parties having a continuing economic relationship. Under these contracts, suppliers and consumers voluntarily limit their future options to minimize costs and uncertainty. A regulatory agency may also be treated as if it were the agent of a consumer group in negotiating and administering such a contract. See *id.* at 11-18.

Owen and Braeutigam encourage industries to make strategic use of the administrative process in what they view as a "regulation game":

No industry offered the opportunity to be regulated should decline it. Few industries have done so. Railroads, airlines, telephone companies, radio stations, and most other industries have warmly embraced regulation when it was offered and have strenuously resisted efforts to remove it.... Regulation protects such industries against competition from outsiders and from within the industry. It provides a degree of protection from congressional investigation. Regulation greatly reduces the risk of bankruptcy from causes other than competition. And, while regulation may make very high rates of return difficult to achieve, it does virtually guarantee a steady stream of adequate profits. *Id.* at 2.

Regulation may also be viewed as a legal way of removing competition: "Regulated firms face the most serious financial threats, not from their regulators, but from potential competitors. Regulation is an excellent device for eliminating competition within the industry and for preventing direct entry." *Id.* at 8.

374. See Stone (1982) at 73; GAO (1993) at 55.

375. John E. Gray, *Energy Policy: Industry Perspectives* (Cambridge, MA: Ballinger Publishing Co., 1975) at 72 (App. C).

376. Philip E. Sorensen, *An Economic Analysis of the Distributor-Dealer Wholesale Gasoline Price Inversion of 1990: The Effects of Different Contractual Relations* (N. p., April 1991) at 31.

377. Yamaguchi and Isaak (1990) at 76-77; see also note 21 and accompanying text in chapter 10.

378. See *id.* at 79-80:

Different products are consumed by different interest groups. The tourist industry, for example, will want to keep the cost of jet fuel low; electric utilities will argue for lower fuel oil prices; the general public will lobby for lower gasoline prices. When the government sets the prices, there is constant pressure to subsidize one fuel at the expense of another. Furthermore, the world market changes, creating shortages of one product and surpluses of another, but governments often find it politically difficult to follow the changes in the market because of public outrage. . . . [M]ost governments prefer not to attempt to regulate oil--consumers will always be angry, but it is safer to let them vent their anger on Greedy Big Oil than at the voting booths.

379. See text accompanying note 31 in chapter 13.

REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Chapter 10  
PRICE CONTROLS

Question (8) of the Resolution requests the views of survey participants on the following:

- (8) The effects of regulating retail gasoline prices of company-operated retail service stations.

State Government

AG: The Attorney General stated that "[t]he competitive effect of regulating prices is to eliminate price competition":

The theoretical economic effect of regulating prices is to fix marginal revenue for the sale of gasoline at the regulated price. To maximize profits and minimize losses, the seller must adjust its marginal costs so that they equal the regulated marginal revenue. If the size of the operation at that level of cost is anything other than the most efficient size in the long run, the effect will be to upset the efficient allocation of resources among various industries in the State. The consequent tendency would be toward over-investment in some markets and under-investment in others, and hence toward waste. Waste is harmful to consumers. 380

DBEDT: The department noted its earlier opposition to the regulation of petroleum prices in Hawaii in its responses to questions (1) and (7), and further stated that no evidence has been found that oil companies in Hawaii are engaged in anticompetitive behavior:

More specific to the case of regulating gasoline prices of only company-operated retail service stations, we believe getting the price right would be difficult, if not impossible. A major problem for regulators in this instance would be to match the regulated price with market-driven prices which may fluctuate minute-by-minute in the world market. Further, but perhaps more important is the fact that after years of investigation, no evidence has been found of any anti-competitive behavior on the part of the oil companies

in Hawaii. There is also no evidence that company-owned and franchised stations, or those leased to branded dealers are detrimental to competition in the retail gasoline market. 381

#### Gasoline Dealers

HARGD: The Association found that while costs to implement such a program would be substantial, it would nevertheless benefit Hawaii's consumers in certain circumstances:

It would not attack the issue relating to the lack of competition at the supply level of distribution or the control over the supply of petroleum products. Although it would require substantial financial resources, it would provide the state with information with respect to petroleum marketing and the profits required to justify prices approved by the agency establishing such prices. It would provide protection to the Hawaii consumer if in fact the differential in prices between the West Coast and Hawaii were not justified. Under these circumstances, the costs of implementation of such a program would be justified. 382

#### Jobbers

HPMA: HPMA asserted that free-market competition was preferable to government regulation of prices, which would hurt consumers:

Governmental regulation of prices as opposed to free-market price regulation has never proved to be effective. Any industry that has been saddled with government price regulation has proven to be a disincentive to reinvest and participate in free market profit opportunity. If the intent in retail gasoline is to provide the best service at the best price to the consumer, the only way to achieve this goal is through free-market competition. As long as investors see an opportunity to participate in future profits, industry will reinvest to harvest this potential profit. HPMA believes that the consumer deserves choices, and regulation of retail gasoline prices will hurt the consumer because the major oil companies, jobbers and private investors will not invest in an unknown regulated environment. The marketplace is the best regulator for retail gasoline prices. 383

Aloha Petroleum: Aloha Petroleum stated that regulating retail gasoline prices would be both anticompetitive and anti-business, as well as probably unconstitutional:

Regulating retail gasoline prices of company-operated retail gasoline stations would restrict competition and would not be beneficial to Hawaii's petroleum market. Any business needs the flexibility to adjust to market conditions. Regulating gasoline prices of company-operated stations would be anti-business. Finally, since this regulation would only apply to company-operated stations, it is probably unconstitutional. 384

#### Oil Companies

Shell: Shell noted that it did not have any company-operated retail service stations in Hawaii, but was unaware of any reason why this category of station should be singled out for government regulation of prices. Shell also reiterated its opposition to government regulation of prices as harmful to consumers in its response to question (7), noting that price controls and mandatory allocation of gasoline in the 1970s produced severe product shortages, causing long lines at service stations to buy gasoline. 385 Shell further noted that price controls would result in broader negative market repercussions:

Moreover, limiting price regulation to company-operated stations would not necessarily limit the adverse economic effects of unnecessary regulation to those stations and their customers. Regulating prices at company-operated stations would not only increase their cost of operation and consequently increase their prices, but would also have wider market effects. The regulated price would likely become a target or marker that would facilitate the establishment of similar prices throughout the retail market. Depending on the level of the regulated prices, they would be likely either to stabilize prices at higher levels than would otherwise prevail, or if the regulated price were set too low to provide suppliers a reasonable return on their investment, suppliers' incentives to provide gasoline and invest in service stations would be diminished and the amount of gasoline and automotive services available to consumers would be reduced. Shell is aware of no evidence that public administrators are better suited than market participants to the task of determining appropriate

prices for products sold in competitive markets, or quickly adjusting such prices in response to changing market circumstances so as to avoid adverse economic effects for consumers. 386

BHP: BHP argued that regulation would be detrimental to consumers by removing their freedom to choose the competitive prices and service offered by company-operated stations:

The landscape of gasoline retailing in Hawaii encompasses competitive product/service offerings of many different types. Be it price, convenience, quality, service or some other buying characteristic, the gasoline consumer has the unrestricted capacity to choose between competitive offerings and select the one deemed to be superior in value in their circumstance. In short, consumers and purchase decisions serve as the ultimate value judgment on how successful a product and business is. Consumers decide what they want and how much they are willing to pay for it and successful retailers must find their niche within this landscape.

Regulating retail gasoline prices would serve to take the value judgment out of the consumers hand and place it instead with some third party regulator. Given that no one is in a better position to know what consumers want than the consumers themselves, under a regulated scenario the consumer is worse off. The consumer may be left with the lowest common denominator with competitors having no real incentive to meet consumer requirements.

A scenario in which only a segment of retail outlets such as company operated stations were regulated would restrict these stations in their ability to compete effectively in the marketplace to win and maintain customers. Discriminative regulations would allow competitors to make offerings to consumers designed to win business from the regulated company operated station to which that station may not be able to respond to. Putting it bluntly regulated company operated gasoline stations would be sitting ducks subject to the actions of non-regulated competitors. Prices could be regulated too high, in which case customers would cease to patronize the station and it would go out of business, or prices could be regulated too low, in which case costs would not be covered and

the station would go out of business. Non-regulated stations would be free to make either scenario a reality as they would have the ability to freely set their price and regulated stations would not be able to adequately respond.

In conclusion regulation of company operated stations would serve to disadvantage them relative to their competitors. Consumers would also be losers since there could be less competitors and they would have a diminished ability to make value judgments on competitive offerings through their purchases. They would no longer be free to exercise their right to pay for what they want, and a segment of the market would be restricted from offering to them what they may desire at a price they are willing to pay. 387

Chevron: Regulating these prices would result in the closure of Chevron's company-operated stations:

[T]here would be no purpose in regulating such prices except to keep them "up." ... Chevron has only three company-operated stations in Hawaii. It sets consumer prices at those stations to match its local competition. If Chevron were required to keep those prices artificially high, the stations would lose volume, would become uneconomic, and would go out of business. Government mandates which keep gasoline prices at company-operated stations artificially high are the equivalent of banning such stations. [S]tudy after study on this subject has demonstrated that banning such stations results in higher prices to consumers. 388

#### Discussion

This section discusses question (8) of the Resolution with respect to price controls, focusing on proposals for below-cost sales and minimum-markup legislation, and equal protection of the laws.

#### Price Controls

Generally, a state may control prices for the public welfare under the state's "police power", i. e., the power to impose restraints on personal freedom and property rights to protect the public health, safety, and morals, or the promotion of general prosperity and public

convenience, subject to federal and state constitutional limitations.<sup>389</sup> Although price controls impair the value of private property, they are generally not considered to be takings unless they unreasonably impair the use or value of property, in which case they may be deemed a "regulatory taking" requiring compensation.<sup>390</sup> Federal government price controls, which are usually imposed for reasons of equity and perceived market inefficiencies, may take several different forms, including cost-of-service ratemaking, historically-based price regulation, windfall profits taxes, subsidies, competitive bidding for monopoly rights, and nationalization.<sup>391</sup>

With respect to the gasoline marketing industry, although price controls may be similarly justified for reasons of equity and to remedy perceived market defects, several commentators have noted various problems attributed to price controls under nonemergency conditions.<sup>392</sup> For example, Sorensen (1991) maintained that proposed legislation to regulate gasoline prices would either limit the ability of refiners to respond to market conditions by fixing prices on the basis of historical costs, or would mandate some minimum spread between dealer tank wagon and rack prices. With respect to the former, he argued that the gasoline industry is not a natural monopoly and, as such, should not be subject to price control regulations similar to that of a public utility.<sup>393</sup> Moreover, Sorensen believed that a system of gasoline price controls would mandate "significant new government spending for administration and enforcement. The history of government price controls for the oil industry in the 1970s provides evidence of the inefficiency of such controls."<sup>394</sup>

In arguing that federal government-imposed price controls were the proximate cause of the gasoline shortages in the 1970's, Merklein and Murchison (1980) cited an internal memorandum of the United States Department of Energy as setting out the case against gasoline price controls.<sup>395</sup> That memorandum noted that an inability to earn an adequate return on new capital investment, together with fixed profit margins, worked as a disincentive to such investment. Although consumer demand for unleaded and high-octane gasoline had increased during the 1970s, refiners had not invested in unleaded gasoline production facilities that were sufficient to meet increased demands, since price controls prevented that product's profitability from rising with changing demand. In addition, the memorandum stated that price controls had "contributed to many inefficiencies in the market, inhibited experimentation with new pricing structures, and created serious distortions in the competitive relationship of firms."<sup>396</sup> Fenili (1985) also found that decontrol allowed for greater efficiency in gasoline marketing. In particular, the removal of federal price and allocation controls permitted operational changes consistent with emerging technology and consumer demands, including a shift away from

full-service sales to lower-priced self-service sales, but which had been constrained by federal regulations. 397

The inefficiencies caused by federal price controls might be similarly experienced by Hawaii's refiners and marketers under a system of state imposed price controls, it may be argued, ultimately leading to higher costs for Hawaii's consumers. For example gasoline price controls may lead to more bureaucracy and, as a result, higher taxes and gasoline prices. 398 To the extent that proposed price controls are intended to eliminate price gouging, for example, during a price inversion, these efforts may also be misplaced. In addition, proposals to enforce a mandated differential or functional discount below dealer tankwagon price for jobbers may "undermine a competitive market process where the extent of contractual agreement between the parties determines the degree of price volatility faced by wholesale buyers." 399

Yamaguchi and Isaak (1990) also maintained that because petroleum products are jointly produced goods, regulating only gasoline prices would create serious market distortions:

The first thing that should be noted is that it is impossible to regulate only gasoline prices without introducing serious distortions into the market. Unlike a single energy commodity such as electricity, petroleum products are jointly produced goods. The profits from refining are the sales revenues of all the products less the cost of crude and operations. Often the cost of one product is falling while the cost of another is rising. The overall profitability of refining can easily be calculated, but the profitability of any one product is impossible to evaluate. It is often hard for outside observers to understand, but there is no such thing as the "production cost" of gasoline. It is therefore impossible to set a fair price for gasoline that will ensure a fair return on investments.

Economists have grappled unsuccessfully with this problem for years. In the end, countries that have decided to regulate the price of any oil product have found that they have to regulate the prices of all oil products if serious distortions are to be avoided. Under regulation, it is quite easy for a government-set price to be considerably higher than what would be seen in an unregulated market--especially if only a single price is controlled. 400

They further noted that most countries attempting to regulate gasoline prices soon realize that they must not only regulate all prices, but must also control imports, investment, and operating decisions; "[o]ne price regulation decision soon leads to regulation of the entire industry, and usually to controls on trade of a type that it is not clear are enforceable or legal at anything below the national level." 401

#### Below-Cost Sales and Minimum-Markup Laws

In the gasoline marketing industry, according to the GAO (1993), states have proposed several types of laws regulating the price of petroleum products in response to concerns of unfair pricing by the petroleum industry, including below-cost sales laws, which generally require that a refiner not sell gasoline for less than the refiner's average cost, and minimum-markup laws, which establish minimum wholesale and retail gasoline margins. 402

**Below-Cost Sales Laws.** In addition to below-cost sales laws focusing specifically on petroleum products, many states have enacted below-cost sales laws with respect to commodities and services generally pursuant to their police power in response to perceived anticompetitive practices, which have withstood constitutional challenge. 403 These statutes are not price-fixing laws but are rather aimed at "loss leader" selling, and are intended to protect small independent merchants who cannot afford to sell below cost and are unable to compete with those retailers that engage in these practices. 404

Hawaii's below-cost sales law is contained in the State's Unfair Practices Act, codified in chapter 481, part I, Hawaii Revised Statutes, which generally prohibits firms from producing or selling a commodity or service "with the intent to destroy the competition of any regular established dealer" in that commodity or service. 405 Hawaii's below-cost sales law prohibits any person from selling, offering for sale, or advertising any product or service "at less than the cost thereof to such vendor", or from giving away any such article "with the intent to destroy competition." 406 In addition, Hawaii's Unfair Practices Act provides exceptions to otherwise prohibited below-cost sales, including exceptions for damaged goods, the closing out of stock, and good faith efforts "to meet the lawful prices of a competitor ... selling the same article or product, or service or output of a service trade, in the same locality or trade area..." 407

With respect to petroleum products in particular, proponents of below-cost sales laws and other gasoline pricing regulations have maintained that such legislation is necessary for reasons similar to those advanced by proponents of retail divorcement legislation, namely,

to preserve competition by protecting competitors--in particular, small and independent businesses--against predatory pricing by large oil companies. 408 Several states have cited these arguments in enacting legislation regulating gasoline pricing. For example, Tennessee's Petroleum Trade Practices Act, which provides in part that "[n]o dealer shall make, or offer or advertise to make, sales at retail at below cost to the retailer, where the effect is to injure or destroy competition or substantially lessen competition..." 409 was enacted to preserve independent and small wholesalers and retailers in the motor fuel marketing industry and to prevent the subsidized pricing of petroleum products. 410

The Montana Legislature has also found that subsidized, below-cost pricing is a predatory practice, and that below-cost pricing laws are effective in protecting independent retailers and wholesalers of motor fuel. 411 Florida has similarly enacted a Motor Fuel Marketing Practices Act, which contains a below-cost sales provision "to replace retail divorcement with a more effective and pro-consumer statutory scheme to address specific unfair and predator practices in motor fuel marketing." 412 In part, that statute makes it unlawful for refiners to sell any grade or quality of motor fuel at a retail outlet below refiner cost, or for a nonrefiner to sell such fuel below nonrefiner cost, "where the effect is to injure competition." 413 Exceptions are made for "[a]n isolated, inadvertent incident" or if the below-cost sale was made "in good faith to meet an equally low retail price of a competitor selling motor fuel of like grade in the same relevant geographic market which can be used in the same motor vehicle...." 414 Florida enacted this statute to encourage competition and prohibit predatory practices. 415

Opponents of below-cost sales laws, however, maintain that these laws are responsible for higher gasoline prices 416 and that evidence of systematic predatory pricing--one of the prime rationales for enacting such legislation--has not been found. Federal, state, and industry studies indicate that the petroleum industry is not engaged in predatory pricing against dealer-operated stations, either on the U.S. mainland or in Hawaii's retail markets. It is further argued that pricing below cost--one of the characteristic features of predatory behavior--makes little economic sense because of its unprofitability, and would expose predators to existing antitrust laws if they were able to gain any monopolistic control over the market. 417

**Minimum-Markup Laws.** Proponents of minimum-markup laws similarly contend that these laws help to prevent predatory pricing. 418 The United States Department of Energy (1984), however, found that this rationale and other reasons frequently offered in support of minimum-markup laws were flawed. In particular, the DOE found that

"[t]here is no reason to believe that predatory pricing of gasoline is taking place. No oil company has the power to establish a monopoly in gasoline marketing."419

Another rationale offered in support of minimum-markup legislation is the prevention of the use of low-priced gasoline as a "loss leader," i. e., a retail item sold at a loss to attract customers. However, according to the DOE, gasoline is not the type of commodity that makes a very good loss leader, since "[i]t is too large an item in the service station's total sales to allow losses on gasoline sales to be more than offset by increased sales of other items."420 Arguments that such legislation could facilitate a manufacturer's cartel or avoid free rider effects are similarly rejected by the DOE.421 The department also maintained that minimum-markup legislation may have the effect of impeding efficient gasoline distribution by protecting high-cost firms from more efficient competitors:

Minimum markup laws may serve to protect high-cost firms from the competition of efficient ones. In particular, they may protect existing firms from efficient new competitors by creating a barrier to entry. In gasoline marketing, high-volume retailers have been capturing an increasing share of the market. Minimum markup legislation would tend to stem this movement toward more efficient gasoline distribution by interfering with the market responses of business firms and consumers. New marketers would not be able to sell at low margins initially in order to attract customers to try new distribution and marketing techniques. In addition, they would be reluctant to reduce prices if unexpected changes in costs (perhaps due to unexpected changes in sales volume) might put them in violation of prohibitions against below-cost sales.422

Finally, the DOE stated that minimum-markup laws may hurt consumers by resulting in higher gasoline prices, both by denying consumers the benefits of more efficient distribution and marketing methods and by forcing consumers to purchase more services than they would otherwise consume under free market conditions. Minimum-markup laws are also costly and difficult to enforce.423

#### Equal Protection

It may be argued that legislation regulating the retail gasoline prices of only company-operated retail service stations--as opposed to all retail service stations--violates the equal protection guarantees of the United States and Hawaii Constitutions.424 Specifically, the major oil companies in Hawaii may contend that there is no rational

basis for singling out company-operated stations to achieve the purpose of this legislation.

Generally, while the State may make classifications to promote the general welfare, these classifications must not be made arbitrarily.<sup>425</sup>

The court's initial inquiry is whether the legislation should be subjected to a strict scrutiny or rational basis test.<sup>426</sup> The court has traditionally used the rational basis test where suspect classifications or fundamental rights are not at issue.<sup>427</sup> Under the rational basis test, the court determines whether a statute "rationally furthers a legitimate state interest" and seeks only to determine "whether any reasonable justification can be found for the legislative enactment."<sup>428</sup> Once the court determines that the Legislature passed the law to further a legitimate state interest, "the pertinent inquiry is only whether the Legislature rationally could have believed that the [statute] would promote its objective."<sup>429</sup> Because the classification made in question (8) of the Resolution is presumably for regulatory purposes, the burden would be on the litigants, i.e., the incumbent oil companies, to show that it is arbitrary and capricious and bears no reasonable relationship to the object of the statute; "[t]he general law is that regulatory classifications are presumed valid and constitutional, and are to be upheld unless no reasonable state of facts is conceivable to support them."<sup>430</sup>

Presumably, the State's objective in enacting legislation regulating the retail gasoline prices of company-operated retail service stations would be to increase the viability of independent dealers and increase competition in the State's gasoline retail market. Oil companies, on the other hand, may argue that the means chosen to accomplish this purpose do not bear a reasonable relationship to that purpose, since regulating retail gasoline prices at these stations would ultimately result in a decrease in competition as company-operated stations are driven out of business.

The decision of the United States Supreme Court in *Exxon Corp. v. Governor of Maryland*,<sup>431</sup> while not directly on point, is nevertheless instructive in this case. In denying a substantive due process challenge to Maryland's retail divorcement statute, the Court found that Maryland's statute was rationally related to the legitimate purpose of controlling the state retail gasoline market, despite evidence presented by refiners casting doubt on the economic wisdom of that statute:

Responding to evidence that producers and refiners were favoring company-operated stations in the allocation of gasoline and that this would eventually decrease the competitiveness of the retail market, the State enacted

a law prohibiting producers and refiners from operating their own stations. Appellants argue that this response is irrational and that it will frustrate rather than further the State's desired goal of enhancing competition. But, as the Court of Appeals observed, this argument rests simply on an evaluation of the economic wisdom of the statute ... and cannot override the State's authority "to legislate against what are found to be injurious practices in their internal commercial and business affairs...." ... Regardless of the ultimate economic efficacy of the statute, we have no hesitancy in concluding that it bears a reasonable relation to the State's legitimate purpose in controlling the gasoline retail market, and we therefore reject the appellants' due process claim. 432

While the oil companies' equal protection challenge would include the argument that the classification made in this case is arbitrary and does not rationally further any legitimate state interest, the State could maintain, as in Exxon, that regulating the retail gasoline prices of only company-operated retail stations is necessary to remedy injurious practices in the Hawaii's internal commercial and business affairs, and is rationally related to the legitimate purpose of controlling Hawaii's retail gasoline market.

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Endnotes 10

380. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, dated July 26, 1995, at 1-2.
381. Letter from John Tantlinger, Ed. D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated July 26, 1995, at 1.
382. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated August 1, 1995, at 2.
383. Letter to researcher from Alec McBarnet, Jr., Vice President

- of the Hawaii Petroleum Marketers Association, dated August 14, 1995, at 1.
384. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., dated September 21, 1995, at 6.
385. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated July 31, 1995, at 1, citing the United States Department of Justice's 1980 report to the President concerning the gasoline shortage of 1979.
386. *Id.* at 1-2.
387. Letter from Susan A. Kusunoki, BHP Hawaii Inc., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 10, 1995, at 1-2.
388. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 7.
389. Gregory R. Kirsch, "Note: Hurricanes and Windfalls: Takings and Price Controls in Emergencies," 79 Va. L. Rev. 1235, 1239-1241 (Aug. 1993) (footnotes omitted); Black's Law Dictionary, 5th ed. (St. Paul, MN: West Publishing Co., 1979) at 1041.
390. Kirsch (1993) at 1241 (footnotes omitted); see text accompanying notes 25 to 39 in chapter 11 for a discussion of eminent domain.
391. See United States, President's Commission for a National Agenda for the Eighties, Panel on Government and the Regulation of Corporate and Individual Decisions, Government and the Regulation of Corporate and Individual Decisions in the Eighties (Washington, DC: 1980) (hereinafter, "President's Commission (1980)") at 15.
392. Even in emergency situations, it has been argued, price controls are not only ineffective but hurt consumers by giving rise to black markets or, if these are prevented by strict enforcement of price controls, queuing. For example, Kirsch (1993) noted the following:

When prices are held below their free market equilibrium level, black markets arise. The

"invisible hand" of profit-seeking forces an approximation of the free market price in the form of under-the-table payments, bribes, or "back-alley" sales at illegal prices. Black market sellers demand prices even higher than the free market emergency price to compensate for the risk of being caught and punished, further exacerbating disaster victims' inability to afford needed goods. Thus, price controls often result in a "double whammy": consumers pay black market prices that are higher than the hypothetical free market equilibrium price, yet the quantity of goods supplied does not increase as it would under free market pricing because incentives to market entry are reduced by enforcement of price controls.

Even if black markets are prevented by strict enforcement of the price controls, some new mechanism must perform the allocative function served by prices in a free market. Queuing is the typical replacement mechanism by which scarce supplies are allocated when consumers cannot "vote with their wallets." Queuing wastes human resources as consumers spend their time waiting in lines. The government could put rationing mechanisms in place to allocate goods on a more logical basis than one's willingness to wait in line. But one suspects that government rationing, like queuing, involves "red tape," inefficiency, graft, and favoritism. Thus, price controls do not help to get needed goods into the hands of disaster victims, and if effectively enforced, they will probably reduce the quantity of available goods.

Id. at 1259-1260 (footnotes omitted); see also Hawaii, Department of Planning and Economic Development, *Managing a Gasoline Shortage in Hawaii* (Honolulu: Oct. 1981) at 42 (vol. 1): "The overriding effect of price controls is to sustain a shortage because price is not free to rise to choke off demand."

The Hawaii Legislature, finding that "any severe disruption in petroleum product supplies for use within the State would cause grave hardship, pose a threat to the economic well-being of the people of the State, and have significant adverse effects upon public confidence and order and effective conservation of petroleum products...", has granted to the Governor or the Governor's representative the

authority to control the distribution and sale of petroleum products in the event of a shortage or anticipated shortage of these products. See Haw. Rev. Stat. §125C-1. Among the powers granted to the governor are restricting the sale of petroleum products to specific days or hours, instituting a statewide rationing plan, and purchasing and reselling or otherwise distributing petroleum products. Haw. Rev. Stat. §125C-3. The state Department of Business, Economic Development, and Tourism is also required to prepare a biennial state energy emergency preparedness plan "to be implemented in the event of, or in anticipation of, a change in the State's petroleum supply or demand situation that is judged by the governor to be unmanageable by the free market." Haw. Rev. Stat. §125C-31(a). Counties must also prepare energy emergency preparedness plans in coordination and consistent with the state plan. Haw. Rev. Stat. §125C-32.

393. Philip E. Sorensen, *An Economic Analysis of the Distributor-Dealer Wholesale Gasoline Price Inversion of 1990: The Effects of Different Contractual Relations* (N. p., April 1991) at 31 (footnote omitted):

A price control system based on historical costs would require that the government establish and enforce complex accounting controls over refiner pricing. Such controls are economically justified only in a public utility setting, where the economic character of the industry are those of "natural monopoly" (i. e., economies of scale which continue up to such large output levels that single-firm production is more efficient than production shared among any larger number of firms).

But gasoline marketing does not fit the requirements of "natural monopoly". Government price controls for gasoline markets are no more justified than for food retailing or the marketing of office machinery. In these and other important U. S. industries, dual distribution is commonplace and serves to enhance efficiency by permitting various degrees of specialization to be adopted by sellers. The flexibility and price-responsiveness provided by this system would be lost under a system of price controls, as would the commitment of American society to maximum freedom of markets.

394. Id.
395. H. A. Merklein and W. P. Murchison Jr., *Those Gasoline Lines and How They Got There* (Dallas: Fisher Institute, 1980) at 111.
396. Id.
397. See Robert Fenili, "The Impact of Decontrol on Gasoline Wholesalers and Retailers," *Contemporary Policy Issues*, vol. 3, no. 3, pt. 2 (Spring, 1985) at 119-129; see also United States, Department of Energy, *Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers* (Washington, DC: March 1984) (hereinafter, "DOE (1984)") at 33: "Decontrol has brought about significant changes in the way oil companies are distributing their product. These alterations in distribution strategy are in direct response to the confluence of factors affecting the industry--decreasing demand, increasing costs, and changing consumer buying patterns." See generally id. at 33-53.
398. Sorensen (1991) at 31 ("Public utility-type regulation of gasoline prices would ... impose major new cost burdens on the refining and marketing industry, reducing its efficiency and leading to higher prices for its products. Consumers would share a large part of these costs directly and indirectly in higher gasoline prices and higher taxes paid to support the regulatory bureaucracy.")
399. Id. at 31, 32.
400. Nancy D. Yamaguchi and David T. Isaak, *Hawaii and the World Oil Market: An Overview for Citizens and Policymakers* (Honolulu: East-West Center Energy Program, Aug. 1990) at 76 (emphasis in original); see also id. at 76-77:

To take an example of what might occur in Hawaii: Suppose that the government has assessed the "reasonable" cost of gasoline, either based on California prices plus some transport cost, or based on some formula that estimates what it costs the refiner to manufacture. Then suppose that one of the refiners installs additional hydrocracking to meet a great increase in demand for jet fuel. The hydrocracker will produce substantial quantities of naphtha as a "byproduct" (although in another state, it might be the jet fuel that was the "byproduct");

with proper processing, this naphtha can be changed into gasoline. If this gasoline is in excess of the needs of the local market, then it would have to be exported. In this case, the free-market price locally would drop below the Californian price, probably by an amount equal to the transport cost. The current regulated price would be too high, under either the formula approach of the "California plus transport" approach.

Obviously, there would be a need for readjustment of the price. But according to what? To determine what would not be "fair," it would be necessary to look at the cost of the hydrocracker, and the sales price of the jet fuel that it produces. Thus, the problem of setting the gasoline price hinges on the jet fuel prices. Furthermore, only one of the refiners has installed this new equipment; should the other refiner be penalized (or receive additional benefits) based on the investment decisions taken by its competitor? ...

401. *Id.* at 77.

402. United States, General Accounting Office, Energy Security and Policy: Analysis of the Pricing of Crude Oil and Petroleum Products (Washington, DC: March 1993) (hereinafter, "GAO (1993)") at 127-128. The GAO also cited anti-price-gouging laws, which prohibit refiners from charging excessively high prices for petroleum products. Citing statistics of the American Petroleum Institute, the GAO noted that in 1990, forty-two states had considered legislation regarding gasoline pricing; this number dropped to twenty-five the following year. Between 1990 and 1991, petroleum pricing legislation was passed in five states: below-cost sales and minimum-markup laws in Florida, Montana, and Utah, and anti-price-gouging laws in Connecticut and Massachusetts. *Id.* at 128. The GAO further noted that states have proposed two other types of laws to deal with similar concerns, namely, divorcement and open-supply statutes. Open supply proposals are discussed in chapter 4 of this study; retail divorcement is discussed in chapter 15.

403. See cases cited at *Sixty Enterprises, Inc. v. Roman & Ciro, Inc.*, 601 So.2d 234, 237 (Fla. 3d Dist. Ct. of App. 1992).

404. *Id.* at 238 n. 7; see also Francis M. Dougherty, "Annotation: Validity, Construction, and Application of Statutory Provision Prohibiting Sales of Commodities Below Cost-Modern Cases," 41 A.L.R. 4th 612, 617 (1985).
405. Haw. Rev. Stat. §481-1. That section provides in pertinent part:

§481-1 Unlawful practices. It shall be unlawful for any person, firm, or corporation, doing business in the State and engaged in the production, manufacture, distribution, or sale of any commodity, or product, or service, or output of a service trade, of general use or consumption, or the product or service of any public utility, with the intent to destroy the competition of any regular established dealer in the commodity, product, or service, or to prevent the competition of any person, firm, private corporation, or municipal or other public corporation, who or which in good faith, intends and attempts to become such dealer, to discriminate between different sections, communities, or cities or portions thereof, or between different locations in such sections, communities, cities, or portions thereof in this State, by selling or furnishing the commodity, product, or services at a lower rate in one section, community, or city, or any portion thereof, or in one location in such section, community, or city or any portion thereof, than in another after making allowance for difference, if any, in the grade or quality, quantity and in the actual cost of transportation from the point of production, if a raw product or a commodity, or from the point of manufacture if a manufactured product or commodity, and in the overhead cost....

This part shall not be construed to prohibit the meeting in good faith of the rates of a competitor as herein defined, selling the same article or product, or service or output of a service trade in the same locality or trade area, or to prevent a reasonable classification of service by public utilities for the purpose of establishing rates.

The inhibition hereof against locality discrimination embraces any scheme of special rebates, collateral contracts, or any device of any nature

whereby such discrimination is, in substance or fact, effected in violation of the spirit and intent of this part.

406. Haw. Rev. Stat. §481-3. That section provides:

§481-3 Sales at less than cost. No person, partnership, firm, corporation, joint stock company, or other association engaged in business within the State shall sell, offer for sale, or advertise for sale any article, or product, or service or output of a service trade, at less than the cost thereof to such vendor, or give, offer to give, or advertise with the intent to give away any article or product, or service or output of a service trade, with the intent to destroy competition.

The term "cost" as applied to production includes the cost of raw materials, labor, and all overhead expenses of the producer; and as applied to distribution "cost" means and includes the invoice cost of the merchandise to a distributor or the replacement cost of the merchandise to a distributor, whichever is lower; less all trade discounts except customary discounts for cash; to which shall be added (1) freight charges not otherwise included in the invoice cost or the replacement cost of the merchandise as herein set forth, and (2) cartage to the distributor outlet if done or paid for by the distributor, and (3) a markup to cover a proportionate part of the cost of doing business, which markup, in the absence of proof of a lesser cost, shall be six per cent of the cost to the distributor as herein set forth after adding thereto freight charges and cartage but before adding thereto a markup; provided that in the case where a person, partnership, corporation, or association is engaged in the business or makes sales both at retail and wholesale, the "invoice cost" includes all elements recognized by good accounting practice as proper elements of the cost; provided further that taxes passed on to a purchaser as a separate item from the price of merchandise shall be included in the advertised price or offer of sale of the merchandise if such taxes are used to compute the markup of six per cent as provided herein.

The "cost of doing business" or "overhead

expense" means all costs of doing business incurred in the conduct of the business and includes without limitation the following items of expense: labor (including salaries of executive officers), rent, interest on borrowed capital, depreciation, selling cost, maintenance of equipment, delivery costs, credit losses, all types of licenses, taxes, insurance, and advertising.

407. Haw. Rev. Stat. §481-6. That section provides as follows:

§481-6 When sale at less than cost permitted.  
Sections 481-3 to 481-5 shall not apply to any sale made:

- (1) In closing out in good faith the owner's stock or any part thereof for the purpose of discontinuing the owner's trade in any such stock or commodity, and in the case of the sale of seasonal goods, or to the bona fide sale of perishable goods to prevent loss to the vendor by spoilage or depreciation, provided notice is given to the public thereof;
- (2) When the goods are damaged or deteriorated in quality, and notice is given to the public thereof;
- (3) By an officer acting under the orders of any court;
- (4) In an endeavor made in good faith to meet the lawful prices of a competitor, as herein defined, selling the same article or product, or service or output of a service trade, in the same locality or trade area;
- (5) By the government or any agency thereof, of the United States, the State, or any county, or by post exchanges or ships' service stores operating under and in accordance with United States army or naval regulations.

In case of any sale at less than cost which does not fall within (1) to (5) of this section, the burden

of proof shall be on the defendant to show that the sale was not made for the purpose of injuring competitors and destroying competition within the meaning of this part.

Any person, firm, or corporation who performs work upon, renovates, alters, or improves any personal property belonging to another person, firm, or corporation, shall be construed to be a vendor within the meaning of this part.

408. See, e.g., Rayola Dougher and Thomas F. Hogarty, *The Impact of State Legislation on the Number of Retail Gasoline Outlets*, Research Study #062 (Washington, DC: American Petroleum Institute, Oct. 1991) at 1, 7:

General laws requiring minimum markups or prohibiting sales "below-cost" are on the books in about one-half of the states, but "below-cost" selling laws specific to gasoline existed in about nine states during the mid-1980s. These specific laws were promulgated in response to claims by retailer representatives that major refiners use company-operated outlets to sell motor gasoline at prices "below-cost," and thus put them out of business. Proponents have argued that "below-cost sales" laws, if effectively designed and enforced, would preserve the number of outlets selling gasoline.

409. Tenn. Code Ann. §47-25-611(a)(1) (1994).

410. Tenn. Code Ann. §47-25-603(b) (1994):

Independent and small dealers and distributors of petroleum and related products are vital to a healthy, competitive marketplace, but are unable to survive subsidized below-cost pricing at the retail level by others, who have other sources of income. Below-cost selling laws have been effective in preserving independent and small retailers and wholesalers in other trades and businesses from subsidized pricing. Subsidized pricing is inherently unfair and destructive to, and reduces competition in, the motor fuel marketing industry, and is a form of predatory pricing. An additional purpose of this part is to prevent and eliminate subsidized pricing of petroleum and related products.

See also D. E. Jones and A. M. Alfano, "Injury to Competitors Is Injury to Competition: Predatory Pricing Under State Law," 24 Antitrust L. & Econ. Rev. 57 (Summer 1992).

411. Mont. Code Ann. §30-14-802 (1993); see also Utah Code Ann. §§13-16-1 to 13-16-12 (Michie 1994) ("Motor Fuel Marketing Act").
412. *Sixty Enterprises, Inc.*, 601 So.2d at 235 n. 1.
413. Fla. Stat. Ann. §526-304(1)(a) and (b) (West 1995).
414. Fla. Stat. Ann. §526-304(2)(a) and (b) (West 1995).
415. Fla. Stat. Ann. §526-302 (West 1988):

The Legislature finds that fair and healthy competition in the marketing of motor fuel provides maximum benefits to consumers in this state, and that certain marketing practices which impair such competition are contrary to the public interest. Predatory practices and, under certain conditions, discriminatory practices, are unfair trade practices and restraints which adversely affect motor fuel competition. It is the intent of the Legislature to encourage competition and promote the general welfare of citizens of this state by prohibiting such unfair practices.

The constitutionality of Florida's Motor Fuel Marketing Practices Act was upheld by Florida's third district court of appeal, finding that the Act was "rationally related to furthering the legislature's legitimate objective of protecting competition in the retail motor fuel market by prohibiting predatory pricing practices which the legislature has determined are unfair." *Sixty Enterprises, Inc.*, 601 So.2d at 238-239. The court further noted that "[i]t is beyond question that protecting competition is in the public interest and is an important objective of both state and federal legislative bodies. Healthy competition is valued because it increases the economic benefits to the public as a whole." *Id.* at 236-237 (footnote omitted).

416. For example, Dougher and Hogarty (1991) cited studies indicating that below-cost sales laws that are specific to

gasoline sales raise prices by limiting price competition:

A study of general below-cost selling laws that applied to gasoline sales in 24 metropolitan areas found that retail gasoline prices were higher in these areas than in 19 metropolitan areas without below-cost laws. Even after accounting for a range of other factors, the study found that prices for all grades and types of service examined were consistently higher in states with below-cost laws than in states without them. ...

A study of below-cost laws specific to gasoline sales in three such states found the same results; below-cost laws raised prices by limiting price competition. Motor gasoline prices were found to have increased in states after implementation of "below-cost" selling laws relative to gasoline prices in nearby states without similar legislation. Moreover, the study also showed that within the states with "below-cost" laws, resellers recorded greater price increases on average than did major refiners. This result suggested that marketers' pricing practices were those affected most by such laws, an outcome expected if aggressive price competition by chain retailers were stifled. Thus, while such laws are designed to prevent predatory price cutting, their impact on consumers was found to be adverse.

Id. at 8 (footnotes omitted). They further noted that the results were inconclusive regarding the impact of minimum-markup and below-cost sales laws on the number of retail gasoline outlets. In a comparison of the percentage change in the number of outlets in states prohibiting below-cost sales with the percentage change in corresponding regional and national totals from 1977 to 1987, Dougher and Hogarty found that "only five of the nine 'below-cost' states experienced changes that suggest the possibility of the preservation or growth of outlets when comparisons are made with regional averages." Id.

417. See note 72 and accompanying text in chapter 15.

418. See, e.g., T. Crawford Honeycutt, "Competition in Controlled and Uncontrolled Gasoline Markets," *Contemporary Policy Issues*, vol. 3, no. 3, pt. 2 (Spring, 1985) at 107. Honeycutt maintained, however, that "minimum-markup laws

protect high-cost firms from the competition of low-cost firms... ", and concluded that "protectionist legislation, such as minimum-markup requirements or divorcement, inevitably forces consumers to support less efficient marketers and reduces competition." Id. at 107, 117.

419. DOE (1984) at 107.

420. Id. (footnote omitted).

421. See id. at 107-108.

422. Id. at 108.

423. Id. at 109 (footnotes omitted):

To the extent that minimum markup laws restrain gasoline marketers from lowering prices and introducing more efficient distribution methods, they result in higher prices to the consumer. Some consumers may benefit from increased services, frills, and promotional deals as marketers turn to nonprice forms of competition. On the other hand, consumers who do not value these services will be denied the option of foregoing them in order to purchase gasoline at lower prices. In effect, minimum markup legislation forces consumers to purchase less gasoline (because of the higher price) and more service (because of increased nonprice competition) than they would under free market conditions. Minimum markup legislation reduces consumer welfare because it does not allow consumers to optimize their consumption decisions.

Minimum markup legislation may restrain the introduction of new gasoline marketing methods that not only involve less service, but also are more efficient than traditional methods. To the extent that prices are higher because minimum markup laws present a barrier to the entry of more efficient distribution systems, the laws impose a cost on consumers that is not offset by other factors such as increased service. Thus, consumers may have to pay higher prices not only because they are forced to pay for more service than they would consume in a free market, but also because they are denied the benefits of more efficient new distribution and marketing methods.

Finally, it should be noted that significant costs would be involved in effective enforcement of minimum markup laws. The laws tend to be vague and complex, resulting in costly legal proceedings. Given the poor history of effectiveness of minimum markup and fair trade legislation in general, it is doubtful that any benefits from the legislation would be worth the cost.

424. The Fourteenth Amendment of the U.S. Constitution provides: "nor shall any State ... deny to any person within its jurisdiction the equal protection of the laws." Article I, section 5 of the Hawaii Constitution provides that "[n]o person shall be ... denied the equal protection of the laws....".
425. *Hasegawa v. Maui Pineapple Co.*, 52 Haw. 327, 329 (1970) (citations and footnote omitted); see also *Allied Stores of Ohio v. Bowers*, 358 U.S. 522, 527-528:

The guarantee of the equal protection of the laws, found in both the Hawaii and Federal Constitutions, was not intended to interfere with the power of the State to prescribe regulations to promote the general welfare of the people. Nor was it intended that the demand for equal protection require that all laws apply universally to all persons and that they never classify when imposing special burdens upon or granting special benefits to distinct groups. It has been recognized that a state cannot function without classifying its citizens for various purposes and treating some differently from others. ... However, in exercising this right to classify in order to achieve social goals the legislature may not act arbitrarily; that is, the classification must be reasonable in relation to the purpose of the legislation.

426. *Baehr v. Lewin*, 74 Haw. 530, 571 (1993), reconsideration granted in part, 74 Haw. 650 (1993) (citations omitted).
427. *Id.* at 572 (citation omitted); *Richardson v. Sport Shinko (Waikiki Corp.)*, 76 Haw. 494, 516 (1994).
428. *Baehr v. Lewin*, 74 Haw. at 572 (citation omitted).
429. *Housing Finance and Development Corporation v. Castle*, 1995

WL 307742 (Hawaii) (May 19, 1995), slip op. at 15 (citation omitted).

430. Kaneohe Bay Cruises, Inc. v. Hirata, 75 Haw. 250, 260 (1993) (citation omitted) (emphasis in original).

431. 437 U.S. 117 (1978).

432. Id. at 124-125 (1978) (citations and footnote omitted).

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Chapter 11  
TARIFFS AND TERMINALLING

Questions (9) and (10) of the Resolution request the views of survey participants on the following issues:

- (9) The effects of requiring manufacturers, terminal operators, and jobbers of petroleum products to file with the State, a tariff listing all prices at which the manufacturer or jobber offers goods or services for sale or lease;
- (10) The effects of prohibiting any terminal operator having excess capacity from refusing to provide terminalling services to any person at the prices published in the tariff that the terminal operator filed with the State.

State Government

AG: The Attorney General noted that it recommended the filing of a tariff, as proposed in question (9), in its 1990 report.<sup>433</sup> The Attorney General further noted that a requirement that manufacturers, jobbers, and terminal operators post price information would tend to have the pro-competitive effect of enabling buyers to be better informed of available prices; however, "great care would be required in drafting such a measure":

Note should be taken, however, of *United States v. Container Corp. of America*, 393 U.S. 333 (1969). In that case, the United States Supreme Court held that when manufacturers of corrugated boxes exchanged price information in an oligopolistically structured market, and the prices in the market tended to stabilize within a narrow range, the inference was irresistible that the exchange of price information was anticompetitive, and that the effect of the exchange was to stabilize prices, a per se violation of the Sherman Act.

If a consumer sued the State for price fixing on a theory based on the *Container Corp.* case, viz., that

the effect of a law requiring the exchange of pricing data was illegal price fixing, the State would likely plead the so-called "state action" defense established under *Parker v. Brown*, 317 U.S. 341 (1943). The critical issue is whether the state action, i.e., the law requiring sellers to post their offering prices, in effect defers to price fixing discretion in private sellers. *F.T.C. v. Ticor Title Ins. Co.*, 112 S.Ct. 2169, 2176, 2179, 2180 (1992). If it does, the defense would not work. see, e.g., *324 Liquor Corp. v. Duffy*, 479 U.S. 335 (1987). 434

In response to question (10), the Attorney General noted its earlier recommendation of such a measure in its 1990 report, 435 and further stated that "[t]he effect would be to preclude terminal operators (i.e. the oil companies) from refusing to deal with competing sellers looking for storage space. The price in the tariff would likely include a profit increment. But price gouging probably could be prevented by an enforcement action under HRS ñ480-2 by the government or by the party harmed." 436

DBEDT: The Department was generally opposed to the proposals made in questions (9) and (10), arguing that there were few advantages with respect to the filing of a tariff under question (9) if the purpose was to regulate prices:

The effects of filing such a tariff listing depend largely on the purpose for this type of reporting. For example, if the purpose is to simply monitor prices, the effect on the market is likely to be negligible. However, filing such tariffs solely to monitor prices seems to conflict with the state's efforts to unsaddle industry of unnecessary forms and regulation. If, however, the purpose of filing this information is to regulate prices, we see no advantage.... 437

With respect to question (10), the department stated that imposing a requirement to provide terminalling services runs counter to free market principles:

In a free-market economy, competition is key. Competitive advantage often comes from an enterprise possessing economies of scale that a competitor does not possess; e.g., owning sufficient petroleum storage capacity to handle fluctuations of supply and demand in the market. Requiring terminal owners/operators to provide their services and use of their facilities to

those who have not invested the necessary capital to serve their customers is simply not consistent with the principles of a free-market. Finally, we know of no evidence or detailed cost-benefit analysis which would support such action. 438

#### Gasoline Dealers

HARGD: With respect to question (9), the Association argued that requiring the filing of tariffs would be in the interests of consumers and would be less costly than price controls:

Without such requirement, there is no means of establishing whether a petroleum supplier that also retails, is utilizing its multi-level gross profits to control retail market share and retail prices.

Suppliers that market products other than petroleum generally must offer all customer of like categories a price list that is non-discriminatory based on quality, quantity, and terms. The petroleum industry limits such knowledge and such categories. Requiring such information to be public knowledge must be in the public's interest. This would also be less costly than price controls. 439

Regarding question (10), the Association similarly noted that "[t]he mere fact that such a requirement were in existence would have an [effect] on the petroleum industry's control and prices at the supply level. Any such [effect] would be positive for the consumer." 440

#### Jobbers

HPMA: In response to question (9), the Association noted that tariffs and other government regulation will hurt consumers, and that existing antitrust laws are adequate to address price fixing and other illegal activities:

Filing tariffs and government intervention in this free-market system will only hurt the consumer and create a regulatory environment which will encumber all aspects of the petroleum marketing system. Prices can be subpoenaed in antitrust and price fixing investigations. There are laws on the books to allow investigations now. To do it on a regular basis without any illegal activity, is a burden to the

industry and government.

The petroleum industry in the free enterprise system remains the most competitive industry in the world. Manufacturers/refiners expend huge amounts of money attempting to differentiate and add value to their product through service and relationship and brand awareness. Dealers attempt to attract customers through location, convenience, service, and customer relationship building. Consumers have choices, and the more choices that are available, the higher the level of competition. HPMA believes that the consumer is successful when the marketplace is aggressively competing for their business and they have several alternative choices. Gasoline is a commodity and all major manufacturers produce a high-level product that exceeds automobile manufacturers' specifications. To differentiate your product from your competitors, a tremendous amount of investment and salesmanship is necessary to sell your product. 441

In response to question (10), the Association asserted that the refiner has a "fundamental right" to use private property in accordance with the refiner's choice:

HPMA believes that there is a fundamental right of the refiner/manufacturer or a jobber to utilize his storage facility to the best and highest use that he so chooses. Government appropriating or forcing a terminal operator to terminal a competitor is contrary to the American free-enterprise system.

Excess capacity may be considered head space in tankage presently, holding product and/or empty tanks that are held in reserve to support an ongoing maintenance program. To utilize either of these two capacities would cause either commingling of product or compromise a proper maintenance program. A serious competitor should be capable of either providing their own storage space or making their own arrangement without government intervention. If they are unwilling or unable to make this investment, one must question their commitment to the Hawaii market and their staying power. 442

Aloha Petroleum: In response to question (9), Aloha Petroleum stated that listing prices with the State would appear to violate antitrust

laws and would create additional taxpayer burdens:

It is our opinion that listing prices with the State as contemplated in this question would appear to be in violation of anti-trust laws. The petroleum market is subject to extensive anti-trust legislation. It is unclear what the objective is for requiring tariff listings, but this action would require additional government resources to regulate this proposed requirement. Creating more taxpayer burden through more government is not the answer. 443

Regarding question (10), Aloha Petroleum believed that this proposal would encourage existing terminal operators to maintain high inventories or tear down unused or underused facilities, as well as discourage the construction of new facilities:

Although it would appear as if the basic premise of this proposal is beneficial. It also raises many other issues that outweigh its proposed intent. For example, how would excess capacity be determined? [H]ow would terminaling services and ownership of the product be accounted for? Enacting such regulations would only encourage existing terminal operators to either keep inventories high, or tear down any unused or under used terminaling facilities. Conceivably, no new terminals would be built. The only new tankage that would be added would be to accommodate current needs; a premise that is contrary to Hawaii's emergency preparedness, good business judgment and most likely it would not justify the investment. It is our understanding that, according to the Civil Defense Division, Hawaii's petroleum reserve would be inadequate in the event of an emergency. Reducing existing terminaling facilities and/or discouraging the construction of new facilities would not serve the people of Hawaii. 444

#### Oil Companies

Shell: In response to questions (9) and (10), Shell maintained that tariff regulation would reduce competition, resulting in higher prices:

There is no economic justification for tariff regulation in a competitive industry because such regulation reduces, rather than enhances, competition. Tariff regulation in competitive sectors of the economy, such as alcoholic beverage distribution and

the trucking industry, have demonstrably reduced competition and increased prices. Comprehensive economic studies of state motor carrier regulation, for example, have clearly established that such regulation increases prices and profits of carriers and results in economic loss to shippers. For the most part, federal and state tariff regulations have been eliminated as their adverse effects on consumers have been recognized. There is no apparent reason to subject Hawaii's gasoline consumers to such economic harm. 445

BHP: With respect to question (9), BHP stated that posted prices are already available to qualified customers through inquiry notice, while other prices are published in the public domain. Requiring the posting of prices would drive up administrative costs and could violate federal antitrust laws:

Supply transactions are generally based on negotiated supply contracts covering a specified time period, the terms of which, for obvious competitive business reasons are kept confidential. Gasoline dealers typically pay a dealer price, which may vary depending on location, distance, volume purchased, term and other variables.

Requiring the filing of all prices with the State is unnecessary and is not typical industry practice; no other industry is required to publish or post its wholesale prices. Any posted price is currently available to qualified customers by direct inquiry with the company, and a large number of prices are already published in the public domain, including retail and dealer tank wagon prices.

Such a filing requirement would duplicate existing public information; unnecessarily expand the State's administrative and regulatory burden; and, if confidential information is required, could potentially seriously compromise the competitive position of the company being forced to disclose such information.

Posting prices could potentially violate federal anti-trust law by being characterized as a signal by one supplier to others when prices should move either up or down. Should one supplier elect to increase the wholesale price, the other suppliers could merely follow suit in order to gain additional margins without

sacrificing market share. This process could keep prices at artificial levels, eliminating the natural market forces which serve to keep street prices competitive.

Filing prices is unnecessarily duplicative and could potentially destroy the competitive environment which exists today, with little or no benefit to the public. 446

In response to question (10), BHP noted that its refining process yields a number of petroleum products, including jet fuel, diesel and residual fuel oils, and gasoline, and that it is impossible to produce only one of these products at one time. Prohibiting terminal operators from refusing to provide terminalling services would not only reduce the flexibility necessary in refinery production and terminal operations but would create substantial logistical and operational problems and expose the company to financial, physical, and environmental risk and liability:

It is BHP Hawaii's responsibility to manage production and storage of all of its products for the state's economy -- it must sell all of the products it manufactures, otherwise it would eventually exhaust its storage capacity. Prohibiting the right to refuse terminal services to others would severely impair the required flexibility for refinery production and terminal operations including the scheduling of incoming and outgoing product movements.

Inventory management would also be onerous and could result in logistical and operational problems. A likely scenario is where products are backed-up waiting for someone else's product sitting in the company's storage tanks awaiting distribution. Refinery production may need to cease until storage space becomes available. Or, it could lead to short-term excess product having to be shipped off-island thereby increasing environmental risk and economic loss. While a refiner may have some excess storage capacity available at various times, there is not sufficient storage that could be dedicated for any length of time without reducing the efficiency and effectiveness of the refiner and terminal operator.

Terminal owners and operators should be entitled to the right to refuse service to anyone, particularly to

those that are unable to meet any of the financial, operational quality and regulatory standards. To prohibit this right would jeopardize control over the supply and distribution facility and unduly expose the company and its employees to financial, physical and environmental risk and liability.

Quality assurance of product would become an issue since opportunities for product contamination would increase; fuel segregation would be necessary to protect product integrity. Since January 1, 1995, new EPA regulations have been in effect that require biological testing of gasoline and diesel fuel to determine the long-term health impacts of emissions. Fuel manufacturers are also required to register all fuel additives and to ensure they meet proper concentration guidelines. This situation already has resulted in an increase in the company's administrative burden due to increased reporting and data collection requirements.

It is not likely that open terminal services would result in lower gasoline prices to consumers. It could actually lead to higher prices and threaten the economic viability of local refiners and terminal operators. It would increase the complexity of the distribution system rather than simplify it, increasing the likelihood for problems to occur, and reduce the efficiency of operations, discourage private parties from investing in the construction of new facilities, only to have them made available to other parties. 447

Chevron: In response to question (9), Chevron noted that the effect of this requirement would be to raise prices by discouraging discounts:

As a practical matter, it is impossible to extend a discount only to select customers (even to meet competition) if the discounts must be disclosed to all. Further, all price changes will be immediately available to competitors. It would be impossible for a supplier to "steal a march" on the competition by reducing prices in an effort to gain marketshare. Therefore, suppliers are less likely to do so, and the consumer will again be the one hurt. 448

With respect to question (10), Chevron stated that this proposal would discourage the creation of new storage capacity by reducing incentives

to invest in new terminals, raise quality control problems, and result in spot shortages and supply disruptions:

This proposal would appear to be counterproductive and unworkable. First, there is little, if any, excess terminal storage capacity in Hawaii. Second, who would determine when in fact there is "excess capacity"? We doubt anyone has extra tanks that are not being used. How can the state determine if the storage volume in a one-quarter full tank is needed to accommodate the next tanker shipment? This is particularly true for jet fuel and diesel fuel, both of which must be imported into the Islands in significant quantities. There simply must be sufficient storage capacity to accept a cargo when it arrives.

