

2-12-09

Review Of House
Judiciary Report
on Retail Gas
Prices and
Attorney
General's Report
on Gas Pricing

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EXECUTIVE SUMMARY

The House Judiciary Committee was tasked by the Speaker of the House, Representative John Harris, with investigating the retail price of gasoline in Alaska, and specifically why reductions in gas prices significantly trail reductions in gas prices nationwide. Speaker Harris asked the House Judiciary Committee to prepare a report with solid recommendations for legislative action in the 26th Legislative Session.

The legislature initiated this investigation in response to public complaints about the high price of gasoline in Alaska, compared to other states. Since April 2008, Alaskans have seen the price of gasoline rise at an unprecedented rate. Alaskans are now paying the highest prices at the pump in the entire country for gasoline.

Even though the price of crude oil has fallen dramatically since its all-time high, retail fuel prices in Alaska have not fallen in correlation with the crude market. Since 2002, the annual average price for Alaska North Slope (ANS) crude has risen from \$21.79 (FY2002) to record highs in July, 2008 of \$144.00 per barrel, an increase of 665%. ANS crude has now fallen back to under \$40.00 per barrel.¹

To date, the House Judiciary Committee has held three hearings on fuel prices and the Committee plans to continue holding hearings until there is a decoupling of Alaska fuel prices with those nationwide. Unfortunately,

¹ Alaska Department of Revenue, Tax Division, <http://tax.alaska.gov>

the Committee has yet to find a definitive answer to why gasoline prices in Alaska have not equalized with the rest of the U.S. market.

Report Focus

The primary focus of this report is to inform consumers and policy-makers about Alaska's gasoline market and factors that influence Alaska's gasoline prices, and to suggest possible actions the Alaska State Legislature might take in the 26th Legislative Session to ensure Alaskans are not being gouged at the pump.

The meetings held by the House Judiciary Committee represent the fact-finding phase of this investigation. The House Judiciary Committee gathered information from pricing data, stakeholders, the Attorney General's Office, and Econ One's Chief Economist Barry Pulliam.

So far, the Committee has found no concrete reasons to explain why price parity has not returned to the motor-fuels market. However, the Committee has gained a great deal of insight into the gasoline market as a whole, and more specifically, the uniqueness of the Alaska gasoline market.

Conditions Leading to this Investigation

Retail fuel prices have continued to climb in Alaska. While increased energy prices have benefited the State of Alaska through increased revenues, individuals and businesses have been under extreme duress. Since 2002, the annual average price for ANS crude has risen from \$21.79 (FY2002) to an all time high in July, 2008 of approximately \$144.00 per barrel; ANS crude

has now fallen back to under \$40.00 per barrel, a decrease of more than 72%. This upward trend in crude prices caused the cost of all fuels across Alaska to rise at an unprecedented rate. However, now as the price of crude has fallen to a low of under \$40.00 per barrel, the price of gasoline has fallen in the rest of the country. In contrast, Alaskans have not seen correspondingly low prices return to the pump. This has resulted in a broadly-held frustration shared by Alaskan consumers who are keenly aware of the price they pay for gasoline at the pump.

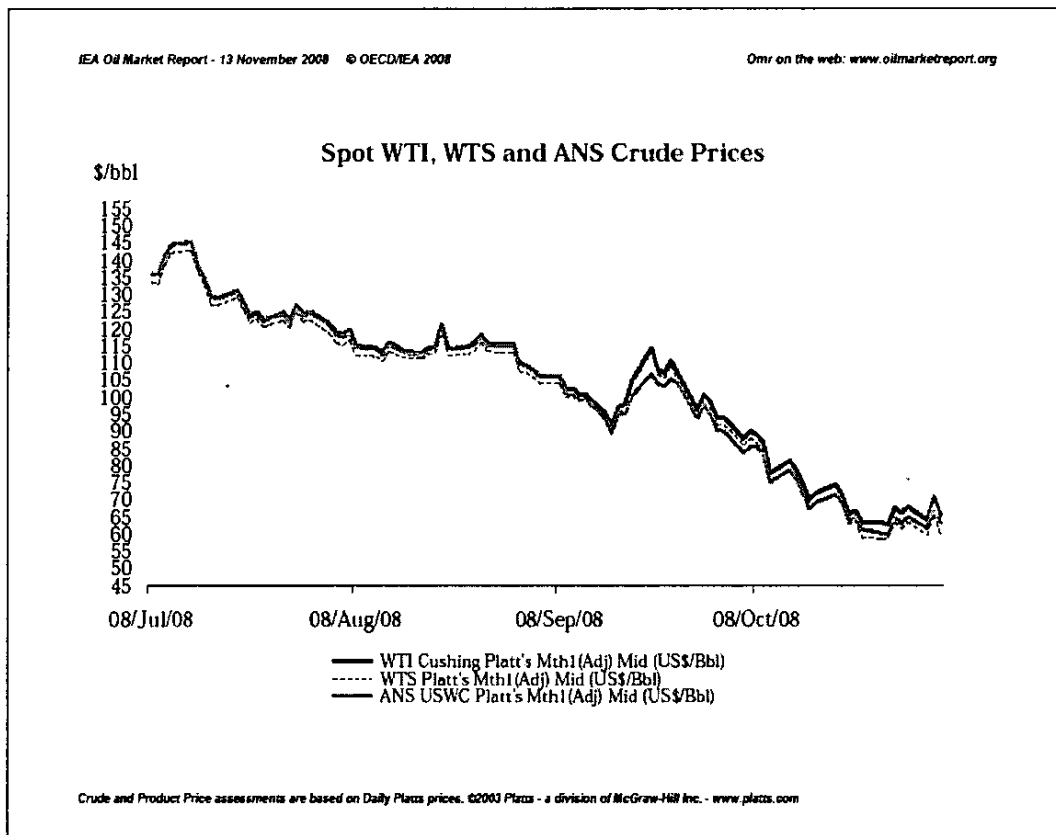
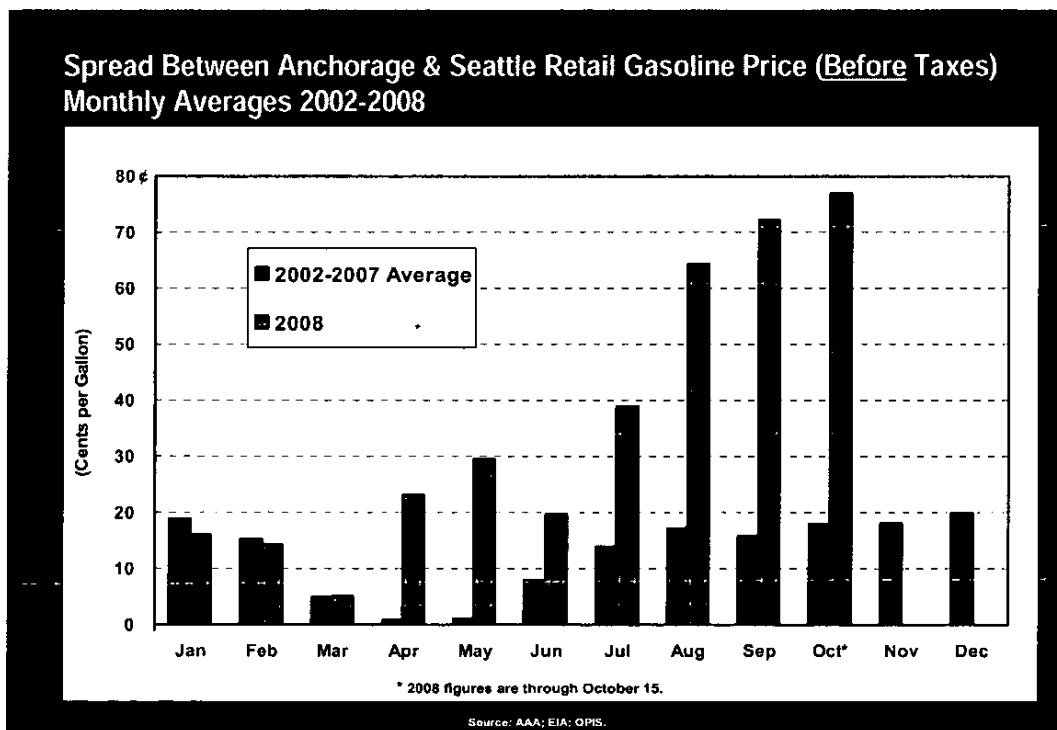


Chart 1, EIA Oil Market report – 13 November 2008, Spot WTI, WTS and ANS Crude Prices. This chart depicts the high and low spot price for ANS Crude 08/07/08 – November 13, 2008

Historically, the price of gasoline in Alaska has been in relative parity with gasoline prices on the West Coast of the United States, and more

specifically, the prices in Seattle, Washington. Gasoline prices in Alaska have historically trended 11 cents per gallon (cpg) higher than the average U.S. market. From 2002 – 2007, the annual average spread between Anchorage and Seattle retail gasoline prices, before taxes, was 17 cpg. Commencing in April of 2008, a pricing disparity began between Anchorage’s retail gasoline prices (traditionally the lowest-priced region in Alaska) and the prices in Seattle. As of October 2008, prices raised a full 71 cpg above Seattle’s prices.

In testimony on November 21, 2008, before the House Judiciary Committee, Barry Pulliam, Senior Economist with Econ One testified that, "the last four months have seen the wildest disparity in prices ever."



**Chart 2, Barry Pulliam 10/23/08 presentation to HJUD Committee
Spread Between Anchorage & Seattle Retail Gasoline Price (Before Taxes) Monthly
Averages 2002-2008)**

As the chart above reveals, Alaska's gasoline prices began experiencing a disparity with the Seattle market in April and have continued an ongoing pricing disconnect. The average per-gallon retail price in Alaska is down from an all time high of \$4.70 on July 24, 2008, to a December 16, 2008 average per-gallon price of about \$2.45 per gallon.

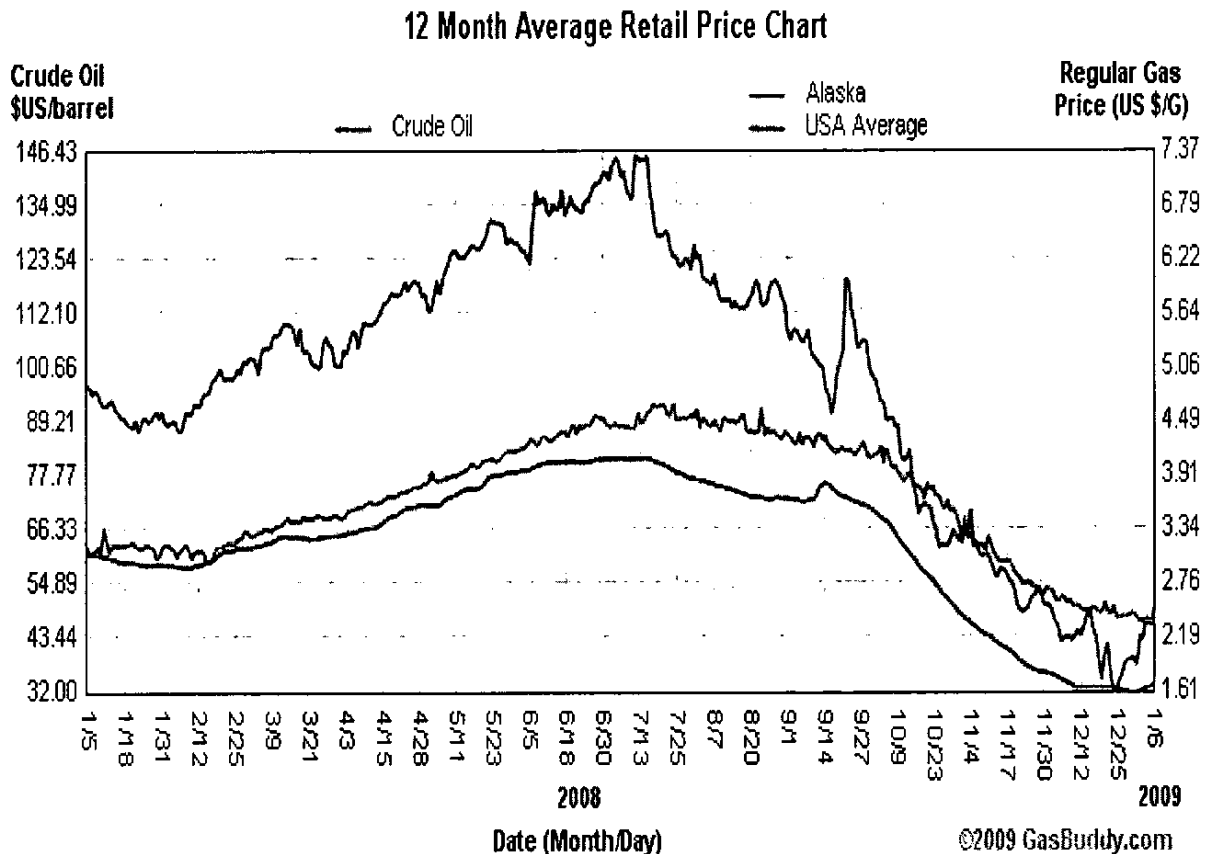


Chart 3, GasBuddy.com 12 Month Average Retail Price Chart, Comparing Alaska, US Average, and Crude Oil prices.