This proposal would probably have exactly the opposite effect of that desired. It would discourage the creation of any new storage capacity, because a supplier would have little incentive to invest in such capacity, if it would immediately be available to competitors at a state-determined rental fee.

Chevron does not commingle the gasoline it manufactures in Hawaii with gasoline manufactured by others. Where this is done for other products, it is done under strict quality controls imposed by the terminal operator. If the state is going to mandate the commingling of products at terminals in Hawaii, very difficult quality control issues will be presented--particularly for gasoline. A regulatory scheme designed to balance all of the conflicting interests in this area would have to be extremely complex.

On balance, any such proposal would likely have little benefit and would likely create endless operational problems which might endanger the smooth working of the present distribution system in the Islands. At present, the marketplace gets petroleum products where they are needed when they are needed. If the Islands' limited storage capacity is to be subject to regulation by the state, it is almost certain that, on occasion, the system will not be able to respond to unanticipated problems and that there will be spot shortages and supply disruptions. 449

## Discussion

Among the issues raised by questions (9) and (10) are those of price discrimination, public utility regulation, and eminent domain.

### Price Discrimination

One of the purposes of question (9) is presumably to deter manufacturers, terminal operators, and jobbers from price discriminating, i. e., offering services or goods for sale or lease at prices higher than posted prices for certain customers, while offering the same services or goods for sale or lease to others, such as affiliates, at lower prices. Anticompetitive price discrimination is already prohibited under federal antitrust laws.<sup>450</sup>

### Public Utility Regulation

Enforcement of the proposals made in questions (9) and (10) would most likely require public utility regulation, either by the Public Utilities Commission or another regulatory body, such as a petroleum regulatory commission proposed in question (7). The merits of regulating Hawaii's petroleum industry as a public utility were discussed in response to question (7) of the Resolution.<sup>451</sup> Questions (9) and (10), however, raise the related issue of tariffs.<sup>452</sup>

One example of a tariff required in a regulated industry in Hawaii is that imposed on motor carriers, which are administered by the Public Utilities Commission. In particular, section 271-21, Hawaii Revised Statutes, requires common carriers by motor vehicle to file with the Commission and maintain for public inspection tariffs showing the rates, fares, and charges for transportation of people or property, and prohibits common carriers from charging or collecting compensation that varies from the tariff rates. That section also prohibits common carriers from making changes in any rates specified in a tariff, or any other rule or practice affecting those rates, except after thirty days' notice of the proposed change filed with the Commission.<sup>453</sup>

Although not specified in the Resolution, the Commission, among other things, may be called upon to determine whether the prices to be charged for goods or services are "just and reasonable",<sup>454</sup> inspect books and records, conduct hearings, and take such other actions as may be necessary and consistent with the State's policies.<sup>455</sup> The Public Utilities Commission or a petroleum regulatory commission, with respect to question (9), would also be required to periodically monitor manufacturers, terminal operators, and jobbers, to assure that their posted prices were the same as those filed with the State, and that the

accounts and records of each party reflected those amounts paid for the sale and lease of goods and services at those prices. With respect to question (10), the Commission would additionally need to ensure that excess capacity at terminal facilities was being offered to third parties at published prices. Although (9) and (10) do not specify these additional requirements, they may be inferred under the assumption that the State intends to enforce these provisions and is not seeking voluntary compliance. 456

#### Eminent Domain

Question (10) raises the issue of whether prohibiting terminal operators with excess capacity from providing terminal services amounts to an unconstitutional taking of private property for public use without payment of just compensation. Assuming, for the purposes of this discussion, that excess terminal storage capacity does exist in Hawaii, does the requirement that that capacity be provided to any person at posted prices filed with the State violate the United States or Hawaii Constitution? 457

Taking. Does the proposed regulation constitute a taking of private property? Although the private property in question--terminal and pipeline space and the use of appurtenant equipment 458 --would not be physically occupied by the State, "a government regulation which allows someone other than the property owner to have permanent physical occupation of a definable part of a piece of property should constitute a taking." 459 On the other hand, the United States Supreme Court has recently commented that "in the case of personal property, by reason of the State's traditionally high degree of control over commercial dealings, he [i.e., the property owner] ought to be aware of the possibility that new regulation might even render his property economically worthless. . . ." 460

While the proposed regulation in this instance would allow someone other than the owner of the terminal to use unoccupied space in the terminal, as well as the owner's pipelines and equipment to transport the crude oil, or petroleum products, as the case may be, to that space, it is questionable whether the use of the space amounts to a "permanent physical occupation" of that space, since the amount of space used may vary, at times, from zero to one hundred percent of the space. Nevertheless, it may be argued that the potential occupation of that terminal space--and consequent need for additional logistical and operational planning to accommodate that (presumably) objectionable occupation--may be viewed as an impairment of the use or value of that property.

In *Kaiser Aetna v. United States*, 461 U.S. 707, a lagoon on the island of Oahu, was historically considered to be private property under Hawaii law. The pond was leased to a resort and private developer who converted the pond into a marina and dug channels to connect the pond to a bay, thereby allowing ships to travel to the bay and ocean from the pond. The federal government argued that, as a result of improvements converting the pond into a marina and connecting it to the bay, it had become a navigable water of the United States. As such, the public acquired a right of access to that which was once a private pond. The United States Supreme Court held that the application of a federal navigational servitude to the pond constituted a taking. The Court, citing *Penn Central Transportation Co. v. New York City*, 438 U.S. 658, noted that there was no "set formula" for determining when justice and fairness required compensation for economic injuries caused by public action, but rather involved an ad hoc, factual inquiry into several factors having particular significance, "such as the economic impact of the regulation, its interference with reasonable investment backed expectations, and the character of the governmental action...". 463

The question whether the government's removal of the right to exclude others from one's private property is a taking therefore requires a balancing of the equities and a review of the facts of the case. In determining whether such a limitation constitutes a taking, a court will generally consider "the character of the government's action in terms of the degree to which it (1) promotes legitimate social goals, (2) diminishes the value of the private property owner's economic interest, and (3) interferes with reasonable expectations regarding the use of the property." 464

Briefly, the government may argue, inter alia, that the proposed regulation does not deprive terminal owners from all economically viable uses of their property, and that such a measure is necessary to generate more price competition in Hawaii's gasoline marketing industry in order to protect consumers and independent dealers. The oil companies, on the other hand, would maintain that there are less restrictive alternatives to the taking of their terminal space, which threatens their economic viability, unduly interferes with their use and operation of these facilities, and exposes them to financial, physical, and environmental risk and liability.

Public purpose. Is the proposed taking for a public purpose? Opponents of this form of regulation would argue that the proposed taking amounts to an "expropriation for a strictly private use". 465 While the stated objective of the proposal is to increase competition in Hawaii's gasoline markets, it may be argued that "the State's interest in competition is nothing more than a desire to protect

particular competitors--less efficient local businessmen--from the legal competition of more efficient ... firms...."466 Moreover, it may be argued that the State finds regulation of Hawaii's large oil companies "politically attractive" since the costs are borne "by a few individuals rather than by the entire tax base, thus immunizing legislators 'from normal democratic processes.'"467 Alternatively, if the public purpose were to limit the economic power of vertically integrated firms, there is no evidence that Hawaii's incumbent integrated oil companies have been earning profits in excess of competitive levels. 468

Proponents of this proposal, however, may argue that the State has a legitimate public purpose in regulating the oligopolistic gasoline markets in Hawaii. In *Hawaii Housing Authority v. Midkiff*, 469 the United States Supreme Court upheld Hawaii's Land Reform Act of 1967, which created a system of transferring residential property from lessors to the lessees of the property, after providing just compensation to the lessors, for the purpose of reducing the concentration of land ownership in Hawaii. In finding that the exercise of eminent domain was for a public purpose, the Court noted that the Act was intended to reduce the perceived social and economic evils of a land oligopoly, and that "[r]egulating oligopoly and the evils associated with it is a classic exercise of a State's police powers."470 It may similarly be argued that providing for the renting of unused terminal space at posted prices is a reasonable and necessary regulation of Hawaii's gasoline markets, which are "highly concentrated oligopolies."471

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Endnotes 11

433. See Hawaii, Department of the Attorney General, An Investigation of Gasoline Prices in Hawaii: A Preliminary Report (Honolulu: Sept. 1990) (hereinafter, "AG (1990)") at 22.
434. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, dated July 26, 1995, at 2.
435. See AG (1990) at 23.
436. AG letter, July 26, 1995, *supra* note 2, at 2-3.

437. Letter from John Tantlinger, Ed. D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated July 26, 1995, at 2.
438. *Id.* at 2-3.
439. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated August 1, 1995, at 2.
440. *Id.*
441. Letter to researcher from Alec McBarnet, Jr., Vice President of the Hawaii Petroleum Marketers Association, dated August 14, 1995, at 1.
442. *Id.*
443. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., dated September 21, 1995, at 6-7.
444. *Id.* at 6-7.
445. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated July 31, 1995, at 2-3, citing Allen, Preechemetta, Shao, and Singer, "The Impact of State Economic Regulation of Motor Carriage on Intrastate and Interstate Commerce," (United States Department of Transportation, May 1990) with respect to studies of state motor carrier regulation.
446. Letter from Susan A. Kusunoki, BHP Hawaii Inc., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 10, 1995, at 2.
447. *Id.* at 3-4.
448. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 7.
449. *Id.* at 7-8.
450. See generally 15 U. S. C. §13; Richard A. Posner, *The*

Robinson-Patman Act: Federal Regulation of Price Differences (Washington D. C. : American Enterprise Institute for Public Policy Research, 1976); see also Richard Albert, "Recent Decisions: Trade Regulations--Clayton Act--Robinson-Patman Price Discrimination Act--Oil Company [Texaco v. Hasbrouck, 496 U.S. 543 (1990)]," 29 Duq. L. Rev. 803 (Summer 1991).

451. See chapter 9 of this study.

452. In the context of public utility regulations, a tariff "is an algorithm for determining the bill to the customer for consumption of a firm's products. In the trivial case of one good with one price, the tariff is simply that price: the customer's bill is the price times the quantity consumed." Kenneth E. Train, *Optimal Regulation: The Economic Theory of Natural Monopoly* (Cambridge, MA: The MIT Press, 1991) at 191 (footnote omitted). "Multipart" tariffs are those with several billing components, while "optional", "voluntary", or "self-selecting" tariffs are those that give a customer a choice among two or more tariffs. For a discussion of multipart and self-selecting tariffs, see *id.* at 191-237 and 263-295, respectively.

453. Section 271-21, HRS, reads as follows:

§271-21 Tariffs of common carriers by motor vehicle. (a) Every common carrier by motor vehicle shall file with the public utilities commission, and print, and keep open to public inspection, tariffs showing all the rates, fares, and charges for transportation, and all services in connection therewith, of passengers or property. The rates, fares, and charges shall be stated in terms of lawful money of the United States. The tariffs required by this section shall be published, filed, and posted in such form and manner, and shall contain such information as the commission by regulations shall prescribe; and the commission may reject any tariff filed with it which is not in consonance with this section and with the regulations. Any tariff so rejected by the commission shall be void and its use shall be unlawful.

(b) No common carrier by motor vehicle shall charge or demand or collect or receive a greater or less or different compensation for transportation or

for any service in connection therewith between the points enumerated in the tariff than the rates, fares, and charges specified in the tariffs in effect at the time; and no carrier shall refund or remit in any manner or by any device, directly or indirectly, or through any agent, or otherwise, any portion of the rates, fares, or charges so specified, or extend to any person any privileges or facilities for transportation except such as are specified in its tariffs.

(c) No change shall be made in any rate, fare, charge, or classification, or any rule, regulation, or practice affecting the rate, fare, charge, or classification, or the value of the service thereunder, specified in any effective tariff of a common carrier by motor vehicle; except after thirty days' notice of the proposed change filed and posted in accordance with subsection (a) of this section. The notice shall plainly state the change proposed to be made and the time when it will take effect. The commission may in its discretion and for good cause shown allow the change upon notice less than that herein specified or modify the requirements of this section with respect to posting and filing of tariffs either in particular instances or by general order applicable to special or peculiar circumstances or conditions.

(d) No common carrier by motor vehicle shall engage in the transportation of passengers or property unless the rates, fares, and charges upon which the same are transported by the carrier have been filed and published in accordance with this chapter.

454. See, e.g., Haw. Rev. Stat. §§269-16(b) and 271-20(c).

455. For example, section 271-20, HRS (rates, fares, and charges of common carriers by motor vehicle), establishes the following procedures for ensuring that rates are just and reasonable and for filing complaints before the Public Utilities Commission:

§271-20 Rates, fares and charges of common carriers by motor vehicle. \* \* \*

(c) All charges made for any service rendered by

any common carrier by motor vehicle in the transportation of passengers or property or in connection therewith shall be just and reasonable, and every unjust and unreasonable charge for such service or any part thereof, is prohibited and declared to be unlawful. It shall be unlawful for any common carrier by motor vehicle to make, give, or cause any undue or unreasonable preference or advantage to any particular person, locality, region, district, island, or description of traffic, in any respect whatsoever; or to subject any particular person, locality, region, district, island, or description of traffic to any unjust discrimination or undue or unreasonable prejudice or disadvantage in any respect whatsoever; provided that this subsection shall not be construed to apply to discrimination, prejudice, or disadvantage to the traffic of any other carrier of whatever description.

(d) Any person, organization, or body politic may make complaint in writing to the public utilities commission that any such rate, fare, charge, classification, rule, regulation, or practice, in effect or proposed to be put into effect, is or will be in violation of this section or of section 271-21. Whenever, after hearing, upon complaint or an investigation of its own initiative, the commission shall be of the opinion that any individual rate, fare, or charge, demanded, charged, or collected by any common carrier or carriers by motor vehicle for transportation, or any classification, rule, regulation, or practice whatsoever of the carrier or carriers, affecting such rate, fare, or charge or the value of the service thereunder, is or will be unjust or unreasonable, or unjustly discriminatory or unduly preferential or unduly prejudicial, it shall determine and prescribe the lawful rate, fare, or charge or the maximum or minimum or maximum and minimum rate, fare, or charge thereafter to be observed, or the lawful classification, rule, regulation, or practice thereafter to be made effective.

(e) Whenever there is filed with the commission any schedule stating a new rate, fare, charge, or classification for the transportation of passengers or property by a common carrier or carriers by motor vehicle, or any rule, regulation, or practice

affecting such rate, fare, or charge, or the value of the service thereunder, the commission may upon complaint of any interested person or upon its own initiative at once and, if it so orders, without answer or other formal pleading by the interested carrier or carriers, but upon reasonable notice, enter upon a hearing concerning the lawfulness of the rate, fare, or charge, or the rule, regulation, or practice, and pending the hearing and the decision thereon the commission, by filing the schedule and delivering to the carrier or carriers affected thereby a statement in writing of its reasons for such suspension, may from time to time suspend the operation of the schedule and defer the use of the rate, fare, or charge, or the rule, regulation, or practice, but not for a longer period than five months beyond the time when it would otherwise go into effect, and after hearing, whether completed before or after the rate, fare, charge, classification, rule, regulation, or practice goes into effect, the commission may make such order with reference thereto as would be proper in a proceeding instituted after it had become effective. If the proceeding has not been concluded and an order made within the period of suspension, the proposed changed rate, fare, or charge, or classification, rule, regulation, or practice, shall go into effect at the end of such period; provided that this subsection shall not apply to any initial schedule or schedules filed by any carrier in bona fide operation when this section takes effect. At any hearing involving a change in a rate, fare, charge, or classification, or in a rule, regulation, or practice, the burden of proof shall be upon the carrier to show that the proposed changed rate, fare, charge, classification, rule, regulation, or practice, is just and reasonable.

(f) In any proceeding to determine the justness or reasonableness of any rate, fare, or charge of any carrier, there shall not be taken into consideration or allowed as evidence or elements of value of the property of the carrier, either goodwill, earning power, or the certificate under which the carrier is operating; and in applying for and receiving a certificate under this part any carrier shall be deemed to have agreed to the provisions of this subsection on its own behalf and on behalf of all

transferees of the certificate.

(g) In the exercise of its power to prescribe just and reasonable rates, fares, and charges for the transportation of passengers or property by common carriers by motor vehicle, and classifications, regulations, and practices relating thereto, the commission shall give due consideration, among other factors, to the effect of rates upon the movement of traffic by the carrier or carriers for which the rates are prescribed; to the need, in the public interest, of adequate and efficient transportation service by the carriers at the lowest cost consistent with the furnishing of the service; and to the need of revenues sufficient to enable the carriers, under honest, economical, and efficient management, to provide the service. \* \* \*

456. See, e.g., AG (1990) at 10 ("it would not be in the interest of the existing oil companies to supply a new competitor with petroleum products in bulk quantities or with terminal storage.")

For a discussion of inadequate information as a

justification for government regulation requiring disclosure of information, see note 14 in chapter 13.

457. The Fifth Amendment of the U.S. Constitution provides in relevant part: "... nor shall private property be taken for public use, without just compensation." Article 1, section 20 of the Hawaii Constitution similarly provides that "[p]rivate property shall not be taken or damaged for public use without just compensation." (emphasis added).

458. The state Department of Transportation, in the name of the State and subject to the approval of the Governor, may acquire private property by eminent domain as may be necessary for the establishment and maintenance of energy corridors in Hawaii. See Haw. Rev. Stat. chapter 277. The purpose of these corridors is to maximize "the utilization of lands available for use in connection with transporting by pipeline or other means, sources of energy including but not limited to oil, its derivatives and natural gas...". Haw. Rev. Stat. §277-2. The Legislature further found that the acquisition of private property for these purposes was for a public use. Haw. Rev. Stat. §277-1(4). While pipelines and appurtenant equipment may already be subject to the State's power of eminent domain under this chapter to

the extent that these properties are necessary for transporting oil along energy corridors, it does not necessarily follow that the terminals used for storing petroleum products would be subject to the same requirements.

459. John E. Nowak, Ronald D. Rotunda, and J. Nelson Young, *Constitutional Law*, 3d ed. Hornbook Series (St. Paul, MN: West Publishing Co., 1986) at 408 (footnote omitted).
460. *Lucas v. South Carolina Coastal Council*, 60 LW 4842, 4848, 112 S.Ct. 2886 (1992); see also *Dolan v. City of Tigard*, 62 LW 4576, 114 S.Ct. 2309 (1994); James D. Smith, "Note: Private Property Protection Legislation and Original Understandings of the Takings Clause: Can They Co-Exist?," 21 *J. of Legis.* 93 (1995); Larry Morandi, "Takings for Granted," *State Legislatures*, vol. 21, no. 6 (June 1995) at 22.
461. 444 U.S. 164 (1979).
462. 438 U.S. 104 (1978).
463. *Kaiser Aetna*, 444 U.S. at 164, citing *Penn Central Transportation Co.*, 438 U.S. at 124.
464. Nowak, Rotunda, and Young (1986) at 409.
465. *Hawaii Housing Authority v. Lyman*, 68 Haw. 55 (1985).
466. *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117, 141 (1978) (Blackmun, J., concurring in part and dissenting in part).
467. "Note: Taking Back Takings: A Coasean Approach to Regulation," 106 *Harv. L. Rev.* 914, 923 (Feb. 1993). See *id.* at 923-925 for a discussion of the "fiscal illusion" problem; see also *Pennell v. City of San Jose*, 485 U.S. 1, 22 (1988) (Scalia, J., concurring in part and dissenting in part).
468. See Hawaii, Department of the Attorney General, *The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices* (Honolulu: 1994) at 13.
469. 467 U.S. 229 (1984).

470. *Id.* at 242, citing, *inter alia*, *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117 (1978) (upholding Maryland's retail divorcement statute as bearing a reasonable relation to Maryland's legitimate purpose in controlling the gasoline market); see also *Housing Finance and Development Corp. v. Castle*, 1995 WL 307742 (Hawaii Sup. Ct., May 19, 1995), slip op. at 12; *Nowak, Rotunda, and Young* (1986) at 416.

471. AG (1990) at 9.

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Chapter 12  
DIVESTITURE

Question (11) of the Resolution requests the views of survey participants on the following:

- (11) The effects of prohibiting manufacturers of petroleum products not only from directly operating retail service stations, but also from franchising them or owning and leasing them to branded dealers (divestiture).

State Government

AG: The Attorney General noted that, ultimately, divestiture would make the gasoline retail market more competitive by "cleansing" that market of inefficient retail dealers. Nevertheless, the price of gasoline would not change significantly:

Requiring the oil companies to divest themselves of their retail outlets would undo one level of the vertical integration of the gasoline markets in Hawaii. After divestiture, the oil companies would have to compete with one another for retail outlets. Assuming the retail outlets were not organized horizontally by means of joint purchasing arrangements, the retail outlets would have to compete against one another for gasoline supplies.

The procompetitive effect hoped-for, would be an increase in competition. Because there are many retail dealers, divestiture should open up vigorous competition at the retail level for both gasoline consumers and for gasoline suppliers.

That, however, won't change the retail price of gasoline much. Increased competition will not bring gasoline prices down if the price is already at a competitive level. The Department's ongoing investigation has failed to establish that the wholesale price of gasoline in recent years has ever

risen substantially above competitive levels.

Moreover, it is not clear that divestiture would help keep the price of gasoline from rising above a competitive level.

The structure of the wholesale gasoline markets in Hawaii is not conducive to competition. (1) There are only two refiners in the market and only five significant wholesalers. (2) The market is dominated by the two refiners, Chevron and BHP. (3) The product, gasoline, is fungible. Additives and brand names don't really make a difference. (4) The demand is inelastic. A relatively small addition to the daily supply of gasoline would drive the retail price down substantially. (5) Entry and exit barriers are relatively high. The principal barrier to entry is the high sunk cost of new storage relative to the storage capacity of the incumbent oil companies. (6) Price information is not freely available. (7) Production capacity generally exceeds demand. And, (8) storage capacity generally falls short of the demand.

The Department concluded both in its 1990 report and in its 1994 report that the incumbent oil companies possessed market power, that is, the power to increase the price of gasoline and to maintain it above a competitive level for a substantial period of time.

Competition at the retail level would not necessarily force the oligopolistically organized wholesale level to become competitive. One refiner would follow the price increase of the second since doing so would increase profits by increasing revenues without increasing costs. The first refiner should maintain the existing price only if doing so would increase profits. The only way the first refiner could increase profits by pricing below his competitor would be by taking enough business away from the competitor to increase revenues more than the cost to service the additional business. But the second refiner surely would not tolerate the first refiner's effort and would promptly cancel its price increase. Therefore, not following the price increase of the other refiner would only forego profits otherwise available.

Since neither refiner currently can supply the

entire consumer demand for gasoline in the Hawaii markets, about 25,000 barrels per day, one refiner would not likely mount an aggressive price war for market share against the other.

Accordingly, divestiture might force a small decrease in the retail price of gasoline. Ironically, the amount of that decrease would be less than the decrease that could be expected from the competition from company stations. The competition from company stations theoretically would eliminate the wholesale profit from the retail price. Divestiture, like divorcement would preserve the wholesale profit. Without substantial competition at the refiner-wholesale level, the decrease in the retail price that would flow from divestiture would have to come from decreases in the retail dealer's profits. The effect would be to cleanse the retail market of inefficient retail dealers. This increase in efficiency would be the primary procompetitive effect of divestiture. 472

DBEDT: The department reiterated its comments to questions (1) and (7) of the Resolution that the prices of refined petroleum products are largely determined by the market price of crude oil, while supply arrangements and local market competition were only secondary determinants of price. Moreover, the department stated that "the federal government (GAO) in its investigation found no evidence that regulatory structures such as divestiture actually resulted in lower gasoline prices or increased competition." 473

#### Gasoline Dealers

HARGD: The Association argued that divestiture would benefit consumers, but would require additional measures to assist independents in financing the purchase of their outlets:

Divestiture would be the most effective method of providing the consumer with the best possible protection with respect to the petroleum marketing systems in operation. It is however the most drastic of such methods of limiting control by petroleum giants, and would require some means of helping independents purchase their facility. If small independents were not able to finance the purchase of their existing franchised location, divorcement would simply substitute multi-operation locations by firms large enough to meet the required financial

requirement, yet not qualify as a petroleum jobber or refiner, if that is the way such a provision were established.

Divestiture would allow a station owner to shop the market for the best price. A problem that would arise is the chance of co-mingling of product from one delivery to another, if additives used for marketing under brand names were used by some and not by others. 474

#### Jobbers

HPMA: HPMA stated its belief that consumers are best served "by creating a competitive environment that motivates manufacturers, jobbers, or individuals to build facilities to satisfy consumer demand":

A major oil company will not build a facility if there is a chance that their facility will be operated by an individual who will be motivated to buy product from someone else. The franchise system, as it is set up, allows a manufacturer to build their proprietary facility, and a franchisee to operate it. If the franchisee is successful, he will have the financial reward that is achieved with a high level of performance. In most instances, the refiner/manufacturer has chosen to use the franchise system because they feel that the franchisee does a better job than the franchise as a director operator. However, it is their choice whether to franchise the facility or operate it directly themselves. For example, the McDonald Corporation, the premier franchiser in the world, chooses to franchise certain facilities and to directly operate other facilities. They believe this is in the best interest of their company and the consumer. The manufacturer should have that choice and government should not be allowed to take that choice away. 475

Aloha Petroleum: Aloha Petroleum argued that divestiture was anticompetitive and would drive up the costs of the distribution network, making it more difficult for undercapitalized dealers to start or operate a business:

Total divestiture as contemplated in this question is anti-competitive. Prohibiting manufacturers of

petroleum products from franchising, owning, or leasing gasoline stations to branded dealers would force the overall cost of the distribution network to increase and would make it more difficult for undercapitalized dealers to establish and operate their businesses. Branded dealers have benefited from the financial support of their suppliers. In several other states, legislation has been enacted that prohibits manufacturers from directly operating retail gasoline stations. If legislation of this sort is contemplated, jobbers should be excluded from its application since jobbers do not have the advantage of producing petroleum products and are dependent on refiners. 476

#### Oil Companies

Shell: Shell stated that divestiture would be harmful to consumers by resulting in less retail competition, increased prices, and fewer consumer services:

A prohibition on investment in retail operations by an entire class of competitors -- the suppliers who have the greatest interest in the efficient distribution of the products they manufacture -- would be virtually certain to lessen competition at the retail level, resulting in higher prices and less services for consumers.... 477

If ownership of retail service stations by persons other than suppliers were economically advantageous, one would expect such ownership to be a widespread phenomenon. On the contrary, however, only a small percentage of retail service station dealers either own their stations or lease them from someone other than their supplier. The reasons for this include the availability of relatively advantageous lease terms from gasoline suppliers and the difficulty and cost of environmental management. 478

BHP: BHP stated that divestiture raises issues relating to taking property without just compensation and infringement of the contractual relationship between station owner and dealer, and would lessen competition, resulting in reduced consumer choice:

In Hawaii's marketplace the majority of gas stations are owned by manufacturers of petroleum products. A minority of these are operated by the manufacturers

themselves while the rest are leased to branded dealers or owned by independent dealers. Legislative divestiture would face some serious legal issues such as it amounts to a taking without just compensation in violation of the fifth and fourteenth amendments or that it infringes upon the established contractual relationship between the station owner and the dealer.

Divestiture would reduce competition by eliminating an established competitive offering from the marketplace, leading to reduced consumer choice. The decrease in competitive intensity would likely result in an increase in consumer prices and a decrease in the number of stations and station operating hours. (This is consistent with the findings of numerous studies on the effects of divorcement in the Maryland market.)

Divestiture and divorcement both serve to limit and restrict a select group of market participants from presenting their product/service offering to the consumer. These discriminated against participants lose both their assets and consequently their ability to offer their product to the consumer. Consumers lose in that they can expect higher prices coupled with fewer and diminished product/service offerings in the marketplace. The winners are clearly those residual market participants who get to unfairly benefit from the diminished competitive environment. 479

Chevron: Chevron stated that divestiture would result in poorer service and higher prices for Hawaii's consumers:

A modern service station represents an investment of approximately \$1.5 million, excluding land costs. To provide such a station with the inviting appearance, cleanliness, convenience, and environmental safety demanded by consumers is a major undertaking. Oil companies have the capital to make these investments and to provide consumers with the type of station they want. If refiners are unable to make such investments, they will then be made by others. But the public will be denied the benefits of vertical integration and of the oil companies' experience and expertise. Quality would deteriorate and prices would increase. 480

Discussion

Divestiture, i. e., forcing vertically integrated oil companies to divest all or a portion of their major operations (also known as "vertical divorcement"), has been viewed as a way to decrease market concentration and interdependence and foster greater competition among the oil companies.<sup>481</sup> This section reviews some of the historical antecedents of divestiture in the petroleum industry, and reviews arguments for and against the vertical structure of that industry.

Probably the "single greatest step" taken by the federal government in this area was the divestiture suit brought against the Standard Oil Company under the Sherman Antitrust Act, following the rise of that company under the direction of John D. Rockefeller.<sup>482</sup> Although Standard Oil was only one of many economic empires arising in the United States in the last half of the nineteenth century, it was arguably the most successful and notorious.<sup>483</sup> Through a syndicate of thirty-three companies, Standard Oil had achieved a position of dominance at the refining level which was subsequently protected by integrating backwards into transportation; the company eventually was able to effectively control the entire industry at all levels.<sup>484</sup>

At the turn of the century, the Standard Oil monopoly had begun to weaken when a combination of large new discoveries in Texas and growing political hostility enabled new businesses to enter the market and build themselves into integrated companies. The practices of the Standard Oil Trust had already led many states to pass antitrust laws, and the antitrust movement was gathering momentum at the national level.<sup>485</sup> Finally, in May 1911, in the landmark antitrust decision of *Standard Oil Co. v. United States*, the United States Supreme Court upheld a lower court decision finding Standard Oil in violation of the Sherman Act and forcing it to divest itself of its constituent companies, thereby destroying its vertically integrated structure.<sup>486</sup>

In the aftermath of that decision, the larger of the companies divested from Standard Oil proceeded to integrate by merger and expansion. Many of the severed companies themselves became fully integrated and, by the 1930s, eight of them were among the twenty largest oil companies in the country.<sup>487</sup> Three of the divested companies, namely, Exxon (formerly Standard of New Jersey), Mobil (formerly Standard of New York), and Socal (formerly Standard of California), eventually grew larger and wealthier than their parent company. In addition, because ownership of the new companies was transferred to the same stockholders and because company officials had long worked together, "the restructured companies began with a degree of mutual cooperation and interdependence that has characterized the relationships of the majors ever since."<sup>488</sup> While some viewed the vertical integration of the divested oil companies following the break-up of Standard Oil as further evidence of the strategic (i. e.,

anticompetitive) advantages of vertical integration, 489 others viewed integration of the severed companies, as well as the reintegration of the parent, as a way to minimize the risks inherent in the oil industry and foster greater competition. 490

The attempt of the federal government to compel the vertical divorcement of the major oil companies in the Standard Oil decision marked a turning point in terms of legislative initiative: "It was from this precedent that future efforts to remold the vertical structure of the oil industry through proposed divorcement legislation would emerge." 491 Divorcement legislation was first introduced during the 1930s; interest in this legislation subsequently increased during disruptions in the crude oil markets. 492 Calls to dismantle the integrated oil companies again arose out of the 1973-1974 energy crisis. 493

Proponents of divestiture believe that it would encourage greater competition in the oil industry by preventing the accumulation of monopoly power:

The basic arguments of the proponents of energy industry divestiture are couched in terms of enhancing competition. For example, the preamble to one of the recent bills argues that "existing antitrust laws have been inadequate to maintain and restore effective competition in the petroleum industry." So it is proposed that the laws be changed "to require the most expeditious and equitable separation and divestment of assets and interest of vertically integrated major petroleum companies." Another bill is designed to "create competition in the petroleum industry, thereby, breaking the economic stranglehold of monopoly power" and "to prevent in advance the aggrandizement of monopoly power over alternative domestic sources of energy." 494

On the other hand, it is argued that no oil company has the power to establish a monopoly in gasoline retail marketing, 495 and that divestiture would inevitably lead to decreased competition within the oil industry:

[T]he structure of the oil industry in terms of number, size, and diversity of companies is a strongly pro-competitive factor. Dismemberment legislation would create a larger total number of companies, but at each of the levels--producing, refining, transportation, and marketing--there would be the same number of companies

as there are now, or possibly less. Competition would not be increased since there is no inter-functional competition, only competition within like lines of business. Moreover, there would be a tendency to eliminate the diversity of interest which together with low concentration ratios and ease of entry constitute the strongly competitive factors in the petroleum industry.

Dismemberment legislation would complicate the ease of entry which has always characterized the petroleum industry. Companies which have started in one function and wish to integrate into others where it appears more efficient to do so would be barred from competing in such fields. . . . If the companies themselves tried to create such a structure of limiting markets and erecting barriers to entry as is created by dismemberment legislation, they would be charged with a violation of antitrust laws. 496

Moreover, it has been argued that divestiture would ultimately lead to higher social costs in terms of increased costs to consumers, less energy development, reduced technological innovation, and greater dependence on foreign oil:

Vertical divorcement could very well have the perverse effect of creating higher prices for petroleum products by virtue of the higher costs that would result from the increased production, investment, and inventory requirements following an adaptive response to vertical divorcement. Moreover (and critically), by retarding technological innovation, vertical divorcement could stultify productivity improvements and jeopardize the development of new sources of energy. In short, vertical divorcement offers nothing to benefit the American consumer or to reduce the dependence of the United States on the OPEC cartel. It is more likely to increase product prices and increase the U. S. dependence on foreign oil. If lower prices, efficient resource allocation, and less dependence on foreign supplies are the intended policy objectives, vertical divorcement should be abandoned as a serious policy alternative. 497

Underlying question (11) of the Resolution is the assumption that such a measure may be necessary to prevent vertically integrated oil companies from driving independent dealers out of business. The major

petroleum companies, it is argued, help to undercut small independent service stations through such practices as predatory pricing and downstream subsidization, i. e., that vertically integrated companies are subsidizing their marketing operations to eliminate non-branded, independent marketers from the marketplace.

However, there is no evidence of predatory pricing in Hawaii's retail gasoline markets, 498 and, as noted in chapter 3, the decrease in the number of lessee and open dealer stations and increased importance of company-operated stations may be attributed to a number of alternative explanations, including changes in gasoline consumption trends; the trend toward large- volume, self-service outlets; the decline in demand for repair and maintenance services; the growth of convenience stores; the effects of governmental regulation; and changes in lease rents and increasing land values. 499

Other factors may also contribute to a refiner's decision whether to operate a company store or to use a lessee dealer, such as the economics of gasoline marketing in rural areas as opposed to urban areas. 500 The United States Department of Energy (1984) noted that the decision whether or not to operate a company store is made as part of a broader marketing strategy. 501 Vertical integration may be an important factor where high volumes of gasoline are sold, as in self-service "gas express" style outlets. In particular, the DOE noted that based on the economics of vertical integration, owning and operating high- volume outlets may in some cases be more efficient and yield greater economies than traditional dealer outlets:

[T]he managerial economies that affect the choice of using a dealer versus an employee to operate an outlet have been stressed. There is an additional explanation based solely on the economics of vertical integration in the absence of such economies. There is some irreducible minimum amount of labor and capital required to operate an outlet. At relatively low volumes, the input factors are used effectively in fixed proportions. When this is the case, there is no efficiency motive to integrate fully by both owning and operating the outlet. At larger volumes, however, the ratio of factor inputs can be varied to achieve greater economies. It appears that the cost-minimizing ratio of capital to labor input increases with volume. This is particularly clear when the labor quality is held constant. For example, the income necessary to retain a dealer-entrepreneur-mechanic at a location is substantially greater than the income required to retain a low-skill, part time, minimum wage employee.

The dealer-entrepreneur tends to have greater difficulty in varying the quantity of quality-constant labor input because the dealer's high-quality labor input is difficult to subdivide.... [H]owever, if a dealer may operate more than one high-volume outlet, this difficulty can be reduced. In summary, the traditional dealer-entrepreneur is less able to take advantage of efficiencies that can be obtained at higher volumes by varying the ratio of quality-constant input factors. This stems from the relative fixity of the traditional dealer's own labor input. 502

Therefore, it may be argued, divestiture legislation would result in greater inefficiency and run counter to consumer preferences by favoring traditional dealer outlets over more efficient high-volume outlets.

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Endnotes 12

472. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, dated July 26, 1995, at 3-4; see also AG (1990) at 20-21; AG (1994) at 11, 20-21.
473. Letter from John Tantlinger, Ed. D., Energy Planner for the Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated July 26, 1995, at 3.
474. Letter to researcher from Richard C. Botti, Executive Director of the Hawaii Automotive & Retail Gasoline Dealers Association, dated August 1, 1995, at 3.
475. Letter to researcher from Alec McBarnet, Jr., Vice President of the Hawaii Petroleum Marketers Association, dated August 14, 1995, at 1-2 (emphasis in original).
476. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., dated September 21, 1995, at 7-8. Retail divorcement, which prohibits manufacturers and jobbers from operating retail service stations in Hawaii

under certain circumstances, is codified at section 486H-10, Hawaii Revised Statutes; see Appendix H.

477. Shell further cited the following testimony opposing divorcement legislation from the U. S. Department of Justice, in an analysis that Shell considered to be equally applicable to the divestiture concept, in explanation of why such legislation would be harmful to consumers:

[T]he retail gasoline industry is competitive in most markets. Major oil companies have partially integrated into retailing to provide an apparently more efficient and lower cost means of distributing motor fuel. Prohibiting major oil companies from using what they believe is an efficient method of distributing motor fuel will not result in lower retail prices; rather, it is far more likely to force consumers to pay for a less efficient distribution method in the form of higher gasoline prices or lesser availability of supply, or both.

Statement of Charles F. Rule, Deputy Assistant Attorney General, Antitrust Division, U. S. Department of Justice, before the Committee on the Judiciary, U. S. Senate, concerning S. 1140, at p. 11 (Oct. 9, 1985); Shell letter, Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Company, dated July 31, 1995, at 3.

478. Shell letter, July 31, 1995, supra note 6, at 3.
479. Letter from Susan A. Kusunoki, BHP Hawaii Inc., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 10, 1995, at 4-5.
480. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 8.
481. In this report, the terms "divestiture" and "vertical divorcement" are used interchangeably to refer to the divestment of a vertically integrated oil company of its major operations, in this case, its retail outlets; the terms "divorcement" and "retail divorcement", on the other hand, are used to refer to the prohibition of integrated oil companies from operating their own retail outlets. See chapter 15 for a discussion of retail divorcement.

482. Jeffrey L. Spears, "Note: Arguments For and Against Legislative Attacks on Downstream Vertical Integration in the Oil Industry," 80 Ky. L.J. 1075, 1076 (Summer, 1992); see generally Bruce Bringham, *Antitrust and the Oil Monopoly: The Standard Oil Cases, 1890 - 1911* (Westport, CT: Greenwood Press, 1979).
483. Franklin Tugwell, *The Energy Crisis and the American Political Economy: Politics and Markets in the Management of Natural Resources* (Stanford, CA: Stanford University Press, 1988) at 47.
484. Fred C. Allvine and James M. Patterson, *Competition, Ltd.: The Marketing of Gasoline* (Bloomington: Indiana University Press, 1972) at 216-217; but see Alan Stone, *Regulation and its Alternatives* (Washington, DC: Congressional Quarterly Press, 1982) at 76, noting that a body of evidence, although subject to dispute, suggested that Standard Oil did not as a matter of common practice engage in predatory conduct.
485. Tugwell (1988) at 48.
486. 221 U.S. 1 (1911).
487. Arthur M. Johnson, "Lessons of the Standard Oil Divestiture" in *Vertical Integration in the Oil Industry*, ed. Edward J. Mitchell (Washington, DC: American Enterprise Institute for Public Policy Research, 1976) at 191.
488. Tugwell (1988) at 48-49.
489. See, e.g., Allvine and Patterson (1972) at 216.
490. Johnson (1976) at 213-214:

The post-dissolution record of companies severed from the Standard Oil combination in 1911 suggests that vertical integration was not a device fostered by the trust to monopolize the industry but a logical structure for stabilizing operations in a basically unstable industry. Taking advantage of the atomistic competition of domestic independent producers, the Standard Oil combination achieved stability primarily through its dominance in refining, marketing, and transportation. When the antitrust decree of 1911 sought to end that dominance by divorcement, the economic advantages of vertical integration were

directly challenged. But the historical record shows that they were not to be denied. Reintegration of the parent company, Jersey Standard, and integration of its principal severed companies was achieved within two decades while the industry itself became more competitive.... The antitrust decree hastened the end of the grip that Standard Oil had held on the industry, though the combination was already losing ground in 1911. But it was through vertical integration of the severed companies and reintegration of the parent that competition was fostered, not only with non-Standard companies but also between the former affiliates of the combination.

491. Spears (1992) at 1077.
492. *Id.* at 1077 n. 14.
493. John E. Gray, *Energy Policy: Industry Perspectives* (Cambridge, MA: Ballinger Publishing Co., 1975) at 15.
494. Gerald L. Parsky, "The United States Treasury Analysis: The Effects of Divestiture" in *Capitalism and Competition: Oil Industry Divestiture and the Public Interest*, Proceedings of the Johns Hopkins University Conference on Divestiture, Washington, D. C., May 27, 1976, ed. George A. Reigeluth and Douglas Thompson (Baltimore: Center for Metropolitan Planning and Research, and School of Advanced International Studies, Johns Hopkins University, 1976) at 50; see also Walter S. Measday, "The Case for Vertical Divestiture," in *Capitalism and Competition*, *id.* at 12-19.
495. See United States, Department of Energy, *Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers* (Washington, DC: March 1984) (hereinafter, "DOE (1984)") at 107.
496. W. T. Slick, "A View from a Large Oil Company," in *Witnesses for Oil: The Case Against Dismemberment* (Washington, DC: American Petroleum Institute, 1976) at 26-27.
497. David J. Teece, "Vertical Integration in the U. S. Oil Industry," *Vertical Integration in the Oil Industry*, ed. Edward J. Mitchell (Washington, DC: American Enterprise Institute for Public Policy Research, 1976) at 182; see also Edward J. Mitchell, "Capital Cost Savings of Vertical Integration", *id.* at 101. See generally R. J. Boushka, et

al., *Witnesses for Oil: The Case Against Dismemberment* (Washington, DC: American Petroleum Institute, 1976); Annon M. Card, "The Case Against Divestiture" in *Capitalism and Competition*, supra note 23, at 19-24.

A recent study also concluded that, in certain instances, vertical integration in an oligopolistic industry leads to higher social welfare compared with alternative vertical structures, such as spot market transactions, exclusive contractual relations, and mixed integration. See Changqi Wu, *Strategic Aspects of Oligopolistic Vertical Integration*, studies in Mathematical and Managerial Economics, vol. 36, ed. Herbert Glejser and Stephen Martin (Amsterdam: North-Holland, 1992) at 210.

Another study focusing on industry structures with only a few upstream producers, each of which uses downstream intermediaries that carry only its product line, found that "consumers are best off when manufacturers sell through company stores independent of whether the manufacturers are colluding or behaving noncooperatively." Timothy W. McGuire and Richard Staelin, "An Industry Equilibrium Analysis of Downstream Vertical Integration," *Marketing Science*, vol. 2, no. 2 (Spring 1983) at 188. The authors noted, however, that their results suggest that "when manufacturers in an oligopoly are behaving noncooperatively, we should not infer from their use of privately-owned franchised dealers in a conflict-free channel structure that the consumer is getting as low a price as possible":

Thus, for example, the apparently fierce competition among automobile dealers or (at times) gasoline station dealers does not imply that the automobile manufacturing or petroleum industries are highly competitive. Rather, the use of franchised dealers by profit-maximizing manufacturers implies that both retail and manufacturers' profits are greater than they would be if the manufacturers were to switch to a pure factory outlet distribution structure." McGuire and Staelin (1983) at 188.

498. Walter Miklius and Sumner J. LaCroix, *Divorcement*

Legislation and the Impact on Gasoline Retailing in the United States and Hawaii (Honolulu: University of Hawaii, January 20, 1993) at 7. See notes 66 to 74 and accompanying text in chapter 15 for a discussion of predatory pricing.

499. See notes 26 to 38 and accompanying text in chapter 3.

500. DOE (1984) at 78, 83.

501. *Id.* at 96 (footnote omitted):

Companies that consider using their own employees to run their outlets are not interested simply in having company-operated stations to run. They must believe that company-operated outlets are the most profitable means to accomplish their overall marketing strategy. For example, it may be that a company has decided that as a result of ... changes in the marketplace ..., the most efficient way to market gasoline is through a series of high volume, low overhead, pumpers staying open 24 hours a day and 7 days a week. The most direct way of accomplishing this would be to run the outlets with their own employees and set the prices low enough to obtain the needed volumes. An alternative would be to use franchisees but to specify narrowly the hours of operation and minimum volumes required. It even would be possible to franchise the outlets in groups of two or more stations with common management thus enabling [them] to achieve whatever economies of scale exist in multi-station management.

502. *Id.* at 46 n. 33. An earlier DOE study also noted that a marketing style favoring high-volume outlets may be considered both more efficient and profitable in certain circumstances than conventional retail outlets. See United States, Department of Energy, *The State of Competition in Gasoline Marketing*, Final Report (Washington, DC: Jan. 1981) at ES-2:

This study develops an alternative explanation which shows that the profitability of alternative marketing channels depends upon the investment costs of providing stations, the operating costs of selling gasoline through different outlets, and the selling price at these different outlets. Under certain conditions, a low-volume, dealer-operated network is the most profitable to the refiner-supplier. Thus,

the alternative explanation asserts that the marketing style adopted by the major refiners was the most profitable for these firms at the time.

This explanation also helps explain today's movement to higher volume outlets generally and to company stores for some refiners. Because of changes in consumer preferences, increases in construction and operating costs, the legalization of self-serve, etc., the higher volume network has become relatively more profitable than a lower volume, dealer-oriented system. Viewed in this light, today's movement to high-volume, company-operated outlets may not be subsidization, but may represent a profit-maximizing response by refiners to changing market conditions.

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Chapter 13  
PETROLEUM INDUSTRY INFORMATION REPORTING

Question (13) of the Resolution requests the views of survey participants on the following:

- (13) The effects of active enforcement of the Petroleum Industry Information Reporting Act of 1991 and Act 291, Session Laws of Hawaii 1991 (codified as chapter 486I, Hawaii Revised Statutes). 503

State Government

PUC: The Petroleum Industry Information Reporting Act has never been implemented by the Public Utilities Commission, which maintains that it has not received sufficient resources to undertake its implementation. 504

AG: The Attorney General noted that funding and enforcement of Act 291 would greatly expand the State's ability to conduct antitrust enforcement and responsible legislative oversight of Hawaii's petroleum product markets, which would benefit consumers:

The chief effects of funding and enforcing the Petroleum Industry Information Reporting Act of 1991 would be the establishment of a data base about the supply of and demand for petroleum products in Hawaii. In particular, the data base would enable:

a. The PUC to evaluate the eight items listed in HRS §486I-4 and thereby make the reports to the Governor and the Legislature required by HRS §486I-5(a). This, in turn would enable the Legislature to enact appropriate legislation and the Governor to initiate appropriate executive actions.

b. The Attorney General to evaluate whether any person or persons doing business in the petroleum product markets in Hawaii are violating any antitrust laws.

Currently, there is no comparable data base available to the Legislature, the Governor, or the Attorney General.

The Department of the Attorney General currently possesses investigative powers sufficient to collect the information. But the Department has neither the funds, the equipment, the storage space, the personnel, nor the expertise necessary to gather, analyze, and interpret such data except on a basis limited in the extreme.

In other words, the funding and enforcement of the Petroleum Industry Information Reporting Act would significantly expand the ability of the state government to do appropriate law enforcement and legislative oversight in the petroleum product markets in Hawaii, especially the gasoline markets. The result should be highly beneficial to consumers. 505

DBEDT: The department noted that the supply and demand data requested by chapter 486I would be duplicative of that already provided by the petroleum industry to the department under chapter 486E, and that consumer prices could increase to enable the industry to comply with additional reporting requirements. Moreover, the expenditure of substantial resources would be required to provide for the implementation of chapter 486I by the Public Utilities Commission:

It is difficult to speculate what effects might be felt as a result of active implementation of Chapter 486I (Hawaii Revised Statutes (HRS)). Inasmuch as the petroleum industry already provides supply and demand data to the Director of Business, Economic Development, and Tourism, as required by Chapter 486E, HRS, active implementation by the Public Utilities Commission (PUC) of Chapter 486I, HRS, would result in a duplicative burden on industry for at least the supply and demand data required under Chapter 486E. With respect to the reporting of the petroleum industry's financial information, this would constitute an additional burden on industry heretofore unfelt in Hawaii. It is unclear what, if any, effects active implementation of this law would have on end-user prices. However, it seems reasonable to speculate that the additional administrative burden placed on the petroleum industry could actually cause product prices to increase to enable the industry to support these new requirements.

We believe that our response ... to Question 7 ... of this survey is relevant to the likely effects active

enforcement of Chapter 486I, HRS, might have on its implementing agency -- the PUC. The analytical skills and resources required to effectively implement the requirements of Chapter 486I, HRS, would likely be far above those required currently by the PUC to regulate the electric and gas utilities. Skills in economics, chemistry, petroleum logistics, international politics, petroleum industry-relevant law, and so forth would be required of the Commission's staff. More important, during this period of economic and budgetary constraints, it is highly unlikely that sufficient revenues can be obtained to provide the resources necessary for the PUC to effectively implement this law. 506

#### Gasoline Dealers

HARGD: "Since the information provided or not provided to the State under these legal requirements are confidential, we do not know what affect they have had on the industry, franchised dealers, or the consumer." 507

#### Jobbers

HPMA: The Association argued that chapter 486I is unnecessary and inappropriately interferes with private enterprise, and that the costs of reporting will inevitably be passed on to consumers:

[The] Petroleum industry Information Reporting ... appears to be designed specifically for Hawaiian Refiners and does not directly affect Hawaiian Jobbers who are customers of various majors and Hawaiian Refiners. In view of the encumbering reporting regulations that the above-mentioned chapter requires from the Hawaii Refiners, this appears to be an instance of government interfering with private enterprise and asking a lot of proprietary information for the purpose of a commission review. It is HPMA's view that these types of commissions are not necessary and do not act in the best interest of the consumers. Staff at the refinery is going to have to spend hours of time providing this information. All these additional costs have to be passed on to the consumer. The petroleum industry is highly competitive, and the consumer should be the ultimate motivating force for the decisions that the manufacturers, dealers & jobbers

make regarding services & expansion of their product line. Government's role is not to interfere in this process but to provide the arena that the competitive forces will benefit the consumer. 508

Aloha Petroleum: Aloha Petroleum believed that active enforcement of chapter 486I would require additional governmental resources, which could lead to higher fuel costs:

Chapter 486I, Hawaii Revised Statutes, requires the submission of specific information based on classification to the Public Utilities Commission within the time periods prescribed therein. It is our understanding that Aloha does not currently qualify as a major marketer, oil producer, storer or transporter and therefore Aloha is unsure of the effect of active enforcement of this Chapter. However, it would appear that the reporting, analysis and enforcement provisions of this Chapter would require the utilization of additional governmental resources which could lead to higher fuel costs. 509

#### Oil Companies

Shell: Shell stated that enforcing chapter 486I would increase oil industry costs, which would most likely be passed on to consumers in the form of higher gasoline prices:

This statute requires the oil companies doing business in Hawaii to report regularly, in a form required by the public utilities commission, data concerning their business operations, including the following:

- Feed stock
- Petroleum receipts
- Refinery stocks
- Inventory
- Finished product supply and distribution
- Exchanges
- Refinery capacity
- Storage capacity
- Amounts transported
- Sales

The effect of such a reporting requirement would be to increase oil industry costs. The increased cost

burden would be proportional to the quantity and frequency of required reporting, and would most likely be passed on to consumers in the form of higher prices for gasoline.

There is no apparent need for the government to accumulate, maintain and protect such a costly database. Some of the information listed in the Act -- for example, data with respect to taxable sales of gasoline, refining capacity and storage capacity -- is already either reported, or otherwise available, to the government and reporting it again to the P. U. C. would be redundant. In addition, any information that may actually be necessary for legislative or law enforcement purposes can be readily obtained when needed through the usual processes. 510

BHP: BHP noted that additional procedures must be established before chapter 486I can be implemented:

Any analysis of the "effects of active enforcement" of HRS, Chapter 486I, at this time, would be premature. Prior to any information being provided under this statute, the type of data, its format and the procedures for submission and maintenance within the commission, must be established. Steps should also be taken to ensure that any required information is not duplicative of information already being submitted or readily available through other sources. Once the necessary rules have been established if the required information is provided there would be no need for any type of "active enforcement". 511

Chevron: "The Petroleum Industry Information Reporting Act requires that oil companies and others submit various information to the Public Utilities Commission. Chevron is fully complying with that law. If the law is not actively being enforced, Chevron is not aware of it." 512

#### Discussion

This section discusses the rationale that inadequate information regarding an industry may in some cases serve as a justification for government intervention requiring disclosure of certain information. Question (13), regarding the Petroleum Industry Information Reporting Act of 1991, is reviewed in this context as a form of disclosure regulation. 513

Breyer (1979 and 1982) noted that consumers must have sufficient information to evaluate competing products to allow competitive markets to function well, and must understand the characteristics of their buying choices and identify the range of buying alternatives. In this context, information is itself a commodity that requires the expenditure of resources to produce: buyers spend money, time, and effort searching for alternative suppliers, while sellers spend money researching, labeling, and advertising to differentiate their product from other similar products.<sup>514</sup> While "[i]n well-functioning markets, one would expect to find as much information as consumers are willing to pay for in order to lower the cost or to improve the quality of their choices",<sup>515</sup> regulation may be used to correct for inadequate information or lower the costs to consumers of obtaining information.<sup>516</sup>

Disclosure is an obvious remedy to the problem of inadequate information.<sup>517</sup> While disclosure may be regarded as a form of classical governmental regulation, Breyer instead views disclosure as an alternative to regulation, since it does not regulate price, allocation of products, or production processes, nor does it restrict individual choice to the extent accomplished by other forms of regulation. "Moreover, since freely functioning markets require adequate information--which disclosure helps provide--disclosure, like antitrust, can be viewed as augmenting the preconditions of a competitive marketplace rather than substituting regulation for competition."<sup>518</sup> Some forms of disclosure are not designed to make competitive markets function more effectively but may instead be used for noneconomic purposes, such as helping to enforce gambling laws or informing voters about campaign contributors. When used for economic purposes, however, disclosure assists consumers in making more informed choices.