Economic Impact of Gas Prices in Alaska

The economic impact of the high price of motor fuel has been devastating, not just to Alaska's citizens, but across the business sector. There is not a person or a business in Alaska that has not experienced higher

prices due to increased fuel costs. The impact has been especially hard this summer on Alaska's fishing industry, trucking industry, mining industry, tourism industry, aviation industry and of course on consumers. In addition to paying more for gasoline and heating fuel, consumers all across the State have paid more for consumer goods, as transportation costs have increased.

Alaskans are justifiably upset. They have seen the quality of their lives deteriorate. Also, due to high fuel prices, a number of Alaskans have chosen to relocate, either to urban regions of the state or to the Lower 48. Recent data on moving trends within the State suggest that more people are moving into the State than out, but people are also moving from rural areas into urban centers seeking a cheaper and better standard of living. Because gasoline and energy prices are too high in rural Alaska, as are prices for food and other necessities, rural Alaskans' quality of life is suffering.

FINDINGS

Through public hearings the House Judiciary Committee gathered facts and obtained information from industry representatives, from the Attorney General's Office, from expert Barry Pulliam, Chief Economist at Econ One, from the Port of Anchorage, and from public testimony. This process helped the Committee understand factors that affect gas prices in Alaska, and allowed the Committee to explore some options for the 26th Legislative Session. Below are some explanations of key components of industry standards that affect the retail price of gasoline:

- **Crude Oil Prices:** Increasing crude oil prices help explain a significant amount of the upward movement of gas prices. The cost

of crude helps account for the bulk of the total price of a gallon of gasoline. Crude oil prices are determined by worldwide supply and demand. World crude oil prices reached an all-time high in July of 2008, due mainly to high worldwide demand relative to supply. Other contributory factors include political events and conflicts in major oil producing regions, as well as the declining value of the U.S. dollar.

- **Refinery Margins:** The refining cash margin per barrel of crude oil represents all product revenues minus the costs of feedstocks (crude oil plus other additives), and other operating costs per barrel of crude oil. Margins at U.S. refineries are affected over time. The cash margin (dollars per barrel of crude oil processed) is affected by crude oil and product markets. Margins also vary according to facility configuration (complexity), scale and efficiency, the nature of the crude processed, and the region where the facility is located. In addition, margins can be affected by environmental regulations such as the Clean Air Act Amendments of 1990 (CAAA) that required changes in product specifications to produce cleaner fuels.
- **Retail & Net:** Retail gasoline prices reflect the price paid by consumers. The Oil Price Information Service (OPIS) model uses five elements to calculate and track the retail gasoline market: (1) taxes, (2) distribution, (3) net, (4) retail margin, and (5) wholesale (rack) costs. Net is retail prices, minus \$0.184 per gallon Federal taxes and \$0.018 per gallon distribution costs. Net contains two categories, retail margin and rack rates.

- **Retail Margin:** Retail margin is the difference between net profits and the rack (wholesale) price paid for the merchandise. The retail margin represents the net proceeds to the retailer/distributor after costs are paid.

- **Rack:** Actual wholesale prices are negotiated by refiners and retailers and are often reduced for particular customers by volume discounts, rebates, and other negotiated price decreases. The rate posted by OPIS does not reflect these reductions. The posted rack rate may, and probably does, overstate the price distributors are paying and correspondingly understates profit margins.

- **Wholesale/Retail Margins:** The wholesale/retail margin is the difference between the wholesale price of gasoline (rack rate) and the retail price, less the cost of transport.

- **Taxes:** Taxes include Federal taxes at the rate of 18.4 cents per gallon, state taxes, and local taxes.

- **Consumption Rates:** The amount of gas consumed in a market.

- **Prices and Geography:** The geography of a region and its infrastructure can and does affect pricing.

- **Pricing Strategy:** Gasoline is not sold at a “cost-plus price”; thus, the price is not determined based on the cost to purchase, refine,

transport, and market the product plus a percentage for profit. Instead, the price of gasoline is determined by what the market will bear.

- **Storage:** The amount of gas held in reserves.
- **The price of gasoline.** Ultimately, the price of gasoline is determined by the following formula:

Gas price = cost of crude + cost to refine + cost to distribute + cost of marketing + taxes and competition.

The cost of crude oil is the lion's share of the cost of gasoline and is both variable and volatile. Refining/distribution costs have global and regional factors, which include but are not limited to electricity costs, gas/fuel costs, environmental regulations, equipment costs, maintenance costs, and labor costs, and the cost of additional capital investments that may be required by regulation changes. Ultimately, however, the market sets the price with influences from competition and local market characteristics.

These are general market concepts true to all markets. However, we also found that there were market forces that were unique to Alaska.

Findings Unique To Alaska's Gas Market

- **Decoupling of Pricing Parity with the Rest of the Nation:** Since July of this year, ANS crude has dropped down to \$45.53 from an all time high of \$144.00 per barrel, however gas prices in Alaska have

not dropped at the same rate. Even though the U.S. averages have dropped below \$2.00 per gallon, Alaskans' are still paying an average of approximately 98 cpg more at the pump.

National Average	\$1.835
Alaska Average	\$2.817

Chart 4, AAA's Media Site for Retail Gasoline, Dated 11/28/08, www.fuelgaugereport.com/sbsavg.asp

- **Consumer Shock:** The House Judiciary Committee heard testimony that the rapid rise in the price of crude was so extreme that the industry could not raise its price of gasoline quickly enough to keep ahead of the margins. This helps explain why Alaskans have seen a delay in price parity at the pump.
- **Alaska's Supply Area:** Alaska is part of the Petroleum Administration for Defense District V (PADD V), the West Coast supply area. Therefore, the most relevant comparison of gas prices should be made with the Pacific West Coast; although these markets do not always follow in lockstep, there has historically been a causal relationship between the two.

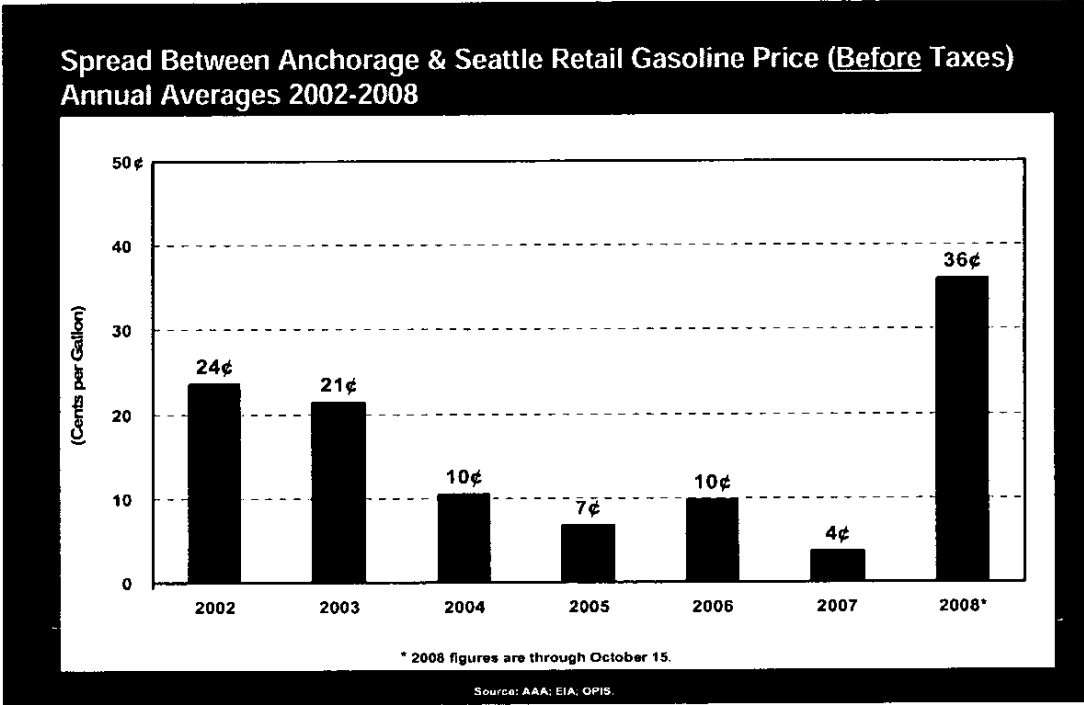


Chart 5, Barry Pulliam October 23, 2008 Presentation to the House Judiciary Committee

- Being Smallest is Not the Best:** Alaska has the smallest demand for gasoline of any state, ranking 50th in motor gasoline sales, with a volume that is 0.2% of the national average.

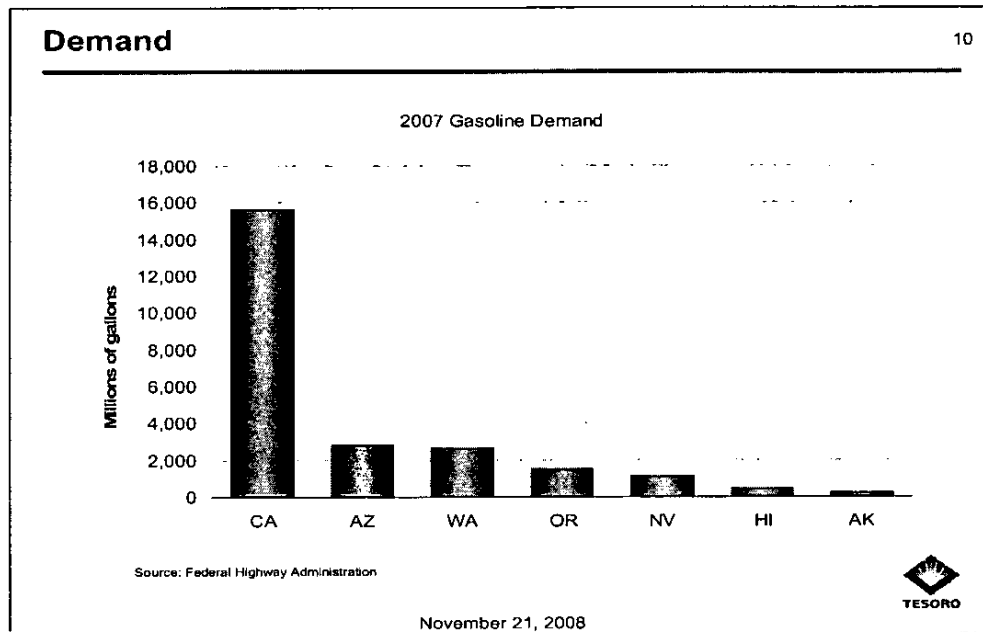


Chart 6, Tesoro Alaska presentation to House Judiciary Committee, November 21, 2008

Due to the fact that demand is small and remains relatively unchanged, Alaska does not have much market power. For the Alaska gasoline market, refiners make only what the market will consume and have no outside competition that would cause them to lower prices. The market is too efficient; supply and demand are too evenly matched.

- **Natural Inefficiency of the Marketplace:** Due to Alaska's small demand for gasoline, there are only two simple refineries making gasoline in the state, Tesoro Alaska located on the Kenai Peninsula and Flint Hills Resources located in North Pole. Alaska's refineries are the least complex in the nation and they do not manufacture a great deal of gasoline. Being smaller and less efficient, they must

spread their fixed costs over a smaller amount of barrels of refined products.

- Unbalanced Portfolio of Production:** In the Alaska refining market jet fuel is king. Alaska refineries were built for the refining of jet fuel, with sales of jet fuel totaling over 60% of product sales, while motor gasoline accounts for only 10-15% of product sales. However, markets on the West Coast differ, with gasoline refining being nearly 50% of what the 18 large refineries located in the PADD V region produce.

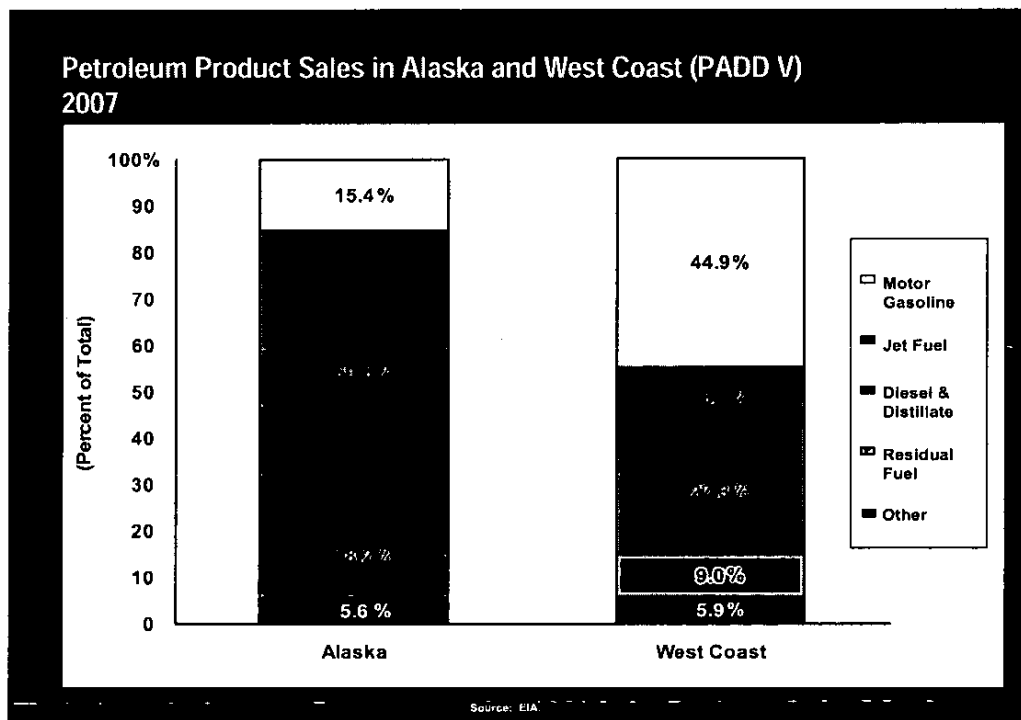


Chart 7, Petroleum Product Sales in Alaska and West Coast 2007
 Barry Pulliam Presentation to House Judiciary Committee, October 23, 2008.

- **Lack of Price Sensitivity:** The demand for gasoline in Alaska is not as “price sensitive” as it is in the rest of the country. Regardless of the price, the demand does not significantly change. Accordingly, there is less incentive for Alaska suppliers to lower their prices compared with other areas of the country where demand drops significantly when the prices rise.
- **Isolated Market:** Alaska is also an isolated market with only three suppliers, the Tesoro Alaska Refinery, the Flint Hills Refinery, and Chevron which imports gas to the Southeast. Due to Alaska’s isolated market, retailers and consumers cannot shop across borders for a lower price, which lowers competition that might otherwise exist. Rural Alaska is an even more isolated market, having no population density and no highway or transportation system except for barges on which to move gasoline.
- **Seasonality:** Although demand is fairly predictable, gasoline consumption in Alaska is seasonal, with a summer time demand being 25% above the annual average.

Gasoline Demand in Alaska is More Seasonal than West Coast 10-year Averages (1999-2008)

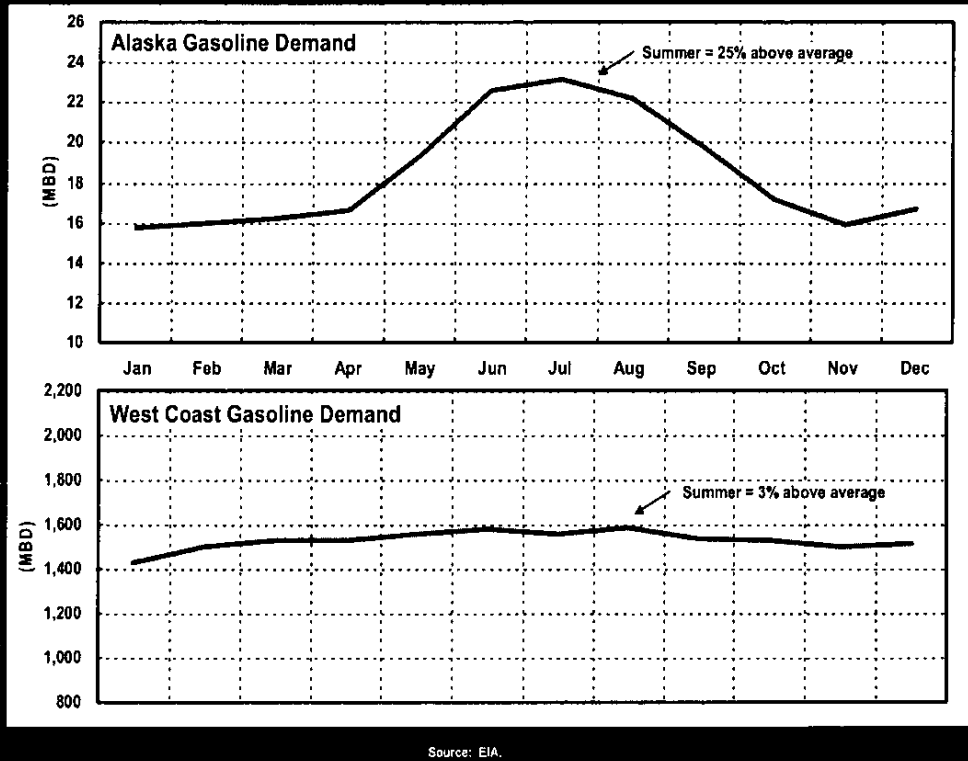


Chart 8, Barry Pulliam, Presentation to the House Judiciary Committee, October 23, 2008.

- **Lack of Storage in Alaska:** Alaska has limited infrastructure for the moving and storage of gasoline, which adds to the cost of gasoline.
- **Alaska's Tax Structure:** Alaska pays the lowest combined state and federal taxes in the U.S. on a gallon of gasoline. Because the State Legislature eliminated the 8% state sales tax this past summer, Alaskans now pay only federal taxes of 18.4% per gallon, plus any local municipal tax. In contrast, the U.S. average for taxes on a gallon of gas is 48.4%.

Gasoline Taxes by State

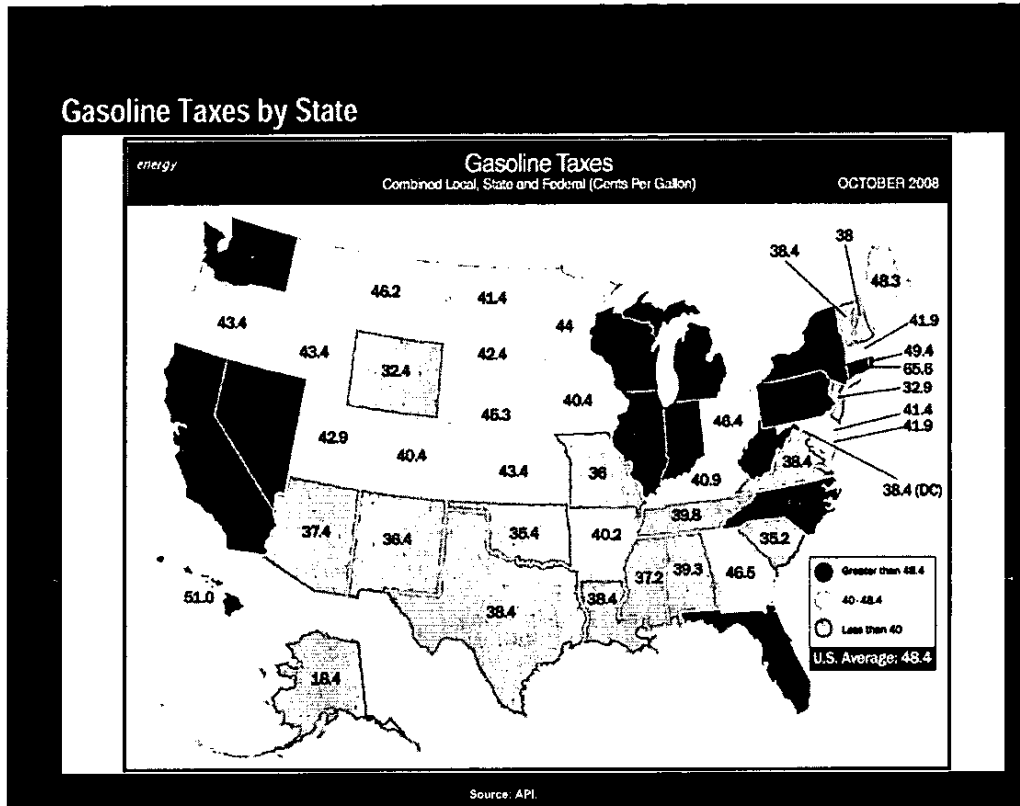


Chart 9, Barry Pulliam, Presentation to the House Judiciary Committee, October 3, 2008.

- **Just In Time Inventory:** Alaska gasoline refiners manufacture and import only the gasoline Alaskans need. This was evidenced this summer when a supply interruption occurred at the Flint Hills Resources rack because the refinery had to close for unexpected repairs making new supplies of gasoline unavailable.
- **Irregularity of Delivery in Southeast Alaska:** Gasoline sold in Southeast Alaska is barged up from the Pacific Northwest and down from the Cook Inlet. Because fuel is only barged in once a month or every few months, it takes longer for prices to reflect current market conditions. It may take up to two or three months to exhaust current

supply before less (or more) expensive gasoline is available to be sold to retailers.

- **Annual Pricing in Rural Alaska:** Gasoline and heating oil in the remote parts of Alaska is barged in only once a year. Due to three seasons of severe ice conditions, fuel has been barged into rural communities during the summer months when the fuel prices are highest, thereby setting the price for the entire year.
- **No Benefit of a Supra-Competitive Market:** Alaska has a limited supply mechanism and a lack of supply sophistication, such as gas supply pipelines that are present in the Lower 48. Due to this fact Alaska has not been subject to any of the supra-competitive pricing seen in the Lower 48, which was caused by the U.S. being awash in gasoline once consumer demand lowered due to high prices. Alaskan refineries produce only what the market demands, meaning that consumers will not experience a competitive discount spurred by oversupply.
- **Barriers to Entry:** Alaska's market has three suppliers of gasoline and is defined as being highly concentrated. Economists call such a market an "oligopoly," because, while not quite a monopoly only a few companies control the market. Oligopolies do not always lead to higher prices. However, even with new suppliers entering the market, existing sellers may be able to keep prices high without much concern about the new competition.

- **Import Parity:** In a purely competitive market the price disparity between Seattle and Alaska's gasoline prices should make it profitable to barge cheaper West Coast gas into Alaska's market. This is known as "import parity." Import parity however, does not seem to affect the price of gas in Alaska. This is due to two conditions, one being Alaska's limited market in which to sell the gasoline and the other being a lack of terminal space.

These are market conditions that are unique to Alaska, yet these market characteristics alone do not explain why the prices at the pump have not fallen in line with the declining price of crude, or found some parity with markets in the Lower 48. Whatever the cause, Alaskans are feeling the adverse economic impact of high motor fuel prices across the State.

RETAIL GASOLINE

The House Judiciary Committee held its first hearing in Fairbanks on September 10, 2008. This meeting emphasized the different elements of the gasoline market. At this meeting the Committee heard testimony from different segments of the market: refiners, distributors, and retailers. As well, we heard testimony from Senior Assistant Attorney General Ed Sniffen who explained current Alaska laws and reported on the status of the Attorney General's investigation.

The Committee learned that retail profit margins were well within acceptable limits, with small independent retailers struggling to make

profits, while large retailers associated with national retail or wholesale stores were not losing money on gasoline. Those retailers had pricing power to offer special discounts to store consumers and could offset any losses through sales of in-store merchandise.

Credit card purchases also cut into the retailer's profit margin. Purchasing fuel by credit has cut into retailer's profits because retailers pay up to three-cents per dollar (3%) in credit card transaction fees.

Additionally, through testimony, the Committee learned that in the competitive gasoline retail market it is not uncommon for retailers to set their prices off the prices seen on their competitors' marquees. This is not a violation of Alaska's antitrust laws since there was no collusion; it is just a marketing strategy.

From the retail gasoline industry the Committee heard from Lois Hein, Co-owner of Riverview Quick Stop in North Pole, Alaska. The Riverview Quick Stop is a small retail gasoline and convenience store. Ms. Hein gave compelling testimony as to how difficult making a profit has become with high prices. Ms. Hein brought before the committee a petition against high fuel prices, signed by over 140 of her customers. The petition has been forwarded to the Governor's office.

Ms. Hein testified that Riverview Quick Stop has had to raise its prices \$1.00 in the past week, and that as of September 10, 2008 the price was \$4.38 at the Riverview Quick Stop. At the time of this report, gasoline prices at the Riverview Quick Stop have fallen to \$2.60 per gallon. Ms.

Hein was quite frank in her testimony, informing the committee that Riverview priced its gasoline 20 cents above Flint Hills' rack rate for cash sales and 25 cents above the Flint Hills' rack rate for credit card sales. Ms. Hein further testified that the Riverview Quick Stop's prices were about 20 cents higher than prices in downtown Fairbanks. Ms. Hein further testified that Riverview Quick Stop used to sell about 700 gallons of gasoline per day; now however, Riverview is now averaging about 300 gallons a day.

Ms. Hein testified that at one point in late August or early September she was unable to get gasoline from Flint Hills Refinery and thus the Riverview Quick Stop had to shut down its pumps. This disruption was caused by a short outage of gasoline production at the Flint Hills Refinery in North Pole. It was a temporary glitch, but it could have been a lot more serious had Flint Hills not been able to get back into production. This event illustrates the extreme fragility of the state's fuel-supply-and-distribution system.

The Committee also heard testimony from Safeway, Inc., a large retailer that sells gasoline primarily as an added convenience for its grocery customers. Glenda Wood, Safeway's Director of Fuel Pricing, testified that although its stations are not expected to lose money, Safeway is in business to sell groceries and gasoline is offered as a convenience. Safeway is mainly a West Coast operator with gasoline stations in Washington, Oregon, California, Colorado, Arizona, Texas, and Chicago, and a few stations on the East Coast.

Ms. Wood further testified that in Alaska Safeway gets most of its gas from either the Tesoro or Flint Hills Refineries and that Safeway buys its gas at the best possible price that it can; however, wholesale gasoline prices are higher in Alaska than other states.