In order to implement the disclosure requirements, however, regulators must set standards specifying what is to be disclosed and in what manner, which may involve problems associated with other forms of classical regulation: "In setting those standards, [the regulator] will have to deal with those very problems of information, enforcement, anticompetitive effects, and judicial review that plague other forms of standard setting."<sup>519</sup> Other problems include burdensome paperwork requirements and disclosure's ineffectiveness in dealing with environmental and other issues.<sup>520</sup> Disclosure nevertheless allows for greater freedom of consumer choice than classical regulation. While classical regulation may specify the type of product that must be sold or the process that must be utilized, at the worst, disclosure may seek too much information or the wrong information.<sup>521</sup>

The Petroleum Industry Information Reporting Act of 1991 (PIIRA) requires refiners and each major marketer, oil producer, oil transporter, and oil storer to submit to the Public Utilities Commission certain information relating to petroleum and petroleum products with respect to their areas of specialty within specified time periods. Under the PIIRA, the PUC is required to publish annually and submit to the Governor and Legislature a summary, analysis, and interpretation of the information received from the petroleum industry.<sup>522</sup> The PUC's analysis is to include such items as the nature, cause, and extent of petroleum or petroleum products shortages or conditions affecting supply, the economic and environmental impacts of any petroleum and petroleum product shortages, and emerging trends relating to supply, demand, and conservation of petroleum and petroleum products.<sup>523</sup>

The disclosure of data required by the PIIRA does not necessarily seek to benefit consumers in decisionmaking directly, but rather indirectly by assisting state policy makers in formulating both economic and noneconomic decisions on behalf of consumers, including, presumably, enforcement of the antitrust laws, since information obtained by the PUC is to be shared with the Attorney General.<sup>524</sup> The stated objective of the PIIRA is to aide state policy makers in developing and administering energy policies "in the interest of the State's economy and the public's well-being."<sup>525</sup>

Proponents of the PIIRA argue that the disclosure of the information required by that Act is cost effective and necessary for energy planning. In testimony submitted to the Senate Committee on Consumer Protection and Business Regulation in support of Senate Bill No. 1329 (1991) (later enacted as the PIIRA), Drs. Yamaguchi and Isaak of the East-West Center Energy Program noted that the bill was modeled after California's PIIRA legislation, which was enacted in that state in 1980.<sup>526</sup> They note that PIIRA data collected in that State, which is summarized and published for public use by the California Energy Commission in their Quarterly Oil Report, has been "very useful" in California and that a similar program in Hawaii would be a more cost effective means of data collection than the initiation of ad hoc investigations in response to crises. They further cited the following reasons in support of this reporting requirement:

The oil companies may find the new requirements somewhat cumbersome, but PIIRA may actually be to their long-term advantage. First, filing PIIRA data will enhance State and public understanding of the industry, which may reduce the number of accusations and charges levelled at the companies each time the price of oil goes up. Second, the PIIRA forms will be standardized,

so that filling them out on a monthly basis should become increasingly convenient once the companies develop efficient internal data collection and reporting methods. Filing the data with the State may also reduce the number of data requests fielded by the companies on a day-to-day basis, since a single state entity will then be responsible for handling public and inter-agency requests. Third, each oil company should feel more secure in the knowledge that its competitors are required to provide the same data, and that proprietary data will be held in confidence so that cooperation with the State will not jeopardize its ability to compete in the market. 527

Yamaguchi and Isaak further commented that the data obtained could "feed into energy demand forecasting, comprehensive energy planning, evaluation of alternative and renewable energy resources, and energy emergency preparedness planning", and that establishing such a data base was "a vital element in the State's current efforts on integrated energy planning." 528 In an earlier report, they noted that the importance of obtaining accurate information has been undervalued, and, given Hawaii's almost total dependence on oil, is critical in the likely event of future gasoline shortages. 529 A 1974 report to the Hawaii House of Representatives investigating Hawaii's gasoline market also noted shortages of both gasoline and data, and recommended the collection of information to prepare the State for future contingencies. 530 The lack of data has also hampered the Attorney General in its investigation of gasoline prices in the State. 531

Opponents of the PIIRA, however, object to that Act as intrusive and burdensome. In particular, industry officials noted their concerns over Senate Bill No. 1329 (1991) relating to the confidentiality of data and the additional burdens that would add to their costs of doing business in the State. For example, with respect to the issue of confidentiality, testimony provided on Senate Bill No. 1329 by both Chevron and P. R. I. noted that the information requested was proprietary and that confidentiality requirements in the bill were insufficient to safeguard company data. 532

Moreover, additional expenditures would be necessary in order for the Public Utilities Commission to implement the PIIRA. Additional government expenditures may be deemed impractical, it may be argued, given the State's current budget problems. The PUC is apparently understaffed relative to the responsibilities requested of it under that Act. Yamaguchi and Isaak commented (in the related context of the proposed regulation of the oil industry) that the PUC, among other things, lacks the resources necessary to analyze oil industry data:

In Hawaii, both the Public Utilities Commission (PUC), and the Division of Consumer Advocacy are understaffed relative to their mandates. Many states have economic and operations models of the electric power sector that rival or even exceed the complexity of the analytical tools found within the utilities. Oil analysis is more complicated than electric-power analysis by an order of magnitude. Good oil economists are difficult to find outside the oil companies, and they command salaries that are far higher than can be paid in the public sector. Even if oil analysts were readily available, it would require at least a doubling, and probably a tripling, of the size of the PUC to tackle the problem of oil-industry regulation. It is not the kind of job that can be performed by merely hiring a few economists to monitor the situation. A good oil team needs to have a command of economics, refinery operations, linear programming, chemistry, shipping, and international politics. Seemingly minor details--such as the percentage paraffin content of the naphtha produced from a new crude in Indonesia--can have critical effects on the market. Oil companies themselves, which employ large staffs of planners and analysts, still pay hundreds of thousands of dollars per year for specialized consulting services. ... 533

In an effort to determine the amount of money that would be necessary to implement the PIIRA, the Bureau asked the Public Utilities Commission to provide estimates of the annual and start-up costs for such implementation; however, the PUC was unable to provide estimates within the time requested.<sup>534</sup> The Department of Business, Economic Development, and Tourism was also requested to provide the same estimates, assuming that: (1) the responsibility for implementing the PIIRA was (hypothetically) transferred from the PUC to DBEDT; and (2) the Department's costs reflected only those necessary to implement the provisions of the PIIRA that were not already being implemented by the Department under chapter 486E, Hawaii Revised Statutes.<sup>535</sup> The Department stated that first year start-up costs would total \$104,396, while recurring subsequent year annual costs would amount to \$88,196, if the Department was required to implement the PIIRA. The Department's cost estimates are contained in Appendix J.

Moreover, the Department concluded that implementation of the PIIRA would be redundant of data gathering, analyses, and reporting activities already conducted by other state and federal government

agencies, including DBEDT and the United States Energy Information Administration (EIA). The Department further concluded that "[w]hile not all of this information is reported within the structure of a regular monthly report or other periodic basis, it is available to the state when and if it is needed and does not constitute an excessive resource burden on industry or state government when it comes to data reporting and analyses."<sup>536</sup> Presumably, the PUC's start-up and recurring costs to implement the PIIRA would exceed those of DBEDT, since the PUC is not currently involved in the type of oil industry data gathering or analysis already being conducted by DBEDT.

Finally, it may be questioned whether the PIIRA exceeds the scope of disclosure legislation and is (in part) quasi-regulatory in nature. Certain provisions of that Act, it may be argued, may be viewed as exceeding the kind of information necessary for the State to develop and administer energy policies on behalf of the citizens of the State. For example, the Department commented that section 486I-3(h), Hawaii Revised Statutes, requests price information that may be viewed as having a regulatory purpose:

[Section] 486I-3(h) requires reporting of petroleum product prices and sales volumes by end-use sector and petroleum product. Again, consumption information is available from data gathered under Chapter 486E, HRS. With respect to the reporting of price information, unless this information is to be used for regulatory purposes, it is unclear as to its utility, especially when market price information on various petroleum products is also available through EIA reports and other private sources.... If this price information is desired for a regulatory purpose, we do not believe it is necessary, and collection by DBEDT would be inconsistent with the DBEDT Director's role as the State's Energy Resources Coordinator (ERC). The ERC is to serve as an energy advisor, coordinator, and facilitator for the Governor, industry, and all levels and branches of government. However, the ERC is not a regulator. 537

In summary, it may be argued, the PIIRA is duplicative of existing law, requests information that may readily be obtained from other sources, and (in part) exceeds the scope of disclosure legislation by requesting information that may be considered regulatory or quasi-regulatory in nature.

## PETROLEUM INDUSTRY

### Endnotes 13

503. Contrary to the implications of this question, the Petroleum Industry Information Reporting Act of 1991 (the "PIIRA") and Act 291, Session Laws of Hawaii 1991, refer to the same statute, a copy of which is contained in Appendix I.
504. Telephone interview with Clay Nagao, Chief Counsel of the Public Utilities Commission, on June 15, 1995.
505. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, August 31, 1995, at 1-2.
506. Letter from John Tantlinger, Ed. D., Energy Planner, Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, September 1, 1995, at 1 (emphasis in original).
507. Letter to researcher from Richard C. Botti, Hawaii Automotive and Retail Gasoline Dealers Association, Sept. 1, 1995, at 1.
508. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, Sept. 7, 1995, at 1. The HPMA's response to this question also included a discussion of Act 238, Session Laws of Hawaii 1995 (amending section 486H-10(a), Hawaii Revised Statutes), which has been included instead under the HPMA's response to question (15) of the Resolution. See text accompanying note 8 in chapter 15.
509. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., dated September 21, 1995, at 9.
510. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Co., dated August 31, 1995, at 1-2.
511. Letter from Susan A. Kusunoki, BHP Hawaii, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated September 8, 1995, at 1.
512. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative

Reference Bureau, dated August 7, 1995, at 9.

513. The requirement that manufacturers, terminal operators, and jobbers file a tariff with the State listing all of the prices at which goods and services are offered for sale or lease, as proposed in question (9) of the Resolution, may similarly be viewed as an example of disclosure. However, it may be argued that this proposal exceeds the scope of disclosure and is more regulatory in nature. As noted by the response of the Department of Business, Economic Development, and Tourism, it is unclear whether the purpose of the tariff is to monitor or regulate prices. Whether the intent is to ultimately assist consumers in making more informed choices or to provide additional price information to policy makers and investigators of the petroleum industry, filing tariffs may nevertheless require the involvement of the proposed petroleum regulatory commission (question (7) of the Resolution), the Public Utilities Commission, or some other state agency in a some regulatory capacity.
514. Stephen G. Breyer, "Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform," 92 Harv. L. Rev. 549, 556 (Jan. 1979); Stephen G. Breyer, Regulation and its Reform (Cambridge, MA: Harvard University Press, 1982) at 26.
515. Breyer (1982) at 26.
516. In particular, Breyer cited the following as typical rationales for regulation in this area:
- (1) Incentives to produce and disseminate information may be skewed. Some information requiring detailed research, for example, may be expensive to produce initially but subsequently inexpensive to make available. Because the information may be easily reproduced at low cost, those in the best position to produce the information may not do so, even though the information may benefit others, since the recipients may never pay the original producer. While much of this information may be protected by copyright and patent laws, the problem may nevertheless lead to a demand for regulation.
  - (2) A party to a transaction may deliberately seek to

mislead another party by misrepresentation or omission of material facts. While misrepresentation may be grounds for rescission of a contract and damages, the high costs of court actions may not serve as an adequate deterrent. "The rationale for government action to prevent false or misleading information rests upon the assumption that court remedies and competitive pressures are not adequate to provide the consumer with the true information he would willingly pay for. Thus, the Securities and Exchange Commission (SEC) regulates the issuance of securities, while the buyer of used cars is typically left to his basic judicial remedies." *Id.* at 27.

- (3) Buyers may be unable to evaluate the characteristics of certain products or services. For example, laypersons may not be readily able to evaluate the potential effectiveness or dangers of a drug without additional information. Regulation may be desired both to specify what information must be provided and to assist consumers in evaluating the information that is supplied.
- (4) The market, on the supply side, may not be sufficiently competitive to provide all of the information that consumers would willingly pay for. For example, accurate information regarding the nicotine content of cigarettes or the fuel economy of cars was unavailable to most buyers until the government required disclosure. There may also be tacit understandings in an industry not to supply certain information. "[0]ne does not find individual airlines advertising safety records. Since the airline industry is highly competitive in many respects, this fact suggests that tacit understandings not to supply certain varieties of information may be easier to reach (the industry need not be highly concentrated) than are tacit agreements not to compete in price or in service quality. *Id.* at 28.

On the other hand, opponents of the rationale for regulating the provision of information often focus on whether the rationale is applicable to particular cases. For example,

it may be argued that the market is functioning competitively, there is little deliberate deception, or consumers are sufficiently capable of evaluating the qualities of a product; "[t]hey may argue that a particular agency's efforts to provide information are too expensive, that the information is unnecessary, that disclosure itself may mislead consumers, or that it may interfere with the competitive workings of the marketplace." *Id.*

517. *Id.* at 193. Other forms of regulation may also be necessary in response to a lack of necessary information, such as screening, standard setting, and bargaining. See *id.* at 192, table 3.

518. *Id.* at 161.

519. Breyer (1979) at 579 (footnote omitted).

520. United States, President's Commission for a National Agenda for the Eighties, Panel on Government and the Regulation of Corporate and Individual Decisions, Government and the Regulation of Corporate and Individual Decisions in the Eighties (Washington, DC: 1980) at 23:

[D]isclosure is not entirely free of administrative problems. Regulators must decide how and to whom information is to be disclosed. In some cases, however, the act of collecting and disseminating the information in the required form can be quite burdensome, as are some campaign disclosure laws and the registration requirements for small businesses selling securities. Moreover, disclosure cannot be expected to overcome powerful incentives acting upon both buyers and sellers to ignore important social values that cannot adequately be expressed in unregulated markets. For example, disclosure will normally prove ineffective in dealing with environmental problems, for consumers cannot be expected voluntarily to purchase a substantially more expensive brand of a product that was produced in a more costly but less environmentally destructive way.

521. Breyer (1982) at 162-163:

Despite the similarity of problems faced by the regulator implementing disclosure and these other forms of classical regulation, there remains one

important difference. Ordinary standards governing primary conduct oftentimes forbid or dictate the type of product that must be sold or the process that must be used. As such, they interfere with consumer choice and impede producer flexibility. To the extent that those standards deviate from the policy planner's ideal (as they inevitably do), the restrictions on choice and conduct are clearly undesirable. Standards governing disclosure, however, do not restrict conduct beyond requiring that certain information be provided. The freedom of action that disclosure allows vastly reduces the cost of deviations from the policy planner's ideal. At worst, too much information or the wrong information has been called for. It does not stop buyers from obtaining products or producers from making them. ...

For these reasons, disclosure regulation does not require regulators to fine-tune standards as precisely. The regulators need less information from industry, there are fewer enforcement problems, there is less risk of anticompetitive harm, and there is greater probability of surviving judicial review. ...

522. Haw. Rev. Stat. §486I-5(a).

523. Haw. Rev. Stat. §486I-4(a).

524. Haw. Rev. Stat. §486I-9. That section also requires the PUC to make information available to the Director of Business, Economic Development, and Tourism and the Consumer Advocate, and requires the safeguarding of confidential material.

525. The Legislature made the following findings and declaration accompanying that Act:

SECTION 1. Legislative finding and declaration. The legislature finds and declares that the petroleum industry is an essential element of Hawaii's economy and is therefore of vital importance to the health and welfare of all people in the State of Hawaii.

The legislature further finds and declares that a complete and thorough understanding of the operations of the petroleum industry is required by the state government at all times to enable it to respond to possible shortages, oversupplies, and other market

disruptions or impairment of competition.

The legislature further finds and declares that information and data concerning all aspects of the petroleum industry, including, but not limited to, crude oil production, supplies, refining, product output, prices, distribution, and demand are essential for the State to develop and administer energy policies which are in the interest of the State's economy and the public's well-being. The legislature further finds that because Hawaii is a physically small and geographically remote economy, certain of its markets tend to be concentrated. Market concentration is a function of the number of firms in the market and their respective market shares. In a highly concentrated market, market prices tend to rise above competitive levels. Market prices persistently above competitive levels are harmful to consumers and the public. Barriers to competition tend to cause supracompetitive prices to persist.

The legislature further finds that the markets for oil and oil products in Hawaii are highly concentrated markets. 1991 Haw. Sess. Laws Act 291, ñ1.

526. See California Public Resources Code, ññ25350 et seq. ("Petroleum Industry Information Reporting Act of 1980").
527. Testimony of Dr. Nancy Yamaguchi and Dr. David Isaak, East-West Center Energy Program, on Senate Bill No. 1329 (1991) before the Senate Committee on Consumer Protection and Business Regulation, March 1, 1991, at 1-2. Drs. Yamaguchi and Issak noted that their role in Hawaii state energy issues was "informal and voluntary". Id. at 1.
528. Id. at 2.
529. Nancy D. Yamaguchi and David T. Isaak, Hawaii and the World Oil Market: An Overview for Citizens and Policymakers (Honolulu: East-West Center Energy Program, Aug. 1990) at 82-83:

Whether or not there are any anticompetitive practices in the Hawaii oil industry, (and, as we have noted earlier, none have been proven), the importance

to government in monitoring the situation has been undervalued. Per capita, Hawaii is one of the most oil-dependent areas in the world. The values of alternative resources are always evaluated against the cost of oil, but often with little understanding of where the costs are headed. This is not the last disruption that will be seen in the oil market. International oil lurched into a volatile environment beginning in 1973, and it is now in a permanent state of fluctuation. The drop of prices beginning in 1986 was not "a return to normal," but rather a violent downward fluctuation that was just as dangerous in its own way as the price hikes of 1973, 1979, and 1990. The government needs to develop the skills to monitor and analyze the market, not merely to deal with short-term crises, but also to serve the ongoing needs of a number of branches of the government.

530. Hawaii House of Representatives, Special Committee on Energy, Investigation of the Hawaii Gasoline Market (Honolulu: March 1974) at 70-71:

[T]he State of Hawaii should compile and maintain accurate data on the supply and demand for petroleum products in the State. One of the major problems encountered during the severe gasoline shortage of early 1974 was the lack of such data. This lack hampered the State's efforts to assess the extent of Hawaii's shortfall to make policy decisions based on solid information and to justify the State's appeals to the FEO for additional supplies of gasoline. In the event of another severe shortfall, the State should be prepared with accurate data at hand.

531. In testimony regarding Senate Bill No. 1329, the Attorney General noted that its investigation "involved delays in obtaining oil industry data in a timely manner" and that "inconsistency in the way the data was presented and the multitude of technical information supplied by each of the oil companies impaired prompt assessment." See Testimony of the Attorney General on Senate Bill No. 1329 (1991) before the Senate Committee on Consumer Protection and Business Regulation, March 1, 1991, at 2. The Attorney General further noted that "[t]hese delays might have been avoided had the oil companies been required by law to make regular, periodic, and uniform reports of specified data to a unit of state government...". *Id.* The Attorney General stated in

its 1994 interim report on the investigation of gasoline prices that the information requested by Act 291 "is essential to providing an adequate fact basis for appropriate legislative oversight, regulatory action, and antitrust enforcement." Hawaii, Department of the Attorney General, The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices (Honolulu: 1994) at 20.

532. Testimony of Craig Peterhansen on behalf of Chevron U. S. A., Inc., and testimony of George Aoki on behalf of Pacific Resources, Inc., on Senate Bill No. 1329 (1991) before the Senate Committee on Consumer Protection and Business Regulation, March 1, 1991 (both at page 2).
533. Yamaguchi and Isaak (1990) at 80-81.
534. Telephone interview with Milton Higa, Administrative Director, Public Utilities Commission, on October 23, 1995.
535. These estimates were requested of the Department for two reasons. First, the Director of Business, Economic Development, and Tourism was originally specified as the entity responsible for collecting the information requested in the PIIRA in the original version of that Act, rather than the PUC; the PUC was substituted for the Director in a subsequent version. See House of Representatives Standing Committee Report No. 1222, dated April 5, 1991, by the Committees on Consumer Protection and Commerce and Judiciary, regarding Senate Bill No. 1329, S. D. 1, H. D. 2. Second, as noted in the Department's testimony, the petroleum industry already provides supply and demand data to DBEDT as required by chapter 486E; chapters 486E and 486I (the PIIRA) therefore overlap in terms of the information requested. The Department is also required to "undertake energy development and management" pursuant to section 26-18(a), HRS, and the Director of Business, Economic Development, and Tourism serves as the Energy Resources Coordinator pursuant to section 196-3, HRS.
536. Letter to Wendell K. Kimura, Director of the Legislative Reference Bureau, from Seiji F. Naya, Director of Business, Economic Development, and Tourism, dated October 18, 1995, at 2. (Appendix J).
537. Id.

REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Chapter 14  
INDEPENDENT DEALERS

Question (14) of the Resolution requests the views of survey participants regarding the following:

- (14) Measures that could be initiated to reduce the cost of conducting business for independent dealers (i. e., lease rent and environmental regulations).

State Government

AG: "Rent control, tax reductions, and environmental exemptions easily come to mind. But the cost of such measures would have to be paid by tax payers generally or some other class of persons. Reducing the cost of doing business for independent dealers and increasing it for others raises serious political questions. The Department of the Attorney General is not competent to evaluate political questions."538

DBEDT: The department suggested that assistance could be provided in complying with environmental regulations. It further noted that while independent dealer stations have declined, the ability of consumers to obtain gasoline has not been jeopardized:

While sympathetic to the plight of independent dealers as they deal with the high cost of doing business in Hawaii, it is unclear what the government could do to help them reduce this cost. Of course, compliance with environmental regulations, especially those dealing with underground petroleum storage tanks is costly. However, most of these regulations are imposed by the federal government which under the new Congress may be more amenable to loosening certain restrictions. Nevertheless, in Hawaii where our primary fresh water supply is the Islands' aquifers, it would seem imprudent to relax these standards simply to cut costs.

Over the period 1980-1991 there was a 45% increase of motor vehicles registered in Hawaii. The number of service stations had decreased by 71%; however, the

number of retail fuel pumps in the state had climbed dramatically by 62%. Over the same period, annual gasoline sales rose by 63.3 million gallons, or 20%. During this period, a new type of gasoline retailer -- the convenience store -- seems to be overtaking the traditional gasoline retailer -- the full-service gasoline station. Statistical information bears out the fact that while independent dealer stations have declined, the ability of the motoring public to obtain gasoline has not suffered. 539

#### Gasoline Dealers

HARGD: The Association maintained that the State could assist independent dealers by reducing the cost of doing business generally, and that the State should have provided financial assistance to these dealers in meeting underground storage tank (UST) requirements. In addition, the Association noted that the retail divorcement moratorium has assisted independent dealers:

Because of the complexity of requirements for petroleum products, and the fact that federal laws and regulations play a major part in increasing the costs involved with compliance, measures that could be initiated to reduce the cost of conducting business would be in the areas of regulation. They would include issues affecting business in general, such as workers' compensation, liability insurance, lab or regulations, etc. If the State had adopted a State UST Financial Obligation Program when other states were doing so, it would have provided protection for independent dealers. The Legislature chose not to adopt a program, and it is now too late. The legislature did however prohib[it] petroleum suppliers from opening more vertically integrated consumer locations. This in itself has paid benefits to both the dealer and consumer by providing a value to suppliers wishing to maintain or gain marketshare. Because operating via a dealer network is the only way to sell to the consumer, suppliers waived the UST insurance requirement in franchise agreements. This meant the suppliers "self insured" the locations while UST liability insurance was not available. We believe this played a major roll in either controlling or reducing costs of dealers, while the actual costs involved were included in the wholesale price of gasoline. 540

## Jobbers

HPMA: The HPMA noted the following general and specific measures to assist independent dealers:

There are several measures that would be beneficial to independent dealers. Some of these are common to all business in Hawaii and are as follows:

- . The revision of the Workers' Compensation laws in Hawaii that would significantly reduce the WC premium.
- . A reduction in property taxes by zoning retail facilities at a lower tax rate, rather than the highest and best use.
- . Revision of Tort laws in Hawaii, thereby reducing the insurance required to defend oneself against frivolous law suits.

Specific measures to reduce the independent dealer cost that applies to the petroleum industry would be:

- . To deregulate the Petroleum industry in Hawaii, for example: Rescind Chapter 486I and Act 238 [Session Laws of Hawaii 1995].
- . Government accepting the role of the facilitator, not [adversarial] to business.
- . To assist the independent dealers in establishing a state tank fund that would provide remediation funds and facilitate underlying insurance coverage. Small dealers are being forced out of business because of their inability to obtain insurance coverage to meet EPA regulations.
- . To remove some onerous restriction from Weights & Measurements that are costly and encumbering to an independent dealer's operation. 541

Aloha Petroleum: Aloha Petroleum noted that while certain measures could be adopted to assist dealers, including subsidies and loans, the real issue is the change in consumer demand away from full-service stations with repair facilities in favor of retail outlets with

convenience stores and other configurations:

There are various methods that could be implemented to assist gasoline dealers with reducing the cost of doing business in Hawaii, such as lease rent subsidies or caps, or low interest loans to assist with environmental compliance. However, these programs ignore the real problem which is consumer preference and changing market trends and they fail to recognize the fact that consumer buying habits have changed. Full-service gasoline stations with repair shops similar to those operated by dealers are becoming obsolete. Consumers are looking for convenience and quick service. Gasoline stations with convenience stores and/or fast food service have in many cases replaced most repair shops at gasoline stations. Most gasoline dealers do not have the expertise and/or the equipment necessary to repair today's automobiles. Extended new car warranties require certified technicians to perform repairs. Almost all of this business is now being done at car dealerships. More government regulations won't solve this problem. The business costs faced by dealers are the same as they are for any other business. Government cannot protect a few at the expense of the majority and the consumer. 542

#### Oil Companies

Shell: Reduced insurance costs, taxes, and environmental costs would assist independent dealers:

- Avoid placing additional costs on the dealer, such as requirements to collect premiums for automobile insurance or to pay for mandatory medical insurance for employees;
- Reduce real estate and ad valorem taxes;
- Relax any environmental regulations that are not cost-effective because they provide a low benefit relative to their high cost. 543

BHP: BHP believed that it would be more appropriate to review assistance to all businesses in the State, rather than subsidizing only one particular interest group that is unable to meet the needs of consumers without assistance:

Independent or open dealers, the "true" mom and pop businesses that service rural or outlying areas, usually own or lease their own land and hold title to the assets on the property. It is these individuals that are most in jeopardy of closing due to increasing environmental, insurance and labor costs. Based upon estimates developed by the Whitney Leigh Corporation as of 12/31/94, open dealers represent approximately 40% of the total number of dealers in the state, and are more heavily concentrated on the neighbor islands.

It is important to note that any measures instituted to reduce the cost of conducting business for such dealers would result in subsidizing, in some form or fashion, a business that is no longer capable of independently meeting the needs of the consumers. If consumers no longer patronize that establishment and purchase their goods or services elsewhere, it would be illogical to take that same consumer's taxes to support that business. If it is governments' desire to support this special interest group, it would be appropriate that recommendations be obtained directly from the independent dealers, as they are in a better position to clearly and accurately discuss their issues.

If measures are to be consistent with the desires of the consumers of the State of Hawaii, then the list should consist of items which support all business in Hawaii, and not only independent dealers. These measures could consist of tax credits, changes to land use regulations, workers' compensation laws, relief from certain environmental regulations and rising land costs, and expediting of the permit application process.

While some of these measures may assist the independent dealer, they do not guarantee the success of any business. 544

Chevron: Chevron maintained that all government regulations should be reviewed under a cost-benefit analysis to minimize costs; lessee dealers are already overprotected under federal and state laws and do not require further protections provided by lease rent and other special interest legislation:

This item appears to cover two unrelated subjects.

First, it appears to relate to minimizing the impact of regulations on independent dealers. Chevron believes that all governmental regulations should be reviewed using cost/benefit analysis and that care should be taken that the regulations achieve their desired goal in such a manner as imposes the minimum costs on the regulated community and through that community on the consumer.

The reference to "lease rent" suggests that the item may also be asking about special interest legislation to protect lessee dealers, i.e., reducing the rents that might be charged to such dealers. It is hard to imagine why service station dealers, who are already the most protected class of middlemen in the nation (see for example, the federal Petroleum Marketing Practices Act, 15 U.S.C. §2801, et seq.; Hawaii Revised Statutes, chapter 486H), should be singled out for rent protection. Further, because service station rents are an element of competition between oil companies, service station rents are significantly below those typically charged for other commercial properties of equal value. For example, during 1994, rents paid to Chevron by its lessee dealers did not even cover Chevron's out of pocket costs for rents paid to third parties, taxes and maintenance, let alone cover depreciation or provide a return on Chevron's \$100 million investment in service stations leased to dealers in Hawaii. Any level of rent control which could constitutionally be imposed would still permit rents to dealers at a level double those typically charged by Chevron to its lessee dealers in Hawaii. 545

#### Discussion

The responses to question (14) include a number of measures to aid independent dealers as well as small businesses generally, including workers' compensation and tort law reform, tax reductions, relief from paying employees' unemployment and mandatory medical insurance, and other proposals to reduce government bureaucracy and the high costs of doing business in Hawaii. 546 These proposals are generally consistent with the desire of many small businesses to reduce government regulation which impacts more heavily on them than on larger firms. 547 This section focuses on the two items specifically mentioned in question (14), namely, environmental regulations and lease rent, and examines proposals to reduce the cost of conducting business for

independent dealers in these areas.

### Environmental Regulations

As noted in chapter 3, Miklius and LaCroix (1993) argued that the cost of complying with environmental regulations "already has been and will continue to be the single most important factor affecting gasoline marketing."<sup>548</sup> Environmental regulations include underground storage tank (UST), financial responsibility, environmental cleanup, and other environmental regulations.

#### (1) UST regulations.

Federal Environmental Protection Agency (EPA) regulations regarding USTs specify requirements for new tank installations, upgrading existing tanks, and installation of leak detection systems.<sup>549</sup> Many UST owners in Hawaii are faced with increased costs to replace or upgrade their older tanks.<sup>550</sup> In a 1990 study, the Hawaii Department of Health found that the majority of tank owners and operators in the State--approximately fifty-seven percent--fall into the category of small business enterprises.<sup>551</sup> The Department noted that smaller firms are more likely to have older tank systems that have an increasing likelihood of leaking, yet are inherently less likely than large firms to have the financial resources to upgrade their tank systems or to pay for corrective action. Many of these small owners and operators, moreover, are located in rural areas and have older, unprotected steel tanks.<sup>552</sup>

The Department further noted that Hawaii's unique hydrogeology aggravates the UST problem. Generally, Hawaii's high ground-water table and highly permeable soil in the areas where most USTs are located poses a greater health and environmental risk in the event of a UST release than in other areas with a deeper ground-water table.<sup>553</sup> However, the Department found that health risks may be moderated to some extent by the selective sourcing of drinking water wells in areas that are distant from USTs and commercial development.<sup>554</sup>

Miklius and LaCroix cite two reasons why the high cost of complying with UST regulations affected open dealers and independents more severely than lessee dealers. First, open dealers and independents had to incur these costs immediately, whereas at the lessee dealer-operated stations, complying with the EPA regulations was the responsibility of the lessor. In the long run, the lessors would seek to recoup these investments through higher lease rents. Second, open dealers and independents encountered difficulties in securing loans to upgrade their facilities. Many financial institutions had decided to stop

making loans to these retailers because of a court decision that exposed lenders to liability for leaks, environmental damage, and third-party claims. 555

Without access to credit, many open dealers and independents were unable to comply with the UST regulations and were forced to close their stations. According to the EPA's own estimates, approximately 64 percent of small retail firms and 40 percent of single station owners were expected to at least experience temporary financial hardship, while approximately 30 percent of single service stations and 25 percent of small retail firms were expected to close or file for bankruptcy. Miklius and LaCroix further note that the UST compliance costs reinforced the trend toward large volume stations; according to a University of California study, a station selling 25,000 gallons per month would need 6.6 cents per gallon to recover the cost of tank replacement, while an outlet selling 300,000 gallons would require only 0.6 cents per gallon. 556

(2) Financial responsibility regulations.

Under EPA regulations, marketers are required to show that they are financially able to pay for clean-up of an underground storage tank leak or spill, including correcting environmental damage and compensating third parties for property damage or personal injury. This can be accomplished by demonstrating the ability to manage at least \$1,000,000 in costs resulting from tank leaks. 557 Financial responsibility requirements may be met through one of several different means, including self-insurance; pollution liability insurance; guarantees, surety bonds, or letters of credit ensuring their ability to pay; coverage under state-required mechanisms or state trust funds approved by the EPA; or an owner-established trust fund. While large firms can generally meet the requirements through self-insurance, smaller firms must generally purchase insurance or obtain coverage under a state trust fund to demonstrate financial responsibility. 558

Because of potentially high liability, private liability insurance is expensive, and costs have been rapidly increasing. In order to assist marketers, twenty-seven states have established trust funds that have been approved by the EPA which help to lessen the impact of high clean-up costs, and another ten state funds are being reviewed for compliance with EPA guidelines. Hawaii, however, has not established such a fund. 559

(3) Cleanup and other environmental regulations.

Additional costs must also be incurred when a gasoline station is closed. EPA regulations require removal of USTs and an environmental

investigation, costing a minimum of \$15,000 and \$7,000, respectively. If soil contamination is found, remediation must meet specified standards; in some cases, contaminated soil must be transported to the mainland for appropriate treatment. Station closing costs may exceed \$1,000,000, depending on the nature of the contamination.<sup>560</sup> Delays may also force stations to close for as long as a year before their leases expire, adding a year's lease rental to the closing costs.<sup>561</sup> Other proposed environmental regulations include the adoption of vapor recovery systems and production of oxygenated and reformulated motor fuels.<sup>562</sup>

(4) Small business assistance.

Act 317, Session Laws of Hawaii 1990, amended chapter 342L, Hawaii Revised Statutes (underground storage tanks) to: (1) require the Department of Health to perform a study to establish an actuarially sound financial assurance fund to help UST owners and operators meet federal financial responsibility requirements that were adopted to ensure adequate funding to pay for the clean up of future releases and associated liability costs, and (2) require the Department to establish a financial responsibility guarantee fund.<sup>563</sup> The Department's study determined that Hawaii could develop its UST financial responsibility program using a combination of four different types of programs, namely, financial assurance funds, cleanup funds, reinsurance programs, or loan programs:<sup>564</sup>

A financial assurance fund is designed to supplement or provide insurance coverage for corrective action, third-party liability costs, or both, and may be either a full or partial coverage fund. The study noted that general fund revenues, a gasoline tax, tank fees, and bonds could be used to fund the various phases of a financial assurance program.

A cleanup fund provides the State with a pool of money from which to pay for cleanups when an owner or operator is insolvent, cannot be located, or refuses to cooperate in a cleanup, but does not assist tank owners and operators in complying with state and federal financial responsibility requirements.

A reinsurance program is designed to reinsure commercial insurance carriers who agree to insure UST owners and operators, and pays insurance carriers for some portion of their losses under UST policies.<sup>565</sup>

A loan program is designed to help tank owners and operators meet the costs of regulatory compliance, including the costs

of tank replacement, upgrading, and closure.

The Department's study discussed two hypothetical loan programs to assist small businesses in Hawaii that were similar to existing small business loan programs in the State. The first program would provide direct loans for small business UST improvements. Small business owners are defined as any owner or operator owning only one UST facility. Several other states also have direct loan programs for tank upgrade or replacements, including Rhode Island, New Jersey, Maine, and Vermont. Some advantages of this program is that it increases environmental protection by assisting small businesses, and the program would protect Hawaii's petroleum distribution network, particularly in small areas. However, the State would need to capitalize the program with a large pool of funds, since default rate on loans is likely to be high, assuming that the State would be making risky loans that a private lender would not have made. The State would also face an administrative burden from evaluating loan applications. 566

The second hypothetical program is the small business UST improvement loan guarantee program, under which the State guarantees a private lender that the State will pay eighty percent of the outstanding loan balance in the event of a loan default by the tank owner or operator. Other states with similar programs are Iowa, Oregon, California, and South Dakota. As with the first hypothetical program, the primary beneficiary would be small businesses. Since financing for these businesses would be available at affordable interest rates, future environmental protection would be increased by reducing the risk of tank releases. Although the State would not need to capitalize the program with a large pool of funds as in the first hypothetical, the State would need to capitalize a reserve fund to be used in the event of a loan default. In addition, depending on the funding source used, large businesses would be effectively subsidizing small businesses to upgrade or replace their tanks. 567

In 1991, the Legislature changed the proposed financial responsibility guarantee fund to a loan program, under which the Department of Health was to collect fees to make loans to businesses to replace, upgrade, close, take remedial action relating to, and clean up releases from, their underground storage tanks. Fees were placed into a separate account of the Hawaii capital loan revolving fund. 568 However, this program was repealed on January 1, 1994. 569

#### Lease Rent

Lease rents in Hawaii have increased significantly since 1981. This increase was due to several factors. Part of the rent increase was

attributable to adjustments in distortions introduced by federal price and allocation controls in the 1970s. From 1973 to 1981, rents were either frozen or constrained.<sup>570</sup> Rental increases were also due in part to the manner in which they were collected. Historically, rent paid by lessee dealers was apportioned between a percentage of the dealer tank wagon (DTW) price and a lump sum based on the volume of gasoline sold. However, in the 1970s, many refiners moved from volume-based to flat rents by introducing higher lump sum payments. In 1981, flat rents were replaced with variable rent programs. Miklius and LaCroix argued that part of the increase in rents may therefore represent a reduction in the portion of the rent formerly included in the DTW price.<sup>571</sup>

Changes in rental policies also included such factors as inflation and the desire to create volume incentives.<sup>572</sup> In addition, the DOE (1984) noted that changes in rental rates may have reflected a desire to avoid prosecution under the antitrust laws: "[B]y taking the rental charges out of the tank wagon price and putting it into a lump sum payment, the refiner ran less risk of running afoul of the Robinson-Patman Act. The latter does not apply to rents, but does govern the retail price at which the product may be sold."<sup>573</sup>

Miklius and LaCroix note that a substantial portion of increased rentals reflects the increased value of lands in Hawaii, which have risen beyond many people's expectations. In addition, land values may be exaggerated by current appraisal methods which use comparables financed with Japanese funds during the 1989-1990 "Japanese bubble period" in the renegotiation of land leases. In some cases, land values established for purposes of renegotiating leases has exceeded the earning power of actual or potential uses of land, forcing businesses to close. Land lease increases have already forced the closure of several gasoline stations, and, since many leases are up for renegotiation in the near future, more closures are expected.<sup>574</sup> In addition, property owners may decide not to renew a lease because the land can be rented for investment purposes at a rate of return that is much higher than a gasoline station; this is often the case when the station is located in a business district, shopping center, or downtown area:<sup>575</sup>

... Many of Oahu's service stations were built in the 1960s on leasehold land. Their 25- and 30-year leases are coming up for renewal and renegotiation. Lessees face huge lease increases. ... In the past five years Chevron has closed seven stations. Five of those were on Oahu and all were on leased land.

In some cases, landlords refuse to renegotiate. They simply want the property back. Last year Shell

closed its station at Pensacola and Kapiolani because it lost its lease. "The owners wanted to use the property for something else..." ...

The underlying real estate is simply too valuable - even when dealers or the oil companies own the land themselves. For example, Unocal recently closed its station at Beretania and Bishop streets. Once the site is cleaned up, Unocal plans to put the property on the market.

... Downtown fee simple property fetches from \$500 to \$700 a square foot. Unocal has plans to close four Honolulu stations that sit on land it owns. The company has closed 11 stations in recent years. In the past decade the company's market share in Hawaii has fallen from 29 percent to 13 percent.<sup>576</sup>

Proposals to assist independent dealers with lease rent payments may lead other financially distressed businesses to request similar relief from the Legislature. Limiting such assistance to independent dealers may also be considered unfair favoritism of only one type of small business, since many other small businesses are faced with similar lease rent problems. Moreover, opponents may argue that this type of government assistance supports an increasingly inefficient form of business, especially in view of changes in consumer preference away from full-service gasoline stations with repair facilities in favor of retail outlets with convenience stores.

However, if legislators find that independent dealers are in greater need of protection than other small independent businesses in Hawaii, and that their protection is in the public interest, such assistance may include a lease rent assistance program, in the form of a low-interest loan fund to assist in lease payments; a property tax reduction by rezoning certain retail facilities at a lower tax rate; and other subsidies, including rent caps or some other form of rent control. Alternatively, legislators may wish to provide such assistance more broadly to all small businesses facing lease rent problems, or only to those small businesses engaged in some form of energy production.

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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

538. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, August 31, 1995, at 2.
539. Letter from John Tantlinger, Ed. D., Energy Planner, Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, September 1, 1995, at 2.
540. Letter to researcher from Richard C. Botti, Hawaii Automotive and Retail Gasoline Dealers Association, Sept. 1, 1995, at 1.
541. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, dated Sept. 7, 1995, at 1-2.
542. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., dated September 21, 1995, at 9-10.
543. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Co., dated August 31, 1995, at 2.
544. Letter from Susan A. Kusunoki, BHP Hawaii, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated September 8, 1995, at 1-2.
545. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 9.
546. See generally Sanford Inouye, *Small Business: Current Problems and Opportunities*, Report No. 4 (Honolulu: Legislative Reference Bureau, 1988); Thomas Kaser, "Hawaii Firms Moving to Cheaper Pastures," *The Honolulu Advertiser*, August 4, 1995, p. B1; see also Belden Daniels, Nancy Barbe, and Harry Lirtzman, "Small Business and State Economic Development," in *Expanding the Opportunity to Produce: Revitalizing the American Economy Through New Enterprise Development*, ed. Robert Friedman and William Schweke (Washington, DC: The Corporation for Enterprise Development, 1981); Steven Holtzman, *Alternative State Policies in Aid of Small Business* (Columbus: Ohio Legislative Services Commission, July 1991); Richard J. Judd and Barbra K. Sanders, "Regulation, Small Business, and

Economic Development: A Historical Perspective on Regulation of Business," in *Small Business in a Regulated Economy: Issues and Policy Implications*, ed. Richard J. Judd, William T. Greenwood, and Fred W. Becker (New York: Quorum Books, 1988); and Roger J. Vaughan, *Small and New Business Development: An Action Guide for State Governments* (Prepared for the Coalition of Northeastern Governors Policy Research Center, Washington, DC: May 1983).

547. California, Office of Economic Policy, Planning and Research, *State Regulation and Economic Development* (Sacramento: 1982) at 15-17:

A great deal of the recent political opposition to regulations of all kinds has come from small business organizations. In general, small firms assert that regulations which require equal results from firms of all sizes impose extra burdens on smaller firms due to economies of scale in equipment or other changes required, and in the maintenance of specialized staff required to monitor regulations and select the most efficient method of response. Thus, it is argued, the unit cost of response is higher for small firms than large firms. This has led to calls for "two-tiered regulation" in which small firms are exempted from regulation or face less stringent requirements. The increased interest in the effects of regulation on small business coincides with research findings which argue that smaller firms are the source of a majority of net new job creation. These research findings are now frequently mentioned in regulatory proceedings by small business advocates as a reason to reduce regulation.

See also Paul Sommers and Roland J. Cole, "The Costs of Complying with Government Requirements: Are Small Firms Disproportionately Impacted?" in *Small Business in a Regulated Economy: Issues and Policy Implications*, ed. Richard J. Judd, William T. Greenwood, and Fred W. Becker (New York: Quorum Books, 1988).

548. Walter Miklius and Sumner J. LaCroix, *Divorcement Legislation and the Impact on Gasoline Retailing in the United States and Hawaii* (Honolulu: University of Hawaii, Jan. 20, 1993) at 31 (footnote omitted).
549. Specifically, all USTs must be single-walled, corrosion-

protected, equipped with leak detection monitors, and contain spill-and-overflow catch basins, while all new tank installations must be epoxy-coated with cathodically protected steel, fiberglass-reinforced plastic, or fiberglass-coated steel. Existing tanks may be upgraded by adding cathodically-protected systems, installing interior lining, or both. Since UST piping is the most common source of leaks, upgrading of piping systems is required to meet corrosion requirements. EPA cost estimates for a leak detection system range from \$3,000 to \$8,000 for a station with three 5,000-gallon tanks; retrofitting existing tanks with cathodic protection range costs from \$10,000 to \$40,000; and three new 10,000 gallon single wall tanks cost between \$76,000 and \$100,000. Id.

550. The Hawaii Department of Health (1990) reported that the majority of tanks in Hawaii (seventy-three percent) are made of steel; only twelve percent of these have cathodic protection or an internal lining. The piping for forty-one percent of all UST systems is made from galvanized steel, while 11 percent of the piping uses bare steel. Approximately ninety-seven percent of the piping does not have cathodic protection. EPA technical standards require that all tanks and piping be upgraded by December, 1998, to include cathodic protection and spill and overflow devices, or be replaced and to have leak detection equipment. Moreover, the average age of tanks in Hawaii is eighteen years, which is somewhat older than the average age for tanks nationwide, and more than seventy-five percent are older than nine years. Because most older tanks are constructed of bare steel, they are less likely to have corrosion protection or leak detection devices than new tanks, making them more likely to leak. See Hawaii, Department of Health, On Act 317, Session Laws of Hawaii, 1990 Requesting a Study on the Development of a State Financial Assurance Fund Program for Owners and Operators of Underground Storage Tanks (Honolulu: Dec. 27, 1990) at ES-2 (hereinafter, "DOH (1990)").
551. The Department also found that seven major oil companies own approximately 30 percent of USTs, while federal, state, and local government entities own about 16 percent of USTs. Although the average tank capacity of tanks in the State is about 60,000 gallons, about 40 percent have a capacity of less than 1,100 gallons. DOH (1990) at ES-3.
552. DOH (1990) at ES-3 to ES-4; see also John S. Conniff and

Charles G. Gavigan, "Preserving Rural Gas Stations: State Financial Assistance for Underground Petroleum Storage Tanks," 15 U. Puget Sound L. Rev. 71 (Fall, 1991).

553. DOH (1990) at ES-3:

The geology of Hawaii is drastically different from that of the contiguous states with widely varying conditions among the islands. . . .

Hawaii is highly dependent on ground water (over 95 percent of Hawaii's drinking water comes from ground water). In Honolulu, where approximately two-thirds of the USTs in Hawaii are located, depth to ground water is between 5 and 20 feet.

The soil types in Oahu and the other islands are highly permeable. The soil in Oahu is a combination of alluvial deposits and coral fills. It resembles sand in permeability. The soil on the younger islands (i. e. Maui and the island of Hawaii) is largely volcanic. The permeability of these basaltic soils exceeds that of most other soil-types. A large percentage of the remaining one-third of the USTs in Hawaii (i. e. USTs not located in Honolulu) are located on these younger islands. In these soils, releases move rapidly toward the ground water, creating more contamination and increasing cleanup costs.

Overall, Hawaii has a high ground-water table, and highly permeable soil in the areas where most USTs are located. Because of these hydrogeological conditions, an UST release poses a greater risk to human health and the environment than it would in areas with a deeper ground-water table.

554. *Id.* The Department noted that "[g]roundwater wells and drinking wells are typically installed inland and not along the coast. Because development is mostly along the coastal regions of the islands, contamination from development and UST releases may have a reduced effect on drinking water wells." *Id.* at ES-3 n. 6.

555. Miklius and LaCroix (1993) at 32, citing *United States v. Fleet Factors Corp.*, 724 F. Supp. 955 (S.D. Ga. 1988), *aff'd* and *remanded*, 901 F.2d 1550 (11th Cir. 1990).

556. Miklius and LaCroix (1993) at 32-33. Anecdotal evidence in Hawaii also suggests that EPA regulations concerning UST requirements and clean-up necessitated the closure of many service stations:

... A station in Hilo was suddenly closed at the end of the lease because the owner did not want the risk of having to clean up the property in case it became polluted. Developers in Kakaako are finding out that the clean-up from the pollution caused by small repair shops and gas tanks is extremely costly in terms of cleaning the sites and construction delays.

Of the twenty-three stations interviewed on the Big Island, eight have closed gas operations or plan to because of the new regulations concerning tank replacement costs and insurance. Three on Maui have stopped pumping gasoline or plan to, one has pulled his tanks on Kauai and on Oahu only two dealers indicated that they would be stopping gas sales, all based on this problem.

Julia E. Schoen, *The Consumer and Gasoline Marketing in Hawaii: The Impact of Direct Retailing of Motor Fuel by Refiners and Distributors on the Consumer* (Honolulu: Department of Commerce and Consumer Affairs, 1992) at 5.

557. See Miklius and LaCroix (1993) at 33. Hawaii's financial responsibility law with respect to USTs, section 342L-36, HRS, requires the Department of Health to adopt requirements for maintaining evidence of financial responsibility for taking response action and compensating third parties for bodily injury and property damage caused by an accidental release, and allows the Department to establish the amount of required coverage for particular classes or categories of underground storage tanks or tank systems containing petroleum at not less than \$1,000,000 for each occurrence.
558. United States, General Accounting Office, *Underground Petroleum Tanks: Owners' Ability to Comply with EPA's Financial Responsibility Requirements* (Washington: July 1990) (hereinafter, "GAO (1990)") at 9.

EPA regulations divide underground petroleum storage tank owners into four categories based primarily on the number of tanks that they own. Category 3 includes owners of 13 to 99 tanks, while category 4 includes

owners of 1 to 12 tanks and most nonmarketers, i. e., owners who do not market petroleum products and have a tangible net worth of less than \$20,000,000. See GAO (1990) at 1-2. The GAO's 1990 survey of category-3 and -4 tank owners found that nearly one-third of state officials indicated that more than half of the category-3 firms would not be able to comply with the EPA's financial responsibility deadlines by the April 1990 deadline, while over two-thirds of the officials stated that more than half of the category-4 firms would not be able to meet the October 1990 deadline, usually citing the following reasons for inability to comply: "(1) high trust fund deductibles (for states with funds); (2) costly insurance; (3) old, high-risk tanks; and (4) technical requirements such as those necessitating costly tank improvements...." GAO (1990) at 15.

A similar survey conducted by the Hawaii Department of Health (1990) to assess the impact of the federal financial responsibility requirements on owners and operators of petroleum USTs in Hawaii found that approximately half of the respondents had obtained the required level of financial assurance. Although at the time of the survey only two of the compliance deadlines had passed, and owners and operators of fewer than one hundred tanks did not have to comply, about one-quarter of the respondents--mostly independent owners and operators, some local government entities, and small petroleum marketers and nonmarketers--expressed difficulty in obtaining the required coverage due to the general unavailability of private insurance. Respondents cited such difficulties as the lack of available insurance coverage for both corrective action and third-party liability costs, high deductibles and large premiums for policies offered, the unwillingness of insurers to cover USTs, and the high cost of meeting stringent underwriting requirements. See DOH (1990) at ES-4.

559. Miklius and LaCroix (1993) at 33. As states have developed trust funds, private insurance to cover USTs has disappeared, and state funds themselves are running out of money. See Allison R. Hayward, "Common Law Remedies and the UST Regulations", 21 B.C. Env'tl. Aff. L. Rev. 619, 665-666 (Summer 1994); see *id.* at 655-656 (footnotes omitted):

Most states have established funds to clean up tank sites and compensate victims. These funds take the place of the financial responsibility requirement in federal law. Usually, the fund's budget is supplied by a tax on fuel sales. In such a case, a tension exists between cleaning up sites in cases where no liable and financially capable party can be assigned the costs, and keeping the fuel tax level. In addition, clean-up contractors wary of their own liability seek to provide expensive and extensive remediation rather than control costs.

Some states seek to control fund expenditures by placing deductibles on enterprises that are large enough to be self-insured. Others place strict guidelines on what permits a tank owner must acquire before he can be reimbursed for site remediation. Even so, state funds run out of money. In Michigan, for example, the state receives \$4 million every month in fee revenue for its fund to cover payments of \$15-17 million in requests. At the end of fiscal year 1992, Florida's fund held a balance of \$24 million, but \$139 million in claims had been filed against it. Even in states with solvent fund programs, the state is slow to reimburse claims. A recent study estimates that these state funds have collected \$900 million a year in fees, but have paid out only \$926 million, and only 44,000 sites have been cleaned up, an estimated ten percent of the total. EPA has yet to promulgate regulations to address what happens when state funds that replace private liability requirements under the UST regulations become insolvent.

560. Miklius and LaCroix (1993) at 34.
561. See, e.g., Ellen Paris, "Out of Gas," in *Hawaii Investor*, vol. 12, no. 9 (Sept. 1992) at 36 (noting that Unocal's Kahala service station, at the corner of Waiālae Avenue and Hunakai Street in Honolulu, closed one year before its lease expired to allow time for site cleanup).
562. Miklius and LaCroix (1993) at 34.
563. 1990 Haw. Sess. Laws, Act 317, §2, codified as Haw. Rev. Stat. §342L-36.5.
564. DOH (1990) at ES-4 to ES-5.

565. See, e.g., Wash. Rev. Code chapter 70.148 (1994); DOH (1980) at 4-6. The purpose of Washington's program is "to provide pollution liability reinsurance at a price that will encourage a private insurance company or risk retention group to sell pollution liability insurance ... to owners and operators of underground petroleum storage tanks, thereby allowing owners and operators to comply with the financial responsibility regulations of the EPA." Wash. Rev. Code ñ70.148.005(2) (1994). The program is funded by a tax on petroleum products to be used to make payments on the reinsurance contract. See Wash. Rev. Code chapter 82.23A (1994). The pollution liability insurance agency, which was simultaneously created to administer the program and scheduled to sunset in 1995, was reauthorized and extended to 2001 in the 1995 legislative session. See Wash. Rev. Code ñ70.148.030 (1994); Council of State Governments, *Environments West* (Spring 1995) at 11. The director of that agency is authorized to expend up to \$15,000,000 for the financial assistance program. Wash. Rev. Code ñ70.148.020(3) (1994).

Washington's trust fund also provides financial assistance for corrective action in small communities, both to prevent supply disruptions and to maintain the economic viability of rural communities. Wash. Rev. Code ñ70.148.120 (1994) provides in pertinent part:

[T]he state has enacted laws designed to limit and prevent environmental damage and risk to public health and safety caused by underground petroleum storage tank leaks. Because of the costs associated with compliance with such laws and the high costs associated with correcting past environmental damage, many owners and operators of underground petroleum storage tanks have discontinued the use of or have planned to discontinue the use of such tanks. As a consequence, isolated communities face the loss of their sources of motor fuel and face the risk that the owner or operator will have insufficient funds to take corrective action for pollution caused by past leaks from the tanks. In particular, rural communities face the risk that essential emergency, medical, fire and police services may be disrupted through the diminution or elimination of local sellers of petroleum products and by the closure of underground storage tanks owned by local government entities

serving those communities.

The legislature also recognizes as a fundamental government purpose the need to preserve a minimum level of economic viability in rural communities so that public revenues generated from economic activity are sufficient to sustain necessary governmental functions. The closing of local service stations adversely affects local economies by reducing or eliminating reasonable access to fuel for agricultural, commercial, and transportation needs.

To assist small communities, the legislature authorized cities and counties to certify that a local private owner or operator of an underground storage tank met a "vital local government, public health or safety need", qualifying the owner or operator for financial assistance. Wash. Rev. Code §70.148.120(1) (1994). In addition, local government entities may also obtain financial assistance for local government USTs. Wash. Rev. Code §70.148.120(2) (1994).

566. DOH (1980) at 3-12 to 3-16.

567. Id. at 3-17 to 3-21.

568. 1991 Haw. Sess. Laws, Act 267, §2. Under the capital loan program, the state Department of Business, Economic Development, and Tourism may make direct loans to small business concerns "for the financing of plant construction, conversion, expansion, the acquisition of land for expansion, the acquisition of equipment, machinery, supplies, or materials, or for the supplying of working capital." Haw. Rev. Stat. §210-6 (1994).