Ms. Wood opined that wholesale prices are higher in Alaska due to limited refining capacity, and also because Alaska refiners are independents with no stake in the more profitable up-stream market: they buy their crude and then add on their costs and a profit mark-up. Alaska also has higher transportation costs for getting the gas from the refinery to the retail market. It is Safeway's belief that the limited refining capacity in Alaska is the cause of the high price of gasoline.

The Committee also heard from Lisa Sundborg of Alaska Petroleum, a fuel distributor and retailer. Ms. Sundborg testified that her company delivers both wholesale and retail fuel. Alaska Petroleum has 17 trucks and they purchase gasoline from the Flint Hills Refinery and some heating fuel from the Petro Star Refinery. Ms. Sundborg further testified that distribution requires a lot of money for the purchase of fuel at the rack and that her company's profit is set at 14%.

Through the above testimony and the testimony from Mr. Sniffen of the Department of Law, the Committee was presented with evidence that the high fuel prices in Alaska were originating at the refinery level. Mr. Sniffen testified that the chart below "shows what the retail margins are from rack to pump price. The green line is Seattle and retail margins spike up and down

with much more volatility than Anchorage or Fairbanks. This shows that the problem is not from rack to retail, but at the refineries rack rate.”

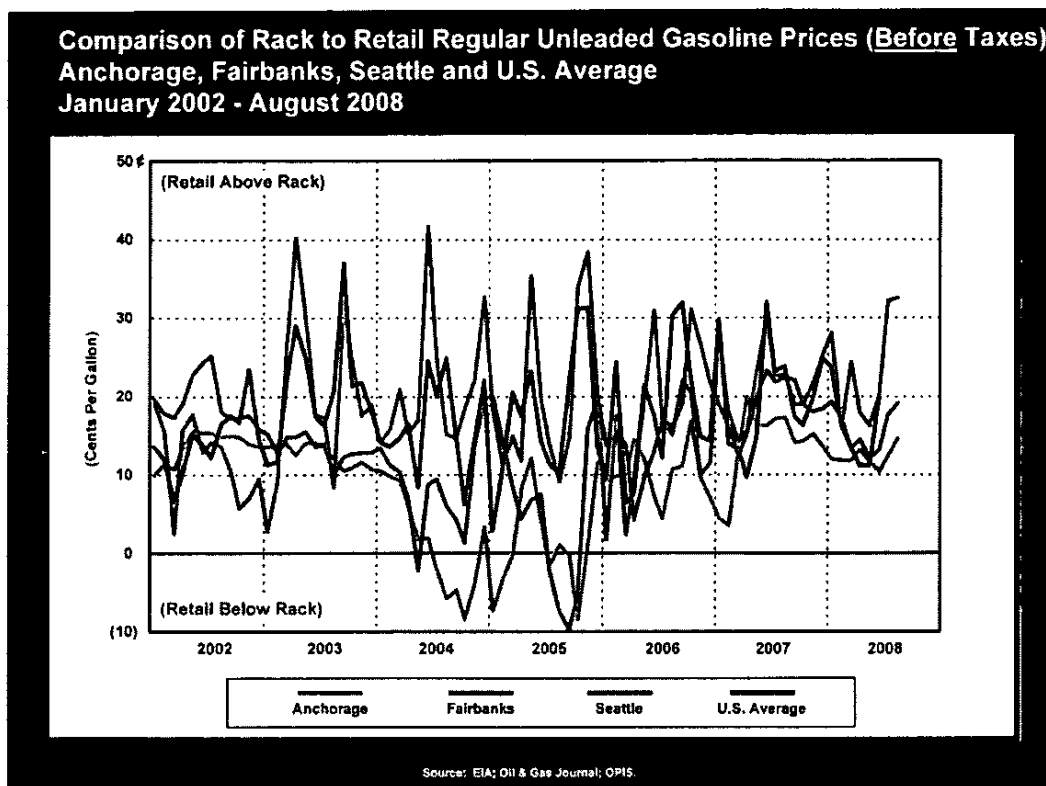


Chart 10, presented by Senior Assistant Attorney General, Ed Sniffen at the House Judiciary Meeting on September 11, 2008.

THE REFINING INDUSTRY

Refineries break down crude oil's long-chain hydrocarbon molecules into useful shorter-molecular-chain petroleum products. The profit margin that a refiner can expect to make by "cracking" crude oil is termed the crack spread. Crack spread is an oil industry and futures trading term that refers to refiners' profits. Refineries profits are directly tied to the differential between the price of crude oil and petroleum products they produce. The

refining industry is currently experiencing an unsustainable negative gasoline crack spread, which is being driven by the global credit crisis, conservation, and reduction in demand. This is known as demand destruction.

All commercial Alaska refiners are independent refiners, being only partially integrated into the oil industry. However, balance in the industry is best achieved when a company has a stake in both the upstream and the downstream portions of the market. Refining companies that are involved only in the downstream aspect of the market must purchase crude and then deal only in refining and distribution. This makes the refiners particularly vulnerable in volatile oil markets, since they share none of the high upstream profits.

The current negative crack spreads seen in the refining industry are unsustainable and have even had some experts calling this the “dark ages of refining.” One has only to look at the stock prices of Tesoro and Valero, two of the largest partially-integrated refiners in the U.S., to see that the refining industry is currently experiencing a negative crack spread.

Tesoro’s stock prices have experienced a 52 week high of \$56.53 per share on November 23, 2007, and fell to a 52 week low of \$6.71 per share on November 20, 2008. As of November 28, 2008, Tesoro was trading at \$9.19 a share. With current low crude prices the crack spread is beginning to recover, but conservation and demand destruction have remained in place.

At the time that this report was published, Tesoro's stock price has recovered to \$16.95 per share, still well off its 52 week high.

Valero Energy Corporation, another large, partially-integrated refiner, also shows the effects of a negative crack spread in this volatile market. Valero experienced a 52 week range of \$71.25 to \$13.94 per share. And, as of November 28, 2008, Valero's stock was trading at \$18.35 per share. Today, with crude under \$40.00 per barrel, Valero is trading at \$25.25 per share.

ALASKA'S REFINING INDUSTRY

Alaska has a total of six refineries in state. Two are located on the North Slope and provide refined products for operations on the Slope. The State's largest refinery is the Tesoro Alaska Refinery located in Nikiski on the Kenai Peninsula. The Flint Hills Refinery is located in North Pole, and can run more crude through the crude units, but cannot produce as much product as the Tesoro Alaska Refinery. There are also two smaller Petro Star refineries, located in North Pole and Valdez. Petro Star produces kerosene, diesel, and home heating oil.

All of Alaska's refineries, with the exception of the Tesoro Alaska Refinery, are classified as small topping plants. Topping plants cannot refine all the crude oil they take in and it is either put back into the TAPS line or exported and sold at a loss. Many topping plants in the United States have closed due to unprofitability. The refineries in Alaska are also all smaller than other refineries. They are older and less efficient than most

other U.S. refineries which have enjoyed modernization or have been scrapped. Additionally, Alaskan refineries have their own feedstock and operational issues.

For the purpose of this gasoline study, we will look at the two refineries producing gasoline, Tesoro Alaska Company and Flint Hills Resources.

Flint Hills Resources

Jeff Cook, Director of External Affairs, testified at all three hearings for Flint Hills Resources. The Flint Hills Resources Refinery is located in North Pole, Alaska. Mr. Cook relayed that Flint Hills Resources had sixty years of experience in the refining business. Flint Hills Resources owns refineries in other states as well as Alaska and purchased the North Pole Refinery in 2004. The refinery first began production in 1977, and Flint Hills Resources is the fourth owner of the facility.

The plant was built by Earth Resources. When it was originally built, it was built to process 25,000 barrels of oil per day. Earth Resources expanded the plant's capacity to 45,000 barrels per day in 1980. Earth Resources then sold the majority of its stock to MAPCO. MAPCO expanded the plant in 1985 to increase the amount of heating oil and jet fuel produced; MAPCO also added asphalt and gasoline production. Capacity increased to 90,000 barrels a day in 1985 and eventually expanded to 220,000 barrels per day. In March of 1998, the plant was bought by

Williams Companies. Flint Hills Resources Alaska acquired the North Pole Refinery and its associated terminals in July of 2004.

Today, the refinery produces about 50,000 barrels a day of saleable product, approximately 77% of which is jet fuel.

Gasoline & Naphtha	10%
Jet Fuel/#1 Fuel Oil	77%
#2 Diesel	8%
Gas Oil	4%
Asphalt	1%
Total	100%

Chart 11, Flint Hills North Pole refinery production by volume (www.FHR.com.)

The North Pole Flint Hills Refinery produces less than 15% of the gasoline used in Alaska and the refinery mainly supplies gasoline to the Interior. Flint Hills had to cut back on gasoline production due to new sulfur requirements that went into effect for gasoline on January 1, 2007. Jeff Cook also testified that because of federal fuel issues with the State of Alaska, Flint Hills is at the maximum capacity for the production of gasoline.

The company also owns and operates product terminals in Fairbanks and Anchorage that store and distribute asphalt, fuel oils, diesel, jet fuel, and gasoline. The Anchorage Terminal receives product from the North Pole Refinery via Alaska Railroad tank cars, annually off-loading 28,000 rail cars. That product is then distributed locally and to locations along Alaska's coastline.

The Flint Hills North Pole Refinery accounts for about 40% of the Alaska Railroad's business. The Alaska Railroad would itself face economic hardship were the refinery to close.

The North Pole Refinery gets its crude from the State of Alaska, by purchasing royalty oil. Flint Hills North Pole refinery takes in between 180,000 to 200,000 barrels of crude per day. After the crude is distilled and turned into a few basic products, the rest is returned into the TAPS line and the refinery pays into the quality bank². A portion of the oil taken from the TAPS line is also refined into product to run the plant, thereby increasing Flint Hill's operating costs over refineries that are powered by cheaper natural gas. With gas to oil at a 6 to 1 equivalent, Flint Hills Refinery is at an economic disadvantage. Additionally, as the flow of crude oil in the pipeline has declined, the oil in the line is cooler and more-sticky than the warm oil the plant was originally designed to take in, therefore, the plant must use more energy to heat this cooler, stickier crude.

State royalty oil has been a mixed blessing for the North Pole Flint Hills Resources Refinery. Royalty oil played a key part in the construction of all refineries in Alaska. Prior to the building of the North Pole Refinery there was debate as to whether the refinery would be viable, but community leaders and State officials strongly supported the building of the plant. Earth Resources was given a 25 year contract that assured the company a guaranteed supply of oil at the prevailing average royalty price paid by

² The TAPS Quality Bank was created in the early 1980s to compensate shippers of higher quality crude that is commingled with lower quality crude from another shipper.

North Slope Producers, and allowed the refinery to deposit the unused portion of crude back into the pipeline.

Flint Hill's 2004 purchase of the refinery coincided with the end of the original 25 year royalty oil contract that the State had issued to Earth Resources. Allowing the purchase of the plant, the State negotiated a new contract with Flint Hills that provided for a guaranteed amount of oil. However, this time the State added a premium to be paid on top of the average royalty in-value price. According to the agreement of sale, the price paid by Flint Hills Refinery for royalty oil from each Unit from which sale oil is nominated is:

Price = ANS Spot Price - \$1.55 - Tariff Allowance + Quality Bank Allowance - Line Loss

However, the premium proved to be problematic for Flint Hills. As the price of crude escalated, it became increasingly hard for the company to recoup its expenses. Flint Hills is currently trying to renegotiate with the State parts of the royalty contract, including premiums. Flint Hills took another financial hit when the tariff on the Trans-Alaska Pipeline was readjusted downward for shipments of crude oil in-state. This was a retroactive adjustment that had the effect of raising the cost of royalty oil purchased by Flint Hills. These recent tariff decisions by the Regulatory Commission of Alaska (RCA) and Federal Energy Regulatory Commission (FERC) left Flint Hills Resources having to pay a huge back-payment of several hundred million dollars to the State.

Increased environmental emission regulations and increasingly stringent federal requirements on the type of fuels produced have forced many topping plants to close. The Flint Hills North Pole Refinery has been able to keep pace with new environmental regulations, but to comply it has had to change the type of fuel it produces, and this has impacted the amount of gasoline and road diesel that it produces. Jeff Cook testified that while the refinery still produces some gasoline and off-road diesel, the company is now forced to buy gasoline and diesel fuel from other sources in order to meet the full needs of its customers. A new issue facing refineries is pending federal rules for lower benzene in gasoline. The installation of technology to meet this new mandate will involve substantial capital investment for Alaska refineries. Flint Hills Resources will have to consider it if will make this capital investment in its North Pole Refinery.

Flint Hills Resources recently closed a chemical plant in Odessa, Texas, stating that the significant amount of investment needed to reposition the plant for success prompted the decision. Flint Hills' president Brad Razook sent the North Pole Refinery an e-mail in May stating that the plant would be assessed to make sure that it was adding value to the company. Mr. Razook laid out three options for the plant that included, (1) selling the plant, (2) making reconfigurations, or (3) investing in upgrades to increase volume and lower operating costs. Unfortunately, the high price of crude throughout the summer and into the fall does not bode well for keeping the plant profitable and adding value.

When oil prices are high, the Flint Hills North Pole Refinery is not able to make a profit due to the fact that most of their product is jet fuel

which is a commodity whose price is controlled by the world market; since jets can refuel anywhere, prices must remain competitive. With the recent and perhaps still ongoing slide in crude oil pricing, Flint Hills has become profitable again, but the challenges facing the company remain.

Governor Palin recently announced a joint effort between the state and Flint Hills to conduct an evaluation of the refinery's future, "aimed at positioning the North Pole Refinery for long-term success." Although few details were given, the press release reads as follows:

The State and Flint Hills will evaluate options aimed at improving the plant's ability to respond to volatile energy costs, varying product demands and volatile refinery margins as well as facilitating plant upgrades needed to position the plant to succeed long-term. Flint Hills is providing data to the Department of Natural Resources, which has assured confidentiality. This data allows DNR the opportunity to analyze refinery economics; this analysis is expected to take from 3 to 6 months.³

Additionally, on December 19, 2008, Kevin Banks, Director of the Division of Oil and Gas for the State of Alaska, announced that the State may ease the terms of its royalty oil supply contract with Flint Hills Resources. "Flint Hills is now providing us with financial information on the plant, which will guide us in making a decision," said Mr. Banks.

Jeff Cook said that, "the company's conclusion of the analysis is that no significant investment is possible for the company. The required spending is in the hundreds of millions of dollars." The House Judiciary

³ The Governor's press release at <http://www.gov.state.ak.us/news.php?id=1579>

Committee and State representatives met in an executive session on January 14, 2009, to discuss viable options.

There has been no indication that the State is considering either purchasing or establishing an ongoing business partnership with Flint Hills Resources. Additionally, Flint Hills Resources has also testified before the Committee that they are not looking for a hand-out from the State.

Tesoro Alaska Company

Kip Knudson, External Affairs for Tesoro Alaska Company, testified twice before the House Judiciary Committee. Tesoro Alaska Company, like Flint Hills Resources, is an independent refiner and is therefore more at the whim of market forces. Tesoro is headquartered in San Antonio, Texas, and has seven refineries with a 660,000 barrel per day (bpd) crude capacity. Tesoro also owns a retail network of over 900 sites, employs 5,500 people, and is a publicly traded company.

Tesoro Alaska Company's refinery is a medium complex refinery located in Nikiski, Alaska, on the Kenai Peninsula. The Kenai refinery has a 72,000 bpd capacity, and ranks 81st in capacity among U.S. refiners. Tesoro is the main supplier of gas in Alaska. Due to some conversion at the plant the refinery can take 100% volume and produce 125% volume. Heavy vacuum gas oil, fuel oil, bunker and road asphalt have no market in Alaska and are exported. Mr. Knudson testified that once Tesoro Alaska Company buys the crude they own it, unlike the other Alaska refineries that can return any unused crude into the TAPS line. Approximately 1/3 of Tesoro

Alaska's output is sent outside for processing. This is usually the bottom third and is generally sold at cost or below.

Tesoro Alaska Company also owns a pipeline system for distribution at the Nikiski Terminal, the Anchorage Terminal, and the Anchorage Airport. Tesoro Alaska Company sells their products to anyone who will purchase from them. Kip Knudson testified that the Tesoro Alaska Company Kenai Refinery produces to meet market demand, and that they do not overproduce or flood the gasoline market in Alaska, therefore production capacity changes daily.

Tesoro Alaska Company purchases approximately 50% of its crude from Anadarko on the North Slope, approximately 25% from the Cook Inlet, and the refinery imports approximately 25% light foreign crude by chartered vessel. Importing crude oil is expensive and we can expect to see imports grow as the Cook Inlet production declines.

The Kenai refinery employs over 200 people and makes a value-added product mix of propane, gasoline, jet fuel, diesel fuel, heavy vacuum gas oil, fuel oil/bunker, and road asphalt. The company also owns 31 convenience stores in Alaska, 29 of which sell fuel, and has over 58 branded dealers. Tesoro Alaska Company is the only refinery that can produce ultra-low sulfur diesel (road diesel), which means that Tesoro Alaska Company is the only Alaskan refiner in the market.

Tesoro Alaska Company used to be a big royalty oil consumer. Now, however, that has diminished and Kip Knudson of Tesoro Alaska Company

expressed that this might be because the buyers were not pleased with the royalty oil pricing. Mr. Knudson said, "After you bought the barrel, years later you might get an adjustment."⁴

Since Tesoro Alaska Company did not provide the Committee with any of its financial information and Tesoro is a publicly-traded company, Tesoro's 2008 Third Quarter Report to the SEC is helpful to assist the Committee in understanding the company's profits and costs in the Pacific North West Market, which includes Alaska and Washington. Unfortunately, Alaska is not reported separately. However, we do know that Alaska represents 10 percent of the company's refining capacity.

During the first half of 2008, industry refined profit margins remained weak, reflecting record high crude oil prices which increased more rapidly than product prices. After peaking in early July 2008, crude oil prices declined rapidly. Product prices declined less dramatically than crude oil prices. However, of note, diesel margins increased above 2007 levels beginning in the 2008 second quarter due to continued strong global demand and low inventories. Tesoro reported that its 2008 third-quarter earnings rose five-fold due to higher profit margins.

As can be seen from the chart below, Tesoro reported a gross refining margin per barrel of \$13.76 in the Pacific Northwest in the third quarter, compared to a company average of \$16.69.⁵

⁴ House Judiciary committee record 9/10/08 at 10.47.

⁵ Gross refining margin per barrel is calculated by dividing gross refining margin by total refining margin by total refining throughput. Gross refining margin is calculated as

	Three Months Ended		Nine Months Ended	
	September 30		September 30	
	(Dollars per million except barrel amounts)			
<i>Pacific Northwest (Alaska and Washington)</i>	2008	2007	2008	2007
Refining throughput (thousand barrels per day)(h)	\$162	\$185	\$166	\$184
Gross refining margin (c)	\$205	\$86	\$372	\$623
Gross refining margin (\$/throughput barrel) (c)	\$13.76	\$5.01	\$8.19	\$12.43
Manufacturing cost (c) (d) (\$/throughput bbl)	\$3.79	\$2.84	\$3.94	\$2.80

Chart 11, Tesoro Corporation 2008, 3rd Quarter SEC Report (page 33)

One question that remains unanswered is: Are refiners in Alaska making exceptionally high profits to carry and make up for losses in the rest of the region, or are high gasoline prices due to unsustainable losses in markets related to other refined products?

A parallel corporate example might be Alaska Airlines' pricing for in-state travel versus pricing for travel in competitive markets on the West Coast. Why is airfare from Fairbanks to Anchorage more expensive than travel from Seattle to Portland or even to the East Coast?

The Committee was not able to fully determine the costs and profits for Alaska's refinery operations. However, it was clear that the proportion of gasoline prices attributable to the refinery margin has increased dramatically in recent months. Since March of 2008, the margin in Alaska

revenue less costs of feedstocks, purchased refined products, transportation and distribution. Manufacturing costs per barrel is used to evaluate the efficiency of refinery operations. Manufacturing costs per barrel is calculated by dividing manufacturing costs by total refining throughput.

has increased over 230 percent, with half of the increase coming since crude oil prices began their dramatic price decline, from all-time highs in July. By comparison, the refining margin in Washington increased about 63 percent and the average component for U.S. refineries was an increase of 120 percent.⁶

Current Alaska Law

Ed Sniffen, Senior assistant Attorney General, relayed to the Committee that this is the second investigation into price gouging by the Attorney General's Office. The first was started in 1999, under the Knowles Administration, and concluded three years later, with a final report being issued in 2002. The initial investigation was prompted because the State was experiencing similar high fuel prices. Like the present investigation, the Attorney General's Office issued Civil Investigative Demands (CIDs), which are like subpoenas, to determine if any antitrust laws are being broken. The Attorney General's Office concluded in its November 21, 2002 report that there was insufficient evidence to indicate a violation of Alaska's antitrust laws. (See, attachment 1, Attorney General's December 21, 2001, Update and Status, and November 21, 2002, Closing Report)

Under current Alaska law, in order to establish a violation of Alaska's antitrust statute, AS 45.50.562 and AS 45.50.564, or comparable federal law on which Alaska's laws are patterned, there must be evidence that two or more companies entered into an agreement to fix petroleum prices. The fact

⁶ Legislative Research Report 09.053, *Petroleum Refineries and Gasoline Prices in Alaska*, December 18, 2008.

that companies charged prices in excess of the competitive level or raised or lowered prices in a parallel fashion is not enough evidence to establish an agreement. Evidence of uniform pricing must be established by showing that the parties got together to engage in a cooperative pricing agreement. Cooperative pricing behavior involves a “meeting of the minds” either by tactic or active collusion, by engaging in behaviors: such as, (1) actions contrary to an entity’s own economic interests, (2) a departure from normal business practices, (3) motive to conspire, (4) opportunity to conspire, (5) a high level of intercompany communications, and (6) past antitrust violations.⁷

No state in the U.S. currently regulates gasoline prices. Economic forces inclusive of production costs, supply, demand, and competition in the market place determine the final gasoline price. Refiners, distributors, and retailers can sell gasoline at any price they want, provided consumers are willing to pay the price. If the prices were to reach an “unconscionable level,” that could also violate Alaska’s consumer protection laws.

Demand Destruction Benefits Consumers

While Alaska’s demand for gasoline remained relatively unchanged during high gasoline prices, demand for gasoline in the rest of the country dropped significantly. The large refineries in the Lower 48 are not set up for lower production, and the market quickly becomes flooded with product, creating a supra-competitive market. Suddenly, there is a glut of gas on the market, which in turn causes the price of gasoline to drop like a rocket. In

⁷ See, *In re Baby Food Litigation*, 166 F.2d 112, 122 (3rd Cir. 1999)

contrast, Alaska has not enjoyed this same supra-competitive market and the State has not seen prices drop in-step with markets in the contiguous United States. This variable is one of the factors accounting for the decoupling of price parity with the Lower 48.

Import Parity and Terminal Capacity

Import parity is a concept that was brought before the Committee. Import parity begs an answer to the question as to why, when Alaska's gasoline prices get so high is it not profitable for a third party to barge gasoline in and sell it on the Alaska market. In a purely competitive market the threat of importing cheaper gas should regulate prices. However, there must be a place to store the gasoline and a market in which to sell it.

Steve Ribuffo, Executive Director of the Port of Anchorage, explained gasoline storage at the Port of Anchorage. The Port of Anchorage is a tenant port, meaning that all improvements are made by the tenants. The Port of Anchorage only leases the property and the tenants make the improvements on the leased property. The Port has static storage for 2.8 million barrels of petroleum product, and that storage is full, being spread among lessees Flint Hills, Tesoro, Signature Fuels, and Chevron. Mr. Ribuffo also explained that 100% of the jet fuel used at Elmendorf Air Force Base comes through the Port first. Mr. Ribuffo explained that currently the Port of Anchorage is space limited out--meaning that even if another company wanted to import fuel into Alaska, there is a lack of terminal space. However, currently there are plans to expand the Port of Anchorage, as well as separate plans to

expand the Mat-Su Port. This proposed solution is subject to capital investment and is years away from completion.

Tight Retail Market

Also explaining the lack of import-parity with the Lower 48 is Alaska's tight retail market for gasoline. A new company entering Alaska's gasoline market would not be able to sell gasoline to branded gas stations, such as Tesoro or Chevron; because they are branded companies, they already have their suppliers. Alaska does not have the same kind of non-affiliated stations that are found in larger markets in the Lower 48. The large chain stores such as Costco, Sam's Club, Fred Meyer and Safeway and the small independent retailers, such as the Riverview Quick Stop might be able to buy from a gasoline supplier new to Alaska, but most of the retailers are already contracted with suppliers. Stores that could negotiate new contracts with a third party supplier represent only a small portion of the gasoline retailers in Alaska. Even if a new supplier were able to negotiate contracts with these independent retailers, those contracts may be inadequate to economically support a supplier new to Alaska. The other question that begs an answer is if someone were to barge in gasoline, would Alaska refiners immediately lower their prices, thereby making importing gasoline uneconomical and squeezing out the new competition? The lack of terminal space and the tight retail market create considerable barriers for entry into the gasoline market.

Price Gouging

Currently, Alaska does not have a price gouging law. Sellers of all goods and services can set their prices at what the market will bear, and they are not required to set prices on a cost-plus basis. The amount of profits a business can make on a product is not capped. Alaska's gasoline market is unique; even when prices rise, the demand for gas by volume does not change much. Alaskans must drive. There is presently very little evidence of demand destruction in the State; thus there is less incentive for suppliers to lower their prices, compared to areas of the country where demand drops significantly when prices rise.

In states that have price gouging laws, these laws are usually triggered by a declared "state-of-emergency." These laws are fashioned to protect consumers when a disaster such as a hurricane occurs. They are established to make sure that retailers do not take advantage of citizens who needed necessities, particularly in a time of emergency. For example, a \$400 generator can not be marked up to \$1,400 because of the demand created by a natural disaster. North Carolina, in House Bill 653, recently amended its legislation to broaden the definition of "state of emergency" to include "an economic emergency." The price of gasoline at the pump is more a reflection of what the market will bear, than of "monopolistic predatory pricing."