569. 1992 Haw. Sess. Laws, Act 259, §33.

570. Miklius and LaCroix (1993) at 28, 59; United States, Department of Energy, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers (Washington, DC: March 1984) (hereinafter, "DOE (1984)") at 58-60.

571. See Miklius and LaCroix (1993) at 28-29, 59-60.

572. Id. at 28, citing DOE (1984) at 56-61. The DOE (1984) also noted that greater consumer price awareness may have contributed to pressures for rent increases:

With the increase in the price of gasoline, consumers have become much more price conscious. They are more willing to shop around for the best price. Added to this willingness is the perception that gasoline is a fungible commodity, that is, there are few differences among major brands or between branded and unbranded gasoline. As a result, refiners are less able to maintain a wide price spread for similar grades of gasoline among brands [or] between branded and unbranded gasoline. Refiners cannot put large rent increases into the DTW price [of] gasoline and expect to remain competitive. DOE (1984) at 60-61.

573. DOE (1984) at iii; Miklius and LaCroix (1993) at 29.

574. Miklius and LaCroix (1993) at 29-31, 60.

575. Schoen (1992) at 5.

576. Paris (1992) at 34.

REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Chapter 15  
RETAIL DIVORCEMENT

Questions (15), (16), and (17) of the Resolution request the views of survey participants on the following issues:

- (15) The effects of the provision contained in section 486H-10(a), Hawaii Revised Statutes, that allows manufacturers and jobbers to open one company operated retail service station for each dealer operated service station owned by that manufacturer or jobber, up to a maximum of two company owned retail service stations;
- (16) Whether laws in other states prohibit or limit the number of retail service stations that may be opened or operated by wholesalers, producers, or refiners of petroleum products, or their subsidiaries; and
- (17) Whether or not the existing moratorium has resulted in lower gasoline prices for consumers.

These questions raise similar issues and are discussed together. The survey participants were requested to respond only to questions (15) and (17); the divorcement laws of other jurisdictions as requested by question (16) are contained in the discussion section following the survey comments.

State Government

AG: Regarding question (15), the Attorney General stated its belief that section 486H-10, H. R. S., was "anti-consumer, anti-competitive, and anti-dealer":

Such effects probably could not be measured in any meaningful way. Theoretically, the provision establishes an artificial and arbitrary entry barrier to new competition. But the barrier is only partial. Therefore, the provision compromises vigorous competition and at the same time compromises protection of dealers from competition. The measure is anti-

consumer, anti-competitive, and anti-dealer. Only those with sufficient capital to explore any loopholes will benefit. The small dealer certainly will not benefit. 577

With respect to question (17), the Attorney General noted that consumer prices have increased, partly due to a lack of competition:

The Department of the Attorney General has no such evidence. The only evidence the Department has is that consumer prices have increased. The Department believes that the lack of competition is an important factor explaining the increase. The Department cannot say at this point what other factors have contributed. 578

DBEDT: With respect to question (15), the department noted that while there is no evidence illustrating the effects of section 486H-10, restrictions on naturally occurring competitive forces are likely to be detrimental to free-market efficiencies:

We know of no evidence that exists to illustrate the effects of the existing restriction under Section 486H-10(a), HRS. The direct results of this restriction would probably be better identified by industry members to whom it applies. However, we offer the observation which we have stated throughout our responses to the survey, that any restrictions on the naturally occurring competitive forces in the market are likely to be detrimental to the efficiencies of a free-market. Nevertheless, the best evidence of the effects of this restriction would be to determine what plans by industry to add additional retail stations, if any, were impacted by the restriction. This can be best answered by industry itself. 579

Regarding question (17), the department stated that it knew of no evidence that the moratorium had resulted in lower gasoline prices for consumers. The department further noted that "federal policy now recognizes that free market forces are the best way to deal with gasoline supply and demand, and that government intervention (i.e., allocation and price control) has only served to exacerbate past shortages and market disruptions." 580

Gasoline Dealers

HARGD: With respect to question (15), the Association believed that section 486H-10 has allowed for controlled growth by suppliers seeking to capture market share:

We believe the provision has allowed the opening of a few new locations in new growth areas. It has also provided [a specified entity] with the opportunity to avoid franchising any locations, thus maintaining a cloak of confidentiality around their pricing structure, and questions of impropriety within their pricing structure. We do not believe this has created a negative impact to either the dealer organization or the consumer. We believe it has allowed controlled growth by suppliers wishing to capture market share utilizing the vertically integrated method of marketing. 581

Regarding question (17), the Association stated that the moratorium has helped to maintain the viability of independent dealers:

We do not believe lower prices would have occurred with or without legislation. Petroleum prices are controlled not by retail strategies, but by strategies of refiners and suppliers. Likewise, we have seen no evidence of a price increase to the consumer based on the prohibition of suppliers from opening unlimited locations at their discretion.

Price competition at the retail level is contingent upon wholesale competition. With the franchisor being the supplier, landlord, and franchisor, they in reality control the limited means of competition available at the retail level. With the supplier/landlord/franchisor being allowed to compete through vertically integrated retail locations, it provides the supplier with total control of the retail pricing structure of gasoline to the consumer.

It is our conclusion that the moratorium has accomplished the following:

- Maintained an importance of independent dealers as a means for suppliers to maintain marketshare.
- Provided a means for independent dealers to survive the federal UST requirements.

- Provide[d] the consumer with the most possible locations during a trend by suppliers to sell higher volumes through fewer locations all on a self-serve method of retailing.
- Provide[d] more job stability than would otherwise exist by providing a need for a dealer organization. 582

#### Jobbers

HPMA: With respect to question (15), the HPMA believed that "this provision is totally restricted to jobbers":

Jobbers are customers of refiners and buy their product at a functional discount which is a lower price than dealer tankwagon. This functional discount, which is standard in the petroleum industry, provides for the cost of a jobber operating his own equipment, trucks, terminal and various distribution activity. There is not enough margin for a jobber to purchase product from a manufacturer, operate his business, and make a return on his investment in a new facility if he is forced to put a dealer in between him and the consumer. Traditionally, jobbers operate their own facilities because they are low-cost operators. They need to absorb the margin that would otherwise go to a dealer. A refiner/manufacturer can provide for a dealer type operation if he so chooses to because there is only one layer of a dealer in between him and a consumer -- whereas a jobber is a second layer from a manufacturer and then putting another layer of a dealer in between him and the consumer make it economically unfeasible for a jobber to build a facility under the restriction of 486H-10(a). This statute totally inhibits the jobber from retail expansion and therefore penalized the consumer. 583

The HPMA further noted that Act 238, Session Laws of Hawaii 1995 (in part amending section 486H-10(a), H. R. S.), has decreased competition in Hawaii's retail gasoline market:

Act 238 ... is government intervention in the marketplace. The effect of this [Act] has been to dampen competition in the retail gasoline market and to facilitate the status quo, which has led to the growth of the market share of the major oil companies because their marketing is done through retail dealers. This

act has stopped the expansion of jobbers & independent refiner/marketers who have chosen to market through company-operated stations for various reasons. If the purpose of this moratorium for the past four years has been to create more competition in the marketplace, it has failed miserably. The consumer benefits from choices and competition; he loses when competition is restricted by Act 238.584

Finally, with respect to question (17), the HPMA argued that the moratorium has not benefited Hawaii's consumers:

HPMA can strongly state that there have not been lower gasoline prices to the consumer and that competition has been restricted by the existing moratorium. Government moratoriums and intervention historically cause prices to rise and are a disservice to consumers. The consumer benefits if there are more new stations built, increasing the level of competition and allowing him to have choices. Any restriction of that process by government is to the detriment of the consumer. In the free-market system, the marketplace will punish a manufacturer or jobber that over expands and creates more supply than demand. This is the beauty of the American free-enterprise system. Government should not hamper this process. 585

Aloha Petroleum: In response to question (15), Aloha Petroleum also argued that the moratorium restricts competition and is therefore not beneficial to consumers:

Regardless of whether manufacturers or jobbers are able to open two new company-operated locations, any moratorium is a restriction on business and thus competition and is not beneficial to the consumer. The moratorium was designed to protect a small group of large branded dealers without adequate consideration of the cost to the consumer. In addition, the moratorium ignores the direction in which the gasoline consumer is headed, which is for fast and convenient service. This trend is not recognized or helped by the moratorium and the consumer is inevitably harmed. 586

With respect to question (17), Aloha Petroleum noted that the moratorium protects a few large branded dealers at the expense of consumers and may have prohibited other gasoline distributors from entering Hawaii's markets:

It is evident that the moratorium has not resulted in lower gasoline prices and may indeed have caused an increase in gasoline prices. The moratorium has prohibited the opening of any new company-operated locations and unsuccessfully attempts to protect a few large branded dealers at the expense of the consumer. Consumers are looking for quick service with convenience stores and fast food facilities. Due to this preference of consumers and the advanced automotive technology that virtually requires repairs to be completed by car dealerships, the full-service facilities offered by dealer-operated facilities with repair shops are becoming obsolete. When existing dealer-operated gasoline stations have closed for reasons such as increased lease rent payments, operating costs, EPA requirements, etc., the moratorium has prohibited gasoline distributors or jobbers from opening company-operated stations at those sites. This has in some circumstances created a void and neighborhood customers have been forced to either drive further or purchase from the remaining stations who, without the competition, may have increased prices. The moratorium may also have prohibited other gasoline distributors from entering Hawaii's market. For these reasons, it is our belief that the moratorium has actually increased gasoline prices. Competition is the best way to encourage lower gasoline prices. Jobbers play a crucial role in the petroleum industry and have been instrumental in keeping gasoline prices down. Jobbers have historically offered gasoline at prices a few cents below the major brands. However, jobbers do not manufacture petroleum products and must rely on refiners for product. As such, any legislation implemented to continue the moratorium should be drafted to exclude jobbers. 587

#### Oil Companies

Shell: With respect to question (15), Shell noted that this section may reduce competition and, in the long run, could result in higher prices:

Shell does not have company-operated service stations in Hawaii, but we believe the retail market should be available to suppliers as it is to dealer operators. Assuming that all other factors affecting

competition remain the same, restricting the number and type of competitors with access to the market, whether dealer-operated or company-operated, may reduce competition and in the long run could result in higher prices than would have prevailed in the absence of the restriction. 588

In response to question (17), Shell stated that it had insufficient data to determine what effect the moratorium has had on prices:

Shell does not have sufficient data to determine whether the moratorium has had any effect on prices. For example, we do not know how many additional company-owned service stations would exist, or where they would be located, in the absence of the moratorium.

Gasoline prices are generally responsive to competition in the market. Over time, a wide variety of factors influences the degree of competition. It is difficult to isolate any one factor, such as the moratorium, to determine whether it has had any relationship to prices, much less a cause-and-effect relationship. This is particularly true in this case, because the moratorium has been in effect for a relatively short period of time. 589

BHP: Regarding question (15), BHP stated that section 486H- 10(a) favors dealers while limiting the ability of jobbers and manufacturers to compete:

The provision arbitrarily limits a category of market participants, namely jobbers and manufacturers, from providing their competitive offering directly to consumers. The jobbers and manufacturers are disadvantaged in that the provision decreases their ability to compete. The surest way consumers can ensure that the things they value are offered to them at a price they are willing to pay, is to have the broadest constituency possible trying to satisfy their wants. Dealers are the real winners in that the provision effectively designates them as the favored constituents to operate a profitable business enterprise while arbitrarily excluding others. It also shelters them from competitive offerings from the excluded market participants.

While this provision was enacted by the 1995 legislature, we recognize it as a temporary compromise put into place during the additional two year extension of the current moratorium. BHP Hawaii continues to believe that the consumer is best served by an open competitive market driven by an economy that is not controlled by legislation, but by a free enterprise system. 590

In response to question (17), BHP stated that "[t]here is no evidence to suggest that the moratorium has resulted in lower gasoline prices for consumers, rather it has resulted in a significant reduction in the number of service stations and less serviced areas." 591

Chevron: With respect to question (15), Chevron stated that "[t]he Hawaii moratorium on new company-operated stations is anti-competitive and anti-consumer":

If you eliminate one major group of players from the retail marketplace, particularly the one group which has an interest in minimizing the cost of distribution between the refinery and the pump, then consumer prices will inevitably go up.

In this context, the effect of the current provision allowing a company to open two new company-operated stations if it first opens two new dealer-operated stations is negligible. 592

With respect to question (17), Chevron stated that "it is inevitable that the moratorium has resulted in higher gasoline prices for Hawaii consumers. It could not possibly have any other effect. Every impartial study conducted on this subject has reached the same conclusion. . . ." 593

#### Discussion

In addition to divestiture, or vertical divorcement, as discussed in chapter 12, retail divorcement, that is, prohibiting or restricting the operation of retail service stations or the retail sale of gasoline by refiners or producers, has been used to restructure the oil industry through legislative initiative. 594 This section reviews the retail divorcement laws of other jurisdictions (as requested by question (16) of the Resolution), studies conducted in other jurisdictions, arguments for and against divorcement, predatory pricing, and concerns regarding independent dealers.

#### A. Divorcement Laws of Other Jurisdictions

Divorcement laws are currently in effect in five states other than Hawaii--Connecticut, Delaware, Maryland, Nevada, and Virginia--as well as the District of Columbia. Florida has repealed its divorcement statute,<sup>595</sup> while Louisiana's statute became inapplicable by its own terms after eight months.<sup>596</sup> Since 1974, divorcement bills have come before forty-one state legislatures.<sup>597</sup>

##### Connecticut

Connecticut's divorcement law reads as follows:

Sec. 14-344a. Retail service stations; opening and operation by producers or refiners prohibited after July 1, 1979. After July 1, 1979, no producer or refiner of petroleum products shall open a major brand, secondary brand or unbranded retail service station in the state and operate such station with employees of such producer or refiner, a subsidiary company, commissioned agent or under a contract with any person, firm or corporation managing such station on a fee arrangement with such producer or refiner. Any such station shall be operated only by a retail service station dealer. As used in this chapter, "retail service station" means a place of business where gasoline or special fuel is sold and delivered into the tanks of motor vehicles for use as fuel in the operation of such motor vehicles.

Sec. 14-344b. Retail service stations; operation by producers or refiners prohibited after July 1, 1980. After July 1, 1980, no producer or refiner of petroleum products shall operate a major brand, secondary brand or unbranded retail service station in the state with employees of such producer or refiner, a subsidiary company, commissioned agent or under a contract with any person, firm or corporation managing such station on a fee arrangement with such producer or refiner. Any such station shall be operated only by a retail service station dealer.<sup>598</sup>

##### Delaware

Delaware's divorce statute reads:

§2905. Independence of retail dealers.

(a) No manufacturer of petroleum products shall open a major brand, secondary brand or unbranded retail gasoline outlet or service station in the State, that would be operated by company personnel, a subsidiary company, or a commissioned agent.

(b) The Office of Retail Gasoline Sales shall adopt rules or regulations defining the circumstances in which a manufacturer may temporarily operate a service station in times of emergency or similar special circumstances. 599

District of Columbia

The District of Columbia's divorce law reads as follows:

§10-212. Restrictions on operation.

(a) After April 19, 1977, no producer, refiner, or manufacturer of motor fuels as the terms are defined in §10-201 (10) and (12) shall open a retail service station in the District of Columbia, irrespective of whether or not such retail service station will be operated under a trademark owned, leased, or otherwise controlled by such producer, refiner, or manufacturer, unless such retail service station is to be operated by a person or entity other than either an employee, servant, commissioned agent or subsidiary of such producer, refiner, or manufacturer or a person or entity who operates or manages such retail service station under a contract with such producer, refiner, or manufacturer which provides for a fee arrangement.

(b) After January 1, 1981, no producer, refiner, or manufacturer of motor fuels as the terms are defined in §10-201 (10) and (12) shall operate a retail service station in the District of Columbia, irrespective of whether or not such retail service station will be operated under a trademark owned, leased, or otherwise controlled by such producer, refiner, or manufacturer, with employees, servants, commissioned agents, or subsidiaries of such producer, refiner, or manufacturer or with a person or entity who operates or manages such

retail service station under a contract with such producer, refiner, or manufacturer which provides a fee arrangement. However, any entity, which as of October 9, 1979, operates a retail service station in the District of Columbia, and of which a producer, refiner, or manufacturer as defined in §10-201 (12) only has no more than 49 per centum voting control, may continue to operate such station after January 1, 1981, so long as no producer, refiner or manufacturer as defined in §10-201 (12) only has more than 49 per centum voting control of the entity. 600

#### Maryland

In 1974, Maryland became one of the first states to enact a divorce law. 601 Maryland's divorce statute was challenged in court and ultimately upheld by the United States Supreme Court in 1978 in Exxon Corp. v. Governor of Maryland. 602 Following a one-year transition period allowing producers and refiners to enter into alternative arrangements, Maryland's divorce statute became effective on July 13, 1979; however, because of further litigation, several service stations remained company-operated until 1981. 603 Maryland's statute, which has been the subject of numerous studies on the effects of divorce, was rewritten and recodified on October 1, 1992, as follows: 604

#### §10-311. Operation of station

(a) In General. -- Except as provided in subsection (c) of this section, each retail service station in the State:

(1) shall be operated by a retail service station dealer; and

(2) may not be operated by a producer or refiner of motor fuel;

(i) with a commissioned agent, company personnel, or a subsidiary company; or

(ii) under a contract with a person who manages the station on a fee arrangement with the producer or refiner.

(b) Scope of section. -- This section does not apply to facilities that an agricultural cooperative

association owns and operates ...

(c) Exemption. -- A retail service station shall be exempt from subsection (a) of this section for a fiscal year that starts July 1, if:

(1) on January 1, 1979, the station was operated by a subsidiary of a producer or refiner of motor fuel; and

(2) the gross revenues of the subsidiary from the sale of motor fuel in the State for the preceding calendar year is less than 2% of the gross revenues of the subsidiary from all retail operations in the State for the preceding calendar year. 605

Nevada

Nevada's divorcement law reads as follows:

ñ597. 440. Restrictions on refiner's operation of service stations.

1. On or after July 1, 1987, except as provided in subsection 3, a refiner shall not commence the:

(a) Direct operation of a service station, with his own employees or through a subsidiary or commissioned agent or a person on the basis of a fee; or

(b) Sale of motor vehicle fuel at a service station.

2. On or after July 1, 1988, except as provided in subsection 3, a refiner shall not engage in the direct operation of more than 15 service stations in this state, with his own employees or through a subsidiary or commissioned agent or a person on the basis of a fee.

3. A refiner may operate a service station for not more than 90 days if the:

(a) Retailer voluntarily terminates or agrees not to renew the franchise; or

(b) Franchise is terminated by the refiner...  
. 606

## Virginia

Virginia's divorcement law reads as follows:

ñ59.1-21.16:2. Operation of retail outlet by refiner; apportionment of fuels during periods of shortage; rules and regulations. -- A. After July 1, 1979, no refiner of petroleum products shall operate any major brand, secondary brand, or unbranded retail outlet in the Commonwealth of Virginia with company personnel, a parent company, or under a contract with any person, firm, or corporation, managing a service station on a fee arrangement with the refiner; however, such refiner may operate such retail outlet with the aforesaid personnel, parent, person, firm, or corporation if such outlet is located not less than one and one-half miles, as measured by the most direct surface transportation route, from the nearest retail outlet operated by any franchised dealer; and provided, that once in operation, no refiner shall be required to change or cease operation of any retail outlet by the provisions of this section.

During the period July 1, 1990, through June 30, 1991, no refiner may construct and operate with company personnel as defined in this section any new major brand, secondary brand, or unbranded retail outlet in the Commonwealth of Virginia, except on any property purchased or under option to purchase by March 1, 1990.  
\* \* \*607

## B. State Reports

Hawaii and several other jurisdictions have completed reports regarding retail divorcement, including the following:

### Arizona

In 1987, a joint legislative study committee on petroleum pricing, marketing practices, and retail divorcement was convened, inter alia, to investigate these issues, study the laws of other states, and determine the impact of retail divorcement in Arizona. 608 After reviewing Maryland's divorcement statute and Georgia's proposed

divorcement legislation, as well as testimony from all aspects of the petroleum industry, the committee rejected legislation that would address the issue of retail divorcement. The committee noted that the antitrust division of the Arizona Attorney General's office and the Bureau of Competition of the Federal Trade Commission both testified that they had no knowledge or evidence of predatory pricing practices in the State. The Attorney General's office further noted that current laws were "more than adequate to handle any possible case involving predatory pricing or anticompetitive behavior" and that "evidence supports the fact that any legislation in this area will increase prices". 609

#### Hawai i

The merits of retail divorcement legislation in Hawaii have been reviewed in several recent reports, including the following:

Attorney General. In 1993, the Attorney General reviewed a number of studies, mostly relating to Maryland's divorcement law, and concluded that "none of the studies establish a conclusive case for or against divorcement"; the decision to implement divorcement in Hawaii, according to the Attorney General, ultimately comes down to a policy decision: "If the better policy favors the protection of independent dealers from competition even at the cost of higher prices to the public and perhaps inefficiency in the market, divorcement is appropriate. If the better policy is to promote competition, efficiency in marketing, and lower consumer prices, divorcement should be rejected." 610

In 1995, the Attorney General was asked by the Legislature for a legal opinion as to whether permanent divorcement would constitute a taking in violation of the Fifth Amendment of the United States and Hawaii Constitutions, and any other legal ramifications that may arise from permanent divorcement legislation. The Attorney General concluded that section 486H- 10, Hawaii Revised Statutes, does not violate the eminent domain clauses of the United States or Hawaii Constitutions. In particular, the Attorney General found that section 486H-10 does not deprive manufacturers and jobbers who own retail service stations of all economically viable use of their property, nor does that section "prohibit an oil company from leasing their property to independent dealers" or "from owning retail service stations or from making arrangements for them to be operated as retail outlets for the oil company's products." 611

Department of Commerce and Consumer Affairs. In a study prepared for that department, Schoen (1993) sought to answer the question whether

consumers derived any benefits from divorcement by focusing on dealers and divorcement at the "grass roots" level in Maryland, and concluded that divorcement does not appear to have harmed consumers, who "have accepted divorcement". 612

University of Hawaii Professors Walter Miklius and Sumner J. LaCroix.

Professors Miklius and LaCroix (1993) believed that divorcement legislation would lead to higher gasoline prices in Hawaii and reduce the number of retail outlets. On the basis of Maryland's experience with divorcement<sup>613</sup> and their own independent analysis, Miklius and LaCroix concluded that retail divorcement legislation in Hawaii would similarly increase gasoline prices in Hawaii and result in fewer service stations.<sup>614</sup> They concluded that Hawaii's divorcement law is anticompetitive and would impose large financial burdens on Hawaii's consumers.<sup>615</sup>

University of California at Berkeley Professor David J. Teece. Pacific Resources, Inc. commissioned Professor David Teece in 1991 to prepare a study of retail divorcement in Hawaii with the assistance of the Law and Economics Consulting Group.<sup>616</sup> Teece also believed that divorcement legislation would be harmful to Hawaii's consumers, based in part on his findings that the impact of divorcement legislation on the mainland "has been to increase prices and lower service, thus protecting inefficient competitors by making the market less competitive, all at the expense of consumers."<sup>617</sup>

## Maryland

Maryland was one of the first states to pass a retail divorcement law in 1974 (effective in 1979), which has generated a significant amount of controversy.<sup>618</sup> In 1978, Maryland's statute was upheld by the United States Supreme Court in *Exxon Corp. v. Governor of Maryland*.<sup>619</sup> After reviewing various studies conducted regarding the economic impact of Maryland's divorcement statute, Maryland's Department of Fiscal Services concluded that "divorcement led to both higher gasoline prices and shorter hours of operation in the period following divorcement."<sup>620</sup>

Although the department found that available data was insufficient to produce a reliable estimate of the adverse dollar impact on the state's motorists since that statute became operative, the department's analysis indicated that both economic theory and empirical research showed that divorcement had cost consumers money.<sup>621</sup> The department further noted that while changes in gasoline marketing had made its analysis more difficult, divorcement nevertheless could not be considered to be in the financial interests of Maryland's consumers.<sup>622</sup>

## Massachusetts

A task force was convened by the Joint Committee on Energy of the Massachusetts Legislature in 1992 to study retail divorcement, open supply, and related issues. After conducting an in-depth study on these issues, the task force concluded that it could not determine whether predatory pricing and company store subsidization was being practiced in local markets. The task force nevertheless concluded that company operated stations were most likely not a strong enough influence in that state's markets since their numbers and respective market shares were small; "[w]hile there may be isolated cases of such behavior, divorcement cannot be recommended without stronger evidence of the anti-competitive nature of company operated stores."<sup>623</sup> The task force further recommended that the Massachusetts Attorney General examine company operated stations to determine their pricing influence on the local market.<sup>624</sup>

## Montana

In March, 1989, the Montana Legislature approved a House Joint Resolution requesting a joint subcommittee to conduct an interim study of the system of marketing motor fuels in Montana to determine if subsidized pricing and predatory motor fuel franchise practices give unfair competitive advantage to certain retailers and wholesalers.<sup>625</sup> The subcommittee, after considering testimony presented, recommended that the legislature enact bills regulating the price of motor fuel at the wholesale and retail levels and prohibiting below-cost sales of motor fuels, and creating a new Montana antitrust law. The latter bill, which would enact a version of the Robinson-Patman antidisiscrimination act, prohibits a business from discriminating in price between purchasers of commodities of like grade and quality if the effect is to lessen competition or to tend to create a monopoly. The subcommittee rejected several other bills, including one that would have provided for divorcement of the refining and marketing segments of the motor fuel industry.<sup>626</sup>

## Virginia

During its 1990 session, the Virginia General Assembly appointed a joint subcommittee to study divorcement and representative offering<sup>627</sup> pursuant to a House Joint Resolution. The Resolution sought an examination of dealers' allegations that refiners were attempting to force dealers out of business by imposing rigid operating standards and using unfair marketing practices in the sale of motor fuel. Refiners contended that changing business and economic conditions were the

reasons behind dealer troubles.<sup>628</sup> Since 1979, Virginia has had in effect a partial retail divorcement statute that prohibits the operation of refiner-operated retail stations closer than 1.5 miles from any franchised dealer stations. The subcommittee recommended against the implementation of total retail divorcement in Virginia, reflecting "the concern that total retail divorcement would reduce competition in the market place and therefore limit consumers' freedom of choice in the products that they buy."<sup>629</sup> The subcommittee also rejected an attempt to relax the application of the 1.5 mile rule. In general, the subcommittee "failed to discern a clear pattern of unfair competition or other abuses alleged to exist in the sale of motor fuels."<sup>630</sup>

### Washington State

In 1985, the Washington State Senate Select Committee on Petroleum Marketing Practices was convened to conduct an investigation and recommend legislation, if necessary, that would protect independent gasoline dealers and prevent refiners from using unfair business practices.<sup>631</sup> After studying the petroleum industry in Washington, as well as existing and pending federal and state legislation, the committee recommended the enactment of divorcement legislation that included a "trigger" clause to provide that the legislation would become effective only when the gasoline volume sold through major refiner operated retail stations reached twenty percent of the total volume statewide, as determined by the department of licensing of the State of Washington. Upon reaching the twenty percent figure, the major oil companies would be forced to divorce or lease their company operated stores to other operators.<sup>632</sup> In addition, the committee recommended that the Washington State Attorney General conduct a study to determine the extent that refiner actions have affected the state's retail gasoline market since the time of deregulation, as well as the possible future effects of major refiner involvement in the retail sector.<sup>633</sup> In 1986, the Washington State Legislature directed the Attorney General to investigate retail gasoline marketing in that state to determine whether motor oil companies injured the competition of lessee-dealers.<sup>634</sup> The attorney general concluded that the number of instances in which dealer tankwagon (DTW) prices were equal to or higher than retail prices were "clearly too infrequent to sustain the allegation that lessee dealers are being systematically driven from the market because their DTW prices are at or above the retail price levels at competing company-operated stations."<sup>635</sup>

### C. Arguments For and Against Divorcement

Generally, arguments frequently advanced in favor of divorce legislation include the following:

Allows independents to survive. Divorce is necessary to assure the economic survival of independent service stations and enhance their ability to compete as small businesses;

Increases competition. Oil companies are attempting to control, monopolize, and unduly influence the retail gasoline market. Divorce will increase competition in that market;

Gives dealers greater control over their operations. Oil companies control a large portion of dealers' operating costs, including station rent, wholesale price costs, and branding charges, through lease agreements. Dealers have been forced out of business due to artificial increases in these costs and other unreasonable clauses in renewal leases. Elimination of these controls will allow dealers to make business decisions to more effectively compete in the market; and

Eliminates predatory pricing made possible by vertical integration. Vertical integration has allowed oil companies to engage in predatory pricing by permitting them to subsidize low gasoline prices at their company stores through profits obtained at other levels of operation. These prices, which are below cost and below the wholesale prices charged to lessee dealers, are intended to drive lessee-dealers out of the retail gasoline market so that they can be replaced with company-operated stations. 636

Opponents of divorce legislation, on the other hand, have argued that divorce will result in:

Less efficiency. Oil companies vertically integrate downstream to enable them to more efficiently market their petroleum products, not to engage in predatory pricing. Government and academic studies have shown that gasoline marketing is highly competitive and that there is no evidence of predatory pricing. The U. S. Departments of Justice and Energy and the Federal Trade Commission have found no evidence of predatory pricing in the industry. Reductions in the number of service stations can be attributed to changing economic conditions such as escalating construction and operating costs, crude oil prices, government oil pricing, and changing consumer

preferences;

Reduced competition. Divorcement would sharply reduce competition, thereby limiting consumers' freedom of choice. Consumers would be unable to choose among a range of gasoline brands, services, prices, and hours of operation if refiners are excluded from the gasoline market;

Higher gasoline prices and reduced hours of operation. Restricted competition will result in higher gasoline prices for consumers. Studies of Maryland's divorcement statute indicated that divorcement raised gasoline prices reduced the average hours of operation of stations which were divested; and

Fewer employment opportunities, reduced tank safety, and less market innovation. Divorcement would reduce opportunities for employment, training, and advancement in gasoline retailing offered by refiner-operators. The safety of underground storage tanks, which has been enhanced by refiner investments in new and safer tanks, would be reduced. Refiners would be forced to reduce their investment in gasoline marketing, thereby reducing market innovation, which has typically been a strength of refiners' operations. 637

Floor debates preceding the enactment of Hawaii's first divorcement law in 1991, which established a two-year moratorium prohibiting refiners and distributors from opening any new directly operated service stations except in certain circumstances, 638 reflect similar concerns. One legislator speaking in favor of this legislation, after reviewing the Hawaii Attorney General's preliminary findings, expressed her concern over the declining number of independent gasoline dealers and the need to prevent the monopolization of Hawaii's oil industry. 639 Speaking in opposition to this legislation, on the other hand, one legislator argued that there was no evidence of predatory pricing by the incumbent oil companies, and that this legislation constituted an unnecessary intrusion of government into the marketplace. 640 Another legislator concurred, citing the potentially harmful effects of this legislation on Hawaii's consumers and the need for stricter enforcement of existing antitrust laws. 641

#### D. Predatory Pricing

A frequently made argument is that divorcement legislation is necessary to prevent large oil companies from using their company-operated gasoline stations to engage in predatory pricing.

Predatory pricing is considered one of the primary ways that large firms force smaller competitors from the market; once driven from the market, potential competitors are further deterred from re-entering the market by the threat of future predatory behavior:

Much of our antitrust policy is based on the notion that large firms, if unconstrained by government regulation, will frequently drive smaller competitors out of the market through "unfair" business practices. Chief among such alleged practices is predatory pricing. The idea behind predatory pricing is simple: by setting price below cost, a predator can impose losses on his rivals. Although the predator firm also incurs current losses, its greater financial resources allow it to withstand such losses. Eventually, when prey are driven from the market, the predator raises its price and receives monopoly profits which exceed its earlier losses. Furthermore, it need not worry about potential competitors re-entering the market. New entrants are deterred by the knowledge that their entry will induce the monopolist to engage in predatory pricing once again. 642

The oil industry has been one of the most frequent targets of allegations of predatory pricing. One reason is the historical distrust of major oil companies dating back to the time of pre-dissolution Standard Oil, in which Standard Oil was alleged to have used price cutting to achieve monopoly power. 643 This distrust continues despite the comparatively low levels of retail market concentration maintained by these companies compared to levels maintained earlier in this century. 644

Proponents of divorcement contend that in the absence of divorcement legislation, predatory pricing on the part of the large oil refiners could lead to monopolization of the gasoline market. 645 However, studies undertaken at the federal, state, and industry levels indicate that the petroleum industry is not engaged in predatory pricing against dealer-operated stations. 646

For example, in one study that tested whether predatory pricing had occurred in the Maryland retail gasoline market, Barron, Loewenstein, and Umbeck (1985) concluded that refiner-operated gasoline stations were not charging predatory prices, and argued that predatory pricing by large oil companies generally made little economic sense: 647

Do the allegations of predatory pricing by petroleum firms make sense from an economic point of

view? At least two reasons indicate that they do not. First, ... a policy of predation generally would be quite costly to a predator.... If a petroleum firm were to prey on its lessee dealers, it would drive down the value of its leased stations. Thus, it would impose direct costs on itself. If major petroleum firms wanted to drive their lessee dealers from the market, they could do so at much less cost simply by not renewing the leases upon expiration. Second, for the sake of argument, suppose that major petroleum firms do have some monopoly power in the production and refining of oil. The best way to use that power would not be to attempt monopolizing the retail gasoline market--in which entry is relatively easy--but, rather, to promote a competitive, efficient market.

Sorensen (1991) also found that predatory pricing in the gasoline industry is both unprofitable and unlikely to lead to monopolization of the gasoline market, and that a successful predator would probably be exposed to antitrust action. 648

Despite the relatively high entry barriers to the gasoline marketing industry in Hawaii, Miklius and LaCroix (1993) have similarly concluded that it is "extremely unlikely that refiners or jobbers are predating on their own branded dealers", 649 and further note that predatory pricing is unlikely in Hawaii's retail markets:

First, several major oil companies have no company-operated stations (UNOCAL and Shell) and, therefore, lack the vehicle for predation. By contrast BHP has no lessee dealers and, therefore, lacks a lessee dealer target for its predatory behavior. Second, the two major oil companies with refineries in Hawaii, Chevron and BHP, have incentives to maintain competition in down-stream marketing. Reducing down-stream competition via predatory pricing behavior is not in their long-run interest if they are acting as duopolists in the refining industry. Finally, while predatory pricing might drive one major player out of the market, several major players would still remain in the marketplace to ensure competitive pricing. 650

#### E. Independent Dealers

Does retail divorcement legislation increase the viability of independent dealers? Some believe that it does, at a cost. In reviewing Maryland's divorcement statute, the Maryland Department of

Fiscal Services concluded that divorcement legislation was not in the financial interests of consumers, and could only be justified on the basis of assuring the viability of small, locally owned businesses in the retail petroleum industry.<sup>651</sup> As noted earlier, Hawaii's Attorney General similarly concluded that a decision to continue retail divorcement legislation involved a policy determination as to whether independent retail dealers should be protected from competition (through divorcement legislation) at the cost of higher consumer prices and potential market inefficiencies.<sup>652</sup>

Independent dealers contend that retail divorcement legislation would allow them to remain in business and would increase competition. Because many of these stations are converting or being replaced by larger self-service stations and convenience store configurations, it is argued, divorcement legislation will help to preserve the viability of small independent dealers and, presumably, assist in retaining the automotive service component of their stations.

Others, however, maintain that divorcement is anticompetitive and does not substantially increase the viability of independent dealers. For example, Dougher and Hogarty (1991) found no evidence that retail divorcement and other legislation purporting to help preserve retail gasoline outlets had done so: "One reason may be that the laws addressed non-existent problems (e.g., refiner predation), while the number of outlets was being affected by fundamental market forces (e.g., increases in the public preference for large volume outlets)."<sup>653</sup>

Honeycutt (1985) believed that divorcement legislation protects lessee dealers from competition from refiners, but that this protection may be short-lived: "Dealers will continue to be subject to new competitive pressures, since wholesalers may introduce more efficient marketing methods and lower prices. For example, after divorcement in Connecticut, wholesalers began to increase their share of gasoline sales. This led to efforts to extend divorcement legislation to include these wholesalers."<sup>654</sup> He concluded that despite the decline in the number of lessee dealers, "the data do not support the thesis that refiner-owned- and-operated outlets have driven lessee dealers from the marketplace."<sup>655</sup>

Finally, Miklius and LaCroix (1993) found that divorcement would not substantially increase lessee dealer viability, and that the State should explore more effective ways to help small businesses in Hawaii:

Given its \$10 million-plus per year price tag, the crucial issue is whether the divorcement law will have a significant effect on the probability of lessee

dealer survival. While under the best case scenario, i. e., conversion of company-operated stations to lessee dealer-operated stations, revenues would increase but profits may not improve.... [T]o the extent that vertical integration reduces supplier's costs, the prohibition of company-operated stations would increase costs. The post divorcement DTW price, therefore, may be higher. Furthermore, divorcement will not directly affect other factors producing lessee dealer attrition. For all these reasons divorcement is unlikely to improve substantially a dealer's probability of survival. This conclusion is consistent with evidence showing that the number of lessee dealer-operated gasoline stations has continued to decline in states (including Maryland) where divorcement laws are in effect.

In all likelihood past trends will continue into the future leading to fewer gasoline stations servicing the market. With increasing costs (particularly from land rentals) the relatively low-volume, conventional stations will become increasingly noncompetitive and will be replaced by fewer large-volume, self-service stations.... [T]he lessee dealer arrangement had a distinct advantage in a conventional station with a repair bay. There is very little, if any, advantage in using this arrangement for operating large-volume, self-service stations. It is not at all surprising that BHP, being a latecomer to the market, adopted this mode of operation.

Divorcement is not going to change these matters. In fact, it is difficult to figure out what it will accomplish aside from increasing gasoline prices to consumers. The large volume self-service stations will still be the most efficient outlets regardless of who operates them and will continue to provide intense competition for the conventional stations.

In short, there is no reason to believe that divorcement in spite of its hefty price tag will substantially increase lessee dealer viability. It does not affect the factors that have caused the decrease in lessee dealer-operated stations. The State should explore other, more effective ways to help small businesses. 656

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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Endnotes 15

577. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, August 31, 1995, at 2-3.
578. *Id.* at 3. In the Attorney General's 1993 report on the impact of divorcement on consumer prices, the Attorney General noted that "Hawaii's retail gasoline prices increased on all islands after the moratorium was enacted.... These increases appear to reflect an increase in dealer tank wagon prices." Hawaii, Department of the Attorney General, *Gasoline Prices in Hawaii: The Impact of Oil Company Divorcement on Consumer Prices* (Honolulu: 1993) (hereinafter, "AG (1993)") at 24. However, while the retailers' margin appeared to be significant at first glance, "considering the amount of gasoline taxes, Hawaii's excise tax, and a gas station's operating costs, the retailers' margin is minimal." *Id.* The Attorney General concluded as follows: "We believe the price data to be inconclusive on the effect of the moratorium. The data do not, in our view, provide a sound empirical basis on which to embrace or reject divorcement." *Id.* at 25.
579. Letter from John Tantlinger, Ed. D., Energy Planner, Department of Business, Economic Development, and Tourism, to Wendell K. Kimura, Director, Legislative Reference Bureau, September 1, 1995, at 2.
580. *Id.* at 3. The department also cited the following references: United States, Department of Energy, *Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers* (Washington, DC: March 1984) (hereinafter, "DOE (1984)") and John Zyren, "What Drives Motor Gasoline Prices?" in *Petroleum Marketing Monthly* (Washington, DC: Energy Information Administration, June 1995).
581. Letter to researcher from Richard C. Botti, Hawaii Automotive and Retail Gasoline Dealers Association, dated September 1, 1995, at 2. The Bureau has substituted the bracketed language for the specific entity named.

582. Id. at 2-3.
583. Letter to researcher from Alec McBarnet, Jr., Vice President, Hawaii Petroleum Marketers Association, dated September 7, 1995, at 2.
584. Id. at 1.
585. Id. at 2.
586. Letter to researcher from Jennifer A. Aquino, Administrative Manager, Aloha Petroleum, Ltd., dated September 21, 1995, at 10.
587. Id. at 11.
588. Letter to researcher from R. A. Broderick, Western Region Business Manager, Shell Oil Products Co., dated August 31, 1995, at 2.
589. Id. at 3.
590. Letter from Susan A. Kusunoki, BHP Hawaii, to Wendell K. Kimura, Director, Legislative Reference Bureau, dated September 8, 1995, at 2.
591. Id. at 3.
592. Letter from J. W. McElroy, Regional Manager, Chevron U. S. A. Products Co., to Wendell K. Kimura, Director, Legislative Reference Bureau, dated August 7, 1995, at 9-10. Chevron cited the government and academic studies included in its Exhibit 1 in support of its contentions. See note 20 in chapter 4.
593. Id. at 10, citing Chevron's Exhibit 1.
594. The United States Department of Energy has cited the following reasons for the increase in retail gasoline marketing divorcement legislation in the 1970s:

This legislative activity was in response to the heavy dealer attrition that occurred throughout most of the 1970s, a period of increasing sales by refiner-operated gasoline stations. Dealers were faced not only with increased competition from refiner-operated outlets and jobber retail operations, but also with

increasing rents and the imposition of credit card processing fees (the latter did not occur until November 1981). It was alleged that integrated refiners were favoring their directly operated outlets (particularly in the allocation of scarce gasoline supplies), and were engaging in predatory subsidization and other anticompetitive practices. It was feared that small gasoline retailers were being forced out of business by the major oil companies.

The sponsors of legislation were leery of a situation where small dealers had to compete with stations operated by the very companies that controlled their gasoline supplies, station rents, and other important aspects of their business. Apparently, many legislators believed that competitive forces in gasoline marketing were not strong enough to prevent refiner-marketers from taking advantage of this situation. In general, the purpose of the legislation was to promote the viability of small independent marketers (dealers) by eliminating the direct competition (and alleged inequitable practices) of refiner-marketers.

DOE (1984) at 97. See also *id.* at 97-105; AG (1993) at 18-19.

595. Until 1985, Florida's divorce statute read as follows:

ñ526.151. Petroleum products dealers; restrictions

(1) After October 1, 1974, no producer, refiner, or a subsidiary of any producer or refiner, shall operate, with company personnel, in excess of 3 percent of the total number of all classes of retail service stations selling its petroleum products, under its own brand or secondary brand.

(2) Every producer or refiner of petroleum products supplying gasoline and special fuels to retail service station dealers shall apply all equipment rental charges uniformly to all retail service station dealers which they supply.

(3) This section shall not apply to any service station operated by a producer or refiner of petroleum products who purchases or obtains more than 90 percent

of the unrefined petroleum products to be so refined from another producer or refiner of petroleum products.

(4) A circuit court or circuit judge shall have jurisdiction, upon hearing and for cause shown, to grant an injunction restraining any person from violating any of the provisions of this section.

Fla. Stat. §526.151 (1984); see *State ex rel. Gas Kwick, Inc. v. Conner*, 453 So.2d 863, 864 n. 1 (Fla. 1st Dist. Ct. of App., 1984) (per curiam).

In 1975, in an unreported Florida case that was never appealed, this statute was declared to be an unlawful exercise of the State's police power, denied producers and refiners of petroleum products equal protection of the laws, and unconstitutionally vague. See *Exxon Corp., et al. v. Conner*, Case Nos. 74-1449, 74-1577, and 74-1772, (Fla. 2d Cir. Ct., Jan. 23, 1975), cited in *State ex rel. Gas Kwick, Inc. v. Conner*, 453 So.2d at 864 and n. 2.

In 1978, the United States Supreme Court upheld the constitutionality of Maryland's divorcement statute, see *Exxon Corp. v. Governor of Maryland*, 437 U.S. 117 (1978), and Florida's divorcement statute was subsequently revived in a 1984 Florida case. See *State ex rel. Gas Kwick, Inc., v. Conner*, 453 So.2d at 863. However, the Florida Legislature repealed its divorcement statute the following year. See *Sixty Enterprises, Inc. v. Roman & Ciro, Inc.*, 601 So.2d 234, 235 n. 1 (Fla. 3d Dist. Ct. of App., 1992); 1985 Fla. Laws ch. 85-74.

596. In 1979, Louisiana enacted a divorcement statute that read as follows:

§1471. Operation of retail service station by producer or refiner of petroleum products.

A. After January 1, 1980, no producer or refiner of petroleum products shall open a retail service station or sales outlet of any nature in the state of Louisiana, and operate it 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, except on an interim basis for a period not to exceed sixty days while seeking a dealer who can operate the station in compliance with this section after the dealer who formerly operated the station in compliance with this section has discontinued such operation. The provisions of this Act shall be effective through August 31, 1980 at which time the provisions of this Act shall no longer be applicable. \*\*\*

La. Rev. Stat. Ann. §1471(A) (West 1987) (emphasis added).

597. John M. Barron, M. A. Loewenstein, and J. R. Umbeck, "Predatory Pricing: The Case of the Retail Gasoline Market," *Contemporary Policy Issues*, vol. 3, no. 3, pt. 2 (Spring, 1985) at 134 n. 5; see also J. Richard Shaner, "Divorcement Pressures Growing Once Again," *National Petroleum News*, vol. 83, no. 6 (June 1991) at 10; Marvin Murphy, "Divorcement Proposals, Other Retail Gasoline Dealer Protection Measures Facing Obstacles at State Level," *Oil Daily*, no. 9526 (June 21, 1990) at 1; Marvin Murphy, "State Lawmakers Target Gasoline Retailers; Wide-Ranging Legislation Sought," *Oil Daily*, no. 9453 (Feb. 23, 1990) at 1.
598. Conn. Gen. Stat. §§14-344a and 14-344b (1995). Chapter 250a (operation of retail service stations) of title 14 does not affect allocation and distribution of fuel by the state, nor does it apply to any service station operated by a producer or refiner with its employees on July 1, 1979, that is used as a training or test marketing center or for advertising or public relations purposes. *Id.*, section 14-344d.
599. Del. Code Ann. title 6, §2905 (Michie 1993).
600. D.C. Code Ann. §10-201 (Michie 1989).
601. Until 1992, the text of that statute read as follows:
- §157E. Declaration or statement by wholesalers, refiners, manufacturers, jobbers and dealers; operation of service station by producer or refiner or management firm; uniform treatment of retail dealers.  
\*\*\*

(b) ... [A]fter 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, 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.

(c)(1) ... [A]fter 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.

(2) A retail service station in operation on January 1, 1979, that is operated by a subsidiary of a producer or refiner of petroleum products as of January 1, 1979 referred to in this subsection shall be exempt from year to year from paragraph (1) of this subsection for the fiscal year beginning July 1, of each year, if the subsidiary's gross revenues from the sale of petroleum products in this State for the preceding calendar year is less than 2 percent of the subsidiary's gross revenues from all retail operations in this State for the preceding calendar year. Md. Ann. Code art. 56, §157E (1988).

602. 437 U.S. 117 (1978).

603. AG (1993) at 11.

604. 1992 Md. Laws ch. 4, §1. The 1992 reenactment was included in Maryland's ongoing revision of its state code.

Telephone

interview with David Warner, Maryland Department of Legislative Reference, August 23, 1995.

605. Md. Code Ann., Bus. Reg. §10-311 (Michie 1992). Section 10-101(i) of that article defines "retail service station dealer" as "a person who operates a retail place of business where motor fuel is sold and delivered into the fuel supply

tanks of motor vehicles. "

606. Nev. Rev. Stat. §§597.440 (1993). Nev. Rev. Stat. §§597.450 (1993) reads as follows:

§597.450. Refiner's sale of motor vehicle fuel to other retailers during temporary operation: Price.

During the temporary operation of a service station by a refiner, the refiner may sell motor vehicle fuel to other retailers in the marketing area of that service station at a price not less than 4 cents below the retail price of fuel at the service station he is operating.

Nev. Rev. Stat. sections 597.440 and 597.450 replaced sections 598.677 and 598.678, respectively, in revision.

607. Va. Code Ann. §59.1-21.16:2 (Michie 1992).
608. Arizona, Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Petroleum Producer Retail Divorcement, Final Report (Dec. 1988), Appendix E (hereinafter, "Arizona Report (1988)").
609. Id. at 34-35 (Appendix A).
610. AG (1993) at 22; see also Hawaii, Department of the Attorney General, The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices (Honolulu: 1994) at 19. The Attorney General further recommended, as an alternative, that the Legislature wait to see what action was taken by Congress on similar federal divorcement proposals; however, no federal divorcement legislation has been enacted to date.
611. See 1995 Haw. Sess. Laws Act 238, §4; Hawaii Attorney General Opinion No. 95-04, dated November 20, 1995, at 2.
612. Julia E. Schoen, The Consumer and Gasoline Marketing in Hawaii: The Impact of Direct Retailing of Motor Fuel by Refiners and Distributors on the Consumer (Honolulu: Hawaii Department of Commerce and Consumer Affairs, 1993) at 55 ("Divorcement has been in place since 1979 in Maryland. It does not appear to have caused any changes in available services or been detrimental to the marketplace. The competition between stations seems healthy and competitive based on price per gallon signs conspicuously displayed.

Franchised stations representing different oil companies still occupy different street corners providing the consumer with a choice of brands and services.")

613. The price of gasoline in Maryland rose after petroleum firms were forced to divest themselves of employee-operated stations. See generally J. M. Barron and J. R. Umbeck, "The Effects of Different Contractual Arrangements: The Case of Retail Gasoline Markets," 27 J.L. & Econ. 313 (Oct. 1984).
614. Walter Miklius and Sumner J. LaCroix, Divorcement Legislation and the Impact on Gasoline Retailing in the United States and Hawaii (Honolulu: University of Hawaii, Jan. 20, 1993) at iv-v. "On the basis of Maryland's experience, we estimate that if the divorcement law was in effect in Hawaii during 1990, Hawaii's consumers would have paid \$11.1 million more for gasoline than they actually paid. This is a lower bound estimate--the actual increase in Hawaii could be much larger." Id. at v.
615. Id. at v:

The proposed divorcement legislation represents a reversal of a long-standing state policy of encouraging additional competition in Hawaii's oil industry. This policy formed the basis for the State's support for building a second oil refinery in Hawaii and was motivated by the expectation that this refinery would increase competition and thus reduce high gasoline prices.... The former PRI refinery was constructed in 1972 and to increase efficiency it integrated down-stream into the retail gasoline market in 1982. On the basis of efficiency considerations, it chose the most efficient outlet to market its products, i.e., the large-volume, self-service-only outlets. There is little question that the appearance of PRI in Hawaii increased competition and kept gasoline prices lower than they would have been in its absence. The results are fully consistent with the aims of the state's ... original policy: increased competition and lower gasoline prices.

Act 295 SLH [1991] departs from this policy. Its aim is clearly anticompetitive. There is, however, no evidence that there is too much competition in Hawaii's gasoline retail market. Divorcement legislation is not in order, as it would impose large

financial burdens on consumers. If the State wishes to help lessee dealers, it should explore other, more effective ways to do so.

616. See David J. Teece, *An Economic Analysis of S.B. 1757*, S.D. 1 "Relating to Prohibition Against Retailing of Motor Fuel by Refiners" (Berkeley, CA: April 1991). This study is self-described as "an independent assessment of petroleum marketing in Hawaii against the backdrop of divorcement legislation pending before the state legislature.... The report reflect[s] the views of Professor Teece and not necessarily those of Pacific Resources, Inc." *Id.* at [i] (Preface). This report was submitted in support of Teece's testimony before the House Committees on Consumer Protection and Commerce and Judiciary, April 2, 1991, regarding Senate Bill No. 1757, S.D. 1 (1991).

617. *Id.* at 18-19:

The adoption of divorcement legislation would be most unfortunate for consumers in Hawaii. First, amongst the most vigorous competitors are the Gas Express stations. Divorcement would force new stations to be franchised, with no guarantee that the dealers would be as competitive. Second, evidence from the mainland where divorcement has been enacted shows that prices go up in both the short and long run as a result of divorcement. A price increase of the same magnitude would cost consumers in Hawaii about \$8.0 million per year. Finally, there are much less draconian instruments already available if predation is indeed a problem, which it is not.

For all of these reasons, it is not in the public interest to pass this protectionist bill. What it does is to protect franchised as well as independent dealers, primarily at the expense of Hawaiian consumers. Hawaii consumers have clearly spoken on the issue. A large number prefer low-price, self-service gasoline stations like Gas Express and low priced, high volume repair shops such as Jiffy Lube or Midas. They like to buy tires at Consumer Tire Warehouse and Costco. Some consumers still prefer full service gasoline stations. These consumers are being served by a smaller number of stations than in the past, because fewer motorists want this kind of service. The proposed legislation will erode the

representation of the low-priced, self serve, day and night operation service stations that motorists have been willing to support with their patronage.

618. See, e.g., Barron and Umbeck (1984); Putnam, Hayes, and Bartlett, Inc., Gasoline Prices in Maryland Following Divorcement, (March 13, 1987) (commissioned by the Maryland Attorney General and the Comptroller of the Treasury); Thomas P. Hogarty and Rayola S. Dougher, "The Impact of Divorcement on Consumers in Maryland: A Critique of 'Gasoline Prices in Maryland Following Divorcement,' by Putnam, Hayes, and Bartlett, Inc., March 13, 1987," American Petroleum Institute Critique #019 (June 1987); and Philip

E.

Sorensen, The Cost to Consumers in Maryland of the Divorcement of Refiners from Retail Gasoline Marketing, 1979-1986, (January 1988). For a review and discussion of these studies, see AG (1993) at 11-22; see also Schoen (1993) at 51-55.

619. 437 U.S. 117 (1978).

620. Maryland, Department of Fiscal Services, Gasoline Station Divorcement: A Review of Studies Concerning the Economic Impact of Maryland's Gasoline Station Divorcement Law (Annapolis: Nov. 1988) at 2.

621. Id.

622. Id. at 3 (emphasis added):

A difficulty in analyzing divorcement today is that considerable change has occurred in the marketing of gasoline since the divorcement statute was enacted in 1974. Many small retail stations have been replaced with large "gas and go" stations. Many stations are now part of convenience stores and the price structure of gasoline is influenced by the pricing of other products. The widening gap between full-service and self-service prices generates an increasing use of self-serve by many motorists. The price differential between cash and credit sales is an added dimension. It is quite possible that the effect of divorcement on a price per gallon basis is less than price per gallon variations from one station to another in close geographic proximity.

The divorcement issue involves the relationship between the oil refineries and the retail service stations. The case for divorcement can only be justified on the basis that this type of state regulation is necessary to assure the viability of small, locally owned businesses in the retail petroleum industry. Divorcement cannot be sustained as being in the financial interests of consumers.

Others have similarly concluded that divorcement legislation of the type enacted in Maryland has a negative impact on consumers. See, e.g., Ben W. Bolch and William W. Damon, "Modeling Divorcement in the Retail Petroleum Industry," *Quarterly Review of Economics and Business*, vol. 28, no. 2 (Summer, 1988) at 59 ("[W]e can find no clear benefits to consumers from regulations of the kind that were passed in Maryland. Indeed, the benefits may be negative to consumers in that dealers that are no longer economically viable may remain in business because of the retardation in adopting more efficient self-service marketing technology."); see also "Cheap Gasoline Isn't as Cheap in Maryland," *Sun* (Baltimore, MD), May 11, 1986, Section F at 11.