POSSIBLE ACTION FOR THE 26th LEGISLATURE

The 26th Alaska State Legislature may want to discuss various options to combat the high price of gasoline. However, it should be noted that meddling in the free market is likely to produce negative consequences with lasting effects on Alaska's economy and employment. We want to avoid unintended consequences at all costs, and regulating prices or tying them to Washington refinery pricing may have a chilling effect on the Alaska market.

State or Public Ownership of Flint Hills Resources

State or public ownership of the Flint Hills Resources Refinery in North Pole has been brought to the Committee's attention by public input. This would involve the State of Alaska or in other words, the people of Alaska, purchasing the Flint Hills North Pole Refinery for the benefit of Alaskans who purchase Flint Hills Resources' products.

However, as previously discussed, the Flint Hills Refinery in North Pole produces only about 15 percent of the gasoline Alaska uses, and it is gasoline used mostly in the Interior region. Thus, this small percent of Alaska's gasoline produced by Flint Hills Resources does not lead the Committee to believe that government or community ownership of the refinery would ultimately lead to lower consumer prices for gasoline across the State.

Additionally, the Flint Hills Refinery product mix is 77 percent jet fuel and 10 percent gasoline. As previously discussed, jet fuel will always be priced in conjunction with the world market. Therefore, the refinery would still have to use gasoline pricing to offset losses when crude reaches exceptionally high prices. We cannot be more emphatic in making this point: Jet Aviation Fuel is the mother's milk of Alaska. We have almost no other value added industry in the State.

Deceptive Trade Practice Legislation (Price Gouging)

This year the House and Senate have introduced identical price gouging legislation, they are House Bill 68 and Senate Bill 54, respectively. These two bills, if enacted, would make it prima facie evidence that refiners are practicing deceptive trade practices under AS 45.50.471, if the refiners are selling motor fuel, jet fuel, fuel for space heating, or diesel fuel at ten percent above of the average wholesale price of the comparable energy resource, as charged by refiners in the state of Washington.

This new law would create an incentive for refiners to hold their prices within 10 percent of Washington's rack prices and would appear to protect the public from "unscrupulous refiners."

However, as noted earlier, the Washington refining industry and ultimately the Washington market bears some, but relatively little commonality with the Alaskan market. Alaska is a much smaller market than Washington. The refining industry is also different in make-up. Washington operates five refineries, four of which are highly complex, high-

conversion operations, which ship gasoline, jet fuel and diesel through a pipeline system that serves Washington and Oregon.

Gasoline, diesel oil, and jet fuel are the largest finished products made by Washington refineries, representing 46 percent gasoline, 23 percent diesel, and 13 percent jet fuel of total production. This is quite a different production ratio than Alaskan refineries that produce 59 percent jet fuel, 15 percent gasoline, and 11 percent diesel. Washington refineries also have much cheaper electricity and fuel their plants with natural gas. The Fairbanks North Star Borough economic quarterly shows the U.S. utility average at 100, with Settle at 81.1, Anchorage at 91.0, and Fairbanks at 214.6.

In Alaska, the market for gasoline is small, because the population is small. Therefore, the refining industry of Alaska was built around the market it serves, jet fuel. A term that the Committee heard throughout testimony was, "in Alaska jet fuel is king." However, the dominant production of jet fuel leaves very little pricing flexibility for a refiner, since the price of jet fuel is set by the world market.

For the reasons stated above, the economic conditions governing Alaska's refining industry are quite different than those governing the refining industry of the State of Washington. Therefore, directly tying Alaska's refiners pricing structure to Washington's refining prices may prove to be like comparing apples to oranges. Refiners in Alaska, by the very nature of the Alaskan market, are already constrained by product

pricing of jet fuel. Under this new law, refiners would lack the flexibility to price commodities to offset losses due to unprofitable jet fuel manufacturing.

The worst unintended consequence of this legislation would be for independent refiners to pack up and leave the State. This would not just shut down the refineries, but affect the entities that rely on the refineries, such as the Alaska Rail Road, the Ted Stevens International Airport, the Fairbanks International Airport, and our air force bases located in both Anchorage and Fairbanks.

There are no legal impediments to prevent the State from regulating the price of fuel. However, when the State of Hawaii enacted its gas cap law in September of 2005, the State saw prices rise shortly after the legislation's enactment and eight months later Hawaii repealed the law. Should Alaska try to regulate its fuel price, the result may be similar to that experienced in Hawaii, with all fuel prices at the refinery level quickly rising and staying at the maximum amount allowed under the law, costing all fuel consumers more.

While it is tempting to quickly pass legislation that would ease the suffering of consumers paying fuel prices that are surprisingly higher than in the Lower 48, the consequences of any bills affecting the free market structure of the refining industry in Alaska must be studied carefully and vetted fully by the legislature should it choose to entertain this type of legislation.

Induce Third Refiner into the Alaska Market

Another possible solution may be for the legislature to incentivize a third refiner to enter the Alaska Market. However, Alaska is currently refining all the gasoline the State can use. Therefore, there is no incentive for a third party refiner to enter the market, since Alaska refiners already have captured the market share. Furthermore, incentivizing a third gasoline refiner into the Alaska market could cause the market to become over-saturated with the consequence that the weakest refiner would be forced to shutdown causing a duopoly of refineries once again.

Incentivize more gasoline storage in Alaska

Alaska may also want to consider adding more gasoline storage strategically around the state. Gas prices may see a decline in rural areas of the state, where gasoline is barged, if more storage terminals for gasoline were to be built in strategic areas of the state. If there were additional gasoline storage the commodity could be purchased when the price is low and stored until it is able to be moved to market.

Sell State Royalty Oil at Below Market Price for Alaskan Consumption

It is a difficult question to determine if it is constitutional for the State to sell its royalty oil at a below market price to an oil refinery in Alaska that intends to sell the product it produces in-state for the benefit of the citizens of Alaska.

In a legal opinion from Donald M. Bullock, Jr., of the Legislature's legal department, Mr. Bullock opines that such a sale would have to be "consistent with the public interest," made for the "maximum benefit of [Alaska's] people,"⁸ and approved by the legislature⁹ for the state to sell its royalty oil to an in-state refinery at a below market value.

Mr. Bullock further opines that there may be issues with the Commerce Clause, article 1, section 8, clause 3, Constitution of the United States because the United States Supreme Court has long recognized that the

⁸ The Alaska Constitution, Article VIII, Sections 1 and 2, provide that:

SECTION 1. Statement of Policy. It is the policy of the State to encourage the settlement of its land and the development of its resources by making them available for maximum use consistent with the public interest.

SECTION 2. General Authority. The legislature shall provide for the utilization, development, and conservation of all natural resources belonging to the State, including land and waters, for the maximum benefit of the people.

⁹AS 38.06.055 provides:

(a) In addition to the recommendation by the board required under AS 38.06.050, the commissioner of natural resources may not enter into a sale, exchange, or other disposition of oil or gas or of the rights or waiver of the rights to receive future production of royalty oil or gas under AS 38.05.183 without the prior approval of the legislature. The legislature may approve a sale, exchange, or other disposition of oil or gas or of the rights or of a waiver of the rights to receive future production of royalty oil or gas only by enacting legislation.

(b) The provisions of (a) of this section do not apply to

(1) the sale, exchange, or other disposition of oil or gas for one year or less if the sale, exchange, or other disposition is entered into to relieve storage or market conditions;

(2) contracts for the sale of state-owned royalty gas or oil that specify the sale and delivery of not more than

- (A) 400 barrels of crude oil per day;
- (B) 460 barrels of natural gas liquids per day; and
- (C) 2,400 Mcf of natural gas per day.

(c) A sale, exchange, or other disposition of oil or gas under (b)(1) of this section may not be continued after the end of one year or renewed with the same party without the prior approval of the legislature under (a) of this section. This subsection does not apply to a sequential competitively bid sale of oil or gas made with the same party under (b)(1) of this section.

commerce clause also limits the power of states to erect barriers against interstate trade. If Alaska enacts such a law, the State would have to be able to “show that it advances a legitimate local purpose that cannot be adequately served by reasonably nondiscriminatory alternatives.”¹⁰ However, the United States Supreme Court left the door open, under some circumstances, to state efforts to provide a limited preference for a state’s own citizens in the use of publicly-owned resources. (See, attachment 2, Legislative Legal Opinion, dated September 12, 2009).

However, while it might be theoretically possible for the legislature to determine that selling royalty oil for less than market value is in the “best interest of Alaska,” passing such a law might prove difficult, since the “best interest of Alaska” means all residents of Alaska. Selling royalty oil to the Flint Hills Refinery and the Tesoro Alaska Refinery would most likely only benefit residents served by those refineries. No one else in Alaska would receive the potential benefit. Conversely, when we sell oil at the market value, the money goes into the general fund and benefits everyone. Although there are arguments both for and against a law that would allow the State to sell its royalty oil to an in-state refinery at below market value, the Alaska Supreme Court would probably make the decision about whether such a law violates the Alaska Constitution, and a challenge to the new law could also rise to the U.S. Supreme Court.

¹⁰ *Taylor*, 477 U.S. at 138, quoting *Hughes v. Oklahoma*, 441 U.S. at 336 (1979).

CONCLUSION

Economic Drama Meets High School Economics Our Conclusion: Opportunity Cost

“Opportunity cost” is defined by Google as: “The value of the next best choice that one gives up when making a decision.”

If Alaskan consumers want near parity in pricing with Seattle refineries and attempt to achieve this parity by meddling with pricing ratios and creating formulas for Alaskan refined gasoline, in relation to Seattle refined gasoline, and if the legislature attempts to accomplish this in statute, the Committee believes we risk closure of the Alaskan refineries, or the voluntary exit from the Alaskan market by the refineries parent companies. Controlling duopolistic, efficient markets by inserting the heavy hand of government will likely have severe consequences that will not benefit consumers.

In the Lower 48 there are two commodities at play. One is the base cost of the resource, which is the price of crude oil; while the second commodity in play is refined gasoline. Refineries do not have spigots and the Committee learned they cannot generally regulate themselves and their production in the way the very simple (simple versus complex refineries) Tesoro Alaska Refinery does, by adjusting output. Therefore, much of the time, in a soft marketplace with the characteristics of (1) demand destruction, (2) conservation practices, (3) recessionary economic conditions, and (4) a surplus supply of refined gasoline in the Lower 48, we see market conditions where refineries are forced to sell their refined gas at a loss, and make their profit margins on other products in their portfolio. So

often, for large, complex refineries, refined gasoline production is a byproduct. The definition of "byproduct" should not suggest that it has lesser value or lesser meaning to the profit matrix of the refinery. Instead, gasoline is often the "valuable leftover" when refineries produce other petroleum products. But often the volume of gas produced by the Lower 48 refineries, which is dictated by the other products they manufacture, swamps the available market place with surplus gasoline.

In Alaska, refined gasoline, although a small part of Flint Hills' and Tesoro's portfolios, is nevertheless a staple of the Alaskan marketplace and is often a critical profit center for the refineries. Although their "raison d'être" (reason to be) is the manufacture of Jet Aviation Fuel, as previously discussed, their profitability relies very heavily on participating in the very efficient supply and demand relationship for gasoline that exists in our isolated market.

Alaska refineries are forced to be globally competitive on the price of Jet-A. With competitive pricing in this niche of the industry set by world markets and global demand and with the variable cost of crude oil and the wild price fluctuations in the Jet-A market itself, the in-state refiners must look to refined gasoline sales and home heating oil (diesel) sales to cover operating costs and generate profit margins. As discussed, if refined gasoline only represents 10 -15% of an Alaska refinery's product mix, but is responsible for carrying the burden of much of the refinery plant's operating costs, then the Committee suggests, in conclusion, that an enormously disproportionate amount of these costs are being borne by Alaskan consumers. Embedded in Alaskans' retail gasoline costs are the occasional

operating losses Alaskan refineries incur in the jet aviation fuel market. Each dollar lost in jet aviation fuel sales are prices compensated for by spreading the cost over a gallon of gasoline produced for consumption by Alaskan consumers.

Periodically over the last decade, Alaska refined gasoline has been at or below Seattle refined gasoline prices. But often, and particularly dramatically since March of 2008, Alaskans have paid a great deal more for refined gasoline. It is not fair. If the committee used layman's language to describe how Alaskans feel, the profanity would be much too graphic and would compromise the professionalism of this report. Suffice it to say, Alaskans feel taken advantage of.

Herein lies the opportunity cost dilemma. Are Alaskans better off regulating our refineries so tightly that they may be forced to close, with the benefit being that we can import Washington refined gasoline and enjoy a more predictable pricing associated with Pacific Northwest rack rate, plus transportation costs? But in so doing, Alaska will also forfeit the value added market of Jet-A. Furthermore, Jet-A would be imported and likely would cost approximately .15 cents more per gallon than the State's aviation industry is presently paying. The state will lose its competitive position. Consumers will pay a little more for air fare, but the volume of freight and aircraft passing through Alaskan airports will quickly fall off the figurative cliff.

The Institute of Social and Economic Research (ISER) at the University of Alaska in its 2007 report on the economic significance of the Ted Stevens Anchorage International Airport notes that, "the contribution

that the airport provides to the state goes beyond the generation of jobs and payroll. The airport is part of the transportation infrastructure that links Alaskans and Alaska businesses to each other and the rest of the world. Without these links, both the cost of doing business and the cost of living would be much higher than they are today, precluding many economic activities and making Alaska a less attractive place to live and work.” Although ISER was not able to pull an actual dollar figure on the value of the service, they reported that it was “quite substantial.”

In 2006, the Ted Stevens International Airport ranked number 3 among the world’s busiest cargo airports. 400,000,000 gallons of jet fuel are moved across the State annually to supply the airport. As can be seen from the chart below, the number of total revenue landings at the Ted Stevens International Airport continues to grow. The chart below shows the historical trend. Cargo landings are increasing and will soon overtake passenger landings.

Fiscal Year	Passenger	Cargo	Total
1990	59,352	19,079	78,431
1991	65,468	18,849	84,317
1992	71,459	20,100	91,559
1993	65,086	19,106	84,192
1994	60,617	21,732	82,349
1995	61,142	23,363	84,505
1996	55,474	26,552	82,026
1997	58,720	31,379	90,099
1998	60,539	34,003	94,542
1999	53,814	33,932	87,746
2000	54,427	38,144	92,571
2001	53,504	39,881	93,385
2002	52,773	39,356	92,219
2003	51,223	41,380	92,613
2004	49,312	42,351	91,665
2005	49,993	45,950	95,973
2006	53,405	47,091	100,496

Source: Ted Stevens Anchorage International Airport

Chart 12, ISER study 2007, Ted Stevens Anchorage International Airport: Economic Significance.

It should also be noted that the Fairbanks International Airport acts as the required diversionary airport for Anchorage Airport's cargo. In 2007, the Fairbanks International Airport used 13,000,000 gallons of Jet-A per year, and accommodated 25,149 aircraft landings.

Besides the Anchorage and Fairbanks Airports there are five other state assets that would be directly impacted should refiners decide to move out of the State of Alaska the associated businesses, are:

- Flint Hills Resources Refinery
- Tesoro Alaska Refinery
- Eielson Air Force Base
- Elmendorf Air Force Base

- Alaska Rail Road

To illustrate the effect refinery closures would have on Alaska, the Committee created the following chart that attempts to scope the value and other measurable comparisons for these industries:

Employer	Number of Employees	Salaries, Wages & Property Taxes	Economic Impact
Flint Hills Resources North Pole	175	21,000,000.00	Flint Hills is the third largest taxpayer in the Fairbanks North Star Borough, paying \$3,300,000 in property taxes in 2008.
Tesoro Alaska Refinery	575	32,000,000.00	
Ted Stevens International Airport	10,222	562,000,000.00	Adding the offsite jobs generated by airport businesses making purchases and workers spending their earnings within the community, the total economic significance of the airport grows to 18,434 jobs and a payroll of \$850 million.
Fairbanks International Airport	100		
Alaska Railroad	799	44,400,000.00	108,000,000.00
Fort Wainwright/Eielson Air Force Base	17,000	354,000,000.00	390,900,000.00
Elmendorf Air Force Base	5848	394,000,000.00	948,700,000.00
Total jobs	34,640		

Chart 12, Economic impact of refinery related industries

If the Alaska Legislature pursues regulation of the refined gasoline market, and should that regulation result in the unintended consequence of closure of the refineries, then Alaska will have lost its ability to produce jet

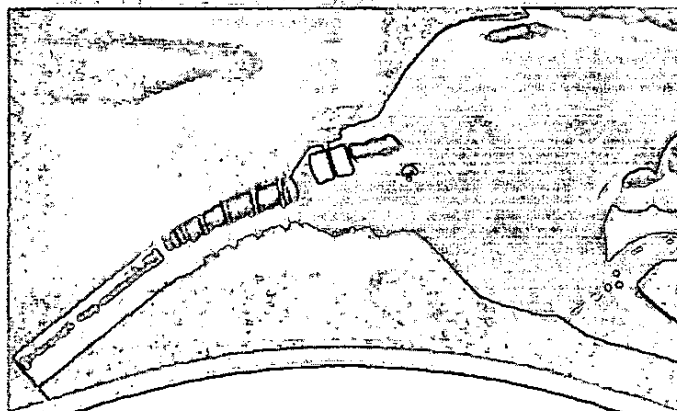
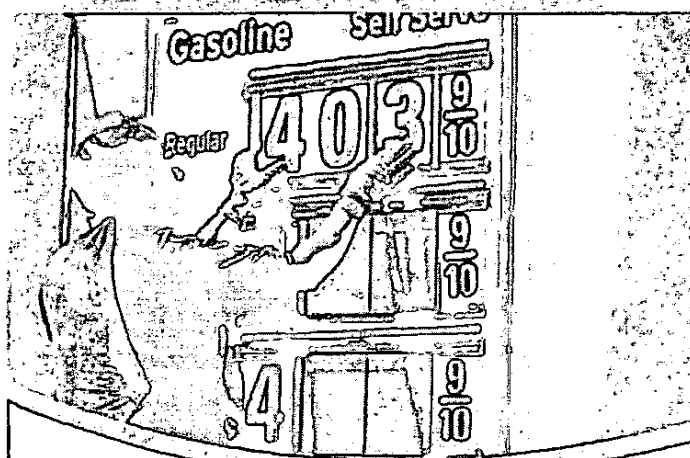
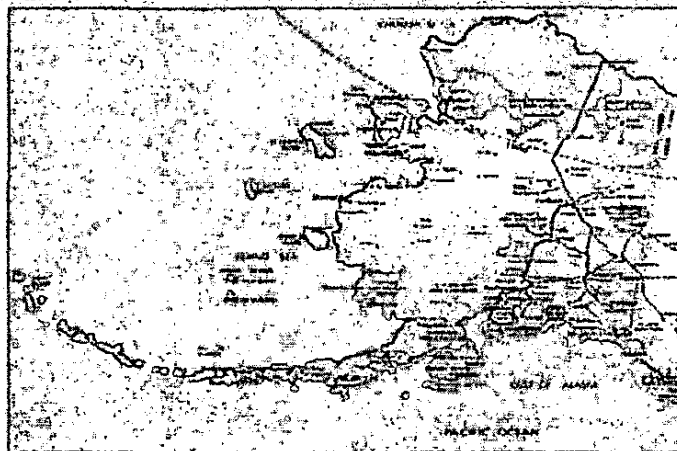
for a little more price volatility at the pump in exchange for the most promising value-added industry Alaska has been able to create since the onset of the TAPS era.

This conclusion notwithstanding, the Committee, after meeting in September, October, November, and January, shares the cynicism of the Alaskan public. There must be a better answer – somebody must be playing “hide the ball.” But we could not find it. This report attempts to find it. This report attempts to lay out the most likely, plausible theory as to why gasoline price-parity with the Seattle market has been lost since March of 2008, and why we have seen periods of intermittent lost price-parity as well as inverse price-parity with Seattle, which has resulted in Alaska having better pricing than the Seattle rack rate.

Finally, the Committee also uncovered disturbing price patterns in Southeast Alaska that have not been fully incorporated into this report. The committee recommends that the Speaker of the House of the 26th Legislature direct a joint effort by the House Judiciary Committee and the House Resources Committee to explore inconsistencies in pricing patterns that affect this vital and vulnerable region of the state.

2008 ALASKA GASOLINE PRICING INVESTIGATION

Attorney General's Report



January 2009

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2008 ALASKA GASOLINE PRICING INVESTIGATION

I. Introduction

The high cost of fuel in Alaska has been a topic of debate for decades. Most Alaskans are accustomed to the fact that the cost of living here is higher than the rest of the country. Alaska's geographic isolation results in higher transportation costs for many goods, and our smaller population does not always lend itself to economies of scale or the same degree of competition enjoyed in other areas of the country. In 1976, the cost to live in Anchorage was 42% higher than the national average.¹ Today, that difference is only about 10%. As the population of Alaska grows and the availability of good and services (and competition for them) increases, prices tend to lower, at least in the more populated areas of the state. But when it comes to fuel and gasoline in particular, consumers in Alaska question why our prices are higher here than just about anywhere else in the country, especially since we have refineries and a supply of oil right here.

Gasoline prices reached record highs in every state across the country, including Alaska in the summer of 2008. These higher fuel prices were driven by the unprecedented rise in the price of crude oil. Oil prices increased from \$85 per barrel in early February to a record high near \$145 a barrel in July. This increase of \$60 per barrel over a 5-month period has never occurred before. Regular-grade gasoline sold at its peak for \$4.45 a gallon in Anchorage (\$4.18 exclusive of taxes) and hit nearly \$8.00 a gallon in some rural areas of Western Alaska.

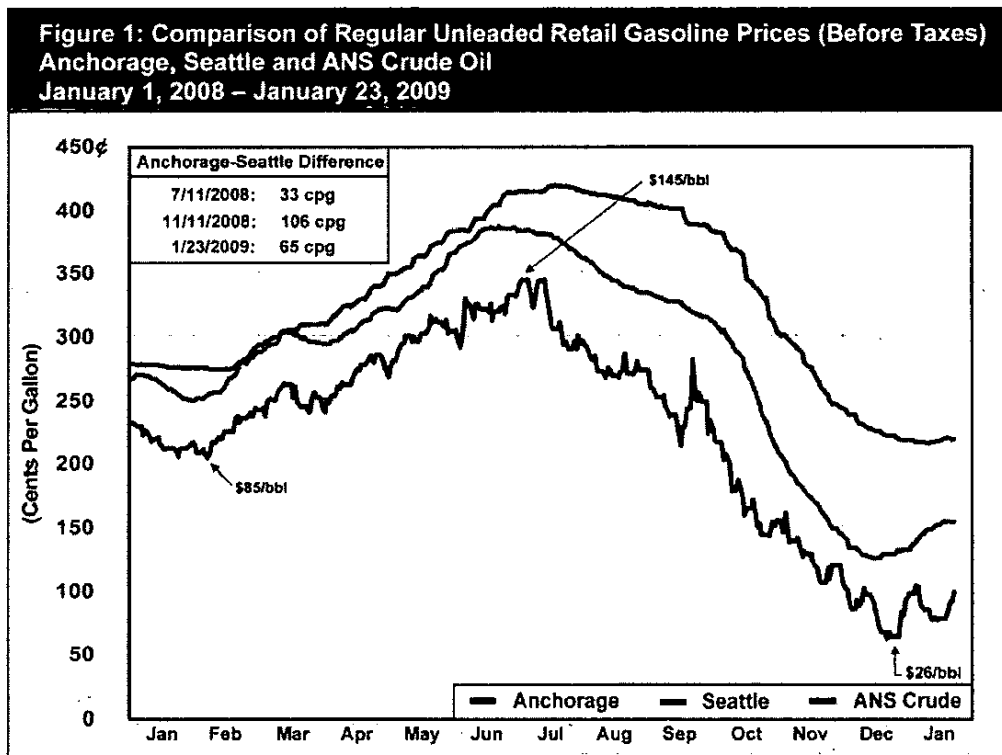
After rising to record levels in mid-summer, crude oil prices plummeted by more than \$110 per barrel over a 6-month period, dropping to less than \$30 per barrel at one point in December before recovering somewhat to the low \$40 per barrel range. This drop also was unprecedented in the history of crude oil markets.

Anchorage gasoline prices rose in the first half of 2008 along with prices in the rest of the nation as crude prices marched upward. This rise did not occur, however, as quickly in Anchorage as it did in the lower-48. During parts of February and March Anchorage gasoline prices were lower than Seattle prices. When crude oil prices peaked in July, Anchorage consumers were paying \$0.33 more per gallon of gasoline (tax adjusted) than consumers in the Pacific Northwest ("PNW"). When crude oil prices began to plummet during the fall of 2008, this average price difference, or "spread," between Anchorage and Seattle reached \$1.06 per

¹ U.S. Department of Labor, Bureau of Labor Statistics, "Urban Intermediate Budget for a 4-Persons Family." (Revised 2/28/96)

gallon as gasoline prices in the rest of the country fell more quickly than they did in Alaska. Prices in Seattle, however are more diverse than Anchorage. The spread between the high and low sellers in Seattle can be close to \$0.40 a gallon. On February 9, 2009, some stations in Seattle were selling gasoline at \$2.39 a gallon – higher than most stations in Anchorage. By contrast, the difference between the high and low sellers in Anchorage is only \$0.10 a gallon.