623. Massachusetts, Open Supply and Divorcement Task Force, Report Concerning House Bills H861 and H4490 Currently Before the Joint Committee on Energy (Boston: Aug. 11, 1993) at v.
624. *Id.* at 12.
625. See Montana Legislative Council, *Motor Fuel Pricing Problems* (Helena, MT: Oct. 1990).
626. *Id.* at 5-6.
627. "Representative offering", also referred to as "wholesale competition option" or "limited open supply", means the ability of a dealer to sell one grade of motor fuel that was purchased from sources other than the refiner with whom the dealer has a franchise agreement, provided that the dealer observes all trademark identification requirements established by the refiner and complies with all federal and state laws relating to motor fuel quality specifications, handling practices, and labeling requirements. See Virginia, General Assembly, Report of the Joint Subcommittee Studying Divorcement and Representative Offering for Inclusion in the Virginia Petroleum Products Franchise Act

(Richmond: 1991) (hereinafter, "Virginia Report (1991)") at 2; see chapter 4 of this report for a discussion of open supply and related issues.

628. Virginia Report (1991) at 1.

629. *Id.* at 11. In reviewing divorcement and open supply laws, the subcommittee heard testimony from the director of litigation of the Federal Trade Commission (FTC) that:

Claims that vertical integration by refiners into gasoline retailing is anticompetitive in and of itself or because of refiner subsidization did not appear to be well founded. Although most refiners in the United States are vertically integrated into gasoline retailing because such integration is efficient, the major oil companies targeted by the divorcement and open supply in Virginia are the least integrated into retailing....

The FTC pointed out that predatory or monopolistic behavior in the petroleum industry is subject to federal law and the Virginia Antitrust Act which address possible anticompetitive practices in the industry more effectively than legislation restricting new entry by potential competitors. *Id.* at 10.

630. *Id.*

631. Washington, State Senate Select Committee on Petroleum Marketing Practices, 1986 Report to the Legislature on the Retail Gasoline Market (Olympia, WA: 1986) at 1.

632. *Id.* at 18. The committee noted that company-operated stations accounted for approximately nine percent of the total gasoline sold statewide in 1984, and that the committee's recommendation, along with other recommendations of the committee, "will ensure the survival of the independent gasoline retailer while continuing the opportunity of the major refiners to market their product at company-operated outlets in Washington." *Id.*

633. *Id.* at 19.

634. See Washington, State Attorney General, Final Report to the Washington State Legislature on the Attorney General's

Investigation of Retail Gasoline Marketing (Olympia: Aug. 12, 1987).

635. *Id.* at 14. The attorney general further noted that at the retail level, gasoline revenues alone were not sufficient to recover the wholesale (DTW) cost, the costs of marketing gasoline, and a reasonable profit margin, and that stations without alternative profit centers (such as a convenience store format) would have difficulty being profitable on the basis of sales of gasoline alone; however,

in view of this evolving nature of the retail gasoline business, slim margins on gasoline do not necessarily evidence an intent by companies to drive out their lessee dealers. In a rapidly changing market with thin retail profit margins due to competitive factors, it would be reasonable to expect that a significant number of dealers would be unable to adapt quickly enough to survive. *Id.* at 27.

636. See Virginia Report (1991) at 5-6; see also Arizona Report (1988) at 18.

637. Virginia Report (1991) at 6-7.

638. 1991 Haw. Sess. Laws Act 295, ñ5.

639. Testimony of Senator Ikeda on Senate Bill No. 1757, S.D. 1, Journal of the Senate of the Sixteenth Legislature of the State of Hawaii, Regular Session of 1991, 29th Day, page 322:

As you know, the attorney general has been conducting ... an ongoing investigation of gasoline pricing in Hawaii. In his September 1990 preliminary report he found the following: First, the gasoline markets in Hawaii are highly concentrated. Second, barriers to the entry of new competition are extremely high at the refinery, terminal storage, and retail outlet levels of the markets. Third, demand for gasoline in Hawaii is highly inelastic. Fourth, historically, wholesale gasoline prices in Hawaii have been above those in competitive markets by an amount substantially in excess of the price of transportation between those markets and Hawaii.

He has tentatively concluded after these findings

that there are four probable causes and these are: the exchange agreements used by the incumbent oil companies, the control of storage facilities by the incumbent oil companies, and the control of retail outlets by the incumbent oil companies, as well as the limited size of the Hawaii market.

I would like to put emphasis on the third of the four probable causes, the control of retail outlets by the incumbent oil companies. This is what we have seen happening over the years. There's no doubt that the facts show that the numbers of independent gasoline dealers have steadily declined. We have seen their numbers reduced from roughly 600 in 1979 to less than 300 today... [G]iven the fact that it's fairly obvious that we lack a competitive environment in this state as far as gasoline pricing is concerned, the only thing that we can do is take steps to keep this business from becoming a total monopoly. And that's basically what has already occurred--it only helps to retain the status quo...

640. Testimony of Representative Tatibouet on Senate Bill No. 1757, S.D. 1, H.D. 1, Journal of the House of Representatives of the State of Hawaii, Regular Session of 1991, 46th Day, page 514:

The proponents of this divorcement legislation have alleged that ... integrated refiners who sell gasoline to the public are somehow engaged in predatory pricing behavior and that this has led to independent franchise dealers going out of business. They argued that permitting refiners to own and operate retail gasoline stations place the dealers in an unfair and competitive disadvantage.

However, in reviewing the information and data that have been prepared by numerous sources contained in the testimony and elsewhere, I have not been able to identify any documented evidence to support the statements that such actions and activities are being promoted in our State[.] On the contrary, study after study ... have discounted the allegations of unfair competition committed by integrated oil companies. In fact the FTC found the divorcement laws have resulted in higher motor fuel prices and fewer choices for consumers.

... I believe this action is premature and another example of unwanted government intervention in the marketplace.

... [I]t is unconscionable that we, as a legislative body, would condone interfering with the marketplace and prohibit certain business activities based on no real documented evidence.

641. Testimony of Representative Thielen, *id.* at 515:

In a free market system such as ours, the general rule is that the more competition there is, the better. There must be a strong presumption against any measure which bans a company from competing.

This bill contains just that--a two year moratorium. Although there was no convincing evidence that oil refiners are competing unfairly, the bill was passed out of Committee.

The ultimate loser of course, as always, will be the consumer. We do not do gasoline buyers any favor by telling them that they cannot buy from a refiner, even if the refiner offers the lowest price of gas.

Hawaii and the federal government already have adequate antitrust laws forbidding anti-competitive actions by oil companies. If there is evidence of antitrust violations, the proper authorities, including our Office of the Attorney General, should act vigorously to enforce those laws. Otherwise, the government should stay out of the free market.

642. Barron, Loewenstein, and Umbeck (1985) at 131; see also Herbert Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice* (St. Paul, MN: West Publishing Co., 1994) at 298-328.

643. Barron, Loewenstein, and Umbeck (1985) at 131-132.

644. Jeffrey L. Spears, "Note: Arguments For and Against Legislative Attacks on Downstream Vertical Integration in the Oil Industry," 80 *Ky. L. J.* 1075, 1078-1080 (Summer, 1992) (footnotes omitted):

Although many politicians are quick to build a

platform upon such public fears, there can be no serious debate concerning the lack of similarity between the high level of industrial concentration within the oil industry prior to 1911 and the low level of economic concentration that characterizes the oil industry today. During Standard Oil's market predominance, it could boast of refining, transportation, and retail market concentration levels hovering around ninety percent. Today, however, the American oil giants are capable of individually controlling only a relatively small percentage of the refined products market. Furthermore, concentration ratios computed for the gasoline market reveal that the level of concentration possessed by refiners has fallen significantly in recent years. Nonetheless, many so-called "consumer advocates" and jobbers feel compelled to lobby passionately in state and federal arenas for legislation to curb purported industry excesses by forcing oil refiners to become divorced from their retail gasoline operations, thereby eroding the degree of vertical integration in the oil industry.

645. Miklius and LaCroix (1993) at 7:

Dealers have, however, suggested an alternative explanation for vertical integration: major oil companies use their integrated operations to predate on their own lessee dealers. If major oil companies are engaging in predatory behavior, this would lend support to dealers' contentions that divorcement legislation would lead to lower long-run prices. Divorcement would prevent major oil companies from increasing future prices to monopoly levels after the predatory activity has driven the lessee dealers from the retail gasoline marketplace.

646. See Arizona Report (1988) at 21 and studies cited therein; see generally DOE (1984); United States, Department of Energy, *The State of Competition in Gasoline Marketing* (Washington, DC: Jan. 1981).

647. Barron, Loewenstein, and Umbeck (1985) at 135 (emphasis in original; footnotes omitted).

648. Philip E. Sorensen, *An Economic Analysis of the Distributor-Dealer Wholesale Gasoline Price Inversion of 1990: The*

Effects of Different Contractual Relations (N. p., April 1991) at 34:

The theory of monopolization is contradicted by the history of the gasoline marketing industry in the U.S. Since the late 1960s concentration ratios in gasoline marketing have declined consistently, and are currently below levels of the 1950s. In addition, an exhaustive federal study (which included audits of refiner-operated stations throughout the U.S.) found no evidence of below-cost pricing or predation.

Predatory pricing in industries with low barriers to entry (such as gasoline marketing) has long been considered to be an unprofitable strategy by antitrust experts. It would not be possible for a hypothetical predatory seller of gasoline to recoup enough foregone profits through supra-competitive pricing in the post-predation period to pay for a predatory pricing campaign since new sellers would enter the market as price levels were raised, ruining any chance that the predatory firm could profit from the strategy. The predatory seller would also face probable antitrust action and suits for damages by competitors if it were ever to gain even a temporary degree of monopoly control over the market.

649. Miklius and LaCroix (1993) at 7.
650. Miklius and LaCroix (1993) at 57; see also *id.* at 7-16. For further discussion of predatory pricing under Hawaii law, see also Lyle Harada and Randall Sing, "Note: Island Tobacco Co., Ltd. v. R. J. Reynolds Tobacco Co. [63 Haw. 289, 627 P.2d 260 (1981)]: Federal and State Views of Hawaii's Antitrust Laws," 4 U. Haw. L. Rev. 195, 202-206 (1982); see also Haw. Rev. Stat. §§480-2 and 481-3.
651. Maryland Dept. of Fiscal Services (1988) at 3.
652. AG (1993) at 22.
653. Rayola Dougher and Thomas F. Hogarty, *The Impact of State Legislation on the Number of Retail Gasoline Outlets*, Research Study #062 (Washington, DC: American Petroleum Institute, Oct. 1991) at 15. Although they found that no definitive conclusions could be drawn with respect to the impact of divorce laws on the number of retail outlets

in a state, Dougher and Hogarty cited examples of market departure by refiners due to the divorcement laws in Maryland and Virginia, and noted that "[t]he departure of major refiners can mean the loss of substantial refiner investments, and hence, a decline in the number of stations." *Id.* at 7; see also "Divorcement Has No Impact on Station Closings: API," *U. S. Oil Week*, Dec. 9, 1991.

654. T. Crawford Honeycutt, "Competition in Controlled and Uncontrolled Gasoline Markets," *Contemporary Policy Issues*, vol. 3, no. 3, pt. 2 (Spring, 1985) at 107.
655. *Id.* at 116. Sorensen (1991) also noted that retail divorcement laws raise retail gasoline prices and have had their greatest relative impact on small and independent refiners, while tending to benefit jobbers over dealers:

Economic theory and various studies of the experience of retail divorcement in states where it has been imposed generally agree that retail divorcement has an anti-consumer effect in raising the average level of retail prices. This is true because it reduces the number of current sellers in the market and bars entry by an entire class of new sellers.

Paradoxically, retail divorcement laws have their greatest relative impact on small and independent refiners--sellers who have not even a theoretical capacity to carry out a "predatory pricing" campaign. To a greater degree than other refiners, small refiners focus their marketing strategy on low-margin, high volume distribution of gasoline through salary-operated stations.

... [E]vidence suggests that jobbers have benefitted relative to dealers as a result of divorcement, but it does not support the notion that retail divorcement eliminates the market conditions which give rise to inversions of wholesale prices. Sorensen (1991) at 34-35.

656. Miklius and LaCroix (1993) at 53-54 (footnotes omitted).

REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Chapter 16  
ALTERNATIVES TO REGULATION

House Resolution No. 174, H. D. 2, contains numerous proposals to regulate Hawaii's petroleum industry. These proposals, as discussed in chapters 4 through 15 generally offer a regulatory approach by considering increased government intervention, primarily in the operation of the downstream facilities of the major oil companies doing business in Hawaii, apparently to ensure both the viability of independent dealers and lower gasoline prices. As will be discussed later in this chapter, however, accomplishing both of these goals simultaneously may not always be feasible.

This chapter explores alternatives to regulation that are not specified in the Resolution but fall within its general subject matter.

This chapter also examines the broader issue of whether, and under what circumstances, the government should intervene in Hawaii's petroleum industry. The regulatory options specified in the Resolution are obviously not the only possible means to resolve the problems presented, nor should legislators feel limited to a consideration of only those options simply because they are stated in the Resolution. While the options presented in this chapter are by no means exhaustive, they suggest several alternate ways to address the issues raised in the Resolution. Each of the choices presented requires a determination of policy on the part of the Legislature. This chapter, however, makes no attempt to resolve these policy issues. Although the survey conducted pursuant to the Resolution has been helpful in ascertaining the views of representatives of Hawaii's petroleum industry, the survey responses in themselves do not form an adequate basis upon which to make any significant policy recommendations.

In particular, part I of this chapter briefly summarizes the regulatory framework proposed by United States Supreme Court Justice Stephen Breyer, including a discussion of justifications for regulation and less restrictive alternatives.<sup>657</sup> Part II reviews other factors impacting on legislative options, including energy, equity, political, and other policy considerations, and explores some of the options available to Hawaii's lawmakers other than those presented in the House Resolution in the context of the framework discussed in part I.

Part I - Regulatory Framework

Justifications for Regulation.

In his framework for analyzing economic regulation, Breyer (1979 and 1982) focused on the justifications for, rather than the causes of, regulation, assuming that regulation is justified "only if it achieves without too great a corresponding cost policy objectives that a consensus of reasonable observers would consider to be in the public interest."<sup>658</sup> In general, the justification for government intervention in the marketplace arises out of the market's inability to handle certain structural problems. While "other rationales are mentioned in political debate, and the details of any program often reflect political force, not reasoned argument ... thoughtful justification is still needed when programs are evaluated, whether in a political forum or elsewhere."<sup>659</sup> In particular, Breyer found that one or more of the following rationales are typically given as justifications for government intervention in the case of market failure:

(1) Control of monopoly power. As discussed in chapter 9, this rationale is based on the need to control the exercise of power by a natural monopolist:<sup>660</sup> "Where economies of scale are so great as to make it inefficient for more than one firm to supply a product, that firm, if not regulated, would increase its profits by restricting output and charging higher than competitive prices."<sup>661</sup> While the justification for regulating the natural monopolist is aimed primarily at allocative efficiency, other equitable considerations come into play, "such as the need to secure a fairer income distribution and distrust of the social and political (as well as the economic) power of the unregulated natural monopolist."<sup>662</sup>

(2) "Rent" control. Sudden increases in price may let persons holding interests in a commodity to earn windfall profits as a kind of economic "rent". For example, the owners of large stocks of oil earned large rents when the price of oil was raised by OPEC in the early 1970s. While rents are not ordinarily regulated, there is often a demand for regulation when rents are great in amount and do not reflect a particular talent or skill on the part of producers. Nevertheless, "[t]o discourage the earning of rents is undesirable, for it would impede the search for efficiency."<sup>663</sup>

(3) Correcting for "spillovers". Regulation is often called for to compensate for the fact that a product's price does not reflect the true costs to society of producing that product. The differences between social costs and unregulated price are spillover costs or benefits, also known as externalities. For example, "[i]f a train emits sparks that occasionally burn the crops of nearby farmers, the cost of destroyed crops is a spillover cost imposed upon the farmers by those who ship by train--so long as the shipper need not pay the farmer

for the crop lost."664

(4) Correcting for inadequate information. Consumers must have sufficient information to evaluate competing products to allow competitive markets to function well. This information is itself a commodity, and regulation may be used to correct for inadequate information or lower the costs to consumers of obtaining information. "In particular, government action may be called for when suppliers seek to mislead customers deliberately, and consumer use of current remedies is expensive or impractical; when consumers cannot readily evaluate the information available ...; or when the market on the supply side is insufficiently competitive to supply all the information demanded."665

(5) Excessive competition. This justification, which is often advanced for the regulation of airlines, trucks, and ships, assumes that if prices fall too low, firms will go out of business and product prices will be too high. The rationale for regulation may refer to the possibility of predatory pricing; however, "[w]here predatory pricing might exist, it can be dealt with through application of the antitrust laws."666

(6) Other justifications. Other possible justifications for regulation include unequal bargaining power, rationalization, "moral hazard", paternalism, and scarcity:

(a) Unequal bargaining power. This justification is often used in support of special legislation to assist smaller industry participants: "The assumption that the 'best' or most efficient allocation of resources is achieved by free-market forces rests in part upon an assumption that there is a 'proper' allocation of bargaining power among the parties affected. Where the existing division of such bargaining power is 'unequal,' it may be thought that regulation is justified in order to achieve a better balance."667

(b) Rationalization. Regulation is occasionally justified "on the ground that, without it, firms in an industry would remain too small or would lack sufficient organization to produce their product efficiently. One would ordinarily expect such firms to grow or cooperate through agreement, and to lower unit costs. But social or political factors may counteract this tendency. In such circumstances, agencies have sought to engage in industry-wide 'planning.'"668

(c) "Moral hazard" describes "a situation in which

someone other than a buyer pays for the buyer's purchase. The buyer feels no pocketbook constraint, and will purchase a good oblivious to the resource costs he imposes upon the economy. When ethical or other institutional constraints or direct supervision by the payer fail to control purchases, government regulation may be demanded."<sup>669</sup> Breyer cites rising medical costs as the most obvious current example of this situation.

(d) Paternalism. The idea that "the government supposedly knows better than individuals what they want or what is good for them" may be used to justify government intervention on the grounds that despite the availability of sufficient information to enable marketplace decisions, consumers cannot be trusted to evaluate the information correctly or may make irrational decisions.<sup>670</sup>

(e) Scarcity. This rationale may be used to justify regulatory allocation due to sudden supply failures: "to rely on price might work too serious a hardship on many users who could not afford to pay the resulting dramatic price increases, as in the case of the Arab oil boycott."<sup>671</sup> However, "[r]egulation on the basis of this justification reflects a deliberate decision to abandon the market, because shortages or scarcity normally can be alleviated without regulation by allowing prices to rise."<sup>672</sup>

#### Alternatives to Regulation.

Breyer noted that nearly all regulatory activities may be grouped into the following seven types (or combinations of these types): (1) cost-of-service ratemaking; (2) historically-based price setting; (3) allocation in accordance with a public interest standard; (4) historically-based allocation; (5) standard setting; (6) individualized screening; and (7) disclosure requirements.<sup>673</sup> As a policy matter, however, Breyer argued that before using regulation, policy makers should be certain that there are "serious defects" in the unregulated market, and that classical regulation should be looked upon as "a weapon of last resort"; in some instances, the problems accompanying regulation may be deemed sufficiently serious as to justify adopting a "least restrictive alternative" approach to regulation.<sup>674</sup> Policy makers should investigate the facts of each individual case, weighing the policy alternatives and selecting those governmental interventions or non-interventions that are best suited to that situation.<sup>675</sup>

Among the types of less restrictive alternatives to regulation discussed by Breyer are the following: 676

(1) Disclosure. As discussed in chapter 13, disclosure legislation may be enacted for economic purposes--typically to assist buyers in making more informed choices--as well as noneconomic ones, for example, to help enforce certain penal laws or provide greater information to assist policy makers in making planning decisions affecting the public welfare. 677

(2) Taxes. While taxation, which usually seeks to raise revenue or encourage certain conduct through special credits or deductions, has "only rarely been used specifically to substitute for regulation", it may nevertheless be used as a supplement to or substitute for regulation. "Taxation should be considered where regulation is intended to transfer income, such as when cost-of-service ratemaking is used to control rent or windfall profits earned by those who control scarce, low-cost sources of oil, natural gas, or housing." 678 Taxes may also deter pollution and other forms of undesirable conduct, thereby substituting for other forms of regulation. However, substituting taxes for other types of regulation nevertheless introduces problems; for example: "Using an excise tax instead of cost-of-service ratemaking to capture excess profits requires the administrator to specify the bounds of the tax. If the upper bound is based on production costs, then the regulator must decide which market price to use. Employing a tax instead of standard setting to control spillovers requires the administrator to determine both the level of the tax and the amount of 'taxable conduct.'" 679

(3) Creation of marketable property rights. In a system of market-based incentives, a limited number of rights to engage in certain conduct, such as pollution, are established; these rights are then bought and sold in a market. "Eventually those willing to pay the most for the privilege of polluting, usually those for whom the cost of avoiding or limiting the conduct would be the greatest, will buy up the rights. Since the number of rights is limited, the regulator knows in advance how much pollution will be emitted." 680 However, a regulator will "not know the price at which firms will find it cheaper to install control equipment than to buy rights to pollute, and, unlike a tax system, a system of marketable rights does not permit estimation of the pollution control costs imposed upon the firms." 681 Breyer also noted that the use of marketable rights as a substitute for classical regulation was not limited to environmental regulation or spillovers, but "may be used to allocate whenever there is a shortage, where (perhaps because of regulation) no market presently exists, or when it is not necessary that allocation of the rights be determined on a

public interest or other nonmonetary basis."682

(4) Changes in liability rules. In certain areas, such as environmental pollution and accident safety, it has been suggested that making tort law changes may encourage the production of safer products or greater use of pollution-free processes. These proposals would increase the risk of liability, as well as the cost, for those who are best able to weigh the costs against the benefits: "This principle is likely to place costs upon the party best able to avoid them, or, where this is unknown, on the party best able to induce others to act more safely."683 Imposing strict tort liability on the most efficient cost-avoider, however, may not be sufficient: "The costs of using the courts are high, and those harmed may have inadequate incentive to bring suit. Results are likely to vary from court to court, at least when damages are measured. Finally, court decisions inevitably reflect moral and legal considerations that may conflict with the efficiency considerations that motivated the proposal for change."684

(5) Bargaining. As an alternative to regulation, bargaining has the advantage of achieving consensus; difficulties arising out of regulation's adversary mode are more often avoided. Bargaining also offers a greater opportunity to maximize the benefits each party can receive, and makes it easier to adapt different rules to special needs, minimizing enforcement by making voluntary compliance more likely. On the other hand, there must be some device to force parties to reach an agreement, the intended beneficiaries may not be organized or sufficiently strong, thereby allowing one party to unilaterally impose its terms on the weaker group, and bargaining may injure those parties who are not represented.685 Bargaining may work well as a substitute or supplement to regulation "when the strength of the parties is roughly equivalent; when decentralization, compromise, and the ranking of priorities is important; when the effect upon nonrepresented parties is not significant; and when agreement itself and not its precise substantive details is of particular importance."686

(6) Unregulated markets policed by antitrust. Unregulated markets are subject to antitrust laws, which are designed to maintain a "workably competitive" marketplace; in particular, "antitrust laws seek to create or maintain the conditions of a competitive marketplace rather than replicate the results of competition or correct for the defects of competitive markets. In doing so, they act negatively, through a few highly general provisions prohibiting certain forms of private conduct."687 While Bork (1978) and other critics argue that antitrust is a form of government regulation, "[o]nly rarely do the antitrust enforcement agencies create the detailed web of affirmative legal obligations that characterizes classical regulation."688 Antitrust laws generally proscribe certain forms of conduct by private

firms, and are enforced either in court or before the Federal Trade Commission. 689 Breyer noted that antitrust is more likely to serve as an effective substitute for regulation when the market defect is predatory pricing, which is prohibited by antitrust laws as a form of anti competitive market behavior. 690

#### Matches of Regulatory Ends and Means.

In considering market defects, classical forms of regulation, and alternatives to regulation in a number of different industries, Breyer found that regulatory failure sometimes resulted from the failure to correctly match the appropriate regulatory tool to the perceived market defect. He proposed the following tentative framework of regulatory reform that policy makers may consider in preventing mismatches:

Problem	Tentative solution
Natural monopoly	Cost-of-service ratemaking; nationalization
Rent control (excess profits)	Taxes; deregulation
Spillovers	Marketable rights; bargaining standards
Excessive competition	Deregulation; antitrust
Inadequate information	Disclosure; screening; standard setting; bargaining
Other (moral hazard, unequal bargaining power, paternalism) 691	Incentive-based regulation; standards

#### Part II - Application of Framework

##### Justifications for Regulation.

The framework in the preceding part may be useful as a guide to assist state lawmakers in deciding whether or not to impose some form of regulation on participants in the petroleum industry, or to repeal or extend existing regulations. 692 This part reviews some of the options available to state policy makers in light of that framework, bearing in mind that often more than one justification may be used to support classical regulation, which should nevertheless be considered "as a weapon of last resort" and only after reviewing less restrictive

alternatives to achieve the same objectives without the creation of additional bureaucracy and potential loss of competition in the marketplace.

Government intervention in Hawaii's wholesale and retail gasoline markets presupposes flaws in those markets. With respect to Hawaii's wholesale markets, the Attorney General has identified the following anti-competitive defects:

The structure of the wholesale gasoline markets in Hawaii is not conducive to competition. (1) There are only two refiners in the market and only five significant wholesalers. (2) The market is dominated by the two refiners, Chevron and BHP. (3) The product, gasoline, is fungible. Additives and brand names don't really make a difference. (4) The demand is inelastic. A relatively small addition to the daily supply of gasoline would drive the retail price down substantially. (5) Entry and exit barriers are relatively high. The principal barrier to entry is the high sunk cost of new storage relative to the storage capacity of the incumbent oil companies. (6) Price information is not freely available. (7) Production capacity generally exceeds demand. And, (8) storage capacity generally falls short of the demand.<sup>693</sup>

Similarly, with respect to Hawaii's retail gasoline markets, the Attorney General found that Hawaii's high entry barriers, inelastic demand for gasoline, and other factors, combined with the fact that Hawaii's markets are highly concentrated oligopolies, all discourage price competition.<sup>694</sup> However, the Attorney General noted that "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."<sup>695</sup> Although the Attorney General's economist found no evidence that the incumbent oil companies have been earning profits in excess of competitive levels, and the Federal Trade Commission's Bureau of Competition concluded that exchange agreements were, on balance, pro-competitive, the Attorney General nevertheless argued that the use of exchange agreements by the incumbent oil companies keep Hawaii's gasoline markets from being competitive.<sup>696</sup>

Do the defects in Hawaii's wholesale and retail gasoline markets necessitate government intervention, or in the case of retail divorcement, continued regulation? In reviewing Hawaii's markets<sup>697</sup> in the context of the types of market failure discussed by Breyer and

typical justifications for classical regulation, the survey participants presented divergent views as to what types of government intervention are required, if any, to make these markets more competitive:

- (1) Natural monopolies. Chapter 9 reviewed competing views as to whether the oil industry is a natural monopoly, and questioned the need for public utility regulation. The fact that no state currently regulates that industry as a public utility, however, appears to weigh more strongly on the side that the industry is not generally considered to be a natural monopoly, or at least that the benefits of regulation are outweighed by the disadvantages of doing so at this time.
- (2) Rent control (excess profits). The Attorney General determined that through 1992, Hawaii's refineries have not been earning profits in excess of competitive levels.<sup>698</sup> The Attorney General believes, however, that the absence of extraordinary profits may be for the purpose of protecting the investments of the incumbent oil companies in the State, i. e., to prevent the importation of inexpensive mainland gasoline into Hawaii, which could increase their losses and force them out of business.
- (3) Spillovers. Both negative and positive spillovers have been reviewed. On the one hand, liability concerns with respect to leaking underground storage tanks and oil spills may deter entry into Hawaii's markets. As noted by the Attorney General: "[E]nvironmental 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 of such a spill must not be underestimated."<sup>699</sup> On the other hand, positive spillovers include substantial investments in Hawaii's economy and infrastructure, including the development of new technologies, by Hawaii's major oil companies.
- (4) Inadequate information. As discussed in chapter 13, while the need for Hawaii's Petroleum Industry Information Reporting Act of 1991 was questioned by some survey participants, that Act was enacted to

provide policy makers with the information necessary to enable the State to "respond to possible shortages, oversupplies, and other market disruptions or impairment of competition" and "to develop and administer energy policies which are in the interest of the State's economy and the public's well-being." 700 Whether there is inadequate information in other areas of the industry to justify the proposal to require the filing of tariffs with the State listing all of the prices at which goods and services are offered for sale or lease by jobbers, manufacturers, and terminal operators, is a matter of debate among government and industry survey participants.

- (5) Excessive competition. Arguments were presented that the integrated oil companies operating in Hawaii's oligopolistic markets, together with the use of exchange agreements, the existence of high entry barriers, market inelasticity, and other factors, result in reduced competition in Hawaii's markets. The incumbent oil companies, on the other hand, argue that Hawaii's markets are in fact competitive. No participant in this study, however, has argued that the State's gasoline markets suffer from excessive competition. 701
- (6) Other justifications. A primary justification for regulation appears to be that of unequal bargaining power. Independent dealers generally assert this rationale to support special legislation, such as retail divorcement and open supply laws, to protect their viability. The major oil companies contend that there are adequate safeguards in place, including the federal Petroleum Marketing Practices Act and federal and state antitrust laws, to protect independents from potential imbalances created by unequal bargaining power, and that there is no evidence of predatory pricing behavior on the part of the large oil companies. Although the justification of scarcity was used in the past to enact federal allocation regulations, this justification has apparently been used with less frequency since the State is "between shortages" at this writing.

#### Additional Factors.

Other factors that are unique to Hawaii or which may have the effect

of skewing market expectations should also be considered in determining whether government intervention in the State's gasoline markets is justified. As discussed earlier, these factors include the following:

- (1) Geographic isolation. Hawaii's location renders it uniquely vulnerable to supply problems. Declining world oil reserves and potentially increased future dependence on unstable Middle East oil reserves will increase Hawaii's vulnerability.
- (2) Dependency on oil. As noted in chapter 3, Hawaii is the only state to import nearly all of its oil, making it "the most vulnerable state in the nation" to disruptions in the world oil market or rapid oil price increases, according to the State Energy Resources Coordinator.<sup>702</sup>
- (3) High entry barriers. Land costs in Hawaii are among the nation's highest. On average, the costs of doing business are also significantly higher than on the mainland.
- (4) Environmental risks. Oil shipment and handling present risks to the State's fragile marine habitats and coastal resort areas; the risk of oil spills may also deter entry into Hawaii's gasoline markets. Hawaii's unique hydrogeology aggravates the underground storage tank problem.

#### Energy Policy.

Another important factor to be considered by state policy makers is that government intervention, if deemed appropriate, be consistent with state energy policy. As provided in the State Constitution, that policy has focused on energy conservation and the increased self-sufficiency of the State.<sup>703</sup> The Hawaii State Plan, as embodied in chapter 226, Hawaii Revised Statutes, further identifies efficient and dependable statewide energy systems, increased energy self-sufficiency, and greater energy security as among the energy planning objectives for Hawaii's facility systems, which include transportation modes and infrastructure.<sup>704</sup> In addition, section 226-103(f), Hawaii Revised Statutes, establishes the economic guidelines for energy use and development that include the development of renewable energy resources, improvement of energy conservation, and the use of "energy conserving and cost-efficient transportation systems."<sup>705</sup>

Conservation has been described as "the cheapest, most immediate and most effective method of reducing near term petroleum requirements." 706

While state energy policy encompasses conservation efforts with respect to fuel oil and other petroleum products, however, the primary focus of the House Resolution is on gasoline. 707 More specifically, this section focuses on energy conservation initiatives with respect to vehicle transportation services, since gasoline is used in the production of those services. 708 The major user of fuel for transportation purposes "is, of course, the automobile, which consumes four times as much fuel per person per mile as public transportation." 709

Several studies produced by state agencies in Hawaii have made a number of proposals with respect to energy policy regarding vehicle transportation and related areas to reduce the demand for and consumption of gasoline, encourage energy conservation, and increase state energy self-sufficiency. The findings and recommendations made in the following studies may be of assistance to state policy makers in reviewing regulatory options: 710

(1) Investigation of the Hawaii Gasoline Market (1974). This Hawaii House of Representatives investigation called for additional energy conservation and related measures to prepare the State for future gasoline shortages. These measures included the compilation and maintenance of supply and demand data for petroleum products, the development of alternate energy sources and greater efforts at conservation, and the development of an efficient public transportation system. 711

(2) Managing a gasoline shortage in Hawaii (1981). Similarly, this Hawaii Department of Planning and Economic Development study reviewed a number of government policies and actions that may influence the demand for gasoline. These include measures affecting the cost of vehicle ownership and operation, such as taxes on vehicle ownership, increased parking charges, and increased taxes on gasoline; increasing the availability of alternate modes of transportation such as increased bus service, ridesharing, and facilities for bicycle and motorbike use and parking; and measures affecting the need for private vehicle transportation and frequency of use, such as flexible working hours and an adjustment of school hours. 712

(3) Hawaii integrated energy policy (1991). This Hawaii Department of Business, Economic Development, and Tourism report noted that "Hawaiian drivers, like their mainland counterparts, are relatively insensitive to marginal changes in the pump price of fuel. Rather, the demand for road fuels is influenced by the fuel characteristics of the private vehicle fleet and by the availability of public

transportation."713 The report further found that Hawaii's cities "cannot continue to support today's urban patterns, which require workers to commute from their suburban homes to downtown work places. This problem is particularly acute in Honolulu, where there are few alternative commuting routes and traffic congestion is rapidly approaching critical levels."714 The final report made a number of proposals with respect to transportation energy use, focusing on measures to reduce the demand for petroleum-based fuels.715

(4) Telecommuting (1992). This Legislative Reference Bureau study found that "telecommuting", i.e., a working arrangement in which an employee works at home, a satellite office, or telework center and communicates electronically between that site and the employer's principal place of business, reduces fuel consumption: "Telecommuters have the opportunity [of] reducing their fuel consumption by forty-seven percent and reducing transportation costs by approximately \$100 annually. The fewer the miles driven, the bigger the saving for the telecommuter, the bigger the reduction in fuel consumption, and the less dependent the community is on oil imports."716

#### Equity Considerations.

State policy makers, in reviewing possible government intervention, should also consider the issue of equity. "The equity of market operations ... plays an important role in decisions to regulate. In this context, equity refers to the distribution of rights in society and of the income and wealth of its members."717 This issue, i.e., how the benefits and burdens from rising energy prices should be distributed across society, has been extremely controversial.

Should government intervene to alter the impact of higher prices? Government intervention is often called for to define the distribution of rights in society more precisely, or to change them or resolve conflicts among them; to guarantee the distribution and availability of services; and to prevent discrimination on the basis of race, gender, national origin, or other qualities unrelated to merit.718 Government intervention is also motivated by "the desire to assure a certain threshold level of access to all, or to a particular subset of material goods and services by all individuals."719 Low wage earners must increasingly devote a larger percentage of their income towards energy expenditures.720 On the other hand, others believe that government's role in the marketplace should be more limited:

Many economists, together with many political conservatives, believe that energy prices should be permitted to rise with little governmental restraint except perhaps for some buffering of the impact upon

the poorest Americans. Advocates of such governmental restraint believe that the nation's energy resources in the long run will be best allocated and achieve energy conservation most quickly when the consumer experiences such price escalation directly and swiftly. According to this logic, the market reflects the true replacement cost of energy resources and far more clearly signals the consumer to conserve energy than would governmentally controlled prices. Furthermore, critics of federal price management usually assert that government intervention in the energy marketplace brings with it new regulatory bureaucracies, costly and confusing masses of new regulations to interfere with the efficient production of energy by private corporations, special concessions to undeserving but politically powerful groups, and other social costs.<sup>721</sup>

What constitutes a "fair" distribution? Conflicts over fairness raise a number of concerns. One area is "the extent to which energy producers and their financial beneficiaries are imposing a justified or unreasonable cost upon energy consumers."<sup>722</sup> Another issue is how much relief is appropriate for persons in different economic groups, i. e., "[a]t what point ... does an American individual or household qualify as sufficiently distressed by high energy prices to merit public assistance or other economic relief?"<sup>723</sup> If public economic assistance is merited, it may be further questioned how it should be compensated--through direct cash subsidies, tax concessions, or some other means--and whether these strategies adequately encourage recipients to conserve energy. Moreover, if government decides that a social group should receive relief from rising energy prices, that relief implies a transfer payment from one group to another:

[N]o matter how it may be disguised, someone has to pay for this economic compensation. Proponents of energy transfer payments generally assert that those who profit unreasonably or excessively from energy price increases or those affluent enough to bear price rises comfortably should provide the revenue for such income transfers--in other words, energy importers, refiners and distributors, stockholders in energy corporations, other financial interests that profit from higher energy prices, and generally the rich.

These economic interests are sure to argue that their profits are neither excessive nor unreasonable. In fact, many energy producers maintain that such profits are the necessary incentive to assure continued

exploration and production. And the middle- and upper-class citizens who might provide the tax revenues to underwrite a substantial portion of these transfer payments are likely to resist increased taxes for this purpose. Indeed, many of these Americans are now seeking tax reductions through energy conservation. ... Thus, those who believe in fairness as a principle in energy pricing often become antagonists when allocating the economic cost of producing this fairness. 724

Finally, fairness is relative; it is argued that "[f]airness becomes whatever policy settlement can be wrested from the multitude of powerful, contentious interests zealous to shape price policy to their own satisfaction. In the end, fair is what government says it is." 725

#### Political Considerations.

Political factors may also play a role in determining the extent of government intervention. Kalt (1981), for example, noted the importance of this factor with respect to the United States Senate in voting on petroleum industry regulation in the 1970s:

[T]he bulk of post-embargo regulation of the petroleum industry has been explicitly designed, at the expense of allocative efficiency, as a mechanism for the redistribution of wealth from crude oil producers to crude oil refiners and refined product consumers. Specifically, it is found that Senate voting behavior is significantly related to the wealth interests of these constituencies and that the policymaking process has been captured to some degree by private interest groups. 726

Those interest groups that are best able to organize and impose their positions on lawmakers may have a strong influence on the course of government intervention:

[A]ny significant increase in energy prices sends virtually all socioeconomic sectors to government demanding action to buffer the impacts upon them, regardless of the ultimate desirability of those impacts. ... The effect of this group mobilization may be inefficient, sometimes highly undesirable, distortions of energy supply and demand. Thus, gasoline demand may be kept too high by government policies that prevent gasoline prices from increasing at a rate that reflects the true replacement cost of

that fuel. The consumer's interest may be served at the expense of national energy conservation.

In summary, the political allocation of economic impacts from rising energy prices--the business of declaring what is fair--will be biased toward those social interests best able to mobilize and impose their definition of economic equity upon government policies. 727

Lawmakers should also be cognizant of their own political motivations in proposing petroleum-related regulations. While Stone (1982) acknowledged that "legislators do want to produce what they conceive to be 'good' public policy. And they do respond to the cross-pressures of interest groups that seek ... policy outputs that will benefit or at least minimally harm them...", he also noted that legislators may be motivated in passing regulatory legislation for reasons that are external to the substance the legislation seeks to address.<sup>728</sup> For example, a crisis may move regulatory issues to the top of the agenda;<sup>729</sup> interest groups may exert significant pressures; legislators may be motivated by concerns about their own or fellow party members' future electoral chances; and "a regulatory statute usually results in a very small claim on the public budget, yet the political payoff to legislators and interest groups may be substantial".<sup>730</sup> Legislators may also be attracted to "symbolic politics": "Since it is virtually costless or at least much cheaper for legislators to deal in grand gesture and symbolic ambiguity rather than in the difficult and costly process of accumulating data, weighing costs and benefits, and assessing alternative means, they have a clear incentive to choose the symbolic path."<sup>731</sup> Lee (1991) is similarly critical of calls for regulatory legislation in response to rising petroleum prices, arguing that such proposals are mostly self-serving.<sup>732</sup>

One means of ascertaining the concerns of Hawaii's gasoline consumers is to increase public participation in decisionmaking regarding proposed oil regulations. Rosenbaum (1981) noted that while "[p]ublic participation is no panacea for resolving all the problems that energy decisions create for social equity" and often works to the advantage of the best organized groups, increased public participation is nevertheless a worthwhile goal:

It is ... important that the development of future energy policies include a generous measure of public participation to maximize opportunities for consideration of the full range of likely consequences. It is particularly imperative that this citizen involvement extend not only to the processes of agenda-

setting, policy formulation, or legitimation, but especially to the stage of policy implementation where the administrative process may otherwise obscure the nature and implications of energy decisions.

Activities more suited to the administrative process--such as public hearings, workshops, citizen advisory commissions, and community surveys--should play an increasingly important part in the implementation of new energy programs. 733

#### Regulatory Options.

If the Legislature determines that any of the rationales discussed in part I of this chapter serve as compelling examples of clear market failure justifying government intervention in Hawaii's gasoline markets, House Resolution No. 174, H.D. 2, offers a number of possible regulatory options available. Arguments for and against each of these options have been reviewed in chapters 4 through 15. These include the following:

- . Question (11) of the Resolution: Vertical divorcement (divestiture)--prohibiting oil companies from owning, franchising, or leasing retail service stations to branded dealers.
- . Question (15): Retail divorcement--make permanent or extend the moratorium in section 486H-10, Hawaii Revised Statutes.
- . Question (7): Public utility regulation, either through the Public Utilities Commission or an independent petroleum regulatory commission.
- . Question (8): Price control regulations specifically focusing on petroleum products, such as below-cost, minimum-markup, anti-price-gouging laws, or strengthening Hawaii's below cost sales law for commodities and services generally in section 481-3, Hawaii Revised Statutes.
- . Questions (1) and (2): Open supply legislation permitting retail dealers to buy gasoline from more than one supplier.
- . Questions (9) and (13): Disclosure legislation requiring the filing of tariffs with the State listing all prices at which goods and services are

offered, and assuring that the Public Utilities Commission carries out its statutorily prescribed duties in implementing chapter 486I, Hawaii Revised Statutes (the Petroleum Industry Information Reporting Act).

- . Question (10): Terminating legislation prohibiting terminal operators with excess storage capacity from refusing to provide terminating services.
- . Questions (6) and (12): Establishment of a public bulk gasoline terminal facility and a public petroleum products storage authority.

Other proposed areas of regulation not specified in the Resolution include uniform price legislation, which is intended to prohibit the selective use of price discounts to assist particular outlets that are competing with other low-priced outlets, 734 and bans on self-service dispensing and mandates of gasoline vapor recovery equipment. 735

#### Alternatives to Regulation.

If, on the other hand, the Legislature determines that the defects in Hawaii's gasoline markets do not amount to complete market failure but still require some form of intervention to avoid the harms produced by an unregulated market, state policy makers should consider some of the less restrictive forms of intervention discussed by Breyer before resorting to classical regulation. These include disclosure, taxes, creation of marketable property rights, changes in liability rules, bargaining, and an unregulated market policed by antitrust laws:

##### (1) Disclosure.

Disclosure has already been reviewed in the discussion section of chapter 13. As noted by the Department of Business, Economic Development, and Tourism, much of the supply and demand data requested by chapter 486I, Hawaii Revised Statutes, is duplicative of that already provided by the petroleum industry to the department under chapter 486E, HRS. A review of these statutes should be made to delete the request for redundant material or otherwise consolidate the requests for information.

Moreover, if the Legislature decides that chapter 486I should be implemented, sufficient levels of funding should be appropriated to enable the Public Utilities Commission to effectively implement that chapter. Another less expensive alternative would be to consolidate

the State's data gathering efforts by transferring responsibility for administering the law to the Department of Business, Economic Development, and Tourism. However, even this course of action would require additional appropriations. Although the State is currently experiencing a significant budget shortfall, increased funding of the PUC--as well as the Department of Business, Economic Development, and Tourism's energy office, the Department of the Attorney General, and other offices as necessary to provide sufficient enforcement of state energy and antitrust laws--may bring increased benefits in the form of future savings from successful energy programs. 736

A recent report of the National Conference of State Legislatures noted that state energy offices, especially in small states, are often inadequately funded and understaffed. However, "[b]ecause of the importance of maintaining accurate records and the potential benefits that can accrue from effective energy legislation, it is proposed that state energy offices receive funding appropriate to the potential great future savings accruable from effective and successful energy programs." 737

## (2) Taxes.

This section focuses on taxes in two different contexts: first as an incentive-based system, and second to discourage fuel consumption and encourage energy conservation.

### A. Incentive-based taxation.

As discussed earlier, taxes may be used as a substitute for or supplement to classical standard setting to address such problems as "rent" control and excess profits. 738 Breyer noted that this type of regulatory tax has already been used in an attempt to regulate oil prices, with mixed results. A tax on windfall profits, implemented following rapid increases in petroleum prices in the 1970s, was initiated concurrently with the decontrol of domestic petroleum prices and created complex tax formulas to produce approximately \$227,300,000,000 in new federal funds in the 1980s. 739 Essentially, domestic crude production was divided into "new" and "old" oil, and a ceiling price was established for each based on rough estimates of production costs. A program was instituted that distributed entitlements to refine old, cheap oil. 740 Breyer noted that although this system of oil regulation avoided the shortage problem, "no one could say that it was successful. The rents were transferred not only to consumers but also to the sellers. And the lower price encouraged increased importation of oil." This system avoided the problems of classical regulation "but at the price of partial failure to achieve the system's major objective: the transfer of windfall profits to the

consumer."741

Taxes might also be used in an incentive-based system to deal with "spillover" problems. Such a system could provide incentives to encourage conduct "in a socially desirable direction, without freezing current technology and while preserving a degree of individual choice."742 With respect to environmental spillovers, such a system seeks a balance between competing objectives, namely, a clean environment and industrial production, while encouraging the development of production processes that allow more of each. Such a system promotes efficiency by encouraging those who can eliminate pollution the most cheaply to be the first to do so. Generally, firms operating in such a system would pay a tax multiplied by their actual emissions, and would pay less to the extent that they curtail emissions. However, "without knowing the individual cost schedules, technology, and demand facing every firm, no one can be certain in advance to what extent firms will curtail emissions or choose to pay the tax. The cost ceiling is known; the future pollution level is not."743 Also, while such a system may be considered more efficient and flexible than classical regulation, other problems present themselves, including problems in dealing effectively with the relations between emission levels and pollution, as well as problems of enforcement, administration, and political acceptability.744

Such an incentive-based system, it may be argued, could be implemented with respect to question (9) of the House Resolution, which proposes to require manufacturers, terminal operators, and jobbers to file tariffs with the State listing all of the prices at which they offer goods and services for sale or lease. Assuming for the purposes of this discussion that the Legislature adopts some form of tariff requirement in accordance with that proposal, firms that exceed the posted rates could be required to pay a tax based on a formula that would increase their tax liability the more they exceeded the posted prices. Such a system would arguably induce those required to file tariffs to adhere to those rates, or factor in such a tax as an additional cost of doing business in Hawaii.

The imposition of taxes (or fines) in this example, however, raises some of the same issues discussed in using taxes to address environmental spillovers. First, while the upper bound of the tax, in principle, is the free-market price of the product or service, that bound must be fixed for purposes of calculation, while free-market prices fluctuate. The taxing authority must set an initial upper bound and determine how to change that rate as prices fluctuate.745 Firms that choose to exceed posted prices to maximize profits may also pass on these extra costs to consumers in other areas. Aside from problems of enforcement and increased costs of administration, oil companies

might also argue that if the rationale for such a tax is to address the problem of excess profits, the Attorney General's own finding--that the incumbent oil companies are not earning profits in excess of competitive levels--obviates the need for such a tax.

#### B. Taxes on fuel consumption.

Taxes designed to discourage fuel consumption and encourage energy conservation include motor fuel taxes, highway tolls and parking taxes, and miscellaneous tax measures.

Motor fuel taxes. As noted in chapter 3, federal, state, and county taxes already comprise a large portion of the price of gasoline at the pump. These taxes include a superfund (leaking underground storage tank) tax; federal, state, and county fuel taxes; and state excise taxes.<sup>746</sup> Since the Honolulu market accounts for about three-quarters of the total state market, the average county tax spread over the entire state amounts to \$0.14 or \$0.15 per gallon.<sup>747</sup> Although the combination of these taxes may appear to be high, it has been argued that lower gasoline prices may not necessarily be in the best long-term interests of Hawaii's consumers, contrary to the assumptions expressed in the House Resolution. As discussed in chapter 6, Yamaguchi and Isaak (1990) noted that lower fuel prices encourage overdependence on imported oil and remove incentives to conserve energy and develop alternative energy sources.<sup>748</sup>

While consumers contend that prices have increased and are among the highest in the nation, the fact remains that Hawaii's consumers still pay some of the lowest prices for gasoline in the world. Yamaguchi and Isaak maintain that increasing or decreasing taxes may be the only impact that state lawmakers may have on the price of oil:

Consumers, of course, do not like higher prices, but the mid-80s showed how effective price-induced conservation can be. Consumers are now complaining that prices have increased, but Hawaiian consumers still pay some of the lowest prices in the world. It may be in the long-term interests of everyone in the state to increase prices (via increased taxes), rather than take measures to roll them back. Unfortunately, this is likely to be a politically unpopular move--and, like most needed but politically unpopular moves in the United States, it is unlikely to occur. It took years of steadily worsening traffic and air pollution before California taxpayers voted to increase gasoline taxes. Oil prices have a degree of political visibility that is unique; and, no matter which party is in office, the

opposition parties invariably use increased prices as a weapon to assault the current administration... Raising or lowering taxes is just about the only major impact that government policymakers can have on oil prices. Indeed, even if oil companies agreed to forego all of their profits on the sales of refined products, it would have only a minor effect on prices at the pump. The driving force behind gasoline prices is crude prices, and ... the real price decisions are made on the international market, not in Honolulu. 749

Brannon (1974) suggested that gasoline be taxed as a net revenue source; one consequence of higher gasoline prices, as may be seen in European countries that impose high gasoline taxes, is the trend toward more fuel-efficient vehicles and a greater reliance on public transportation.<sup>750</sup> However, "[d]espite the foreign precedent, the gasoline tax is a second-or-third-best approach to highway financing. It is regressive and it reflects some, but not all, of the social costs of highway use."<sup>751</sup> Moreover, higher gasoline taxes may have a disproportionate impact on the poor; it has been noted that "[t]he majority of the economically disadvantaged incur real, sometimes calamitous, income losses from climbing energy prices. ... There is ample evidence that the poor generally must commit a larger share of their income to energy purchases."<sup>752</sup> A 1981 state Department of Planning and Economic Development study noted that large increases in the price of gasoline would result in economic burdens for consumers, businesses, and government, but that "[p]articularly hard hit will be low-income consumers who must purchase gasoline for transportation because alternative modes are not available.<sup>753</sup>

One area that reflects some of the concerns associated with higher motor fuel taxes is that of "pay-at-the-pump" motor vehicle insurance. Alarmed by surveys indicating that a large number of Hawaii's motorists are unable or unwilling to pay the high costs of motor vehicle insurance,<sup>754</sup> legislators have introduced bills in recent years that would require motorists to pay for their motor vehicle insurance at the gasoline pump.<sup>755</sup> Proponents of these plans contend that such a measure would provide the necessary funding for universal motor vehicle insurance coverage. Others, however, contend that the additional cost added to each gallon of gasoline<sup>756</sup> would unfairly penalize motorists who must commute long distances, while failing to offer incentives to motorists to drive cautiously.<sup>757</sup>

Highway tolls and parking taxes. Proposals for highway tolls and parking taxes seek to address issues similar to those addressed by a gasoline tax. Variable highway tolls, for example, attempt to reduce commuting by automobile and increase reliance on public transportation

or car pooling by charging motorists for highway expenses. 758 Increasing the cost of parking, including raising charges in public parking facilities<sup>759</sup> and removing existing conservation disincentives such as subsidized parking charges, <sup>760</sup> also may influence consumer demand for gasoline by deterring commuters from bringing their automobiles into the city for the day. <sup>761</sup>

Miscellaneous tax measures. In addition to increasing the price of gasoline and increasing the cost of operating a vehicle through the imposition of highway tolls and parking charges, the cost of owning a vehicle could be increased by raising the vehicle registration fee or ownership tax. <sup>762</sup> A tax has also been suggested for all new automobiles having a fuel efficiency rating of twenty miles per gallon or lower. <sup>763</sup> However, the approach of taxing new vehicles has been criticized as an inefficient means of reducing gasoline consumption. <sup>764</sup> Tax credits and deductions have also been proposed, including a "[s]tate tax credit or incentive passes to use [a] mass transit system and for not owning a car" and "tax credits and deductions for home-based businesses that utilize tele-communication rather than transportation." <sup>765</sup>

### (3) Creation of marketable property rights.

As mentioned earlier, one example of an incentive-based alternative to classical regulation is to allocate pollution under a system of marketable rights. Under such a system, the appropriate agency would set an absolute limit on the amount of emissions permitted in a given area, and would then issue salable rights that total the specified maximum amount of pollution. These rights could then be exchanged in the marketplace, and would eventually be purchased by those who find eliminating pollution the most expensive to do so. Such a system would promote efficiency by encouraging those who can curtail pollution the most cheaply to do so first. <sup>766</sup>

However, there are drawbacks to such an approach. For example, although the administrator knows approximately the maximum emissions that will be produced, he or she cannot know, without detailed cost information about each firm, how much firms will have to pay to bring about that emissions level. Nor can the administrator know in advance the price that the marketable right will achieve at auction. While the level of pollution is known, the future cost of achieving that level is not. A system of marketable rights also presents enforcement problems, including the increased difficulty of monitoring. For example, some firms may continue to use older technology for filtering pollutants, so that inspectors cannot be certain whether or not the firm has violated the law. Another enforcement problem is that the administrator must prevent a firm or group of firms from monopolizing the supply of

marketable rights, thereby preventing new firms from entering the industry. An antitrust action may be necessary to compel these firms to sell their rights to new competitors on reasonable terms.<sup>767</sup> However, "[a]s a practical matter, it may be difficult for either antitrust officials or environmental administrators to know whether high bids for marketable rights reflect concern for the environment, a present industrial need, the need for future expansion, a desire to preserve the possibility for such expansion, or an effort to protect an existing market from new competitors."<sup>768</sup>

The use of marketable rights in place of regulation is not limited to environmental regulation or spillovers, however. Two examples of market-based incentive systems present themselves with respect to House Resolution No. 174, H. D. 2. Assuming, for the purposes of this discussion, that the Legislature seeks to establish a public bulk gasoline terminal facility (as stated in question (6) of the Resolution), a system of marketable rights could be used to allocate limited tank space in such a facility. Storage space in the facility could be reserved for new firms seeking to enter Hawaii's gasoline markets.

The second example assumes, also for the purposes of this discussion, that the Legislature seeks to continue to place limitations on the number of company-operated or company-owned retail service stations in Hawaii, as evidenced by the State's retail divorcement law (section 486H-10, Hawaii Revised Statutes). A system of marketable rights could be implemented that establishes a limited number of company-operated stations on each island. The right to operate a company station could then be auctioned; to the extent not preempted by federal law, both incumbent and nonincumbent oil companies would compete among each other for these rights.

There are a number of problems, however, with both of these proposals. With respect to the public bulk gasoline terminal facility, as noted by survey participants, the incumbent terminal owners would be placed at a competitive disadvantage with respect to newcomers to Hawaii's gasoline markets, the latter of whom would not be required to invest in their own facilities and would be exposed to significantly lower operating costs. There are also numerous practical problems involved, including how much terminal space is to be allocated and problems with logistics, scheduling, quality control, and environmental and product liability issues.

With respect to both proposals, there is also the risk that the competing firms will engage in strategic bidding behavior with anticompetitive consequences. If there are an insufficient number of firms to assure competitive bidding, a few firms may tacitly collude to

keep prices low. Alternatively, larger firms may behave in a predatory manner by buying up unneeded rights in order to prevent smaller rivals from entering the market. While antitrust laws may require these firms to give competitors a reasonable opportunity to gain access to Hawaii's markets or storage space, as the case may be, applying the antitrust laws may raise difficult factual issues. For example, it may be questioned whether a bid is predatory if it excludes a smaller competitor, and at what point the purchase of a right from a small competitor would substantially lessen competition. 769

Another problem lies in determining the initial allocation of rights. For example, should existing company-operated stations be grandfathered? This would give incumbent firms a large windfall, and would require firms seeking to enter Hawaii's gasoline markets to make additional large expenditures that the incumbent firms would not be required to make. In addition, if rights are auctioned off, firms seeking either to purchase storage space or operate company stations would be required to pay substantial additional amounts of money up front, which would reduce the amount of funds available for other needed investments. 770

#### (4) Changes in liability rules.

As noted earlier, another alternative to regulation in certain areas, such as environmental pollution and accident safety, is to make tort law changes to increase the risk of liability, as well as the cost, for those who are best able to weigh the costs of the harm against the benefits. This approach would place the costs on the most efficient cost-avoider, i. e., on the party who is best able to avoid the costs of the harm or who is in the best position to induce others to act more safely. For example, a power lawnmower may injure the purchaser or an innocent bystander, as well as the victim's family and society at large that may be required to pay for the victim's medical care. This approach would make the lawnmower manufacturer strictly liable for any accidents caused by the lawnmower if the manufacturer is in the best position to weigh the risks, benefits, and costs involved. 771

As noted in chapter 14, the high cost of complying with environmental regulations is one of the most important factors affecting gasoline marketing in the State. Small gasoline dealers have been overwhelmed by the high costs of underground storage tank (UST) regulations, cleanup costs, and other requirements. To the extent not preempted by federal regulations, one way to reduce the costs to small gasoline dealers would be to specifically exempt them from environmental cleanup costs associated with leaking USTs.

Under the State's environmental response law, chapter 128D, Hawaii

Revised Statutes, certain persons are deemed strictly liable for the costs of environmental cleanup in the event of a release of hazardous substances, including the owner or operator of a facility or vessel and persons who are contracted to transport the hazardous substances for disposal or treatment.<sup>772</sup> As defined in that law, oil and petroleum products are deemed to be hazardous substances.<sup>773</sup> To reduce the costs to small dealers, the environmental response law could be amended in two respects. First, small dealers could be specifically exempted under that law for the costs of removal or remedial actions resulting from UST releases. Second, assuming that oil refiners and UST manufacturers are in the best position to weigh the costs, risks, and benefits involved, that law could be amended to specify that the refiners who supplied petroleum products to the dealer at whose facility the UST release occurred, as well as the UST manufacturers themselves, are strictly liable for removal or remedial actions, in addition to the other parties who are specified as strictly liable under current law.

There are, however, several problems associated with these proposed amendments. Holding refiners strictly liable will not encourage them to make safer products, since petroleum products are inherently dangerous, it may be argued, and cannot be made more safely. Nor does a system in which manufacturers are required to pay for the negligence of users encourage consumers to use petroleum products in a less negligent way. These amendments would also encourage refiners and UST manufacturers to "shop around" for dealers who will take measures to reduce the number of UST releases; however, "[i]t is highly unlikely that there is any practical way for producers to restrict their sales to prudent users or to encourage them to use [their products] more safely. Thus, some have argued that the result of a shift in liability rules may be safer products but more accidents (as users become more careless)."<sup>774</sup> Such a change in liability rules would also encourage a wider use of exclusive dealing arrangements, as discussed in chapter 4, as refiners seek to retain those dealers known for the fewest releases or the lowest environmental cleanup costs in a long-term contractual relationship. Alternatively, such a change would encourage the wider use of company-operated stations, as refiners seek to reduce regulatory costs.

(5) Bargaining.

Another option is for state and oil industry representatives to engage in bargaining to arrive at a consensus for possible industry action as an alternative to additional government intervention. Discussions among these representatives could enable the achievement of a consensus on issues of concern to all parties in a non-adversarial context, allowing for voluntary compliance with agreed-upon objectives

through incentives rather than by regulatory enforcement.

Industry officials representing the major oil companies, jobbers, and dealers in Hawaii could meet with state officials and consumer groups to consider ways to resolve the lack of price competition in the State's gasoline markets, and seek to obtain mutually agreeable solutions to these issues before the enactment of regulation. The services of a mediator or facilitator may be useful in focusing the issues under consideration.

(6) Unregulated markets policed by antitrust.

Opponents of government intervention argue that even if monopolistic and predatory behavior are found, these types of behavior are already subject to prosecution under existing federal and state antitrust laws, which offer a more rational scheme for dealing with anticompetitive practices in the petroleum industry than divorcement laws and the forms of regulation proposed in the House Resolution. In addition to antitrust laws, Hawaii's fair trade laws (chapter 481, Hawaii Revised Statutes), franchise laws (chapter 486H, Hawaii Revised Statutes, and the federal Petroleum Marketing Practices Act), and other state and federal measures further protect the rights of independent dealers and consumers and ensure competition in Hawaii's gasoline markets. Rather than enacting new regulatory measures, they argue, there should be more vigorous enforcement of the antitrust laws and deregulation of existing special interest legislation, such as Hawaii's retail divorcement statute.<sup>775</sup>

On the other hand, proponents of increased regulation of the oil industry contend that antitrust laws cannot be consistently relied upon to ensure workable competition in Hawaii's markets, since major antitrust cases are expensive and time-consuming to litigate and policing is not always successful. This section begins with a discussion of these contrasting views of antitrust laws in the context of their effectiveness in maintaining competition in the marketplace.

Antitrust and competition. Antitrust law<sup>776</sup> is based on the principle that society is better off if markets behave competitively.<sup>777</sup> According to Breyer, the underlying assumption of antitrust laws is that "a workably competitive marketplace will achieve a more efficient allocation of resources, greater efficiency in production, and increased innovation":

[Antitrust laws] seek to achieve these ends by removing private impediments to workable competition. Where this assumption holds true, antitrust would ordinarily seem the appropriate form for government intervention

to take. Where the assumption fails, one finds the demand for other modes of governmental intervention, such as classical regulation. Viewed in this way, regulation is an alternative to antitrust, necessary when antitrust cannot successfully maintain a workably competitive marketplace or when such a marketplace is inadequate due to some other serious defect. 778

Critics of antitrust, however, argue that there are limitations to a reliance on antitrust law alone. One factor is the length and expense of antitrust actions: "major antitrust cases are very expensive and time-consuming to litigate. Thus, even effective antitrust enforcement will never completely replace other methods of dealing with the problems of inefficiency and inequity." 779 While it has often been noted that antitrust laws are intended to protect competition, not competitors, 780 others make the opposite assertion 781 or consider such characterizations to be mere clichés. 782 It is further argued that unsuccessful antitrust policing may lead to the imposition of less efficient forms of government intervention 783 and that antitrust policy is "at war with itself". 784

Oligopolies revisited. As noted earlier, Hawaii's gasoline markets are highly concentrated oligopolies. Since the focus of House Resolution No. 174, H. D. 2, is to protect the interests of Hawaii's gasoline consumers, one policy issue for state lawmakers to consider is whether government should intervene in Hawaii's concentrated gasoline markets to increase social benefits to consumers and reduce social costs to society. 785 In particular, should state lawmakers consider enacting some form of regulation to reduce the power of these oligopolies or rely instead on antitrust law to police unregulated wholesale and retail gasoline markets?

On the one hand, it may be argued that reliance on antitrust laws to police unregulated markets may be misplaced. Breyer maintained that "[t]he antitrust laws cannot effectively deal with tacit collusion or oligopolistic behavior--the behavior of several firms in a concentrated industry that do not agree to certain anticompetitive behavior but over time informally take actions with the same effect." 786 Waldman (1978) also noted that lawyers, judges, and economists often have different goals and motivations in pursuing antitrust actions against oligopolies. While some economists encourage challenging oligopolists because of potentially high efficiency gains, lawyers are often hesitant to attack oligopolistic industries, and judges may be reluctant to take a strong stand against oligopolists in the absence of collusion. 787

On the other hand, government intervention in Hawaii's gasoline

markets to reduce the power of these oligopolies may result in greater inefficiency and higher prices for consumers. Hovenkamp (1994) suggested that consumers may not necessarily benefit from the restructuring of an oligopolistic industry, since the social cost of breaking up large firms to achieve increased competition may be larger than the cost of leaving the oligopoly industry in its current state.<sup>788</sup> Stone (1976) similarly believed that restructuring industry at lower levels of oligopoly by breaking up large firms may have the effect of increasing prices.<sup>789</sup> Breyer also maintained that while the temptation to regulate oligopolies (and monopolies) may be high, the problems associated with regulation may be sufficiently great to encourage reliance on antitrust laws instead.<sup>790</sup>

"Light-handed" regulation. Although regulation is generally considered to be the opposite of antitrust, antitrust and regulation may nevertheless converge to some extent:<sup>791</sup>

Courts considering antitrust and regulatory matters must deal with such questions as: To what extent should ordinary principles of merger law apply to mergers in the regulated trucking or airline industries? To what extent should such industries be exempt from the scope of the antitrust laws? To what extent should antitrust principles apply to competitively structured portions of industries that are in part naturally monopolized? Should, for example, one portion of the telephone communications industry be regulated as a natural monopoly, while other portions are fully competitive and subject to antitrust?<sup>792</sup>

With respect to the last question--that of the bifurcation of an industry into regulated and unregulated (or less regulated) aspects--the idea of "light-handed regulation" has been proposed:

In recent years, the concept of natural monopoly and the efficacy of regulation in dealing with it have been questioned. Increasingly, it has been argued that in many presently regulated markets, actual or potential competition would be sufficient to protect customers without governmental intervention. These arguments often result in proposals that conventional regulation be replaced either by full deregulation or by some "light-handed" form of less intrusive governmental control. Of particular interest is the approach adopted by the Federal Energy Regulatory Commission ... of lubricating the regulatory process by

applying conventional regulation to noncompetitive markets and light-handed regulation to markets subject to competition. 793

Thus, if some form of regulation is deemed to be necessary, competitive considerations may be integrated into the regulatory process by applying conventional regulation where competitive forces are determined to be inadequate to protect the public interest, and less restrictive forms of regulation where competition is found to be adequate. 794

Antitrust and small business. In addition to protecting Hawaii's gasoline consumers, one of the primary concerns of the Legislature as expressed in House Resolution 174, H. D. 2, is to protect the State's independent dealers: "the continued viability of independent retailers and distributors is essential to the preservation of a fair and competitive motor vehicle fuel market...". 795 This section briefly reviews competing theories of antitrust law and their relation to small business. In particular, is the protection of independent dealers (and small businesses generally) from larger competitors an appropriate goal of antitrust law? Or should antitrust be concerned exclusively with maximizing efficiency, which may be inconsistent with the protection of small businesses?

These questions reflect the underlying tension associated with different schools of thought as to the values and objectives underlying antitrust policy. Essentially, the debate centers on efficiency concerns: "Ought courts view antitrust solely as a means for achieving economic efficiency," ... or ought they regard antitrust as invoking broader policy considerations encompassing economic, social and political values? 796 Advocates of the former view, including the Chicago School, maintain that the exclusive goal of the antitrust laws should be economic efficiency, consisting of both productive and allocative efficiency. 797

On the other hand, it has been noted (Flynn 1986; Hovenkamp 1994) that the United States Congress, in enacting antitrust statutes, did not view economic efficiency as the sole goal of antitrust policy; "[i]ndeed, Congress was generally willing to tolerate a great deal of allocative inefficiency in order to protect certain classes of people, such as small business." 798 Instead, it is argued that the antitrust laws encompass the following four goals: "(1) dispersion of economic power, (2) freedom and opportunity to compete on the merits, (3) satisfaction of consumers, and (4) protection of the competition process as market governor." 799

Advocates of the position that antitrust laws should incorporate both

noneconomic as well as economic values argue that antitrust policy should consider such goals as protecting small businesses from larger competitors. Hovenkamp noted that while this goal may be inconsistent with the goal of maximizing efficiency, courts may take a balancing approach to resolve the conflicting policies, choosing different policies to prevail in different cases:

There is a principled and viable position that antitrust policy must admit certain noneconomic values. At the same time, no one believes that efficiency concerns are irrelevant to antitrust policy. Today the most important debate about basic principles in antitrust is between those who believe that allocative efficiency should be the exclusive goal of the antitrust laws, and those who believe that antitrust policy should consider certain "competing" values--that is, values that either cannot be accounted for within the economic model, or values that can be asserted only at the cost of a certain amount of efficiency. These competing values include maximization of consumer wealth, protection of small businesses from larger competitors, protection of easy entry into business, concern about large accumulations of economic or political power, prevention of the impersonality of "facelessness" of giant corporations, encouragement of morality or "fairness" in business practice, and perhaps some others.

All these alternative goals can be inconsistent with the economic goals of maximizing allocative and productive efficiency. In addition, many are inconsistent with each other. If courts adopt any mixture of goals, antitrust is likely to be guided by conflicting policies which must then be balanced against each other. To be sure, this is not a unique phenomenon. Constitutional law is filled with decisions that balance conflicting policies. Antitrust could reasonably be expected to balance a policy of low consumer prices against a policy of protecting small businesses from larger competitors, and choose different policies to win in different cases. 800

On the other hand, reliance on the economic efficiency approach to antitrust law often provides simple, relatively consistent answers to antitrust questions:

By contrast, those who believe that antitrust

should be concerned exclusively with efficiency can offer a relatively consistent policy, provided there is consensus about the relevant elements of the economic model. If vertical integration is efficient, then the "efficiency only" advocate believes it should be legal, even if it injures small businesses, makes big businesses even bigger, and makes it more difficult for newcomers to enter a particular field. She will not attempt to balance these "competing" concerns against economic efficiency, because she does not see them as competing. They are simply ignored. 801

Posner (1976), an advocate of the economic efficiency approach to antitrust, maintained that antitrust enforcement is not an appropriate method of promoting small business interests, 802 and believed that certain efforts to assist small business, such as making franchise termination more difficult, often end up hurting the very class of small business they were intended to help: 803

Apart from raising in acute form the question of whether it is socially desirable to promote small business at the expense of the consumer, such a policy would be unworkable because it would require comprehensive and continuing supervision of the prices of large firms. There are no effective shortcuts. For example, if mergers between large firms are forbidden because of concern that they will enable the firms to take advantage of economies of scale and thereby underprice smaller firms operating at less efficient scale, one (or more) of the larger firms will simply expand until it has achieved the most efficient scale of operation. If franchise termination is made difficult in order to protect small dealers, the costs of franchising will be higher, and there will be less franchising, which will hurt the very class of small businessmen intended to be benefited. The tools of antitrust enforcement are poorly designed for effective discrimination in favor of small firms, compared, for example, to the effectiveness of taxing large firms at higher rates. 804

Hovenkamp also noted that from an efficiency standpoint, a policy of maximizing the welfare of small businesses might not necessarily benefit society as a whole: "An antitrust policy of maximizing small business welfare would have to be regarded as distributive, because it would force transfer payments from one group of people (consumers or large businesses) to another group of people (small businesses) even

though such a transfer might not make society as a whole better off."805 He further noted that "[t]he history of American antitrust is strewn with the corpses of small businesses who fell victim to antitrust rules designed to protect them",806 citing as an example the case of Standard Oil Co. of California v. United States ("Standard Stations").807

In that case, the United States Supreme Court reviewed Standard Oil's contracts with independent retailers that required all purchases of gasoline to be from Standard Oil. At the time, Standard Oil was the largest seller of gasoline in seven Western states; in 1946, its combined sales equalled 23 percent of the total taxable gallonage sold in that region, sales by company-owned service stations made up 6.8 percent of the total, while sales under exclusive dealing contracts with independent service stations constituted 6.7 percent of the total.808 At issue was whether the standards then applying to tying agreements should be extended to exclusive dealing, i.e., whether a showing that a substantial portion of commerce was affected was sufficient to satisfy the requirement in Section 3 of the Clayton Act that the effect of the arrangement "may be to substantially lessen competition", or whether it must also be demonstrated that competitive activity has actually diminished or probably will diminish.809

In concluding that "the qualifying clause of section 3 is satisfied by proof that competition has been foreclosed in a substantial share of the line of commerce affected",810 the Court found that Standard Oil's actions had violated that standard. Justice Frankfurter, writing for the majority, found that while tying contracts "serve hardly any purpose beyond the suppression of competition",811 requirements contracts "may well be of economic advantage to buyers as well as to sellers, and thus indirectly of advantage to the consuming public."812 The Court noted that interpreting Section 3 of the Clayton Act as requiring a demonstration that competitive activity has actually diminished "would make its very explicitness a means of conferring immunity upon the practices which it singles out."813 Finally, the Court maintained that although the end result may be a greater number of company-owned stations, which may be detrimental to the public interest, this policy issue had not been submitted for their decision:

Though it may be that such an alternative to the present system as buying out independent dealers and making them dependent employees of Standard Stations, Inc., would be a greater detriment to the public interest than perpetuation of the system, this is an issue, like the choice between greater efficiency and freer competition, that has not been submitted to our decision. We are faced, not with a broadly phrased

expression of general policy, but merely a broadly phrased qualification of an otherwise narrowly directed statutory problem. 814

Writing in dissent, Justice Douglas argued against the concentration of power in the hands of a few, maintaining that if the large oil companies could not integrate by exclusive dealing, they would seek to achieve the same result through outright ownership:

Today there is vigorous competition between the oil companies for the market. That competition has left some room for the survival of the independents. But when this inducement for their survival is taken away, we can expect that the oil companies will move in to supplant them with their own stations. There will still be competition between the oil companies. But there will be a tragic loss to the nation. The small, independent business man will be supplanted by clerks. Competition between suppliers of accessories (which is involved in this case) will diminish or cease altogether. The oil companies will command an increasingly larger share of both the wholesale and the retail markets. 815

It may be argued that *Standard Stations*, which was decided in 1949, reflects the mistrust of market concentration and oligopolies that was present during the post-World War II period. 816 These concerns continued in the 1950s "in Congressional policies that were suspicious of business expansion and even hostile toward efficiency", and in the 1960s, during which time antitrust policy was "openly hostile toward innovation and large scale development, and a zealous protector of the right of small business to operate independently." 817 More recently, however, these concerns have softened, and attitudes toward vertical arrangements have "changed radically": "While vertical arrangements were once viewed as posing serious competitive problems, many now consider them largely benign. Indeed, some find it difficult to find any anticompetitive effects at all in contractual agreements between buyers and sellers." 818 Moreover, vertical arrangements such as exclusive dealing help to avoid transaction costs, i. e., the costs of using the marketplace. While antitrust policy makers have historically viewed these practices with suspicion, vertical contracting and similar arrangements may alternatively be seen as simply helping to reduce the costs of doing business. 819

Finally, Hovenkamp noted that Justice Douglas' dissent in *Standard Stations*, while reflecting his strong advocacy of small business, failed to mention that vertical integration by the large oil companies

could result in lower prices at the pump:

The statement is one of Justice Douglas' most candid recognitions of the conflict between small business welfare and economic efficiency. If vertical integration gives an oil company a "competitive advantage" but exclusive dealing is unlawful, competition may force the companies to build their own retail stations. Justice Douglas was not willing to make a second admission, however: the "competitive advantage" in this case meant lower prices for consumers. 820

### CONCLUSION

Should policy makers pursue one or more of the regulatory options suggested in House Resolution No. 174, H. D. 2? The stated and unstated presumptions in the Resolution are that some form of regulation is appropriate, of the various forms suggested. 821 However, the Resolution itself reflects the tensions in policy direction faced by the Legislature. For example, while the focus of the Resolution is to protect the interests of Hawaii's gasoline consumers by ensuring the lowest possible gasoline prices and other areas, the Resolution at the same time seeks to preserve the continued viability of independent dealers and proposes several regulatory measures to effectuate this goal. Unfortunately, as noted in this study, these goals may be at odds with each other. Increased regulation, it has been noted, may increase prices at the pump as regulatory costs are passed on to consumers. Nor does regulation address such factors as changes in consumer preference away from full-service gasoline stations with repair facilities towards retail outlets with convenience stores. Failure to intervene, on the other hand, while potentially keeping prices low and increasing economic efficiency and consumer choice, may further the decline of Hawaii's independent dealers.

The House Resolution posits that the long- and short-term interests of Hawaii's gasoline consumers may be protected by ensuring the: (1) lowest possible gasoline prices, (2) availability of automotive services, and (3) convenient access to retail gasoline outlets. These assumptions also need to be re-examined:

- (1) Lowest possible gasoline prices. This assumption, while presumably in the best short-term interests of consumers, is not necessarily in their best long-term interests. As discussed in chapter 6, it may be more prudent to increase gasoline prices rather than take measures to decrease them, since lower fuel prices

arguably encourage overdependence on oil and remove incentives to conserve energy and develop alternative energy sources. 822

- (2) Availability of automotive services. In the context of the House Resolution, this statement presumes that automotive services will continue to be provided to consumers at conventional dealer-operated service stations. However, the trend has been away from obtaining repair and maintenance at these types of service stations in favor of obtaining these services from automobile dealers and other specialists, as stations have moved toward large-volume, self-service outlets in response to consumer preferences. As noted in chapter 3, this trend was due in part to improvements in automobile technology reducing the frequency of required routine maintenance and allowing manufacturers to offer extended warranties, requiring specialized expertise and equipment for maintenance and repairs, as well as changes in consumer preference, including a decreased demand for automotive repair and maintenance services. 823
  
- (3) Convenient access to retail gasoline outlets. Access to urban retail outlets may entail different legislative responses than access to rural ones. Retail outlets in downtown Honolulu, for example, may be compelled to close due to substantial increases in lease rents and increasing land values. The owners of outlets on high-priced land may also decide not to renew a lease because the land can be rented for investment purposes at a rate of return that is much higher than a gasoline station. On the other hand, a retail outlet in a rural community of the Big Island, for example, may close because of the high costs of clean-up from pollution and compliance with underground storage tank regulations. Alternatively, outlets may opt for a large-volume, self-service configuration with a convenience store or restaurant to remain competitive. 824

This chapter sought to present the regulatory options available to state policy makers in a broader context that considered under what circumstances the government should intervene in Hawaii's petroleum industry, and discussed a number of options ranging from classical regulation to unregulated markets policed by antitrust. The Legislature has already opted to protect Hawaii's independent dealers

to some extent by enacting a form of retail divorcement legislation. Maryland's experience with retail divorcement suggests that while arguably helping independent dealers by suppressing competition, Maryland's consumers have faced higher gasoline prices, shorter hours of operation, and generally reduced consumer choice in the period following divorcement. It is unclear whether the same effects have occurred in Hawaii. Legislators should nevertheless consider whether retail divorcement, if once justified, is still necessary; i.e., whether there is a continuing justification for intervention and whether the costs of reduced economic efficiency, less competition, and higher gasoline prices outweigh the benefits of the (presumably) increased viability of independent dealers. Unless lawmakers find the continued existence of serious market defects, competitive processes should be substituted for regulation.

While a determination of whether or not to further regulate Hawaii's petroleum industry depends to a large extent on the policy choices to be made by the Legislature, nonetheless, as suggested in this report, the Legislature should first consider less restrictive alternatives to regulation before intervening in Hawaii's gasoline markets. Moreover, most of the types of regulation proposed in the Resolution have not been adopted in any other jurisdiction. As noted by Yamaguchi and Isaak (1990), "[t]he tendency all around the world through the 1980s has been for governments to deregulate oil in the countries where it is controlled."<sup>825</sup> While they note that "a government could still reasonably decide that control of oil prices and regulation of the industry is worth the political difficulties that ensue", they maintain that such a decision in Hawaii should be based on an understanding of the practical difficulties involved, including those related to staffing (the absence of persons with expertise in the oil industry in state government and the complexity of oil industry regulation); information (the lack of detailed data on sales volumes, prices, and oil movements); politics (pressure from interest groups to subsidize one type of fuel at the expense of another); and other difficulties (e.g., the impossibility of regulating only gasoline prices without introducing serious market distortions).<sup>826</sup>

In addition, if the Legislature intends that the Petroleum Industry Information Reporting Act of 1991 (chapter 486I, Hawaii Revised Statutes) be implemented, the Bureau recommends the following:

- (1) The overall administrative responsibility for implementing chapter 486I, HRS, should be transferred from the Public Utilities Commission to the Department of Business, Economic Development, and Tourism, in view of the fact that DBEDT is already statutorily required to undertake energy development and management for the

State pursuant to section 26-18, HRS, and currently receives supply and demand data from the petroleum industry in accordance with chapter 486E, HRS (see Appendix J);

- (2) The Legislature should work with DBEDT to review chapters 486I, 486E, and 125C, HRS, as well as all other relevant statutes, to delete or modify material deemed to be duplicative or otherwise unnecessary and to consolidate data gathering, analysis, and reporting requirements in the Department; and
- (3) Sufficient resources should be appropriated annually to enable the Department to successfully implement chapter 486I and all other energy-related laws within the scope of the Department's responsibility.

As this chapter has also attempted to illustrate, state lawmakers must also examine the issue of regulation in the broader context of equitable, political, environmental, and long-term energy planning issues. The latter issue is of particular importance to Hawaii, considering the State's geographic isolation and dependence on oil. As petroleum resources dwindle, 827 lawmakers will be faced with choosing from one of several approaches to energy management, namely, conservation and "hard" and "soft" energy options. Generally, a "hard" energy path "stresses sustained growth of energy production to meet anticipated future demand as projected from past energy consumption."<sup>828</sup> This strategy entails, among other things, a new search for oil and natural gas reserves and the continued growth of centralized systems that generate electricity. A "soft" energy option, on the other hand, "emphasizes more restrained production of energy based on a deliberate effort to moderate future ... demand" and "relies on solar and other renewable energies and favors better end use of existing energy sources."<sup>829</sup> A soft path also encourages the development of small, decentralized systems.

Hawaii's policymakers, whether intentionally or not, have emphasized a predominantly hard energy path for the State. The House Resolution, and, to a large extent, the discussion in this report of the proposals presented in that Resolution, both presuppose and reflect this reliance on a hard energy option. To the extent that oil and its derivatives continue to play a central role in a discussion of energy resources and planning, this will necessarily be the case. Nevertheless, considering the State's dependence on imported oil, dwindling oil supplies, and the other factors discussed earlier, state lawmakers should consider a gradual conversion to a soft energy path, together with the enactment of additional measures encouraging conservation. Any such decision

should be made only after significant citizen participation in energy planning. While conversion to a soft energy path would involve "an expensive up- front restructuring of the economy", the decision to follow a hard path will require Hawaii's residents in the future to face an even more painful transition than the one facing residents today.<sup>830</sup> Moreover, while the hard path is nonrenewable, the soft path "can yield essentially unending energy."<sup>831</sup> Hawaii's abundance of renewable sources of energy, including wind and solar energy, weighs heavily in favor of considering a soft energy path. Without a change in policy direction, however, gasoline and other petroleum products will continue to remain vitally necessary for the short- and long-term needs of the people of this State.

Before enacting any new form of regulation, legislators should evaluate the arguments presented for each proposed type of regulation and review all relevant economic and other data to determine whether there are serious market defects requiring intervention. Stone (1982) argued that "the burden of proof lies with those who advocate regulation and that regulation should not be implemented without convincing evidence"--and that policy makers should first take the following questions into consideration:<sup>832</sup>

1. Does the unregulated market achieve a high level of economic and social performance? If the market does so in all particulars related to performance, our presumption against regulation dictates that our inquiry is at an end. ...
2. Can regulation be justified? Even the most ardent proponents of regulation as a public policy technique do not insist that it is appropriate in order to achieve every desirable public policy goal. ...
3. Will regulation lead to better performance than that which would prevail without government intervention? Even if regulation is justified under certain circumstances, it still does not follow that economic or social performance under regulation will be superior to performance in an uninhibited market. An unregulated market may yield results that fall short ... of performance goals, but in an imperfect world the market still may yield better performance results than under regulatory conditions....
4. Do the costs of regulation outweigh the benefits? ... If the costs of regulation outweigh its benefits, one should be unwilling to institute or continue it,

even though regulation might produce better performance goals than unrestrained competition in one particular area. In other words, regulatory costs that outweigh regulatory benefits frequently indicate performance declines in other areas. ...

5. Is there a public policy instrument that will achieve the particular performance goal better than regulation? Even assuming we find that regulation will lead to better economic and social performance than unrestrained competition, it still does not follow that regulation should be instituted, for there may be superior policy instruments to effect the same or better results. Since the carrot is often more effective than the stick in getting desired results, subsidy policy might be a superior choice in some instances. For the same reason, tax concessions and loan guarantees are other instruments that have been employed instead of regulation... 833

Finally, lawmakers are urged to bear in mind Breyer's recommendation that a restrained approach be adopted in considering whether to impose regulations:

First and foremost, modesty is desirable in one's approach to regulation. It should be painfully apparent that whatever problems one has with an unregulated status quo, the regulatory alternatives will also prove difficult. Before advocating the use of regulation, one must be quite clear that the unregulated market possesses serious defects for which regulation offers a cure. ...

[C]lassical regulation ought to be looked upon as a weapon of last resort. The problems accompanying classical regulation would seem sufficiently serious to warrant adopting a "least restrictive alternative" approach to regulation. Such an approach would view regulation through a procompetitive lens. It would urge reliance upon an unregulated market in the absence of a significant market defect. Then, when the harm produced by the unregulated market is serious, it would suggest first examining incentive-based intervention, such as taxes or marketable rights, or disclosure regulation, bargaining, or other less restrictive forms of interventions before turning to classical regulation itself. It would urge the adoption of classical

regulatory methods only where less restrictive methods will not work. 834

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Endnotes 16

657. While other authors have also addressed issues associated with regulation and its alternatives, see, e.g., Alan Stone, *Regulation and its Alternatives* (Washington, DC: Congressional Quarterly Press, 1982); Almarin Phillips, "Regulation and its Alternatives," in *Regulating Business: The Search for an Optimum* (San Francisco: Institute for Contemporary Studies, 1978), this researcher finds Breyer's framework to be a particularly balanced, well-reasoned approach that may be useful to state policy makers in attempting to resolve the often complex issues presented in the House Resolution. The framework draws primarily from the following two sources: Stephen G. Breyer, "Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform," 92 *Harv. L. Rev.* 549 (Jan. 1979) (written when Breyer was Professor of Law at Harvard University); and Stephen G. Breyer, *Regulation and its Reform* (Cambridge, MA: Harvard University Press, 1982) (written while Breyer was Circuit Judge of the United States Court of Appeals for the First Circuit).
658. Breyer (1979) at 553.
659. *Id.* at 15.
660. See text accompanying notes 22 to 24 in chapter 9.
661. Breyer (1979) at 553-554.
662. *Id.* at 554.
663. Breyer (1982) at 21.
664. *Id.* at 23 (footnote omitted).
665. Breyer (1979) at 556; see also note 14 in chapter 13.
666. *Id.* at 557.

667. Breyer (1982) at 32.
668. Id. at 33 (footnotes omitted).
669. Id. (footnotes omitted).
670. Id.
671. Id. at 34.
672. Id.
673. Breyer (1979) at 560-561.
674. See Breyer (1982) at 184-185.
675. Id. at 188.
676. See generally Breyer (1982) at 156-183; Breyer (1979) at 578-584. Breyer also discusses nationalization as an alternative to classical regulation, which is not considered in this report.
677. See notes 15 to 19 and accompanying text in chapter 13.
678. Breyer (1982) at 164.
679. Id. at 165.
680. Id. at 171-172.
681. Id. at 172.
682. Id.
683. Id. at 175.
684. Breyer (1979) at 583 (footnotes omitted).
685. Id. at 582-583; Breyer (1982) at 177-179.
686. Breyer (1982) at 179. For a discussion of alternate dispute resolution and consensus-building in the electric-utility industry, see Jonathan Raab, "Electric-Utility Industry Braces for a Brave New World -- of Competition," and Matt Gentile, "ZAP! Fed Energy Agencies Use ADR to Boost Their Efficiency," in Consensus: Helping Public Officials Resolve

Stubborn Policy Disputes, No. 28 (Cambridge, MA: MIT-Harvard Public Disputes Program, October, 1995) at 1.

687. *Id.* at 156-157 (emphasis in original).
688. *Id.* at 157.
689. See *infra* notes 120 to 128 and accompanying text.
690. *Id.* at 159; see notes 66 to 74 and accompanying text in chapter 15 for a discussion of predatory pricing.
691. Breyer (1982) at 192 (table 3).
692. Breyer cautions that his framework contains a number of limitations that make it "partial and suggestive in nature, rather than a comprehensive effort to deal with all regulation or to propose definitive solutions...." Breyer (1982) at 7. State lawmakers are therefore encouraged to use this framework, not as a conclusive analysis of regulatory alternatives, but rather as a tool to assist them in making policy decisions.
693. Letter to researcher from Ted Gamble Clause, Deputy Attorney General, dated July 26, 1995, at 3 (response to question (11) concerning divestiture); see text accompanying note 1 in chapter 12.
694. Hawaii, Department of the Attorney General, *An Investigation of Gasoline Prices in Hawaii: A Preliminary Report* (Honolulu: Sept. 1990) at 7-13 (hereinafter, "AG (1990)").
695. Hawaii, Department of the Attorney General, *The Attorney General's 1994 Interim Report on the Investigation of Gasoline Prices* (Honolulu: 1994) at 9 (hereinafter, "AG (1994)").
696. *Id.* ("[I]t remains a fact that the exchange agreements 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.")

697. No attempt has been made at an economic analysis of Hawaii's gasoline markets, which would require, inter alia, an analysis of the interrelationship and profitability of the various petroleum products produced in the refining process. Such an analysis is beyond the scope of this study. See AG (1990) at 9; see also Nancy D. Yamaguchi and David T. Isaak, *Hawaii and the World Oil Market: An Overview for Citizens and Policymakers* (Honolulu: East-West Center Energy Program, Aug. 1990) at 76.
698. AG (1994) at 13.
699. *Id.* at 7. Another negative spillover is air pollution; see, e.g., Walter Wright and Angela Miller, "Gas Cloud from Refinery Sickens 29 Workers Here," *The Honolulu Advertiser*, November 22, 1995, at A1, A6 (reporting the release of sulfur dioxide from the BHP Petroleum refinery); Christopher Neil, "Toxic Gas Leak at BHP Was 20th this Year" and "State Investigates Gas Leak, Plans to Monitor Refinery," *The Honolulu Advertiser*, November 23, 1995, at A1, A2; see also *Haw. Rev. Stat.* chapter 342B (air pollution control).
700. 1991 *Haw. Sess. Laws Act* 291, §1; see note 23 in chapter 13.
701. Sorensen (1991), however, argues that with respect to the United States as a whole, "[b]oth wholesale and retail markets for gasoline in the U.S. are highly competitive." Philip E. Sorensen, *An Economic Analysis of the Distributor-Dealer Wholesale Gasoline Price Inversion of 1990: The Effects of Different Contractual Relations* (Manuscript, April 1991) at 35.
702. See note 10 and accompanying text in chapter 3.
703. *Haw. Const.* art. XI, §1 provides in relevant part:
- Section 1. For the benefit of present and future generations, the State and its political subdivisions shall conserve and protect Hawaii's natural beauty and all natural resources, including ... energy sources, and shall promote the development and utilization of these resources in a manner consistent with their conservation and in furtherance of the self-sufficiency of the State. \* \* \*
704. *Haw. Rev. Stat.* §226-18 provides as follows:

ñ226-18 Objectives and policies for facility systems--energy. (a) Planning for the State's facility systems with regard to energy shall be directed towards the achievement of the following objectives:

- (1) Dependable, efficient, and economical statewide energy systems capable of supporting the needs of the people;
- (2) Increased energy self-sufficiency where the ratio of indigenous to imported energy use is increased; and
- (3) Greater energy security in the face of threats to Hawaii's energy supplies and systems.

(b) To achieve the energy objectives, it shall be the policy of this State to ensure the provision of adequate, reasonably priced, and dependable energy services to accommodate demand.

(c) To further achieve the energy objectives, it shall be the policy of this State to:

- (1) Support research and development as well as promote the use of renewable energy sources;
- (2) Ensure that the combination of energy supplies and energy-saving systems are sufficient to support the demands of growth;
- (3) Base decisions of least-cost supply-side and demand-side energy resource options on a comparison of their total costs and benefits when a least-cost is determined by a reasonably comprehensive, quantitative, and qualitative accounting of their long-term, direct and indirect economic, environmental, social, cultural, and public health costs and benefits;
- (4) Promote all cost-effective conservation of power and fuel supplies through measures including:

- (A) Development of cost-effective demand-side management programs;
  - (B) Education; and
  - (C) Adoption of energy-efficient practices and technologies;
- (5) Ensure to the extent that new supply-side resources are needed, the development or expansion of energy systems utilizes the least-cost energy supply option and maximizes efficient technologies;
  - (6) Support research, development, and demonstration of energy efficiency, load management, and other demand-side management programs, practices, and technologies; and
  - (7) Promote alternate fuels and energy efficiency by encouraging diversification of transportation modes and infrastructure.

705. Haw. Rev. Stat. §226-103(f) provides as follows:

§226-103 Economic priority guidelines. \* \* \*

- (f) Priority guidelines for energy use and development:
  - (1) Encourage the development, demonstration, and commercialization of renewable energy sources.
  - (2) Initiate, maintain, and improve energy conservation programs aimed at reducing energy waste and increasing public awareness of the need to conserve energy.
  - (3) Provide incentives to encourage the use of energy conserving technology in residential, industrial, and other buildings.
  - (4) Encourage the development and use of energy conserving and cost-efficient transportation systems.

The Hawaii State Plan also encourages energy efficiency in planning for the state's facility systems with regard to transportation. Section 226-17(b)(11), Hawaii Revised Statutes, notes that it is the policy of the State to "[e]ncourage safe and convenient use of low-cost, energy efficient, non-polluting means of transportation...", while paragraph (13) of that subsection seeks to "[e]ncourage diversification of transportation modes and infrastructure to promote alternate fuels and energy efficiency."

706. William Noller, ed., *Energy Self-Sufficiency for the State of Hawaii*, prepared by students of civil engineering and interdisciplinary studies, University of Hawaii at Manoa (Honolulu: Sept. 1978) at 123-124. Energy conservation has been pursued by utilities as a less expensive means of recapturing energy. See generally Charlotte A. Carter-Yamauchi, *Utility-Financing of Energy Conservation: A Short-Term Approach to Hawaii's Oil Dependency*, Report No. 3 (Honolulu: Legislative Reference Bureau, 1988). It has also been noted that participation by Hawaii's small businesses in energy efficiency decisions will strongly impact on state energy conservation efforts. Speaking at the Governor's Conference on Energy Investments in Honolulu in 1985, then Lieutenant Governor John Waihee noted that Hawaii "is composed primarily of small businesses with 98 percent of the 21,000 firms in this State having fewer than 100 employees and 50 percent with less than five employees", and that ultimately, "it will be the hundreds and thousands of individual decisions by these firms to invest in energy conservation which will determine the extent to which overall improvement in energy efficiency will take place in Hawaii." Hawaii, Department of Planning and Economic Development, *The Governor's Conference on Energy Investments: Profiting from Energy Savings*, Executive Summary Report (Honolulu: May 8-9, 1985) at 19.
707. For a review of proposed legislative initiatives to reduce energy consumption in the building, utilities, and industrial sectors, see generally Frank Kreith and George Burmeister, *Energy Management and Conservation* (Denver: National Conference of State Legislatures, 1993) at 97-98.
708. See Hawaii, Department of Planning and Economic Development, *Managing a Gasoline Shortage in Hawaii* (Honolulu: Oct. 1981) (vol. 2) at 38 (hereinafter, "DPED (1981)");

Gasoline, like other fuels, is a special case of a

good that is desired not as a final consumption product in and of itself, but rather as an input into the production of final services. In other words, gasoline is not desired for its own qualities, but for its use in the production of vehicle transportation services or mobility. Economists term the demand for inputs such as gasoline a "derived demand" because their demand is derived from the demand for the final goods or services they are used to produce. As a result of this characteristic, the demand for gasoline will depend on the demand for gasoline-powered vehicle transportation services. Determinants of vehicle-transportation-services demand, and hence gasoline demand, include: (1) the price of vehicle

transportation services, including the price of owning, operating and parking a gasoline-powered motor vehicle; (2) the price and availability of alternate modes of transportation such as public transit, bicycling and walking; (3) the number of vehicles and consumers; (4) consumer tastes and preference for transportation; (5) the use and importance of transportation services to the consumer; and (6) information.

709. Gerard M. Brannon, Energy Taxes and Subsidies, A Report to the Energy Policy Project of the Ford Foundation (Cambridge, MA: Ballinger Publishing Co., 1974) at 136.
710. In addition, the following list of legislative proposals aimed at energy conservation in the transportation sector was offered as a starting point for further deliberation in a recent National Conference of State Legislatures publication, some of which are already being implemented on the state and county levels in Hawaii:
- . Promote construction of mass transit systems
  - . Provide initiatives for ride sharing
  - . Implement installation and use of intelligent vehicle/highway systems
  - . Coordinate traffic light sequencing with traffic flow by use of responsive computer programs
  - . Support expansion of telecommuting
  - . Provide funds for scrapping inefficient and polluting vehicles
  - . Purchase alternative fuel vehicles for state agencies

- . Introduce "gas guzzler taxes"
- . Increase gasoline taxes
- . Establish information sharing on alternative fuels with other states. Kreith and Burmeister (1993) at 97.

711. See Hawaii, House of Representatives, Special Committee on Energy, Investigation of the Hawaii Gasoline Market (Honolulu: March 1974) at 70-72 (hereinafter, "Haw. House Report (1974)"):

First, the State of Hawaii should compile and maintain accurate data on the supply and demand for petroleum products in the State. ...

Second, the State should encourage the development of alternative energy sources to reduce our present almost-total reliance on oil. ...

Third, the State should encourage greater efforts at conservation in the future. With continued shortages ahead, we should try to keep our energy demands down within available supplies in order to avoid socially and economically disruptive shortfalls.

Fourth, we should intensify our efforts to develop an efficient public transportation system, especially for commuter use. The private passenger car is an inefficient mode of transportation in terms of energy consumption for simply traveling between home and work.

Fifth, we will now have to take into account the energy factor in future public policy decisions.

712. In particular, the Department reviewed the following measures:

1. Those that influence the price of gasoline-powered vehicle transportation services by affecting the cost of owning, operating and parking a vehicle (example: a tax upon vehicle ownership or operation, an increase in parking charges, a reduction in the availability of parking in certain areas, an increased tax on gasoline that would act to encourage less driving and more fuel-efficient vehicles).

2. Those that decrease the price or increase the availability of alternate modes of transportation (examples: increased bus services, lower bus fares, ridesharing incentives, facilities for bicycle or motorbike use and parking, increased pedestrian walkways).

3. Those that decrease the number of vehicles or drivers (examples: ban on general motor traffic in certain areas, increase in the driving age requirement, ridesharing incentives).

4. Those that influence consumers' preferences for driving or for other modes of transportation (examples: campaign to instill a conservation ethic in gasoline use, increase the attractiveness of alternate modes of transportation).

5. Those that affect the frequency of travel and need for private vehicle transportation (examples: encouragement of flexible working hours so that workers can use alternate forms of transportation, adjustment of school hours to facilitate transportation to school).

6. Those that provide consumers with information needed to make rational decisions about transportation (examples: programs for conservation information including how to save gasoline, alternatives available, where to go for information or services, etc.).

7. Those that allow consumers to travel further on the same amount of gasoline (examples: improvements in traffic flows, engine tune-up programs, vehicle efficiency requirements).

DPED (1981) (vol. 21) at 38-39; see also *id.* at 39-41.

713. Hawaii, Department of Business, Economic Development, and Tourism, Hawaii Integrated Energy Policy (Honolulu: Dec. 1991) at 61 (hereinafter, "DBEDT (1991)"). While not an energy plan for the State, this report on the Hawaii integrated energy policy development program solicited input from persons and organizations throughout the State, identified a number of issues and problems, and made recommendations for solutions to these problems.

714. Id.

715. In particular, the report made the following recommendations regarding transportation energy use:

. Hawaii should analyze the effectiveness of transportation policy options, including public transit, energy pricing and other fiscal policies, and infrastructure changes, that will reduce demand for petroleum based fuels. DBED - Energy Division or the new energy agency, in consultation with DOT, should conduct the analysis and implement those that prove the most effective. Policy options should include use of incentives and disincentives such as rebates and surcharges on new automobiles, and user fee revenues to support alternate fuel development. The energy implications of alternative transportation modes, such as the proposed water ferry system and rapid transit system, should also be analyzed. DOT's Transportation Functional Plan should include specific (energy related) initiatives called for in the Energy Functional Plan. This is a mid-term recommendation.

. State, County and Federal governments, and selected private companies, should form a transportation task force to coordinate fleet-wide demonstrations of alternate fuel and energy-efficient vehicles. The State should prepare a list of ground transportation options complete with technical and cost information on each. At the request of the ERC, a task force should be formed with representatives from appropriate agencies at each level of government and private companies that maintain a corporate fleet to participate in a major "alternative forms of transportation demonstration program." This is a near-term recommendation.

. Hawaii should expand the telework program and other satellite office facilities. The State should publicize the energy savings and other advantages of decentralization strategies and encourage public agencies and private companies and organizations to participate. This initiative is included in the Transportation Functional Plan. This is a near- to mid-term recommendation.

. Hawaii should establish commuter information centers to facilitate commuter ride sharing for government, communities, schools, businesses and hotels/resorts. This initiative is included in the Transportation Functional Plan. This is a near-term recommendation.

. Hawaii should assist the counties of Maui, Kauai and Hawaii in the planning, assessment, development, and/or improvement of public transportation systems. Based on the results of the County-wide Transportation Planning Process, conducted jointly by DOT and the County governments, the State should support and promote public transportation and alternative transportation modes as a means of reducing gasoline consumption. This initiative is included in the Transportation Functional Plan. This is a mid-term recommendation.

. Hawaii should renew, upgrade and implement the bikeway program. DOT should work with the counties, bicycling organizations, bike tour operators and communities in this effort. This initiative is included in the Transportation Functional Plan. This is a mid-term recommendation. Id. at 64.

716. Pamela Martin, *Telecommuting: The Ride of the Future*, Report No. 2 (Honolulu: Legislative Reference Bureau, 1992) at 7. In addition, the Department of Business, Economic Development, and Tourism noted that early assessments of the Hawaii telework center demonstration project "suggest that participants have reduced travel time by 78%, decreased transportation costs by 59%, and reduced fuel consumption by nearly 30%." See DBEDT (1991) at 61 (footnote omitted). In addition, two other recent Legislative Reference Bureau studies also discuss energy policy issues regarding vehicle transportation: Denise Miyasaki, *Two Aspects of Ridesharing: State Parking Control Policy and HOV Lane Enforcement*, Report No. 14 (Honolulu: Legislative Reference Bureau, 1992); and Junie Hayashi, *Rideshare Policies and Programs: A Review*, Report No. 14 (Honolulu: Legislative Reference Bureau, 1989). See also Haw. Rev. Stat. chapter 279G (ridesharing) and chapter 291C, pt. XVII (traffic code; high occupancy vehicle lanes).
717. United States, President's Commission for a National Agenda for the Eighties, Panel on Government and the Regulation of

Corporate and Individual Decisions, Government and the Regulation of Corporate and Individual Decisions in the Eighties (Washington, DC: 1980) at 11-12 (hereinafter, "President's Commission (1980)").

718. *Id.* at 12-13.

719. V. Kerry Smith, "Regulating Energy: Indicative Planning or Creeping Nationalization," in *Regulating Business: The Search for an Optimum* (San Francisco: Institute for Contemporary Studies, 1978) at 69.

720. See Walter A. Rosenbaum, *Energy, Politics and Public Policy*, (Washington, DC: Congressional Quarterly Press, 1981) at 134 (footnote omitted):

Rising energy prices punish and reward most Americans, but not on an equal basis and often without respect for their ability to endure the consequences. In New York, for example, increased energy costs had forced the average older American's household to spend one-third of its income on energy by 1979, whereas middle-income families were spending only 9.6 percent. At the same time, stockholders in the nation's major petroleum companies reaped record dividends. In short, Americans differ in their ability to pay higher energy prices, in the sacrifices they experience, and in the extent to which they also benefit from increased energy prices.

721. *Id.* at 134-135.

722. *Id.* at 135.

723. *Id.* at 136.

724. *Id.* at 136-137.

725. Rosenbaum (1981) at 137. See also Stone (1982) at 125-126:

One person's notion of equity is apt to be another's sense of inequity. For example, if the Interstate Commerce Commission should impose upon a railroad a below-operating cost rate between small communities and allow that railroad to subsidize the resulting loss by charging a high rate between large communities, both the favored and disfavored

communities can point to reasons why the rate structure is equitable or inequitable--depending on whether the argument is made from the winner's or loser's perspective. The smaller communities will point to the need to help commerce and economic growth, lest large urban communities virtually disappear. The large communities will point to the discriminatory rate structure and the fact that large areas in effect are subsidizing smaller ones. ...

726. Joseph P. Kalt, *The Economics and Politics of Oil Price Regulation: Federal Policy in the Post-Embargo Era* (Cambridge, MA: MIT Press, 1981) at 237-8.
727. Rosenbaum (1981) at 137-138.
728. Stone (1982) at 188-189.
729. Gasoline shortages frequently bring calls for regulation and investigation of the oil industry. See, e.g., Haw. House Report (1974); see also Stone (1982) at 179-184; and Bruce M. Owen and Ronald Braeutigam, *The Regulation Game: Strategic Use of the Administrative Process* (Cambridge, MA: Ballinger Publishing Co., 1978), who argue that during shortages, people are more willing to trade off market efficiency for increased procedural fairness; "[w]hen there is a sudden shortage of gasoline or natural gas, ... an overpowering instinct in favor of rationing and price controls seems to motivate both public opinion and political action." *Id.* at 35.
730. Stone (1982) at 190.
731. *Id.* at 186.
732. See Mark R. Lee, "Oil Price Shocks, Antitrust and Politics: The Supply of Petroleum and the Demand for Regulation," 15 *S. Ill. U. L. J.* 529, 537-538 (1991) (footnotes omitted):

Why do politicians persist in responding to petroleum rises with calls for regulation and investigation when this behavior causes such perverse effects? ...

Responding to petroleum price rises with calls for regulation and investigation must somehow serve politicians' self interest. The theory of public

choice suggests three ways in which it might do so. First, this behavior could curry favor with voters. Calls for regulation and investigation play to the nearly universal desire to have more and pay less for everything consumed. The idea that the calls themselves frustrate this desire would probably seem counterintuitive to most voters, and voters qua voters have little incentive to acquire and evaluate the information required to upset their intuition. Thus, responding to petroleum price rises with calls for regulation and investigation may curry favor with voters, thereby securing additional votes.

This behavior could also serve politicians' self interest by currying favor with opinion leaders. A large number of these leaders seem strongly inclined to statism, perhaps because for many of them, their personal wealth tends to vary directly with the amount of resources controlled by government. Currying favor with these opinion leaders could elicit expressions of support, and this might enable politicians to secure more votes and more campaign contributions.

Finally, and most importantly, responding to petroleum price rises with calls for regulation and investigation will induce a lawful flow of cash and cash equivalent favors from the petroleum market to

the politicians. The flow will take a variety of forms: campaign contributions from political action committees, "honoraria" for "lectures," "reimbursement" for the "expense" of attending "seminars" or conferences, and the like. Those making the disbursements publicly justify them as securing "access," but they serve the same function as "protection" payments. The politicians on the receiving end use the flow both to finance elections and increase their wealth.

733. Rosenbaum (1981) at 202, 203.

734. See United States, Department of Energy, *Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers* (Washington, DC: March 1984) at 120-123 (hereinafter "DOE (1984)"). A supplier may grant certain price discounts, in the form of temporary voluntary allowances, temporary competitive allowances, or rent

rebates, to limit its market share loss and protect its dealers in areas of intense price competition. Legislative proposals would prohibit the selective use of these discounts by requiring that they be granted to all of the supplier's outlets in a broad geographical area. *Id.* at 120.

735. See generally Rayola Dougher and Thomas F. Hogarty, *The Impact of State Legislation on the Number of Retail Gasoline Outlets*, Research Study #062 (Washington, DC: American Petroleum Institute, Oct. 1991); Energy Research Associates Inc., *Economic Feasibility of Gasoline Vapor Recovery Systems for Hawaii*, (Honolulu: Hawaii Office of Environmental Quality Control, Feb. 1981); Robert A. Brazener, "Validity and Construction of Statute or Ordinance Regulating or Prohibiting Self-Service Gasoline Filling Stations," 46 A. L. R. 3d 1393 (1972).
736. Moreover, had chapter 486I been implemented upon its enactment in 1991, legislators would now have available four years' worth of relevant, impartial data regarding some of the issues discussed in this report, such as whether a price inversion has occurred in the distribution of gasoline in the State (question (5) of the Resolution) and whether or not the existing moratorium has resulted in lower gasoline prices (question (17)), arguably rendering those portions of the current study unnecessary.
737. Kreith and Burmeister (1993) at 288. The NCSL report also commented that "[l]egislators need objective assistance from professionals who do not have potential to gain financially in the outcome of energy legislation." *Id.* at 289. Each of the survey participants representing the various petroleum industry groups in this study have a stake in the outcome of legislation affecting their interests. While their views should not be disregarded solely on that basis, their arguments nevertheless should be viewed in this context.
738. See *supra* text accompanying notes 22 and 23. Breyer suggested that classical regulation should not ordinarily be used for purposes of rent control; rather, taxes or deregulation are the preferable alternatives. Breyer (1982) at 195.
739. Rosenbaum (1981) at 148-150.
740. Breyer (1982) at 165-167:

Potential shortages were avoided by use of an ingenious program that distributed entitlements to refine old, cheap oil. The program allocated the cheap oil "fairly" among refiners. Each refiner received the right to process an amount of old oil in proportion to the total amount of oil he refined. The government determined monthly the total amount of oil refined in the United States and the proportion of that oil accounted for by old, cheap crude. Each refiner then received a number of entitlement tickets roughly equal to that proportion of his total throughput. Thus, if 23 percent of all oil refined was old, a refiner with a throughput of 1,000 barrels received 230 tickets. If he refined 2,000 barrels, he received 460 tickets. It was unlawful to refine old oil without an entitlement. A refiner with extra (more than 23 percent) supplies of old oil had to buy entitlements from refiners with extra tickets (those using less than 23 percent old oil). The price paid equaled the difference between the world market price and the old-oil price, or about \$9.00 per ticket. Each refiner in effect received the value of having 23 percent of his throughput made up of old, cheap oil, because those with too many tickets sold them to those with too few.

The effect of this system was to lower the cost of imports to the refiner and to lower domestic market prices. The refiner had to pay about \$14.50 for a barrel of imported oil. Yet he received 23 percent of an entitlement ticket (worth about \$2.25) when he imported an extra barrel. Hence, the barrel actually cost him slightly more than \$12.00. He received the \$2.25 when he sold the .23 entitlement to a refiner with an extra .23 barrel of old oil. It represented the potential windfall profit available from the sale of that .23 barrel. Thus, part of the windfall profit was used to subsidize the cost of the import. Under this system, oil will continue to be imported to satisfy demand at prices lower than the world market price so long as rents are available to pay the cost. In other words, there will be (and has been) no perceived shortage because the rents are used in part to pay for the import of sufficient foreign crude to satisfy all demand. ...

741. Id. at 167.
742. Id. at 271.
743. Id. at 273.
744. See id. at 275-284.
745. See id. at 168-169. A similar form of this argument may be used in opposition to the idea of tariffs, as well; since market prices for goods and services fluctuate, filing tariffs and changes to those rates reduces flexibility and increases paperwork and other administrative costs.
746. See text accompanying note 40 in chapter 3.
747. Yamaguchi and Isaak (1990) at 52.
748. See text accompanying note 23 in chapter 6.
749. Id. at 59-60 (emphasis added).
750. Brannon (1974) at 138 (footnote omitted):

It should also be taken into account, in regard to a possible increase in gasoline taxes, that the United States is one of the few major countries that does not treat gasoline as a net revenue source, as it does tobacco and alcohol. Most European countries rely on gasoline taxes to such an extent that ... the price of gasoline is two to three times as high as it is in this country. As should be expected under this pricing arrangement, the consumption of gasoline per capita is about half as high in Europe as it is here, taking into account income differences. A consequence of the heavy gasoline tax is the much greater preference for small cars as well as greater reliance on energy-efficient public transportation.

751. Id.
752. Rosenbaum (1981) at 138.
753. DPED (1981) (vol. 2) at 42. One way that the government may assist consumers who are burdened by higher gasoline prices is to institute an income assistance program. Id. However, programs that subsidize or eliminate income losses resulting

from higher energy costs may resist "national policies to conserve energy in ways that appear to threaten economic growth." Rosenbaum (1981) at 138.

754. See, e.g., Kevin Dayton, "Estimate: 1 in 3 Cars Uninsured," The Honolulu Advertiser, May 22, 1994; Susan Hooper, "Couple Balk at \$14,500 for Auto Coverage," The Honolulu Advertiser, May 23, 1994.
755. In the 1995 Regular Session, for example, House Bill No. 1261 (1995) would have established a system of motor vehicle insurance funded by a "gasoline pump surcharge"--a tax on motor vehicle fuel purchased at the pump--as well as by motor vehicle registration and driver's licensing fees. Similarly, House Bill No. 1560 (1995) would have established a no-fault insurance state fund program, essentially a "pay as you go" no-fault insurance system, funded by no-fault taxes imposed on liquid fuel sold or used for operating motor vehicles in the State, as well as motor vehicle registration and driver's licenses and renewals. While the gasoline tax under this bill would be paid by all drivers at the pump for every gallon of liquid fuel purchased for the operation of motor vehicles, certain public assistance recipients would be provided additional assistance in making the no-fault tax payments.
756. Estimates of price increases range from a low of 23 cents added to each gallon of gasoline to a high of \$1.28 added per gallon. See Hugh Clark, "Rural Commuters Nix Plan; Say Paying Insurance at Pump Too Costly," The Honolulu Advertiser, Aug. 8, 1995, at A5; Kevin Dayton, "Legislators Defer Action on 'Pay-at-Pump,'" The Honolulu Advertiser, Feb. 11, 1993, at A3. In addition, a pay-at-the-pump proposal for the City and County of Honolulu proposed a 50-cent tax on each gallon of gasoline purchased. See Mike Yuen, "Fasi Revs Up 'Pay at the Pump' Plan," Honolulu Star-Bulletin, June 3, 1993, at A-3.
757. See, e.g., Kevin Dayton, Feb. 11, 1993, supra note 100, at A3:

A spokesman for the Chamber of Commerce of Hawaii said pay-at-the-pump schemes do not offer any incentives for drivers to be cautious, because careful and reckless drivers alike would pay the same rates.

Insurance industry officials said the tax would

land especially heavily on people who drive long distances because they use more gasoline.

They argued that people with bad driving records should pay more--not people who drive long distances.

In addition to raising the price of gasoline, opponents also argue that a pay-at-the-pump plan would create a large new state bureaucracy and drive some private insurers out of Hawaii's market. Kevin Dayton, "Gas-Tax Bill for No-Fault Dies," The Honolulu Advertiser, March 2, 1994 (regarding House Bill No. 3596, H. D. 1). Finally, the Tax Foundation of Hawaii has argued that such a measure is regressive and will increase the already high cost of living in Hawaii:

It should be noted that under the proposed measure, drivers who drive the most would be penalized as they would be paying more in fuel taxes and higher registration fees since vehicles used to commute to work more than 40 miles per roundtrip would be subject to higher no-fault taxes. This would result in those who travel the greatest distances paying the bulk of the costs of this new beneficiary program of no-fault insurance.

Distance traveled certainly is no indicator of how safe or dangerous a driver is or the risk involved. In fact, when one considers that the poor live furthest from urban employment centers because housing is less expensive, this measure is regressive with the poor paying the bulk of the taxes collected as their consumption of fuel will be higher...

Unfortunately, ... the proposal to pay for a state no-fault insurance program at the pump may in fact create more problems than it would solve. Certainly the user taxes being tapped for the insurance fund do not bear any direct relationship to the risk exposure experienced by each driver. There is no valid reason for the state to enter the insurance business.

From an economic vantage point, if substantial increases are added to the fuel tax, those increases will have a devastating effect on the already high cost of living in Hawaii. The increased taxes paid by commercial operations will be passed on to consumers and clients and will be included in the base against

which percentage mark-ups are calculated. This cost will pyramid so that the end consumer will see price increases many times more than the nominal increase in the fuel tax.

Finally, it should be noted that the fuel tax has been the traditional funding source for highway improvements and maintenance. It is structured so that it must continually be reviewed for adequacy and relationship between user and beneficiary. Should this proposal be enacted at a substantial rate on fuel for insurance, any future proposals to increase the rate for the purpose of funding highway improvements will be subject to significant resistance.

Legislative Tax Bill Service (Tax Foundation of Hawaii, Honolulu: Feb. 1995) at 234-235 (re: House Bill No. 1560 (1995)). Opponents on the Big Island, which lacks public transportation in many rural areas and where many residents must commute long distances to their places of work, also argue that "unemployment would rise if the cost of gasoline rises so sharply, because people wouldn't be able to afford to commute to their jobs on the relatively large island." See Hugh Clark, Aug. 8, 1995, *supra* note 100, at A5.

758. For example, Brannon (1974) noted the following:

Even though the energy cost of automobile transportation is high the present system of pricing highway services causes people to think that, in most driving decision situations, the highway is cheaper than it really is. Consumers pay for highways through a gasoline tax, which is a fairly uniform charge that applies to various driving conditions. For example, driving to work during rush hours is considerably more expensive from a social standpoint than driving on an open highway free of traffic. The major difference is that the additional crowding involved in commuter traffic when one more car is added means some loss of highway efficiency for all the other cars. Any particular driver, however, evaluates his decision to use the highway only in his own terms--in terms of the time it saves him and of his automobile expenses. He does not consider the slowdown that he imposes on other drivers as a cost.

Economists who have examined this question

uniformly favor variable highway tolls as a way of charging motorists for highway expenses. The tolls would, for instance, be very heavy for passing bottleneck points during crowded hours and probably zero for using highways in times and places where there is no crowding. The public however, has resisted toll booths, presumably because they slow down traffic as well as absorb money, and the Highway Act of 1956 specifically eliminated tolls as a way of paying for highways in the new interstate system. A few older roads that were financed before the interstate system still have highway tolls.

We think that the continued absence of highway tolls results in commuters underestimating the social costs of getting to work by private automobile. This results in over-dependence on automobile commuting and inadequate reliance on mass transportation, which can move people more efficiently and with much less energy outlay.

An ideal solution would be to institute highway tolls at federal, state, and local levels. Because most of the roads involved are technically local streets, an ideal form of bringing about improved pricing of highway services would be a matching grant program from the federal government that would give better treatment to states that raise some highway funds through tolls. *Id.* at 136-137.

759. DPED (1981) (vol. 2) at 40.

760. *Id.*, (vol. 1) at xvii.

761. Brannon maintained that a parking tax was a viable alternative to highway tolls for this reason:

One promising alternative is a parking tax that would parallel the effect of tolls by making it very expensive for a commuter to bring an automobile into the central city for the day. The ideal base of the tax would be daytime parking fees at commercial lots. These would be supplemented by higher parking meter fees for on-street parking and taxes related to the number of free spaces provided business establishments. Higher parking-meter rates should be imposed mainly in the central city; fringe parking

near mass-transit terminals should be tax-free. Because it is the parking of cars involved in rush-hour traffic that should be taxed, there could be a small tax or no tax at all on short-time parking between rush hours.

All of these considerations argue strongly for local imposition of parking taxes. The local government can best identify congested areas and congested times and decide how much refinement to build into the system. The politics of local parking taxes is complex, and there is a fairly well organized automobile lobby. Downtown business interests look on parking taxes as favoring suburban shopping. Again, some federal influence might be brought to bear by introducing differentials in local grants under mass transit in favor of cities that introduce parking taxes. Brannon (1974) at 137.

762. DPED (1981) (vol. 2) at 39.

763. Noller (1978) at 127.

764. See Brannon (1974) at 139-140:

The disadvantage of relying on a tax on new cars as a way of getting at transportation energy use, of course, is that it completely ignores the possibility of inducing consumers to make less use of their present cars, which may also be high polluters. It also overlooks the possibility of cutting the use of new cars. Once he has purchased his car, the consumer will have paid the tax. And whether the tax was high or low, he will continue to find it economical to drive the car to work or around the block for a local errand.

765. Noller (1978) at 127.

766. Breyer (1982) at 272-273. Breyer noted that the federal Environmental Protection Agency is already experimenting with a similar system known as the "bubble": "Instead of a rule limiting the amount of emissions from each of a factory's smokestacks, the EPA places an imaginary bubble over the factory in the form of a rule stating the total amount of pollution the factory can emit, leaving it to the owner to decide how much pollutant each stack will emit.

The owner will curtail emissions more from those stacks where curtailment is cheaper, and less from those where curtailment is more expensive; thus, the same level of curtailment is brought about more efficiently." Id.

767. Id. at 273-274.

768. Id. at 274.

769. See id. at 173.

770. See id. at 173-174.

771. Id. at 174-175 and n. 40; see also R. Coase, "The Problem of Social Cost," 3 J. Law & Econ. 1 (1960) and other sources cited in n. 40; G. Calabresi and A. Melamed, "Property Rules, Liability Rules, and Inalienability: One View of the Cathedral," 85 Harv. L. Rev. 1089 (1972).

772. Haw. Rev. Stat. §128D-6(a) (liability), provides as follows:

"(a) Notwithstanding any other provision or rule of law, and subject only to the defenses set forth in subsection (c):

- (1) The owner or operator or both of a facility or vessel;
- (2) Any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of;
- (3) Any person who by contract, agreement, or otherwise arranged for disposal or treatment, or arranged with a transporter for transport for disposal or treatment, of hazardous substances owned or possessed by such person, by any other party or entity, at any facility or on any vessel owned or operated by another party or entity and containing such hazardous substances; and
- (4) Any person who accepts or accepted any hazardous substances for transport to disposal or treatment facilities or sites selected by such person, from which there is

a release, or a threatened release, which causes the incurrence of response costs of a hazardous substance;

shall be strictly liable for (A) all costs of removal or remedial actions incurred by the State or any other person; to the extent such costs and actions are consistent with this chapter, the state contingency plan, and any other state rules; (B) damages for injury to, destruction of, or loss of natural resources, including the reasonable costs of assessing such injury, destruction, or loss resulting from such release; and (C) the costs of any health assessment or health effects study carried out consistent with this chapter, the state contingency plan, or any other state rules. "

773. Haw. Rev. Stat. §128D-1 defines "hazardous substance" and "oil" in relevant part as follows:

"Hazardous substance" includes any substance designated pursuant to section 311(b)(2)(A) of the Clean Water Act; any element, compound, mixture, solution, or substance designated pursuant to section 102 of CERCLA; any hazardous waste having the characteristics identified under or listed pursuant to §3001 of the Solid Waste Disposal Act; any toxic pollutant listed under section 307(a) of the Clean Water Act; any hazardous air pollutant listed under section 112 of the Clean Air Act, as amended (42 U. S. C. §§7401-7626); any imminently hazardous chemical substance or mixture regulated under section 7 of the Toxic Substances Control Act, as amended (15 U. S. C. §§2601-2671), oil, trichloropropane, and any other substance or pollutant or contaminant designated by rules adopted pursuant to this chapter. \* \* \*"  
(emphasis added).

"Oil" means oil of any kind or in any form, including, but not limited to, petroleum, fuel oil, sludge, oil refuse, oil mixed with wastes, crude oil or any fraction or residue. "

774. Breyer (1982) at 176.

775. Another possible area of deregulation is that of motor vehicle repairs (Haw. Rev. Stat. chapter 437B). That

chapter, it may be argued, places additional restrictions on the provision of automotive services. (House Resolution No.

174, H. D. 2, seeks to protect the interests of Hawaii's gasoline consumers in part "by ensuring the ... [a]vailability of automotive services...".) The Auditor's 1994 sunset review of that chapter recommended that while motor vehicle repair dealers should continue to be licensed, the regulation of individual mechanics was unwarranted. Hawaii and Michigan are the only states that currently license mechanics. See Hawaii State Auditor, Sunset Evaluation Update: Regulation of Motor Vehicle Repairs, Report No. 94-11 (Honolulu: Sept. 1994); see *id.* at 21-51 for proposed legislation.

776. Breyer (1982) gave the following general synopsis of the objectives of antitrust laws:

Although antitrust laws are extremely complex in their application, their essence and objectives can be described very simply. Essentially, the antitrust laws' broadly phrased prohibitions forbid agreements "in restraint of trade," "attempts to monopolize," "monopolization," and mergers that may "lessen competition substantially." The first two prohibitions police anticompetitive market conduct--agreements among firms or actions of individual firms that may prevent or inhibit competition in a particular market. The third and fourth prohibitions are aimed at anticompetitive market structures, in which one firm or a handful of firms, instead of many competing firms, supply an industry's entire output. The law against monopolization allows the courts to restore competition where there is an existing monopoly--say, by breaking apart a firm with monopoly power into several smaller competing firms, thereby restoring competition. The merger law seeks to prevent a presently competitive marketplace from becoming uncompetitive in the future through mergers that reduce the number of competitors and increase concentration within the marketplace.

The basic principle used in applying these prohibitions is the "rule of reason." Essentially, the courts have realized that some agreements or conduct that injure competition or restrain trade may also be commercially necessary or desirable. A

partnership agreement restrains trade between the partners but allows them to compete more effectively against others. Similarly, a firm may obtain a monopoly by selling a better product. Should it be discouraged from doing so? Mergers that increase concentration may also allow firms to produce more efficiently. The "rule of reason" allows the courts to weigh the anticompetitive harms of the practice under attack against the procompetitive justifications, condemning the practice only if, on balance, it produces significant injury. Breyer (1982) at 157 (footnotes omitted; emphasis in original).

777. See E. Thomas Sullivan and Jeffrey L. Harrison, *Understanding Antitrust and its Economic Implications*, Legal Text Series, 2d ed. (New York, NY: Matthew Bender, 1994) at 1; see also Herbert Hovenkamp, *Federal Antitrust Policy: The Law of Competition and its Practice* (St. Paul: West Publishing Co., 1994) at 2-3 (footnote omitted):

Market economies are dedicated to the principle that in the first instance people are responsible for their own welfare. Further, they are best off if they can make voluntary exchanges of goods and services in competitive markets. If all exchanges are voluntary, each person will continue to exchange goods and services until he can make himself no better off by an exchange that is voluntary for both parties to the transaction. If all exchanges occur at competitive prices, society as a whole is wealthier than if some occur at a higher or lower price. An important goal of antitrust law--arguably its only goal--is to ensure that markets are competitive.

778. Breyer (1982) at 158 (footnote omitted). While antitrust policy generally allows activities that increase a firm's productive efficiency (unless the activities also increase the firm's market power), however, "a firm does not generally violate the antitrust laws simply by being inefficient. For example, although vertical integration may reduce a firm's costs and permit it to produce and deliver a product at a lower price, failure to integrate is not illegal under the antitrust laws. The market itself disciplines inefficient firms." Hovenkamp (1994) at 74.
779. President's Commission (1980) at 18.

780. See, e.g., *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962); see also *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 767 n. 14 (1984); *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977); *Oahu Gas Service, Inc. v. Pacific Resources, Inc.*, 838 F.2d 360, 370 (9th Cir. 1988), cert. denied, 488 U.S. 870 (1988).
781. See, e.g., Owen and Braeutigam (1978) at 32: "[M]uch antitrust policy historically has protected competitors, not competition."
782. See John J. Flynn and James F. Ponsoldt, "Legal Reasoning and the Jurisprudence of Vertical Restraints: The Limitations of Neoclassical Economic Analysis in the Resolution of Antitrust Disputes," 62 N.Y.U. L. Rev. 1125, 1126 n. 4 (Nov. 1987): "One of the more popular cliches is that the antitrust laws protect competition, not competitors.... The cliché implicitly asserts that one can have competition without competitors, contains no definition of 'competition,' and is frequently used to deny the congressionally defined goals of antitrust policy in favor of the narrow goals assumed by the neoclassical model." See also John J. Flynn, "The 'Is' and 'Ought' of Vertical Restraints After *Monsanto Co. v. Spray-Rite Service Corp.*," 71 Cornell L. Rev. 1095, 1100 (Sept. 1986).
783. See, e.g., James F. Ponsoldt, "The Enrichment of Sellers as a Justification for Vertical Restraints: A Response to Chicago's Swiftian Modest Proposal", 62 N.Y.U. L. Rev. 1166, 1166-1167 (Nov. 1987) (emphasis in original; footnotes omitted):

In thinking about the intent of the framers of the antitrust laws with respect to vertical restraint agreements, ... I was inspired by two recent concrete, anecdotal events. The first event was the passage of a bill by the Georgia legislature that would have absolutely prohibited vertically integrated oil companies from opening retail gas stations. [Georgia S. Bill No. 177 (1987)] The Georgia legislature acted primarily in response to the urging of a retail dealers' association which cited allegedly coercive, unpoliced vertical conduct by suppliers, allegedly designed to achieve vertical integration.

The second event was the reaction of many of my foreign LL.M. students during an antitrust seminar

devoted to recent lower court developments. In discussing recent vertical restraint cases, students were particularly interested in a recent Ninth Circuit decision in which the court blithely, and without citing any Supreme Court authority, announced that vertical price fixing was not per se illegal and was not unreasonable unless it could be or it was proven to have an anticompetitive effect throughout a defined product and geographic market. [49er Chevrolet, Inc. v. General Motors Corp., 803 F.2d 1463 (9th Cir. 1986)] My foreign students reacted with unusually open cynicism, claiming that antitrust law specifically, and the ability of democratic government to regulate capital in general, were illusory at best, and perhaps fraudulent.

The inferences I draw from these two anecdotes are:

1. Assuming a majoritarian political process truly prevails, legislatures will, as they have throughout history, impose more intrusive, less efficient forms of regulation if traditional antitrust policing does not occur or is unsuccessful; and

2. Those who rely primarily upon the alleged efficiency goals of antitrust--even if their reliance is justified in particular cases--ignore history and political science to our long-term disadvantage. Moreover, an overly permissive attitude toward facially anticompetitive business conduct plays into the hands of either industrial policy proponents or critical legal studies adherents here and abroad, and will undermine our free market.

The Georgia bill referred to in the text ("Gasoline Marketing Retail Sales: Prohibitions") passed both houses of the Georgia Legislature but was vetoed by Georgia's Governor on March 20, 1987. *Id.* at 1166, n. 3; see also Michael Hinkelman, "Big Money Riding on Oil Bill: Georgia Oil Jobbers Push Divorcement Legislation," *Atlanta Business Chronicle*, vol. 13, no. 37, (Feb. 11, 1991) at 1A.

784. See Robert H. Bork, *The Antitrust Paradox: A Policy at War with Itself* (New York: Basic Books, Inc., 1978) at 7 (footnote omitted):

Because antitrust's basic premises are mutually incompatible, and because some of them are incorrect,

the law has been producing increasingly bizarre results. Certain of its doctrines preserve competition, while others suppress it, resulting in a policy at war with itself. During the past twenty years or so, the protectionist, anticompetitive strains in the law has undergone a spectacular acceleration, bringing to pass ... the "crisis in antitrust." ...

A consumer-oriented law must employ basic economic theory to judge which market structures and practices are harmful and which beneficial. Modern antitrust has performed this task very poorly. ... [P]erhaps the core of the difficulty is that the courts, and particularly the Supreme Court, have failed to understand and give proper weight to the crucial concept of business efficiency. Since productive efficiency is one of the two opposing forces that determine the degree of consumer well-being (the other being resource misallocation due to monopoly power), this failure has skewed legal doctrine disastrously. ...

Others argue that there is no "antitrust paradox": "The paradox ... arises because analysts start with the premise that the antitrust laws are 'consumer-oriented' and that their basic goal is to promote economic efficiency.... [I]nstead ... antitrust, as with virtually all government activity, is designed to benefit special-interest groups rather than to promote the 'public interest.'" Bruce L. Benson and M. L. Greenhut, "Special Interests, Bureaucrats, and Antitrust: An Explanation of the Antitrust Paradox," in *Antitrust and Regulation*, ed. Ronald E. Grieson (Lexington, MA: Lexington Books, 1986) at 54.

785. Generally, a social cost may be defined as a net loss that society suffers as a result of a particular transaction, while a social benefit is a net gain. Hovenkamp (1994) at 17; see also Roger D. Blair and David L. Kaserman, *Law and Economics of Vertical Integration and Control* (New York: Academic Press, 1983) at 192.

786. Breyer (1982) at 173.

787. Don E. Waldman, *Antitrust Action and Market Structure*, (Lexington, MA: Lexington Books, 1978) at 15-17:

In the United States, antitrust policy is the primary method used by the government to maintain competition. The broad objective is to inhibit undesirable business conduct and maintain market structures that are conducive to efficient economic performance. While judges, lawyers, and economists might all agree with these basic objectives, their individual objectives may be very different.

Government lawyers often consider victory the major objective. This is understandable, since a lawyer's reputation is built on victories not on positive economic gains to society. If a lawyer wishes to move up the ladder at the Justice Department, it is probably much more important to win cases than to obtain major economic gains. Government lawyers are therefore likely to act quickly in response to a relatively minor complaint from a competitor, since the complaining firm will supply much of the evidence needed for a conviction, but are unlikely to respond at all to a major covert oligopolistic price-fixing scheme, since evidence is difficult to obtain and a conviction is questionable at best. ...

Judges interpret the laws and actually determine the effectiveness of antitrust policy, yet few are schooled in economics. Their decisions are based on their interpretations of the laws, not on the basis of creating a more competitive economy. Historically, judges have interpreted the laws more as a challenge to certain business practices than as a means of directly altering poor market structures or performance. ... [T]he courts have generally ruled that identical prices which result from the natural forces of oligopoly are legal, despite the fact that identical oligopolistic pricing can be more harmful than overt price-fixing agreements in fairly competitive industries. Furthermore, judges have shown a great reluctance to directly change market structures through the use of divestiture, dissolution, or divorcement.

Where does this leave the economist? His

objective is to improve efficiency. The economist is primarily concerned with market power that results in negative efficiency effects. While judges and lawyers are very concerned about the method used to obtain power, the economist's objective is to eliminate the negative effects of power, regardless of the method used to obtain that power. ... Any time the expected welfare gains are greater than the expected costs of litigation, the economist will favor antitrust action.

Since lawyers, judges, and economists have different objectives, conflicts often arise. Lawyers will hesitate to initiate a broad attack on an oligopolistic industry because of a low probability of winning, and an even lower probability of winning during their stay with the government. Economists, however, often encourage challenging oligopolists because the potential efficiency gains are great. ...

Waldman also argued that antitrust actions may affect market structure indirectly by reducing traditional or artificial entry barriers or the threat of retaliation. See *id.* at 21-29; see also Bork (1978) at 413-417.

788. See Hovenkamp (1994) at 158-159 (emphasis in original):

While we can generalize about the types of welfare losses that result from ... cooperative and non-cooperative oligopoly, measuring the social cost in a particular instance is virtually impossible, and ... there have been no complete attempts to do so.

One important caveat even increases our uncertainty. When the policy maker measures social cost, she must always ask "relative to what?" The goal of the antitrust policy maker is generally to find the solution that produces the largest net social gains.... [T]he social cost of certain kinds of remedies, such as the forced breakup of large firms to achieve more competition, may be larger than the social cost of simply leaving the oligopoly industry as it lies.

Hovenkamp further analyzed this issue in terms of the concept of "minimum efficient scale" (MES), that is, the smallest production unit capable of achieving all relevant economies of scale. See generally *id.* at 27-31. In

general, he argued that breaking up oligopolies by dividing the market into smaller firms would deprive all or most of MES, leading to both a loss in productive efficiency and the need for continuing intervention by the State:

One of the most controversial questions in antitrust policy is how courts and enforcers should deal with the problem of poor economic performance in concentrated markets when there is no evidence of express collusion. . . .

Even if courts could administer the restructuring of an entire industry, however, it is by no means clear that consumers would benefit. Absent unusual deterrents to competitive entry, markets are generally concentrated because operation at minimum efficient scale (MES) requires a firm with a relatively large share of the market. For example, if MES in the widget industry requires an output level equal to 30% of market demand at the competitive price, the market in equilibrium is likely to have three or fewer firms. Smaller firms would either combine by merger, increase their own market share by driving other firms out of business, or else go out of business themselves. A program of combatting oligopoly by breaking the market into a dozen firms would deprive all or most of MES, and the costs of the loss in productive efficiency might well exceed the social loss caused by oligopoly performance. Indeed, the fact that the firms are inefficiently small would likely lead to a further round of cartels, bankruptcies or mergers until the industry once again hit an equilibrium in which the firms operated efficiently. Maintaining such an industry at inefficient output levels would require the ongoing, intervening hand of the State. . . .

The problem of scale economies and concentrated markets leaves the antitrust policy maker in a quandary. An oligopoly is an oligopoly, whether or not the high concentration results from economies of scale. Indeed, an oligopoly market in which MES is very high is likely to perform more poorly than an oligopoly in which MES is low. The firms in the latter oligopoly have to worry about new entry. When they measure price and output, they must consider not only how the other firms in the market will respond, but also the possibility that new equally efficient

firms will enter if the price rises too much. By contrast, if there are three firms in a market in which MES exceeds a 30% market share, the firms have less reason to fear new entry. Any new entrant whose market share is less than 30% will have a cost disadvantage. The greater that disadvantage, the more room there will be for supracompetitive pricing by the firms already in the market.

So the consequences of severe structural change in most industries are difficult to predict, and the litigation process is certainly not well designed to make such predictions. Break-up of oligopoly firms will certainly yield an industry with more firms, and they will likely price their output closer to their costs, but their costs could be substantially higher. Ex ante, it may be difficult to say whether the structural change will yield a price increase or a price decrease. Once we include the large administrative costs of predicting when such relief would be appropriate, and the costs of administering such relief, it is doubtful that the result of structural reorganization of oligopoly industries would be efficient.

There are some reasons for believing that the social costs of oligopoly behavior, at least of the noncooperative kind, are small compared to the cost of denying firms the chance to achieve their most efficient rate of output. If that is the case, consumers may be best off if firms are permitted to attain minimum optimal scale, even at the expense of some high concentration, with the antitrust laws used to make both non-cooperative and cooperative price coordination as difficult as possible. *Id.* at 163-165 (emphasis in original).

789. Alan Stone, "Economic Regulation, the Free Market, and Public Ownership," in *Economic Regulatory Policies*, ed. James E. Anderson (Lexington, MA: Lexington Books, 1976) at 198 (footnotes omitted):

The best evidence to date shows that "most if not all of the positive correlations between profit rates and concentration uncovered by some earlier studies can be attributed to variations in the size of firms, not the degree to which markets are concentrated."

Thus, the higher profit rates of high concentration industries are due to the greater proportion of very large firms in such industries. These firms tend to produce more efficiently and at lower average cost than their smaller competitors. Large firms benefit from plant economies of scale, capital raising economies, procurement economies, etc., while multi-plant large firms benefit from economies of coordination, research, and distribution. Thus, a move to deconcentrate industries by breaking up large firms is very likely to increase, not decrease, costs and prices.

This conclusion tends to be confirmed by a study of price increases over the 1947-1971 period which shows that the prices of products produced by large oligopolistic corporations have displayed a generally slower rate of increase than have "market determined" prices. A deconcentration policy might very likely have the effect of raising costs and prices, advancing the rate of inflation and retarding economic development by sharply reducing profits which could be employed for expansion, cost reduction or innovation. Nor is there convincing evidence that any compensating public benefits would accrue from such a policy.

Bork (1978) also maintained that it is false to assume that oligopolistic structures lead naturally to monopolistic behavior and that dissolution of oligopolies produces results that are favorable to consumers; in reality, dissolution would result in a loss of social welfare:

[I]t looks very much as though there is a high probability, amounting in fact to a virtual certainty, that dissolving any oligopolistic firm that grew to its present size would inflict a serious welfare loss. Oligopolistic structures probably do not lead to significant restrictions of output; firm sizes reflect comparative efficiencies; and firms of equal or greater efficiency are free to enter or to grow anytime restriction of output occurs. Bork (1978) at 196; see also *id.* at 173-197.

790. Breyer (1982) at 160-161:

In the area of monopoly and oligopoly some might argue that there should be more regulation and less

antitrust. Although the antitrust laws are reasonably effective in dealing with anticompetitive conduct and in preventing mergers, they are less effective in correcting anticompetitive market structures--monopolies and oligopolies. Monopoly cases, for example, typically take years to resolve. The parties argue whether the defendant in fact possesses monopoly power and whether he has achieved that power through illegitimate exclusionary conduct. Enormous amounts of documentary and economic evidence are produced, and the cases remain in the courts for a decade or more. Moreover, the law condemns only monopolies that rest upon exclusionary conduct. It is feared that to condemn all (nonnatural) monopolies might discourage firms from competing, because the winner of the competitive game would then lose the prize. Thus, the "honest" monopolist may continue to exert economic power in the marketplace. Finally, and most important, the law does not attack existing oligopolies--industries in which a handful of firms dominate the market, and which together may exert as much power as a monopolist. Yet if the law were interpreted to attack oligopolists, it might severely interfere with the incentive of firms to outcompete each other, or it would risk being ineffective. For these reasons, it has occasionally been proposed to regulate the prices of ordinary monopolies and oligopolies. Although the choice--regulation or antitrust--in the area is a close one, the problems of regulation have been thought sufficiently great to warrant reliance upon antitrust instead.

791. Sullivan and Harrison (1994) at 53, 55. In particular, they note that the intersection of regulation and antitrust law raise questions regarding the applicability of each:

Not all formal regulation displaces competition. Regulation and competition sometimes co-exist. Some regulated industries face scrutiny under both agency review and traditional antitrust. Numerous legal and policy issues may be in conflict when antitrust and regulation interact.

A frequent inquiry is: When is antitrust displaced by regulation? Explicit and implicit exemptions from antitrust coverage occur. The "pervasiveness" of the regulatory scheme may dictate

whether antitrust enforcement has any role to play. Exemptions can be absolute or qualified. If only qualified, the industry may be subject to both "regimes of government control." This may raise tensions between antitrust enforcement and economic regulation.

Id. at 55 (footnotes omitted). In discussing matches of regulatory ends and means, Breyer suggested that when the justification for regulation is unequal bargaining power, as may be asserted by small businesses, one alternative to regulation would be exemption from antitrust laws. See Breyer (1982) at 193 ("One might associate ... unequal bargaining power with exemptions from the antitrust laws..."). One example of an explicit antitrust exemption is Hawaii's motor carrier law. See Haw. Rev. Stat. §271-35(h); see also Summer LaCroix, Walter Miklius, and James Mak, "The New Standards of Unfair Competition: An Economic Analysis of the Du Pont v. FTC Litigation," 9 U. Haw. L. Rev. 457, 478 (Fall 1987).

792. Breyer (1982) at 161.

793. William R. Hughes and George R. Hall, "Substituting Competition for Regulation," 11 Energy L. J. 243, 243 (1990) (footnote omitted); see also Raab (1995) at 1, 4.

794. Id. at 245-246:

In recent years there has been a movement to introduce the process of competition into regulated industries to replace the process of conventional regulation in order to achieve competitive results. There has also been a movement in some areas to integrate competitive considerations explicitly with the regulatory process. ...

In an unregulated market or a deregulated market, prices are determined by the play of supply and demand forces unconstrained by governmental intervention. The sellers charge what the competitive process will allow. If competition is effective, in the long run, the typical firm should recover its investment and a fair return thereon. However, return is not guaranteed. A firm may, as a result of skill or good luck, earn a substantial amount on the original cost of the assets involved. Conversely, because of

incorrect decisions or poor fortune, the firm may fail to recover its investment. In an industry regulated by a conventional rate-of-return type of process, prices are based on the regulated firm's costs. A rate base of prudent investments is established and the rate of return necessary to compensate investors is determined and applied to this rate base. This rate base is added to the depreciation and other prudent expenses of the regulated firm to determine the revenue requirement. Rates or prices are designed to cover this cost of service.

Light-handed regulation is a blend of these two basic price-determining processes. Regulators retain jurisdiction over the regulated firm and may set limits or constraints, such as "price-caps," "benchmarks," and so forth; there may be oversight of affiliate relationships, price discrimination, customer complaints or other issues. However, subject to compliance with any ceilings or other constraints, under light-handed regulation, the firm is free to set such prices as will be permitted by competitive supply and demand forces.

795. House Resolution No. 174, H. D. 2 (1995), p. 1, lines 5-7.

796. Flynn (1986) at 1099-1100 (footnotes omitted).

797. Hovenkamp (1994) at 61. Productive efficiency refers to the ratio of a firm's output to its inputs, while allocative efficiency refers to the welfare of society as a whole. *Id.* at 74.

798. Hovenkamp (1994) at 71.

799. Flynn (1986) at 1139.

800. Hovenkamp (1994) at 71-72 (footnotes omitted).

801. *Id.* at 72. Before attempting to balance these competing values, however, state policymakers must be prepared with an understanding of the economics involved:

Before someone can "balance" competing values, however, he must have a fairly good idea about what is being thrown into the scales. This means that the multi-valued policy maker, who believes that antitrust

should consider small business welfare as well as economic efficiency, must have a good basic knowledge of prices, markets and industrial organization. There is no basis for the view that the adoption of some "competing" noneconomic policy for antitrust, such as the protection of small business welfare, permits one to do antitrust without knowing economics. Even the multi-valued policy maker needs economics to help her estimate the relative costs of protecting certain noneconomic values and determine whether society is willing to pay the price. Presumably, it is not worth any price to protect small businesses. If that were the policy, even price fixing by small businesses would be legal. Id.

802. Richard A. Posner, *Antitrust Law: An Economic Perspective*, (Chicago: The University of Chicago Press, 1976) at 19 (emphasis in original):

The popular (or Populist) alternative to an antitrust policy designed to promote economic efficiency by limiting monopoly is a policy of restricting the freedom of action of large business firms in order to promote small business. ... The idea that there is some special virtue in small business compared to large is a persistent one. I am not prepared to argue that it has no merit whatever. I am, however, confident that antitrust enforcement is an inappropriate method of trying to promote the interests of small business as a whole. The best overall antitrust policy from the standpoint of small business is no antitrust policy, since monopoly, by driving a wedge between the prices and the costs of the larger firms in the market ..., enables the smaller firms in the market to survive even if the costs are higher than those of the large firms. The only kind of antitrust policy that would benefit small business would be one whose principal objective was to limit the attempts of large firms to underprice less efficient small firms by sharing their lower costs with consumers in the form of lower prices.

803. See, e.g., the Petroleum Marketing Practices Act (PMPA), 15 U. S. C. section 2801, et seq. Miklius and LaCroix (1993)

note that one of the most important effects of that Act were to restrict the ability of major oil companies to terminate

dealers; "[t]he net effect of the PMPA was ... to give the dealer more latitude to take actions that increase dealer profits at the expense of joint dealer-oil company profits. Since the Act increased the cost of franchising, it provided incentives for companies to use company-owned stores more frequently." Walter Miklius and Summer J. LaCroix, *Divorcement Legislation and the Impact on Gasoline Retailing in the United States and Hawaii* (Honolulu: University of Hawaii, Jan. 20, 1993) at 41-42. But see DOE (1984) at 95-97 (arguing that while the PMPA made the replacement of franchisees by company operations more difficult, there was sufficient flexibility written into the PMPA to allow franchisors to achieve most of their legitimate marketing goals within the franchise system): "It does not appear, therefore, that the PMPA significantly alters the incentives to expand through company operations versus lessee dealers. Nor does the PMPA make the contractual process so difficult that lessee dealers are viewed as an inherently less desirable alternative. The PMPA has not created incentives to eliminate lessee dealers through some form of anticompetitive conduct; nor has it created incentives sufficient to compel refiners to choose one form of distribution over another." *Id.* at 97.

804. Posner (1976) at 19-20; see also Richard Schmalensee, *The Control of Natural Monopolies* (Lexington, MA: Lexington Books, 1979) at 18.
805. Hovenkamp (1994) at 76.
806. *Id.* at 72.
807. 337 U.S. 293 (1949); see also *Texaco v. Hasbrouck*, 496 U.S. 543 (1990). In *Texaco v. Hasbrouck*, several independent dealers in the Spokane, Washington area brought suit against Texaco, alleging price discrimination under the Robinson-Patman Amendments to the Clayton Act. The Robinson-Patman Amendments were enacted in part because of the failure of the Clayton Act to deal with obstacles faced by small businesses, especially their inability to compete with the "expanding 'chain store menace'". See Richard Albert, "Recent Decisions: Trade Regulations--Clayton Act--Robinson-Patman Price Discrimination Act--Oil Company [*Texaco v. Hasbrouck*, 496 U.S. 543 (1990)]," 29 *Duq. L. Rev.* 803, at 810 (footnote omitted), 811, and 812 n. 77 (Summer 1991). The United States Supreme Court nevertheless held that "a price differential that accords due recognition and

reimbursement for actual functions performed does not trigger the presumption of an injury to competition, and therefore is legal under the Clayton Act." See *id.* at 803.

- 808. *Standard Stations*, 337 U.S. at 295.
- 809. *Id.* at 299; *Sullivan and Harrison* (1994) at 178.
- 810. *Standard Stations*, 337 U.S. at 314.
- 811. *Id.* at 305-306.
- 812. *Id.* at 306.
- 813. *Id.* at 311.
- 814. *Id.* at 311-312.
- 815. *Id.* at 320-321 (Douglas, J., dissenting). Justice Douglas further noted the following:

It is common knowledge that a host of filling stations in the country are locally owned and operated. Others are owned and operated by the big oil companies. This case involves directly only the former. It pertains to requirements contracts that the oil companies make with these independents. It is plain that a filling-station owner who is tied to an oil company for his supply of products is not an available customer for the products of other suppliers. The same is true of a filling-station owner who purchases his inventory a year in advance. His demand is withdrawn from the market for the duration of the contract in the one case and for a year in the other. The result in each case is to lessen competition if the standard is day-to-day purchases. Whether it is a substantial lessening of competition within the meaning of the Anti-Trust Laws is a question of degree and may vary from industry to industry.

The Court answers the question for the oil industry by a formula which under our decisions promises to wipe out large segments of independent filling-station operators. The method of doing business under requirements contracts at least keep the independents alive. They survive as small

business units. The situation is not ideal from either their point of view or that of the nation. But the alternative which the Court offers is far worse from the point of view of both.

The elimination of these requirements contracts sets the stage for Standard and the other oil companies to build service-station empires of their own. The opinion of the Court does more than set the stage for that development. It is an advisory opinion as well, stating to the oil companies how they can with impunity build their empires. The formula suggested by the Court is either the use of the "agency" device, which in practical effect means control of filling stations by the oil companies ... or the outright acquisition of them by subsidiary corporations or otherwise. ... Under the approved judicial doctrine either of those devices means increasing the monopoly of the oil companies over the retail field. ... *Id.* at 319-320 (footnote and citations omitted).

816. See Hovenkamp (1994) at 58 (footnotes omitted):

Concern for concentration, entry barriers, and the linkage between structure and oligopoly dominated the post-war period. At the same time, American enforcement agencies became highly concerned--in fact, almost paranoid--about vertical practices that were thought to increase entry barriers, facilitate collusion, or enable firms to leverage additional monopoly profits out of secondary markets. The result was continued aggressive enforcement of the laws against resale price maintenance, new attention to vertical nonprice restraints, and numerous challenges to tying arrangements, exclusive dealing and vertical mergers.

817. *Id.* at 59 (footnotes omitted).

818. William S. Comanor, "Vertical Arrangements and Antitrust Analysis," 62 N. Y. U. L. Rev. 1153, 1153 (Nov. 1987).

819. Hovenkamp (1994) at 38 (footnotes omitted):

One can generalize that avoidable transaction costs are a substantial source of inefficiency in the

economy. Indeed, the business firm itself can be viewed as nothing more than a device for reducing the transaction costs of engaging in business. Reduction or avoidance of transaction costs explains many phenomena that have been made subject to antitrust scrutiny. Among these are mergers, vertical price and nonprice transactions, tying arrangements and exclusive dealing.

Importantly for antitrust analysis, many practices that look suspicious at first appear more benign when transaction costs are considered. Vertical mergers and numerous forms of vertical contracting are a good example. For many years antitrust policy makers tended to look at these practices with great suspicion, viewing them principally as mechanisms for permitting firms to enhance their market power, or perhaps to "leverage" a second monopoly in another market. But in most cases these practices are nothing other than devices by which firms reduce the costs of doing business, by making transactions less risky, less costly, or eliminating them altogether.

820. Hovenkamp (1994) at 388.
821. For example, question number (6) of the Resolution requests the views of survey participants regarding "[t]he effects of encouraging the establishment of a public bulk gasoline terminal facility, which could make the importation of gasoline cost effective and could also lead to a reduction in wholesale gasoline prices..." House Resolution No. 174, H. D. 2, at 3, lines 20-24 (emphasis added). This statement arguably presumes the favorable outcome of the research request.
822. See supra text accompanying notes 92 and 93; see also text accompanying note 23 in chapter 6.
823. See text accompanying note 29 in chapter 3.
824. See text accompanying notes 37 to 39 in chapter 14.
825. Yamaguchi and Isaak (1990) at 80 (emphasis in original); see also Haw. House Report (1974) at 61: "[T]here is an alternative solution to the energy crisis other than [g]overnment regulation; and that solution is not to

regulate the oil industry." (Emphasis in original).

826. See Yamaguchi and Isaak (1990) at 76-82.
827. The United States has already exhausted two-thirds of all the domestic oil and gas that it will ever produce. John Gever, et al., *Beyond Oil: The Threat to Food and Fuel in the Coming Decades* (Cambridge, MA: Ballinger Publishing Co., 1986) at 219.
828. Rosenbaum (1981) at 195.
829. *Id.*
830. Gever et al. (1986) at 220, 221.
831. *Id.* at 221.
832. Stone (1982) at 56.
833. *Id.* at 56-58.
834. Breyer (1982) at 184-185 (emphasis in original).
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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Appendix A

H. R. NO. 174  
H. D. 2

HOUSE RESOLUTION

REQUESTING THE LEGISLATIVE REFERENCE BUREAU TO CONDUCT A STUDY TO

OBTAIN USEFUL DATA AND VIEWS OF PARTICIPANTS IN THE  
PETROLEUM INDUSTRY IN HAWAII TO ASSIST THE LEGISLATURE IN  
FORMULATING POLICIES THAT PROTECT THE SHORT-TERM AND LONG-  
TERM INTERESTS OF HAWAII'S GASOLINE CONSUMERS.

WHEREAS, the Legislature finds that the distribution of  
motor vehicle fuel vitally affects the public health, safety,  
and welfare as well as the general welfare of the State; and

WHEREAS, the continued viability of independent retailers and distributors is essential to the preservation of a fair and competitive motor vehicle fuel market; and

WHEREAS, unfair wholesale pricing policies threaten the viability of independent retailers and distributors as competitors essential to a healthy motor vehicle fuel market; and

WHEREAS, in an attempt to develop solutions with respect to the competitiveness of selling motor vehicle fuel in Hawaii, Act 295, Session Laws of Hawaii (SLH) 1991, was enacted; and

WHEREAS, Act 295, SLH 1991, imposed a moratorium that prohibited refiners and distributors of petroleum products from opening any new direct operated service stations or retail motor fuel outlets; and

WHEREAS, Act 295, SLH 1991, also required the Attorney General to gather and assess authoritative reports on the subject of the impact on motor fuel prices to consumers of a prohibition (also known as divorcement) on direct retailing of motor fuel by refiners and distributors in competition with franchised and independent service stations; and

WHEREAS, in an attempt to further address and promote the competitiveness of selling motor vehicle fuel, Act 329, Session Laws of Hawaii (SLH) 1993, was enacted to extend the moratorium two additional years; and

(Page 2)

WHEREAS, the reason for the extension, as stated by the Conference Committee Report to S. B. No. 124, Regular Session of 1993 (which was enacted as Act 329, SLH 1993), was that "the effects of manufacturers and jobbers operating retail service stations is unclear, and this extension would allow the Attorney General to complete the Attorney General's investigation on the petroleum industry's practices"; and

WHEREAS, although the Attorney General submitted reports in 1993 and 1994 to the Legislature regarding gasoline prices, these reports are not broad enough to provide the Legislature with comprehensive data necessary to formulate sound policies that protect the short-term and long-term interests of Hawaii's gasoline consumers; now, therefore,

BE IT RESOLVED by the House of Representatives of the Eighteenth Legislature of the State of Hawaii, Regular Session of 1995, that the Legislative Reference Bureau is requested to conduct a study to report relevant data from and the views of participants in the petroleum industry in Hawaii. The data and views are intended to provide the Legislature with useful information and data that the Legislature may consider in formulating policies that protect the short-term and long-term interests of Hawaii's gasoline consumers by ensuring the:

- (1) Lowest possible gasoline prices;
- (2) Availability of automotive services; and
- (3) Convenient access to retail gasoline outlets;

and

BE IT FURTHER RESOLVED that the report shall consist of information obtained by the Legislative Reference Bureau from the Hawaii Retail Gasoline Dealers Association (representing lessee and open dealers), Chevron USA and BHP Hawaii Inc., the Hawaii Petroleum Marketers Association, the Western States Petroleum Association, the attorney general, the Department of Commerce and Consumer Affairs, the Department of Business, Economic Development, and Tourism, and the Public Utilities Commission (provided that any person or entity consulted by the Bureau may submit data, responses, arguments, or other statements prepared by appropriate experts or consultants hired by those individuals or entities) with respect to each of the following:

- (1) The effects of prohibiting franchise agreements from requiring franchisees to purchase all of their gasoline from the franchisor or restraining franchisees from  
(Page3) dealing with the franchisors' competitors;
- (2) The effects of limiting the amount of gasoline franchisors require franchisees to purchase from the franchisor;
- (3) The effects of prohibiting gasoline allotment under exchange agreements on the basis of historical market share;

- (4) Measures to ensure the lowest retail gasoline prices for the consumer in the short and long-term;
- (5) Whether price inversion has occurred or is currently occurring in the distribution of gasoline in Hawaii;
- (6) The effects of encouraging the establishment of a public bulk gasoline terminal facility, which could make the importation of gasoline cost effective and could also lead to a reduction in wholesale gasoline prices;
- (7) The effects of establishing a petroleum regulatory commission having general supervision over all petroleum manufacturers and jobbers in the State with the authority to:
  - (A) Authorize new retail service stations and determine whether they may be operated by a petroleum manufacturer or jobber;
  - (B) Restrict price increases when prices rise above a certain percentage over a benchmark market, as determined by rules adopted by the commission under chapter 91;
  - (C) Decide when a petroleum manufacturer or jobber may convert a retail service station from one operated by a gasoline dealer to one operated by a petroleum manufacturer or jobber, and vice versa;
  - (D) Decide when a petroleum refiner may close a retail service station, to prevent communities from being underserved;
  - (E) Review management decisions of petroleum manufacturers and jobbers regarding

(Page 4)

infrastructure, strategic planning, and other areas to ensure market compliance; and

- (F) Review profits for reasonableness in light of the need for petroleum utilities to promote a safe workplace and ensure environmental protection;

- (8) The effects of regulating retail gasoline prices of company-operated retail service stations;
- (9) The effects of requiring manufacturers, terminal operators, and jobbers of petroleum products to file with the State, a tariff listing all prices at which the manufacturer or jobber offers goods or services for sale or lease;
- (10) The effects of prohibiting any terminal operator having excess capacity from refusing to provide terminalling services to any person at the prices published in the tariff that the terminal operator filed with the State;
- (11) The effects of prohibiting manufacturers of petroleum products not only from directly operating retail service stations, but also from franchising them or owning and leasing them to branded dealers (divestiture);
- (12) The effects of establishing a public petroleum products storage authority with power to import, store, and market petroleum products;
- (13) The effects of active enforcement of the Petroleum Industry Information Reporting Act of 1991 and Act 291, Session Laws of Hawaii 1991 (codified as chapter 486I, Hawaii Revised Statutes);
- (14) Measures that could be initiated to reduce the cost of conducting business for independent dealers (i. e. , lease rent and environmental regulations);
- (15) The effects of the provision contained in section 486H-10(a), Hawaii Revised Statutes, that allows manufacturers and jobbers to open one company operated retail service station for each dealer operated service station owned by that manufacturer or jobber, up to a maximum of two company owned retail service stations;
- (16) Whether laws in other states prohibit or limit the number of retail service stations that may be opened or operated by wholesalers, producers, or refiners of petroleum products, or their subsidiaries; and
- (17) Whether or not the existing moratorium has resulted in

lower gasoline prices for consumers;  
and

BE IT FURTHER RESOLVED that the Legislative Reference Bureau is requested to submit the report to the Legislature no later than twenty days prior to the convening of the regular session of 1996. The Legislative Reference Bureau is requested to direct the various parties to submit all responses in a timely manner to ensure the ability of the Bureau to compile and print the report by the date requested; provided that while the Bureau may require portions of the responses to be submitted earlier, the Bureau is requested not to require the respondents to submit responses on all items prior to July 31, 1995; and

BE IT FURTHER RESOLVED that certified copies of this Resolution be transmitted to the Director of the Legislative Reference Bureau, the Attorney General, the Director of Commerce and Consumer Affairs, the Director of Business, Economic Development, and Tourism, the Public Utilities Commission, the Hawaii Retail Gasoline Dealers Association, Chevron USA, BHP Hawaii Inc., the Hawaii Petroleum Marketers Association, and the Western States Petroleum Association.

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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Appendix B

CONTACT PERSONS

Note: All telephone and fax numbers are in area code (808) unless otherwise specified.

State Government

Attorney General:

Ted Gamble Clause, Deputy Attorney General  
Department of the Attorney General  
Commerce and Economic Development Division  
425 Queen Street  
Honolulu, Hawaii 96813  
Phone: 586-1180  
Fax: 586-1205

Department of Business, Economic Development, and Tourism:

John Tantlinger, Ed. D., Energy Planner  
Energy Planning and Policy Group  
Department of Business, Economic Development, and Tourism  
700 Bishop Street, Suite 1900  
Honolulu, Hawaii 96813  
Phone: 587-3836  
Fax: 587-3839

Department of Commerce and Consumer Affairs:

Kathryn S. Matayoshi, Director  
Department of Commerce and Consumer Affairs  
P. O. Box 541  
Honolulu, Hawaii 96809  
Phone: 586-2850  
Fax: 586-2856

Public Utilities Commission:

Yukio Naito, Chairperson  
and  
Clay Nagao, Chief Counsel  
Public Utilities Commission  
465 South King Street, Room 103  
Honolulu, Hawaii 96813  
Phone: 586-2028  
Fax: 586-2066

Gasoline Dealers

Hawaii Automotive and Retail Gasoline Dealers Association:

Richard Botti, Executive Director  
Hawaii Automotive & Retail Gasoline Dealers Assn.  
677 Ala Moana Blvd., Suite 815  
Honolulu, Hawaii 96813  
Phone: 537-1105  
Fax: 599-2606

Alvin Makimoto  
Uptown Service - Maui  
Phone: 244-0869  
Fax: 244-5242

Ron Foss  
Ewa Beach Chevron  
Phone: 689-7996  
Fax: 689-5849

### Jobbers

#### Hawaii Petroleum Marketers Association:

Alec J. McBarnet, Jr., Vice President  
Maui Oil Company  
P. O. Box 66  
Kahului, Maui, Hawaii 96732-0002  
Phone: 871-6220  
Fax: 871-7411

Tom Malone, President  
Aloha Petroleum  
739 N. Nimitz Hwy.  
Honolulu, Hawaii 96817  
Phone: 521-3872  
Fax: 538-6165

Gaylene Nako, Administrative Coordinator  
Hawaii Petroleum Marketers Association  
P. O. Box 23057  
Honolulu, Hawaii 96823-3057  
Phone: 842-5416  
Fax: 845-4127

#### Aloha Petroleum

Tom Malone, President  
Sam Olson, Vice-President of Fuel Operations  
and  
Jennifer Aquino, Administrative Manager  
Aloha Petroleum  
739 N. Nimitz Hwy.  
Honolulu, Hawaii 96817  
Phone: 521-3872  
Fax: 538-6165

### Oil Companies

#### Western States Petroleum Association:

David Young, Public Affairs Manager

Chevron USA Products Co.  
1001 Bishop Street  
Pauahi Tower, Suite 1000  
Honolulu, Hawaii 96813  
Phone: 527-2700

Douglas Henderson  
Western States Petroleum Association  
505 North Brand Blvd., Suite 1400  
Glendale, CA 91203-1925

Chevron USA Products Company:

J. W. McElroy, Regional Manager  
and  
David Young, Public Affairs Manager  
Chevron USA Products Co.  
1001 Bishop Street  
Pauahi Tower, Suite 1000  
Honolulu, Hawaii 96813  
Phone: 527-2700

BHP Hawaii Inc.:

Susan Kusunoki, Manager State Governmental Activities  
and  
George Aoki, Assistant General Counsel  
BHP Hawaii Inc.  
P. O. Box 3379  
Honolulu, Hawaii 96842  
Phone: 547-3111  
Fax: 547-3145

Shell Oil Products Co.

R. A. Broderick, Western Region Business Manager  
and  
Charles W. Corddry III, c/o Legal Department  
Shell Oil Products Co.  
One Shell Plaza  
P. O. Box 2463  
Houston, Texas 77252-2463  
Phone: (713) 241-1752

REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Appendix C

SURVEY QUESTIONNAIRE

This questionnaire is being distributed to all participants specified in House Resolution No. 174, H. D. 2, which requests the Legislative Reference Bureau to provide the Legislature with useful information and data from participants in the petroleum industry in Hawaii that the Legislature may consider in formulating policies that protect the short- and long-term interests of Hawaii's gasoline consumers. Specifically, the Legislature, under the terms of the resolution, seeks to protect these consumers by ensuring the: (1) lowest possible gasoline prices; (2) availability of automotive services; and (3) convenient access to retail gasoline outlets. Please bear these objectives in mind when responding to this questionnaire.

As specified below, we are requesting that you complete this questionnaire in three parts in order to expedite the completion of the required report. Part I should be completed by July 1, 1995; part II should be completed by August 1, 1995; and part III should be completed by September 1, 1995. Specifically, we would appreciate receiving the following:

(A) The name of your department, company, or other entity, address, and the names, titles, and phone numbers of the persons responsible for overseeing the completion of this questionnaire.

(B) The resolution states that "any person or entity consulted by the Bureau may submit data, responses, arguments, or other statements prepared by appropriate experts or consultants hired by those individuals or entities ..." (page 2, lines 42 to 45). If any information or data has been supplied by any such expert or consultant, please supply the names, titles, departments, companies, or other entities, addresses, and phone numbers of those persons.

(C) Views, data, and other relevant information on each of the topics specified in items (1) to (15) and (17) on pages 3 to 5 of the resolution, as set forth below. Please limit your comments specifically to the items identified while bearing in mind the intent of the resolution, i. e., to provide the Legislature with useful information and data that it may consider in formulating policies to protect the short- and long-term interests of Hawaii's gasoline consumers. For example, in responding to item no. (7) (the effects of establishing a petroleum regulatory commission), please frame your

response in terms of whether you believe that establishing such a commission will protect the interests of Hawaii's gasoline consumers in terms of ensuring the lowest possible gasoline prices, the availability of automotive services, and convenient access to retail gasoline outlets, as appropriate, and your reasons why or why not, together with supporting data if available.

Also, in presenting this information and data, please adhere to the following format and order:

- (i) Concisely state your salient points with respect to each numbered item at the outset in one or two paragraphs, if possible;
- (ii) Next, present clear and focused arguments, views, and information, as applicable, in support of your points for each item; and
- (iii) Next, provide data, preferably in the form of charts, graphs, or other aides, as appropriate.

If reasonably possible, please limit your responses to no more than five pages (double spaced) of text for each item, exclusive of data, to prevent the report from becoming bogged down in too much detail. Miscellaneous supporting data and other information not specifically relevant should be included as appendices. If you do not have any comment regarding an item, please state that you decline to comment on that particular item and the reasons why.

Please provide your response to or position concerning each of the listed items by the date specified.

#### PART I - DUE JULY 1, 1995

- (1) The effects of prohibiting franchise agreements from requiring franchisees to purchase all of their gasoline from the franchisor or restraining franchisees from dealing with the franchisors' competitors;
- (2) The effects of limiting the amount of gasoline franchisors require franchisees to purchase from the franchisor;
- (3) The effects of prohibiting gasoline allotment under exchange agreements on the basis of historical market share;

- (4) Measures to ensure the lowest retail gasoline prices for the consumer in the short and long-term;
- (5) Whether price inversion has occurred or is currently occurring in the distribution of gasoline in Hawaii;
- (6) The effects of encouraging the establishment of a public bulk gasoline terminal facility, which could make the importation of gasoline cost effective and could also lead to a reduction in wholesale gasoline prices;
- (7) The effects of establishing a petroleum regulatory commission having general supervision over all petroleum manufacturers and jobbers in the State with the authority to:
  - (A) Authorize new retail service stations and determine whether they may be operated by a petroleum manufacturer or jobber;
  - (B) Restrict price increases when prices rise above a certain percentage over a benchmark market, as determined by rules adopted by the commission under chapter 91;
  - (C) Decide when a petroleum manufacturer or jobber may convert a retail service station from one operated by a gasoline dealer to one operated by a petroleum manufacturer or jobber, and vice versa;
  - (D) Decide when a petroleum refiner may close a retail service station, to prevent communities from being underserved;
  - (E) Review management decisions of petroleum manufacturers and jobbers regarding infrastructure, strategic planning, and other areas to ensure market compliance; and
  - (F) Review profits for reasonableness in light of the need for petroleum utilities to promote a safe workplace and ensure environmental protection;

PART II - DUE AUGUST 1, 1995

- (8) The effects of regulating retail gasoline prices of

company-operated retail service stations;

- (9) The effects of requiring manufacturers, terminal operators, and jobbers of petroleum products to file with the State, a tariff listing all prices at which the manufacturer or jobber offers goods or services for sale or lease;
- (10) The effects of prohibiting any terminal operator having excess capacity from refusing to provide terminalling services to any person at the prices published in the tariff that the terminal operator filed with the State;
- (11) The effects of prohibiting manufacturers of petroleum products not only from directly operating retail service stations, but also from franchising them or owning and leasing them to branded dealers (divestiture);
- (12) The effects of establishing a public petroleum products storage authority with power to import, store, and market petroleum products;

PART III - DUE SEPTEMBER 1, 1995

- (13) The effects of active enforcement of the Petroleum Industry Information Reporting Act of 1991 and Act 291, Session Laws of Hawaii 1991 (codified as chapter 486I, Hawaii Revised Statutes);
- (14) Measures that could be initiated to reduce the cost of conducting business for independent dealers (i. e. , lease rent and environmental regulations);
- (15) The effects of the provision contained in section 486H-10(a), Hawaii Revised Statutes, that allows manufacturers and jobbers to open one company operated retail service station for each dealer operated service station owned by that manufacturer or jobber, up to a maximum of two company owned retail service stations;  
...
- (17) Whether or not the existing moratorium has resulted in lower gasoline prices for consumers.

Note: Item (16) of the resolution, which asked whether laws in other states prohibit or limit the number of retail service stations that may

be opened or operated by wholesalers, producers, or refiners of petroleum products, or their subsidiaries, will be researched and addressed by the Bureau in its report to the Legislature.

(D) Please feel free to make any other comments or remarks relating to the matters discussed in the resolution that you believe should be pointed out to the Legislature.

NOTE: For the purposes of this survey, the following words as used in House Resolution No. 174, H. D. 2, are deemed to have the same meanings as defined in section 486H-1, Hawaii Revised Statutes. We have set out the relevant definitions below:

"Franchise" means:

- (1) Any agreement or related agreements between a petroleum distributor and a gasoline dealer under which the gasoline dealer is granted the right to use a trademark, trade name, service mark, or other identifying symbol or name owned by the distributor in connection with the retail sale of petroleum products supplied by the petroleum distributor; or
- (2) Any agreement or related agreements described in paragraph (1) and any agreement between a petroleum distributor and a gasoline dealer under which the gasoline dealer is granted the right to occupy the premises owned, leased, or controlled by the distributor, for the purpose of engaging in the retail sale of petroleum products supplied by the distributor.

"Gasoline" includes gasoline, benzol, benzine, naphtha, and any other liquid prepared, advertised, offered for sale, sold for use as, or used for, the generation of power for the propulsion of motor vehicles, including any product obtained by blending together any one or more petroleum products with or without other products, if the resultant product is capable of the same use.

"Gasoline dealer" means any person engaged in the retail sale of petroleum products in the United States under a franchise agreement entered into with a petroleum distributor.

"Jobber" means every wholesaler of petroleum products.

"Manufacturer" means every producer or refiner of petroleum products on January 1, 1992, or any subsidiary of that producer or refiner.

"Motor vehicle fuel" means gasoline, diesel fuel, alcohol, and any mixture of those fuels suitable for use in vehicles registered under chapter 286.

"Petroleum distributor" means any person engaged in the sale, consignment, or distribution of petroleum products to retail outlets that it owns, leases, or otherwise controls.

"Petroleum products" includes motor vehicle fuel, residual oils number 4, 5, and 6, and all grades of jet (turbo) fuel.

"Purchase" means any acquisition of ownership.

"Retail" means the sale of a product for purposes other than resale.

"Retail service station" means a place of business where motor vehicle fuel is sold and delivered into the tanks of motor vehicles.

"Sale" means any exchange, gift, or other disposition.

PLEASE SEND YOUR RESPONSES TO OR POSITIONS CONCERNING EACH OF THE RESPECTIVE ISSUES BY THE SPECIFIED DATE TO:

MARK ROSEN  
LEGISLATIVE REFERENCE BUREAU  
STATE CAPITOL  
HONOLULU, HAWAII 96813

Please call me at \*\*\*\*\* if you have any questions.

Sincerely yours,

Mark Rosen  
Researcher

APPROVED:

Wendell K. Kimura  
Acting Director

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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Appendix D

Act 295, Session Laws of Hawaii 1991

S. B. NO. 1757

A Bill for an Act Relating to Prohibition Against Retailing of Motor Fuel by Refiners.

Be It Enacted by the Legislature of the State of Hawaii:

SECTION 1. As used in this Act:

"Affiliate" means any person who, other than by means of a franchise, controls, is controlled by, or is under common control with any other person. "Direct operation" or "directly operated" means operating through employees, through an affiliate, or through persons under any contract which is not a franchise. "Distributor" means any person, including any affiliate of such person, who either purchases motor fuel for sale, consignment, or distribution to another, or receives motor fuel on consignment for consignment or distribution to his or her own motor fuel accounts or to accounts of his or her supplier, but shall not include a person who is an employee of, or merely serves as a common carrier providing transportation service for, such supplier. "Franchise" means any contract between a refiner and a distributor, between a distributor and a retailer, under which a refiner or distributor authorizes or permits a retailer or distributor to use, in connection with the sale, consignment, or distribution of motor fuel, a trademark which is owned or controlled by the refiner or by a refiner which supplies motor fuel to the distributor which authorizes or permits the use. The term "franchise" includes any of the following:

- (1) Any contract under which a retailer or distributor is authorized or permitted to occupy leased marketing premises, which premises are to be employed in connection with the sale, consignment, or distribution of motor fuel under a trademark owned or controlled by the refiner or by a refiner which supplies motor fuel to the distributor which authorizes or permits the occupancy.
- (2) Any contract pertaining to the supply of motor fuel which is to be sold, consigned, or distributed under a trademark owned or controlled by a refiner, or under a contract which has existed continuously since May 15, 1973, and pursuant to which, on May 15, 1973, motor fuel was sold, consigned, or distributed under a

trademark owned or controlled on that date by a refiner.

- (3) The unexpired portion of any franchise, as defined by paragraph (1) and (2) of this subsection, which is transferred or assigned as authorized by the franchise or by any applicable law which permits the transfer or assignment without regard to any provision of the franchise.

"Motor fuel" means gasoline, diesel, and any other fuel of a type distributed for use as a fuel in self-propelled vehicles primarily for use on public streets, roads, and highways. "Refiner" means any person engaged in the refining of crude oil to produce motor fuel, and includes any affiliate of such person. "Retail motor fuel outlet" means any location where motor fuel is distributed for purposes other than resale. "Retailer" means any person who purchases motor fuel for sale to the general public for ultimate consumption. "Service station" means any establishment where motor fuel is sold to the general public for ultimate consumption.

SECTION 2. The attorney general shall gather and assess authoritative reports on the subject of the impact on motor fuel prices to consumers of a prohibition (better known as "divorcement") on direct retailing of motor fuel by refiners and distributors in competition with franchised and independent service stations. The attorney general shall also collect and analyze Hawaii data on the impact of divorcement on the price of motor fuel to customers in Hawaii. The attorney general shall submit a final report no later than fifteen days prior to the convening of the 1993 session of the legislature.

SECTION 3. The department of commerce and consumer affairs shall gather data and study the impact of direct retailing of motor fuel by refiners and distributors in competition with franchised and independent service stations. The department shall review information and data related to the preservation of a mixed marketplace in terms of the level of customer service provided, the maintenance of geographical dispersed "neighborhood" stations, the level of consumer problems associated with the various types of stations, and any alternatives that consumers have for services which are otherwise lost through market changes. The department shall submit its final report no later than fifteen days prior to the convening of the 1993 session of the legislature. The department shall submit an interim report setting forth its research methods and progress to date no later than fifteen days prior to the convening of the 1992 session of the legislature.

SECTION 4. This chapter shall not be applied in a manner that would render such application preempted by the Petroleum Marketing Practices Act (15 U. S. C. §2801, et. seq.) or other applicable federal or state

law.

SECTION 5. For a period beginning on the effective date of this Act, and ending August 1, 1993, refiners and distributors are prohibited from opening any new direct operated service stations or retail motor fuel outlets except where:

- (1) A refiner or distributor has executed a binding lease or has acquired real property in fee simple;
- (2) The land involved has been zoned appropriately to permit service station use or retail motor fuel outlet use and has received a shoreline management area permit, if applicable, as of the effective date of this Act; and
- (3) A refiner or distributor has obtained all of the other necessary permits to commence construction of real property improvements for the purpose of constructing a service station or retail motor fuel outlet, prior to the effective date of this Act.

Provided, however, a refiner shall be allowed to replace two service stations or retail motor fuel outlets within the same county where the refiner or distributor has had to close a station or outlet due to the termination of the real property lease.

SECTION 6. If any provision of this chapter or the application thereof to any person or circumstances is held invalid, that invalidity shall not affect other provisions or applications of the chapter which can be given effect without the invalid provision or application, and to this end the provisions of this chapter are severable.

SECTION 7. This Act shall not apply to existing retailing operations of any refiner or distributor as of the effective date of this Act, but shall apply to any refiner or distributor establishing a retail operation on or after the effective date of this Act.

SECTION 8. This Act shall take effect upon its approval and be repealed August 1, 1993.

(Approved June 20, 1991.)

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REGULATING HAWAII'S

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Appendix E

Act 329, Session Laws of Hawaii 1993

S. B. NO. 124

A Bill for an Act Relating to Motor Fuel.

Be It Enacted by the Legislature of the State of Hawaii:

SECTION 1. Chapter 486H, Hawaii Revised Statutes, is amended by adding three new sections to be appropriately designated and to read as follows:

§486H- Prohibition of manufacturer or jobber from operating a service station. (a) From July 31, 1993 to August 1, 1995, no manufacturer or jobber shall operate a major brand, secondary brand, or unbranded retail service station in Hawaii to sell its petroleum products. (b) For the purposes of this section, the term "to operate" means to engage in the business of selling motor vehicle fuel at a retail service station through any employee, commissioned agent, subsidiary company, or person managing a retail service station under a contract and on a fee arrangement with the manufacturer or jobber. (c) This section shall not apply to any individual locations operated by any manufacturer or jobber on the effective date of this Act.

§486H- Enforcement of prohibition. (a) The attorney general shall commence a civil action to enforce section 486H- , by seeking injunctive or any other appropriate relief. The civil action shall be brought in the circuit court of the circuit where the alleged violation occurred, or where the defendant resides or is doing business. (b) Any person who is injured in another person's business or property by the violation of section 486H- , may bring a civil action for damages or injunctive relief, or both, against the person violating section 486H- . If the plaintiff prevails, the plaintiff shall be awarded reasonable attorneys and expert witness fees; provided that if a court awards only nominal damages to the plaintiff, those fees, in the court's discretion, need not be awarded to the plaintiff. Any action brought under this subsection shall be brought in the circuit court of the circuit where the alleged violation occurred, or where the defendant resides or is doing business.

§486H- Preemption by federal law. This chapter shall not be applied in a manner that would render its application preempted by the "Petroleum Marketing Practices Act", 15 U.S.C. Sec. 2801, et. seq., or

other applicable federal law."

SECTION 2. Section 486H-1, Hawaii Revised Statutes, is amended to read as follows:

"ñ486H-1 Definitions. As used in this chapter:

[(1)] "Franchise" means:

[(A)] (1) Any agreement or related agreements between a petroleum distributor and a gasoline dealer under which the gasoline dealer is granted the right to use a trademark, trade name, service mark, or other identifying symbol or name owned by the distributor in connection with the retail sale of petroleum products supplied by the petroleum distributor; or

[(B)] (2) Any agreement or related agreements described in [subparagraph (A)] paragraph (1) and any agreement between a petroleum distributor and a gasoline dealer under which the gasoline dealer is granted the right to occupy the premises owned, leased, or controlled by the distributor, for the purpose of engaging in the retail sale of petroleum products supplied by the distributor.

"Gasoline" includes gasoline, benzol, benzine, naphtha, and any other liquid prepared, advertised, offered for sale, sold for use as, or used for, the generation of power for the propulsion of motor vehicles, including any product obtained by blending together any one or more petroleum products with or without other products, if the resultant product is capable of the same use. [(2)] "Gasoline dealer" means any person engaged in the retail sale of petroleum products in the United States under a franchise agreement entered into with a petroleum distributor. [(3)] "Good faith" means the duty of a gasoline dealer and a petroleum distributor to act in a fair and equitable manner in the performance and in the demanding of performance of the terms and provisions of the franchise. The petroleum distributor shall not impose on a gasoline dealer by contract, rule, or regulation, whether written or oral, any standard of conduct [which] that is not reasonable and of material significance to the franchise relationship. [(4)] "Inventory" means any product sold to a gasoline dealer for resale purposes by a petroleum distributor. "Jobber" means every wholesaler of petroleum products. "Major brand" means the primary trade name or trademark most commonly associated and identified with a manufacturer's retail service station. "Manufacturer" means every producer or refiner of petroleum products on January 1, 1992, or any subsidiary of that producer or refiner. "Motor vehicle fuel" means gasoline, diesel fuel, alcohol, and any mixture of those fuels suitable for use in vehicles registered under chapter 286. [(5)] "Petroleum distributor" means any

person engaged in the sale, consignment, or distribution of petroleum products to retail outlets [which] that it owns, leases, or otherwise controls. "Petroleum products" includes motor vehicle fuel, residual oils number 4, 5, and 6, and all grades of jet (turbo) fuel. "Purchase" means any acquisition of ownership. [(6)] "Retail" means the sale of a product for purposes other than resale. "Retail service station" means a place of business where motor vehicle fuel is sold and delivered into the tanks of motor vehicles. "Sale" means any exchange, gift, or other disposition. "Secondary brand" means a trade name or trademark, other than a major brand, used to identify a manufacturer's retail service station. "Unbranded" means an independent retail service station dealer, jobber, heating oil distributor, motor fuel wholesaler, or peddler marketing gasoline or special fuels under its own brand, trade name, or trademark, other than those of a manufacturer, or any subsidiary thereof. "

SECTION 3. If a dealer vacates a location, before a replacement dealer can be found, the facility may be company operated for up to one hundred twenty days. If a dealer cancels a lease prior to the expiration of the lease, or chooses not to accept a franchise renewal offer, and there is less than three years remaining for that lease, the facility may be company operated until the termination of that lease.

SECTION 4. If any provision of this Act, or the application thereof to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of the Act which can be given effect without the invalid provision or application, and to this end the provisions of this Act are severable.

SECTION 5. Statutory material to be repealed is bracketed. New statutory material is underscored.

SECTION 6. This Act shall take effect upon its approval.

(Approved June 23, 1993.)

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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Appendix F

Act 238, Session Laws of Hawaii 1995

A Bill for an Act Relating to Gasoline Dealers.

Be It Enacted by the Legislature of the State of Hawaii:

SECTION 1. Chapter 486H, Hawaii Revised Statutes, is amended by adding a new section to be appropriately designated and to read as follows:

"486H- Violation; penalties. Any person who violates section 486H-10 shall be assessed a civil penalty of \$1,000 per day for each violation."

SECTION 2. Section 486H-10, Hawaii Revised Statutes, is amended to read as follows:

"[486H-10] Prohibition of manufacturer or jobber from operating a service station. (a) From July 31, 1993, to August 1, [1995, ] 1997, no manufacturer or jobber shall operate a major brand, secondary brand, or unbranded retail service station in Hawaii to sell its petroleum products[.]; provided that for each dealer operated retail service station owned by a manufacturer or jobber opened on or after July 31, 1995, that manufacturer or jobber may open one company operated retail service station, up to a maximum of two company owned retail service stations. For purposes of this subsection: "Company operated retail service station" means a retail service station owned and operated by a manufacturer or jobber. "Dealer operated retail service station" means a retail service station owned by a manufacturer or jobber and operated by a qualified gasoline dealer. (b) For the purposes of this section, the term "to operate" means to engage in the business of selling motor vehicle fuel at a retail service station through any employee, commissioned agent, subsidiary company, or person managing a retail service station under a contract and on a fee arrangement with the manufacturer or jobber. (c) This section shall not apply to any individual locations operated by any manufacturer or jobber on the effective date of this Act. Nor shall anything contained in this section prohibit a manufacturer or jobber from acquiring or constructing replacement retail service stations to replace any company- operated retail service stations in existence on July 30, 1993, that have subsequently closed due to the expiration or termination of the retail service station's ground lease; provided that:

- (1) The manufacturer or jobber shall negotiate in good faith to renew the ground lease of the retail service stations; and

- (2) The replacement retail service stations shall be located within a one-mile radius of the retail service stations that they replace.

As used in this subsection, "good faith" means an honest and sincere intention to renew the ground lease of retail service stations."

SECTION 3. Act 329, Session Laws of Hawaii 1993, is amended by amending section 3 to read as follows:

"SECTION 3. If a dealer vacates a location, before a replacement dealer can be found, the facility may be company operated for up to [one hundred twenty] one hundred eighty days. If a dealer cancels a lease prior to the expiration of the lease, or chooses not to accept a franchise renewal offer, and there is less than three years remaining for that lease, the facility may be company operated until the termination of that lease."

SECTION 4. The attorney general shall provide a legal opinion twenty days prior to the convening of the regular session of 1996 on whether permanent divorcement would constitute a "taking" in violation of the Fifth Amendment of the United States and Hawaii constitutions and any other legal ramifications which may arise from permanent divorcement legislation.

SECTION 5. This Act does not affect rights and duties that matured, penalties that were incurred, and proceedings that were begun, before its effective date.

SECTION 6. Statutory material to be repealed is bracketed. New statutory material is underscored.

SECTION 7. This Act shall take effect upon its approval.

(Approved June 29, 1995.)

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REGULATING HAWAII'S  
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Appendix G

Appendix G

CHAPTER 486E, HAWAII REVISED STATUTES  
FUEL DISTRIBUTION

Section

486E-1 Definitions

486E-2 Distributors to register

486E-3 Statements

486E-4 Failure to register; to make and file statements;  
making false statement unlawful; penalty

486E-5 Ethanol content requirement

ñ486E-1 Definitions. Whenever used in sections 486E-2 to 486E-4:

"Aviation fuel" means and includes all liquid substances of whatever chemical composition usable for the propulsion of airplanes.

"Director" means the director of business, economic development, and tourism.

"Distributor" means and includes:

- (1) Every person who refines, manufactures, produces, or compounds fuel in the State, and sells it at wholesale or at retail, or who utilizes it directly in the manufacture of products or for the generation of power;
- (2) Every person who imports or causes to be imported into the State or exports or causes to be exported from the State, any fuel; and
- (3) Every person who acquires fuel through exchanges with another distributor.

"Fuel" means and includes fuels whether liquid, solid, or gaseous, commercially usable for energy needs, power generation, and fuels manufacture, which may be manufactured, grown, produced, or imported into the State or which may be exported therefrom; including petroleum and petroleum products and gases, coal, coal tar, vegetable ferments, and all fuel alcohols.

"Month" or "calendar month" means each full month of the calendar year.

"Person", except where the context or sense otherwise requires, means and includes individuals, firms, associations, or corporations.

ñ486E-2 Distributors to register. Every distributor, and any person before becoming a distributor, shall register as such with the

department of business, economic development, and tourism on forms to be prescribed, prepared, and furnished by the department.

ñ486E-3 Statements. Each distributor shall, at such reporting dates as the director may establish, file with the director, on forms prescribed, prepared, and furnished by the director, a certified statement showing separately for each county and for the islands of Lanai and Molokai within which and whereon fuel is sold or used during the last preceding reporting period, the following:

- (1) The total number of gallons or units of fuel refined, manufactured, or compounded by the distributor within the State and sold or used by the distributor, and if for ultimate use in another county or on another island, the name of that county or island;
- (2) The total number of gallons or units of fuel imported or exported by the distributor or sold or used by the distributor, and if for ultimate use in another county or on another island, the name of that county or island;
- (3) The total number of gallons or units of fuel sold as liquid fuel, aviation fuel, diesel fuel, and such other types of fuel as required by the director; and
- (4) The total number of gallons or units of fuel and the types thereof sold to: federal, state, and county agencies, ships stores, or base exchanges, commercial agricultural accounts, commercial nonagricultural accounts, retail dealers, and such other customers as required by the director.

In addition to the above reporting, each distributor shall file with the director, Federal Form FE0-1000 or an equivalent state form to be prescribed, prepared, and furnished by the director, showing the expected supply of fuel products for the coming month, and their intended distribution as categorized by Form FE0-1000 or the equivalent state form. The state form shall be supplied in the event that the Federal Mandatory Petroleum Allocation Regulations should expire, be revoked, or be amended to delete or substantially change the reporting requirements provided therein.

All statements submitted to the director under this section shall be held confidential.

ñ486E-4 Failure to register; to make and file statements; making false statement unlawful; penalty. It shall be unlawful for any distributor, or any other person, to fail, neglect, or refuse to register or to make and file any statement required by section 486E-3 in the manner or within the time therein provided or to make any such statement which is false in any particular. Any distributor or any other person violating the requirements of this section, or sections 486E-2 and 486E-3 shall be fined not more than \$5,000.

[ñ486E-5] Ethanol content requirement. [Section effective July 1, 1996. L 1994, c 199, ñ5.] (a) The department shall adopt rules in accordance with chapter 91 to require that gasoline sold in the State for use in motor vehicles contain ten per cent ethanol by volume. The amounts of gasoline sold in the State containing ten per cent ethanol shall be in accordance with rules as the director deems appropriate. The director may authorize the sale of gasoline that does not meet these requirements as provided in subsection (d).

(b) Gasoline blended with an ethanol-based product, such as ethyl tertiary butyl ether, shall be considered to be in conformance with this section if the quantity of ethanol used in the manufacture of the ethanol-based product represents ten per cent, by volume, of the finished motor fuel.

(c) Ethanol used in the manufacture of ethanol-based gasoline additives, such as ethyl tertiary butyl ether, may be considered to contribute to the distributor's conformance with this section; provided that the total quantity of ethanol used by the distributor is an amount equal to or greater than the amount of ethanol required under this section.

(d) The department may authorize the sale of gasoline that does not meet the provisions of this section:

- (1) To the extent that sufficient quantities of competitively-priced ethanol are not available to meet the minimum requirements of this section; or
- (2) In the event of any other circumstances for which the department determines compliance with this section would cause undue hardship.

(e) Each distributor, at such reporting dates as the director may establish, shall file with the director, on forms prescribed, prepared, and furnished by the director, a certified statement showing:

- (1) The price and amount of ethanol available;
- (2) The amount of ethanol-blended fuel sold by the distributor;
- (3) The amount of non-ethanol-blended gasoline sold by the distributor; and
- (4) Any other information the department shall require for the purposes of compliance with this section.

(f) Provisions with respect to confidentiality of information shall be the same as provided in chapter 486I.

(g) Any distributor or any other person violating the requirements of this section shall be subject to a fine of not less than \$2 per gallon of nonconforming fuel, up to a maximum of \$10,000 per infraction.

(h) The department, in accordance with chapter 91, shall adopt rules for the administration and enforcement of this section.

(i) As used in this section:

"Competitively priced" means fuel-grade ethanol for which the wholesale price, minus the value of all applicable federal, state, and county tax credits and exemptions, is not more than the average posted rack price of unleaded gasoline of comparable grade published in the State.

"Department" means the department of business, economic development, and tourism.

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REGULATING HAWAII'S  
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Appendix H

CHAPTER 486H, HAWAII REVISED STATUTES  
GASOLINE DEALERS

Section

- 486H-1 Definitions
- 486H-2 Wrongful or illegal termination; unreasonable nonrenewal; damages; defenses
- 486H-3 Notice of termination, cancellation, or nonrenewal
- 486H-4 Exceptions
- 486H-5 Gasoline dealer's rights
- 486H-6 Petroleum distributor's penalty; collection
- 486H-7 Right to sue
- 486H-8 Disposition of inventory
- 486H-9 Rights of dealer family member
- 486H-10 Prohibition of manufacturer or jobber from operating a service station
- 486H-10.5 Violation; penalties
- 486H-11 Enforcement of prohibition
- 486H-12 Preemption by federal law

ñ486H-1 Definitions. As used in this chapter:

"Franchise" means:

- (1) Any agreement or related agreements between a petroleum distributor and a gasoline dealer under which the gasoline dealer is granted the right to use a trademark, trade name, service mark, or other identifying symbol or name owned by the distributor in connection with the retail sale of petroleum products supplied by the petroleum distributor; or
- (2) Any agreement or related agreements described in paragraph (1) and any agreement between a petroleum distributor and a gasoline dealer under which the gasoline dealer is granted the right to occupy the premises owned, leased, or controlled by the distributor, for the purpose of engaging in the retail sale of petroleum products supplied by the distributor.

"Gasoline" includes gasoline, benzol, benzine, naphtha, and any other liquid prepared, advertised, offered for sale, sold for use as, or used for, the generation of power for the propulsion of motor vehicles, including any product obtained by blending together any one or more petroleum products with or without other products, if the resultant product is capable of the same use.

"Gasoline dealer" means any person engaged in the retail

sale of petroleum products in the United States under a franchise agreement entered into with a petroleum distributor.

"Good faith" means the duty of a gasoline dealer and a petroleum distributor to act in a fair and equitable manner in the performance and in the demanding of performance of the terms and provisions of the franchise. The petroleum distributor shall not impose on a gasoline dealer by contract, rule, or regulation, whether written or oral, any standard of conduct that is not reasonable and of material significance to the franchise relationship.

"Inventory" means any product sold to a gasoline dealer for resale purposes by a petroleum distributor.

"Jobber" means every wholesaler of petroleum products.

"Major brand" means the primary trade name or trademark most commonly associated and identified with a manufacturer's retail service station.

"Manufacturer" means every producer or refiner of petroleum products on January 1, 1992, or any subsidiary of that producer or refiner.

"Motor vehicle fuel" means gasoline, diesel fuel, alcohol, and any mixture of those fuels suitable for use in vehicles registered under chapter 286.

"Petroleum distributor" means any person engaged in the sale, consignment, or distribution of petroleum products to retail outlets that it owns, leases, or otherwise controls.

"Petroleum products" includes motor vehicle fuel, residual oils number 4, 5, and 6, and all grades of jet (turbo) fuel.

"Purchase" means any acquisition of ownership.

"Retail" means the sale of a product for purposes other than resale.

"Retail service station" means a place of business where motor vehicle fuel is sold and delivered into the tanks of motor vehicles.

"Sale" means any exchange, gift, or other disposition.

"Secondary brand" means a trade name or trademark, other than a major brand, used to identify a manufacturer's retail service station.

"Unbranded" means an independent retail service station dealer, jobber, heating oil distributor, motor fuel wholesaler, or peddler marketing gasoline or special fuels under its own brand, trade name, or trademark, other than those of a manufacturer, or any subsidiary thereof.

[ñ486H-2] Wrongful or illegal termination; unreasonable nonrenewal; damages; defenses. (a) Except as provided in section 486H-3, a petroleum distributor shall be liable to a gasoline dealer who sells the products of the petroleum distributor under a franchise from the distributor for damages and such equitable relief as the court deems proper resulting from the wrongful or illegal termination or cancellation of the franchise during its term or the petroleum distributor's unreasonable refusal to renew the franchise.

(b) A gasoline dealer suffering damages as a result of the termination or cancellation of, or failure to renew, the dealer's franchise may bring an action under this section against the petroleum distributor who wrongfully or illegally terminated, canceled, or unreasonably refused to renew the dealer's franchise in the court of general jurisdiction in which such petroleum distributor has the distributor's principal place of business, is found, or has an agent. The action may be brought without regard to the amount in controversy. If the gasoline dealer prevails in the action, the dealer may recover actual damages sustained, the costs of the suit, including reasonable attorneys' fees, and such equitable relief as the court deems proper.

The court may also grant such temporary relief as it may deem necessary and proper.

(c) It shall be a defense to any action brought under this section that the franchise was terminated, canceled, or not renewed because:

- (1) The gasoline dealer failed to comply substantially with essential and reasonable requirements of the franchise agreement;
- (2) The gasoline dealer failed to act in good faith in carrying out the terms and provisions of the franchise; or
- (3) Of any of the reasons enumerated in section 486H-3; or

- (4) Of other legitimate business reasons; provided that a termination, cancellation, or failure to renew a franchise for the purpose of enabling the petroleum distributor to assume operation of the gasoline dealer's business shall not be considered to be a legitimate business reason unless the gasoline dealer is paid reasonable compensation for the value of the dealer's franchise, including good will.

(d) No action may be brought under this section for a cause of action which arose more than two years prior to the date on which the action is brought.

ñ486H-3 Notice of termination, cancellation, or nonrenewal. A petroleum distributor shall not terminate, cancel, or refuse to renew a franchise with a gasoline dealer without first giving the dealer written notice by certified mail at least ninety days in advance of the effective date of such action as set forth in the notice. Notwithstanding any provision to the contrary contained in this section, a petroleum distributor may terminate, cancel, or refuse to renew a franchise with a gasoline dealer effective five days after the posting of written notice by certified mail to the gasoline dealer at the dealer's last known address, if such action is based on any of the following reasons:

- (1) Citation of the gasoline dealer by the division of measurement standards for adulteration, substitution, contamination, or other degradation of petroleum products sold under the trademark of the petroleum distributor; provided such adulteration, substitution, contamination, or other degradation is caused by the wilful or negligent act of the gasoline dealer;
- (2) Voluntary abandonment of the franchise relationship by the gasoline dealer;
- (3) Conviction of the gasoline dealer of a crime involving the business conducted pursuant to the franchise; or
- (4) Adjudication of bankruptcy of the gasoline dealer, or the dealer's becoming insolvent in the sense that the dealer cannot meet the dealer's financial obligations when due.

[ñ486H-4] Exceptions. No action may be brought under section 486H-2 in connection with the termination, cancellation, or nonrenewal of a

franchise if the franchise agreement provides for the binding arbitration of disputes arising under the agreement, including disputes related to the termination, cancellation, or nonrenewal of the franchise, in accordance with the rules of the American Arbitration Association.

ñ486H-5 Gasoline dealer's rights. (a) A petroleum distributor shall not in any way dictate, force, or attempt to set the retail price of any product sold by the gasoline dealer.

(b) After June 7, 1976, it shall be illegal for any petroleum distributor by any action to require a gasoline dealer to purchase only those tires, batteries, and other automotive accessories sold by the distributor. A gasoline dealer may sell any tires, batteries, and other automotive accessories as may be available to the dealer for retail sale.

(c) The petroleum distributor shall at all times act in good faith in carrying out the terms and provisions of the franchise.

ñ486H-6 Petroleum distributor's penalty; collection. The petroleum distributor's executive officer, representative, or agent who negotiates any contract in violation of section 486H-5(a) and section 486H-5(b), or who otherwise coerces a gasoline dealer in violation of section 486H-5(a) and section 486H-5(b), shall in addition to other penalties provided by this chapter be subject to a civil penalty of up to \$50,000 for each offense.

The penalty shall be assessed and recovered in a civil action brought by the attorney general or by any county attorney or prosecuting attorney in any court of competent jurisdiction. If brought by a county attorney or prosecuting attorney, the entire amount of the penalty shall be paid to the general fund of the county in which the judgment was entered. If brought by the attorney general, one-half of the penalty shall be paid to the county general fund where the action was brought and one-half shall be paid to the State general fund.

[ñ486H-7] Right to sue. Any person who is injured in the person's business or property by reason of a violation of section 486H-5 may sue in any court having jurisdiction in the county where the defendant resides or is found, or where any agent of the defendant resides or is found, or where service may be obtained, without respect to the amount in controversy, to recover the damages sustained by the person, and the person shall be awarded, if judgment is rendered in the person's favor,

attorney's fees together with the costs of the suit. Any action brought pursuant to this section shall be commenced within four years after the cause of action accrued.

[ñ486H-8] Disposition of inventory. Upon termination of a franchise by either the petroleum distributor or the gasoline dealer, whether or not for cause, the distributor shall at the request of the dealer, take back any inventory from the dealer which was supplied by it and which has not diminished substantially in value and is of similar quality as when originally supplied. The petroleum distributor shall reimburse the gasoline dealer for not less than ninety per cent of the cost paid by the gasoline dealer or shall cancel not less than ninety per cent of any debts owed on account of the inventory.

[ñ486H-9] Rights of dealer family member. (a) Upon the death of a gasoline dealer, the franchise of said dealer and any leases or other agreements in connection therewith may be assumed by any dealer family member, who has actively participated in the franchise during the twelve month period immediately preceding the dealer's death (but not necessarily continuously throughout such period), who meets the qualifications necessary to operate the station which would be customarily required by the petroleum distributor in question, and who gives written notice of the dealer family member's election to assume the franchise, and any leases or other agreements in connection therewith, to the petroleum distributor and any lessors of the premises within thirty days of the death of the gasoline dealer and affirms the same in writing within fifteen days after such thirty day period.

(b) Any dealer family member who is entitled to give the notice under subsection (a) shall have the right to operate the franchise during the forty-five day period provided for in subsection (a).

(c) "Dealer family member" shall mean that person from the group consisting of the surviving spouse and surviving adult children of the dealer designated by the dealer in a written designation received by the petroleum distributor prior to the dealer's death, provided that in the absence of any written designation, the dealer family member shall be that one of the dealer's surviving spouse and the dealer's surviving adult children who is entitled to give and gives the notice provided for in subsection (a) and who is chosen by said group. If said group does not choose the dealer family member within forty-five days after the dealer's death, then the petroleum distributor shall have the option of choosing the dealer family member from among those who were entitled to give and give notice of their election to assume the franchise, any leases or other agreements in accordance with subsection

(a).

ñ486H-10 Prohibition of manufacturer or jobber from operating a service station. (a) From July 31, 1993, to August 1, 1997, no manufacturer or jobber shall operate a major brand, secondary brand, or unbranded retail service station in Hawaii to sell its petroleum products; provided that for each dealer operated retail service station owned by a manufacturer or jobber opened on or after July 31, 1995, that manufacturer or jobber may open one company operated retail service station, up to a maximum of two company owned retail service stations.

For purposes of this subsection:

"Company operated retail service station" means a retail service station owned and operated by a manufacturer or jobber.

"Dealer operated retail service station" means a retail service station owned by a manufacturer or jobber and operated by a qualified gasoline dealer.

(b) For the purposes of this section, the term "to operate" means to engage in the business of selling motor vehicle fuel at a retail service station through any employee, commissioned agent, subsidiary company, or person managing a retail service station under a contract and on a fee arrangement with the manufacturer or jobber.

(c) This section shall not apply to any individual locations operated by any manufacturer or jobber on the effective date of this Act. Nor shall anything contained in this section prohibit a manufacturer or jobber from acquiring or constructing replacement retail service stations to replace any company- operated retail service stations in existence on July 30, 1993, that have subsequently closed due to the expiration or termination of the retail service station's ground lease; provided that:

- (1) The manufacturer or jobber shall negotiate in good faith to renew the ground lease of the retail service stations; and
- (2) The replacement retail service stations shall be located within a one-mile radius of the retail service stations that they replace.

As used in this subsection, "good faith" means an honest and sincere intention to renew the ground lease of retail service stations.

[ñ486H-10.5] Violation; penalties. Any person who violates section 486H-10 shall be assessed a civil penalty of \$1,000 per day for each violation.

[ñ486H-11] Enforcement of prohibition. (a) The attorney general shall commence a civil action to enforce section 486H-10, by seeking injunctive or any other appropriate relief. The civil action shall be brought in the circuit court of the circuit where the alleged violation occurred, or where the defendant resides or is doing business.

(b) Any person who is injured in another person's business or property by the violation of section 486H-10, may bring a civil action for damages or injunctive relief, or both, against the person violating section 486H-10. If the plaintiff prevails, the plaintiff shall be awarded reasonable attorneys and expert witness fees; provided that if a court awards only nominal damages to the plaintiff, those fees, in the court's discretion, need not be awarded to the plaintiff. Any action brought under this subsection shall be brought in the circuit court of the circuit where the alleged violation occurred, or where the defendant resides or is doing business.

[ñ486H-12] Preemption by federal law. This chapter shall not be applied in a manner that would render its application preempted by the "Petroleum Marketing Practices Act", 15 U.S.C. Sec. 2801, et. seq., or other applicable federal law.

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REGULATING HAWAII'S  
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Appendix I

CHAPTER 486I, HAWAII REVISED STATUTES  
PETROLEUM INDUSTRY INFORMATION REPORTING

Section

486I-1 Short title

486I-2 Definitions

486I-3 Informational reports; duty; time; scope;  
powers of commission; alternate reports

- 486I-4 Analysis of information; audits and inspections
- 486I-5 Summary, analysis and interpretation of information; reports
- 486I-6 Failure to timely provide information; notice; false statements; civil penalties; person
- 486I-7 Confidential information
- 486I-8 Confidential information obtained by another state agency
- 486I-9 Sharing of information obtained by the commission
- 486I-10 Rules

[ñ486I-1] Short title. This chapter shall be known and may be cited as the Petroleum Industry Information Reporting Act of 1991.

[ñ486I-2] Definitions. Whenever used in this chapter, unless the context otherwise requires:

"Commission" means the public utilities commission.

"Energy" means work or heat that is, or may be, produced from any fuel or source whatsoever.

"Major marketer" means any person who sells natural gas, propane, synthetic natural gas or oil in amounts determined by the commission as having a major effect on energy supplies.

"Major oil producer" means any person who produces oil in amounts determined by the commission as having a major effect on energy supplies.

"Major oil storer" means any person who stores oil or other petroleum products in amounts determined by the commission as having a major effect on energy supplies.

"Major oil transporter" means any person who transports oil or other petroleum products in amounts determined by the commission as having a major effect on energy supplies.

"Person" means any person, firm, association, organization, partnership, business trust, corporation, or company. "Person" also includes any city, county, public district or agency, the State or any department or agency thereof, and the United States to the extent authorized by federal law.

"Refiner" means any person who owns, operates, or controls the

operations of one or more refineries.

"Refinery" means any industrial plant, regardless of capacity, processing crude oil feedstock and manufacturing oil products.

[ñ486I-3] Informational reports; duty; time; scope; powers of commission; alternate reports. (a) Each refiner and major marketer shall submit to the commission, within thirty days after the end of each month and in such form as the commission shall prescribe, information which includes the following:

- (1) Refiners shall report, for each of their refineries, feedstock inputs, origin and volume of petroleum receipts, refinery outputs, refinery stocks, and finished product supply and distribution.
- (2) Major marketers shall report on petroleum and petroleum product receipts, exchanges, inventories, and distributions.

The commission shall prescribe by rule when the first report shall be submitted.

(b) Each major oil producer, refiner, marketer, oil transporter, and oil storer shall submit to the commission, within thirty days after the end of each year and in such form as the commission shall prescribe, information which includes the following:

- (1) Major oil transporters shall report on petroleum by reporting the capacities of each major transportation system, the amount transported by each system, and inventories thereof. The provision of the information shall not be construed to increase and decrease any authority the public utilities commission may otherwise have.
- (2) Major oil storers shall report on storage capacity, inventories, receipts and distributions, and methods of transportation of receipts and distributions.
- (3) Refiners shall report on facility capacity, and utilization and method of transportation of refinery receipts and distributions.
- (4) Major oil marketers shall report on facility capacity and methods of transportation of receipts and

distributions.

The commission shall prescribe by rule when the first report shall be submitted.

(c) Each person required to report pursuant to subsection (a) shall submit a projection each month of the information to be submitted pursuant to subsection (a) for the quarter following the month in which the information is submitted to the commission.

(d) In addition to the data required under subsection (a), each oil refiner who supplies retail outlets in Hawaii shall submit to the commission an annual industry forecast for Petroleum Administration for Defense, District V (covering Arizona, Nevada, Washington, Oregon, California, Alaska and Hawaii). The forecast shall include the information to be submitted under subsection (a), and shall be submitted by October 15 of each year. The commission may require Hawaii-specific forecasts. However, those forecasts shall be required only if the commission finds them necessary to carry out its responsibilities.

(e) The commission may by order or rule modify the reporting period as to any individual item of information setting forth in the order or rule its reason for so doing.

(f) The commission may request additional information as necessary to perform its responsibilities under this chapter.

(g) Any person required to submit information or data under this chapter may, in lieu thereof, submit a report made to any other governmental agency, provided, that:

- (1) The alternate report or reports contain all of the information or data required by specific request under this chapter; and
- (2) The person clearly identifies the specific request to which the alternate report is responsive.

(h) Each refiner shall submit to the commission, within thirty days after the end of each month and in such form as the commission shall prescribe, all of the following information:

- (1) Monthly Hawaii weighted average prices and sales volumes of finished leaded regular, unleaded regular, and premium motor gasoline, and of each other grade of gasoline sold through company-operated retail outlets,

to other end-users, and to wholesale customers;

- (2) Monthly Hawaii weighted average prices and sales volumes for residential sales, commercial and institutional sales, industrial sales, sales through company-operated retail outlets, sales to other end-users, and wholesale sales of No. 2 diesel fuel and No. 2 fuel oil; and
- (3) Monthly Hawaii weighted average prices and sales volumes for retail sales and wholesale sales of No. 1 distillate, kerosene, finished aviation gasoline, kerosene-type jet fuel, No. 4 fuel oil, residual fuel oil with one per cent or less sulfur, residual fuel oil with greater than one per cent sulfur and consumer grade propane.

The commission shall prescribe by rule when the first report shall be submitted.

(i) Refiners that submit form EIA-800 reports to the United States Department of Energy shall provide to the commission copies of their weekly reports.

[ñ486I-4] Analysis of information; audits and inspections. (a) The commission shall, with its own staff and other support staff with expertise and experience in, or with, the petroleum industry, gather, analyze, and interpret the information submitted to it pursuant to section 486I-3 and other information relating to the supply and price of petroleum products, with particular emphasis on motor vehicle fuels, including, but not limited to, all of the following:

- (1) The nature, cause, and extent of any petroleum or petroleum products shortage or condition affecting supply;
- (2) The economic and environmental impacts of any petroleum and petroleum product shortage or condition affecting supply;
- (3) Petroleum or petroleum product demand and supply forecasting methodologies utilized by the petroleum industry in Hawaii;
- (4) The prices, with particular emphasis on retail motor fuel prices, and any significant changes in prices

charged by the petroleum industry for petroleum or petroleum products sold in Hawaii and the reasons for such changes;

- (5) The income, expenses, and profits, both before and after taxes, of the industry as a whole and of major firms within it, including a comparison with other major industry groups and major firms within them as to profits, return on equity and capital, and price-earnings ratio;
- (6) The emerging trends relating to supply, demand, and conservation of petroleum and petroleum products;
- (7) The nature and extent of efforts of the petroleum industry to expand refinery capacity and to make acquisitions of additional supplies of petroleum and petroleum products; and
- (8) The development of a petroleum and petroleum products information system in a manner which will enable the State to take action to meet and mitigate any petroleum or petroleum products shortage or condition affecting supply.

(b) The commission may conduct random or periodic audits and inspections of any supplier or suppliers of oil or petroleum products to determine whether they are unnecessarily withholding supplies from the market or are violating applicable policies, laws, or rules. The commission may solicit assistance of the department of taxation in any such audit. The commission shall cooperate with other state and federal agencies to ensure that any audit or inspection conducted by the commission is not duplicative of the data received by any of their audits or inspections which is available to the commission.

(c) The commission shall analyze the impacts of state and federal policies, rules, and regulations upon the supply and pricing of petroleum products.

ñ486I-5 Summary, analysis and interpretation of information; reports. (a) The commission shall publish annually and submit to the governor and the legislature twenty days prior to the first day of the current legislative session a summary, an analysis, and an interpretation of the information submitted to it pursuant to section 486I-3. Any person may submit comments in writing regarding the accuracy or sufficiency of the information submitted.

(b) The commission may use reasonable means necessary and available to it to seek and obtain any facts, figures, and other information from any source for the purpose of preparing and providing reports to the governor and the legislature. The commission shall specifically include in the reports its analysis of any unsuccessful attempts in obtaining information from potential sources, including the lack of cooperation or refusal to provide information.

[ñ486I-6] Failure to timely provide information; notice; false statements; civil penalties; person. (a) The commission shall notify those persons who have failed to timely provide the information specified in section 486I-3 or requested by the commission under section 486I-3 or section 486I-4(b). If, within five days after being notified of the failure to provide the specified or requested information, the person fails to supply the specified or requested information, the person shall be subject to a civil penalty of not less than \$500 per day nor more than \$2,000 per day for each day the submission of information is refused or delayed, unless the person has timely filed objections with the commission regarding the information and the commission has held a hearing and following a ruling by the commission the person has properly submitted the issue to a court of competent jurisdiction for review.

(b) Any person who willfully makes any false statement, representation, or certification in any record, report, plan, or other document filed with the commission shall be subject to a civil penalty not to exceed \$20,000.

(c) For the purposes of this section, the term "person" shall mean, in addition to the definition contained in section 486I-2, any responsible corporate officer.

[ñ486I-7] Confidential information. (a) Confidential commercial information presented to the commission pursuant to this chapter shall be held in confidence by the commission or aggregated to the extent necessary to assure confidentiality as governed by chapter 92F, including its penalty provisions.

(b) No data or information submitted to the commission shall be deemed confidential if the person submitting the information or data has made it public.

(c) Unless otherwise provided by law, with respect to data provided pursuant to subsection (h) of section 486I-3, neither the commission,

nor any employee of the commission, may do any of the following:

- (1) Use the information furnished under subsection (h) for any purpose other than the statistical purposes for which it is supplied;
- (2) Make any publication whereby the data furnished by any particular establishment or individual under subsection (h) can be identified; or
- (3) Permit anyone to examine the individual reports provided under subsection (h) other than the attorney general, the director of business, economic development, and tourism, the consumer advocate, and the authorized representatives, and employees of each.

[ñ486I-8] Confidential information obtained by another state agency. Any confidential information pertinent to the responsibilities of the commission specified in this chapter which is obtained by another state agency, including the department of taxation, shall be available to the attorney general, the attorney general's authorized representatives, and the commission and shall be treated in a confidential manner.

[ñ486I-9] Sharing of information obtained by the commission. The commission shall make all information obtained by the commission under this chapter, including confidential information, available to the director of business, economic development, and tourism, the attorney general, and the consumer advocate, and the authorized representative of each, who shall safeguard the confidentiality of all confidential information received.

[ñ486I-10] Rules. The commission shall adopt, amend, or repeal such rules as it may deem proper to fully effectuate this chapter.

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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Appendix J

Mr. Windeli K. Kimura  
Acting Director

Legislative Reference Bureau  
Attention: Mr. Mark Rosen  
State of Hawaii, State Capitol  
Honolulu, Hawaii 96813

Dear Mr. Kimura:

As requested by Mr. Mark Rosen in an October 12, 1995, telephone conversation with Dr. John Tantlinger regarding the study on gasoline dealers, requested by House Resolution 174, H. D. 2, this is to provide our comments on and an estimate of the annual cost for necessary resources, if the Department of Business Economic, Development, and Tourism (DBEDT) were required to implement the sections of Chapter 4861, Hawaii Revised Statutes (HRS), which we interpret would not be redundant of the oil industry supply production and data gathering, analyses and reporting DBEDT currently does under the provisions of Chapter 486E, HRS.

First, we offer the following comments regarding Chapter 4861, HRS, implementation of which by the Public Utilities Commission has, as we understand it, not yet been initiated:

1. We believe that the reporting requirements of Chapter 4861-3 (a) are generally the same data currently reported to DBEDT under Chapter 486E. Additionally, in collaboration with Hawaii's petroleum companies over the past 18 months, DBEDT has completely overhauled the data reporting forms and system for this oil supply production demand data. Industry has been completely cooperative in this initiative and we believe concurs with the new forms and system of reporting.

2. Chapter 4861-3 (b) requires reporting of data on capacities of major petroleum transportation and storage capacities. This information would be very useful, particularly for energy emergency planning. However, we believe that the purpose of collecting this information can be achieved under Chapter 125C-2, HRS, which provides that: "[~]the Governor may require importers of any petroleum product or other fuel to monitor and report to the Department of Business Economic, Development, and Tourism relevant supply and demand data." Chapter 125C, HRS, is the enabling legislation for the state's energy emergency preparedness program, which by this statute is the responsibility of the DBEDT Director to maintain and implement. In addition, one of the newly developed reporting forms is one designed to gather oil transportation and storage, and other supply/demand data during market emergencies.

3. With respect to the requirement for a "annual industry forecast for Petroleum Administration for Defense District V (covering Arizona, Nevada, Washington, Oregon, California, Alaska and Hawaii)", we believe

this is redundant of information already available from the U. S. Government. The U. S. Energy Information Administration (EIA) produces volumes of information on the petroleum and other energy industries in the U. S. and internationally. Supply, production, demand data and projections by Petroleum Administration for Defense Districts of the U. S. are available from regular EIA reports.

4. Chapter 4861-3 (Q) requires reporting of petroleum product prices and sales volumes by end-use sector and petroleum product. Again, consumption information is available from data gathered under Chapter 486E, HRS. With respect to the reporting of price information, unless this information is to be used for regulatory purposes, it is unclear as to its utility, especially when market price information on various petroleum products is also available through EIA reports and other private sources, such as Platt's publications, American Automobile Association publications, etc. If this price information is desired for a regulatory purpose, we do not believe it is necessary, and collection by DBEDT would be inconsistent with the DBEDT Director's role as the State's Energy Resources Coordinator (ERC). The ERC is to serve as an energy advisor, coordinator, and facilitator for the Governor, industry, and all levels and branches of government. However, the ERC is not a regulator.

5. Chapter 48614 deals with the analysis and reporting of data regarding potential or actual petroleum shortages, price changes, and financial information on a Hawaii's petroleum companies; e. g., income, expenses, profits, return on equity and capital, price/earning ratios, etc. This section also allows for audits of a company's books for the purpose of determining whether there may have been violations of "policies, laws, or rules" (Chapter 4861-4 (b)).

With respect to information required to plan for and respond to petroleum shortages, we believe the Governor has adequately broad powers under Chapter 12SC, to retrieve any data relevant to the implementation of that statute. With respect to the requirements of reporting data relative to the financial condition of a petroleum company, we do not concur that this information is necessary, unless the industry is to be regulated, which DBEDT opposes. With respect to audits to determine whether the petroleum industry has violated "policies, laws, or rules", we believe that this power already exists within the purview of the Office of the Attorney General with its subpoena power.

6. Conclusion. We conclude that implementation of several sections of Chapter 4861, HRS, would be redundant of data gathering, analyses, and reporting activities already conducted by other government agencies, such as DBEDT, U. S. EIA, etc. While not all of this information is

reported within the structure of a regular monthly report or other periodic basis, it is available to the state when and if it is needed and does not constitute an excessive resource burden on industry or state government when it comes to data reporting and analyses.

Notwithstanding our conclusion above, if DBEDT were required to implement Chapter 4861, we would need the following additional resources to start-up and continue these activities on an annual basis:

RESOURCE (Recurring annual)

Note: Does not include cost of office space and certain other recurring expenses; e. g., telephone, photocopies, general office supplies, etc.)

Accountant (1)	Salaries \$36,000	Fringes (33.63%) \$12,107
Data Entry/Analytical Assistant (1)	\$30,000	\$10,089
TOTAL RECURRING ANNUAL COST	\$66,000	\$22,196
GRAND TOTAL RECURRING ANNUAL COST		\$88,196

RESOURCE (Start-up cost)

AMOUNT

Computers w/ hardware peripherals; e. g., printer, etc., and workstations (chairs and computer table) (2)

\$15,000

Software (2)

\$15,000

TOTAL START-UP COST

\$16,200

GRAND TOTAL FIRST YEAR

\$104,396

Thank you for the opportunity to provide these comments. Should you have any questions regarding this matter, please call me.

Sincerely,  
Seiji F. Naya

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REGULATING HAWAII'S  
PETROLEUM INDUSTRY

Appendix L

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