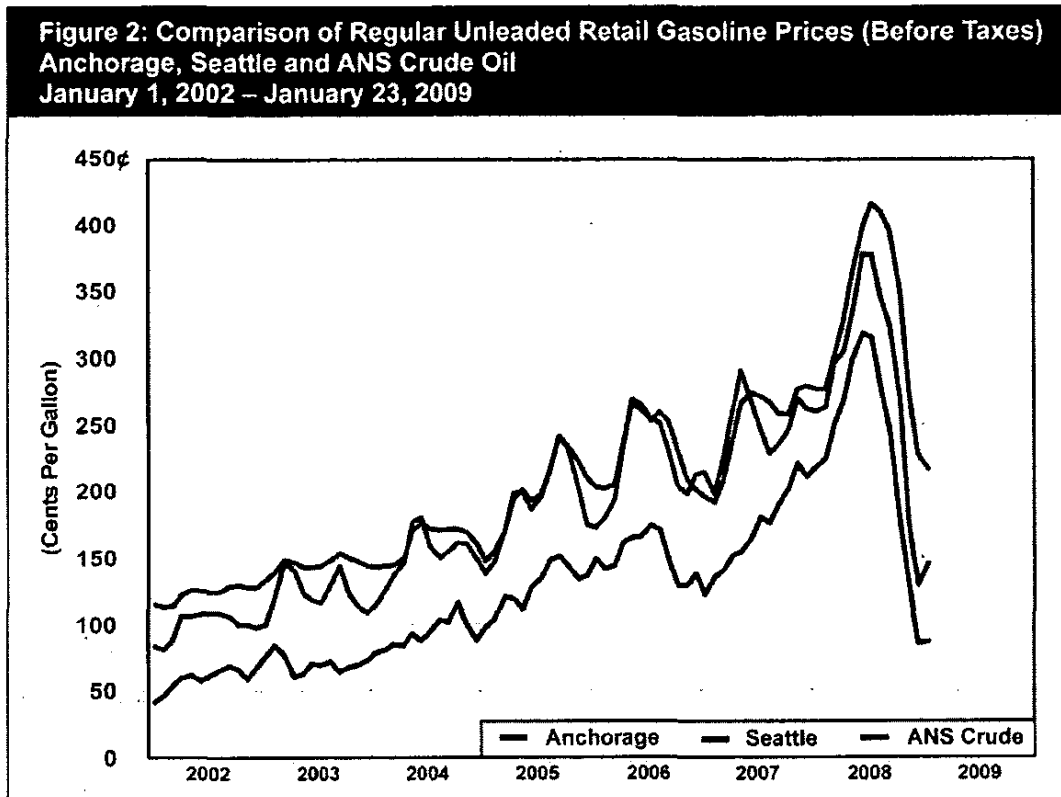
The Anchorage-Seattle spread has narrowed over the past two months as oil prices have stopped falling. In late January, the spread between Anchorage and Seattle was \$0.65 per gallon, a decline of more than \$0.40 per gallon. On February 9, 2009, the spread was less than \$0.60 a gallon. Figure 1 below shows the spread between Anchorage and Seattle retail gasoline prices, along with the price of ANS crude oil from January 2008 through January 2009.



Source: AAA; Energy Information Administration; OPIS; State of Alaska Revenue Department.

Figure 2 shows that Alaska gasoline prices historically have lagged behind price changes in the rest of the U.S. This is consistent with the pricing relationship between Alaska and Seattle that occurred during 2008 and early 2009. The difference between the most recent experience and earlier years is that the spread between Alaska and Lower-48 prices has never been as large

as it was in the fall of 2008. At the same time, volatility in crude oil prices, which factor heavily into gasoline prices, has never been close to the volatility experienced over the past year.



Source: AAA; Energy Information Administration; OPIS; Platts; State of Alaska Revenue Department.
Source: AAA; Energy Information Administration; OPIS; State of Alaska Revenue Department.

The spread between Alaska and PNW gasoline prices during the second half of 2008 presents a frustrating dilemma, and one that concerns state officials. In August 2008, Governor Palin directed the Attorney General to investigate the price of gasoline in Alaska to determine whether the prices set by refiners, distributors, and retailers are the result of any illegal activity. This report summarizes the findings of the Attorney General. The last investigation of gasoline pricing in Alaska was completed in 2002. It was conducted over a several-year period and included the review of hundreds of thousands of documents. The results of that investigation found no illegal activity.²

² In the last 30 years, several states and the federal government have conducted gasoline pricing investigations. In 2008, Washington State completed a comprehensive gasoline price investigation. See <http://www.atg.wa.gov/gasstudyfaq.aspx> for a copy of the Washington study.

II. Executive Summary

Gasoline, like all other commodities, is not regulated by the state. Instead, prices are determined by the forces of supply and demand. Competition in the marketplace is ultimately responsible for determining the price of all consumer goods and services, with few exceptions.³ We do not live in a “cost plus” society. Sellers are not required to price their goods and services based on what it costs to acquire them “plus” a reasonable profit. Instead, sellers can and do price their goods according to the market conditions. If demand is strong and/or supply is limited, prices may exceed cost by 200% or more. Because gasoline is not regulated, the state does not have the authority to tell sellers how to set their prices. Thus, simply having a “high price” is not illegal by itself. Alaska does not impose price controls or “caps” on any product, and there is no “price gouging” law in Alaska. The price of many consumer goods in Alaska is higher than the price you would pay in Seattle or another large metropolitan area. Gasoline is no different.

Prices can be illegal, however, if they are the result of price fixing or other collusive behavior. The laws directed at ensuring that competition remains fair and unrestricted are state and federal antitrust law. Antitrust laws make it illegal to engage in any concerted action that unreasonably restrains trade.⁴ It is also illegal to monopolize, attempt to monopolize, or conspire with another to monopolize any part of trade or commerce.⁵ The purpose of the antitrust laws is to ensure that competition remains fair and unrestricted, which in turn results in lower prices and better service. Thus, if the sellers of gasoline were colluding with each other to “fix” the price of gasoline, they would be violating the law.

Our investigation did not reveal any evidence that this kind of illegal collusion or price fixing has occurred among the refiners, distributors, or retailers of gasoline in Alaska. Instead, there are economic realities of the Alaska gasoline market that likely explain the price of gasoline in Alaska and the relationship between Alaska gasoline prices and prices in the Lower-48.

First, the market for gasoline in Alaska is structurally different than most other gasoline markets in the U.S. Gasoline demand in Alaska is small, and we do not enjoy the same degree of

³ Those exceptions include regulated utilities, like electricity, sewer and water service, and natural gas.

⁴ AS 45.50.562; 15 U.S.C.A. § 1.

⁵ AS 45.50.564; 15 U.S.C.A. § 2.

competition as most markets in the Lower-48. There are few participants in Alaska's gasoline markets at the refining and wholesale distribution level. When few competitors account for the majority of sales, the market is known as an oligopoly. In addition, Alaska is geographically isolated from alternative supply sources outside the state. As a result, potential competition from the Pacific Northwest -- which might otherwise be expected to keep prices in parity with Lower-48 prices -- is limited, particularly during short-term price disruptions such as occurred in 2008. Based on this market structure alone, it is unrealistic to expect that gasoline prices in Alaska should be the same as prices in other parts of the country. The level of competition and available sources of supply in the Lower-48 create supply and demand conditions that are not present here.

Second, the changes in crude oil prices during 2008 were dramatic and unpredictable, making it the most volatile year in crude oil pricing history. After rising \$60 per barrel during the first part of the year, crude oil prices dropped by more than \$100 per barrel in less than six months. These events created market conditions that have never occurred before. The rapid rise and following decline in oil prices, coupled with Alaska's unique oligopolistic market structure appears to account for the unusually high spread between gasoline prices in Alaska and the Lower-48 experienced during the second half of 2008.

This unusually large spread is not, however, inconsistent with historical pricing patterns in Alaska. Alaska's gasoline markets have historically responded more slowly to changes in crude oil prices than larger, more competitively structured markets in the Lower-48. In oligopoly markets there can be a wide range of pricing outcomes depending on the behavior of the individual market participants. Prices can range from a very competitive level to monopolistic. The specific outcome can vary across time and depends on the behavior and goals of the market participants, as well as the potential for competition from non-incumbent sellers to access the market when prices rise above competitive levels. Prices in these types of markets can and do deviate from long-term historical patterns, particularly when input costs change quickly.

Gasoline prices have fallen dramatically in Alaska since the start of this investigation. At the time of writing this report in late January 2009, Anchorage gasoline was selling at about \$2.35 per gallon on average, a drop of more than \$2.00 per gallon since July 2008. In Seattle, gasoline prices have risen over the last month and now average about \$2.10 per gallon. On a tax-adjusted basis this difference is approximately \$0.65 per gallon. While still larger than historical

norms, the spread between Anchorage and Seattle has started to narrow over the past several months, consistent with historical patterns.

In Southeast and Western Alaska, where fuel is supplied by barge, some of the same economic principles apply. There are few competitors, and alternative sources of supply are scarce. In addition, barge markets are characterized by relatively few large deliveries of fuel throughout the year. Unlike markets where supply is replenished every few days, fuel may not be delivered by barge for several weeks or months. Until new deliveries of fuel are made, the price of fuel is not likely to change. If a supply of higher-priced fuel is delivered in summer, lower priced fuel may be months away. When you add the dynamics of the barge market to other factors that affect supply and demand in Southeast and Western Alaska (for example, low volumes and higher transportation costs), prices tend to be higher.

The Attorney General's investigation spanned five months. Thousands of pages of confidential documents were reviewed, and key personnel were interviewed. The Attorney General also retained the services of Barry Pulliam, Senior Economist with the Los Angeles-based economic consulting firm Econ One Research, Inc., to assist in this investigation. Mr. Pulliam assisted the Attorney General's office in its prior investigation of gasoline prices, concluded in 2002. Mr. Pulliam has extensive experience in the analysis of competitive issues involving gasoline markets, and assisted the Attorneys General in California and Hawaii in several investigations involving gasoline prices. Econ One assisted in the preparation of this report.

The key findings of our investigation are set forth below.

Key Findings

- We did not discover evidence of illegal activity.
- The unprecedented increase in crude oil prices, followed by another unprecedented decline (i.e., volatility), resulted in unstable market conditions that added to uncertainty and influenced pricing decisions.
- The structural characteristics of Alaska's petroleum product market, coupled with unusual crude oil price volatility, contributed to the unusual high gasoline prices and higher differential relative to other parts of the country in 2008.
- Higher prices in Alaska relative to other areas flow from higher wholesale (or rack-level) prices. Retailer margins do not account for Alaska's higher prices in 2008.
- The persistent and long-lasting high gasoline prices in southeast and western Alaska are a result of barge delivery economics and related issues, coupled with the items listed above.

III. Discussion

This part of the report is divided into five sections that address different topics related to gasoline markets and pricing in Alaska. The first section provides an overview of the Alaska and federal laws that apply to the pricing of gasoline. The second section provides an overview of gasoline production and distribution. The third section discusses Alaska gasoline markets and how their unique characteristics influence gasoline prices. The fourth examines gasoline prices in Alaska and how those prices compare to the PNW (the closest source of potential competition for gasoline supply to Alaska) and Hawaii (a state with similar market characteristics as Alaska). The fifth section discusses the economics of gasoline markets and competition in Alaska.

A. Applicable Laws.

1. Antitrust Laws.

There are very few laws anywhere that restrict a seller of goods and services from selling a product at any price. These kinds of price control laws are contrary to the established economic model enjoyed by businesses in the United States – the free market economy. In a free market economy, the laws of supply and demand ultimately control the price that a seller sets for a product. If the price is too high, buyers will look for a cheaper price and the seller will lose market share. A price that is too low may not return the profit to stay in business in the long run. Federal and state antitrust laws were developed to make sure this economic model works by prohibiting unreasonable interference with competition.

The antitrust laws make it illegal for competitors to engage in any conduct that unreasonably restrains competition, like colluding with each other to fix prices, or agreeing to allocate the market among a group of sellers. Attempts to monopolize any part of trade or commerce, and conspiracies to monopolize are also illegal. Predatory pricing, which is the practice of selling a product below cost long enough to drive competitors out of business, is a form of illegal monopolization.

The primary federal statute that makes anticompetitive conduct illegal is the Sherman Act, 15 U.S.C.A. §§ 1 and 2. These laws have been codified in Alaska at AS 45.50.462 and .464, and are essentially identical to the federal law. These laws establish two basic requirements: (1) companies cannot agree to limit competition in ways that hurt consumers, and (2) a single company cannot monopolize an industry through unfair practices. In order to find a violation of these laws, the state must prove that either: (1) two or more competitors entered an agreement that had the effect of unreasonably restraining competition, or (2) that a single

business has engaged in conduct (like predatory pricing) that was intended to monopolize any part of trade or commerce or unreasonably restrain competition.

Antitrust laws are far more complex than the brief summary above. Depending on the conduct, if there are overriding business reasons for any practice, it may not be illegal if the conduct has anti-competitive effects. For example, some agreements among competitors have beneficial effects that outweigh any restrictions on competition. In some cases, a failing business may sell its assets to a monopolistic rival and not be in violation of merger restrictions. But the basic principle remains the same – conduct that unreasonably restrains competition is illegal.

Other than antitrust laws, there are very few laws that restrict the price of goods or services. Some services, like regulated utility services, are natural monopolies that are subject to regulation by most state's public utility commissions. Because providers of these services are not subject to competition, their prices are established by a commission that reviews the cost of providing the service and then allows the utility to make a reasonable rate of return on invested capital. In Alaska, the Regulatory Commission of Alaska (the "RCA") regulates all public utilities, including electricity, natural gas, telephone, water, and garbage service. Gasoline is not considered a public utility in most markets. And while the State regulates certain aspects of the industry, the price of gasoline is not regulated by the RCA or any other body in Alaska.

The Attorney General's investigation did not uncover any evidence that refiners, distributors, retailers, or other sellers of gasoline have violated the antitrust laws by colluding with each other, or attempting to maintain an illegal monopoly over gasoline sales.

2. Price Gouging Laws.

"Price gouging" is often defined as a sharp rise in the price of basic necessities over a short period during a time of natural disaster. About 30 states have price gouging laws in one form or another. Alaska does not have a price gouging law of any kind. Lawmakers and economists continue to debate the wisdom of price gouging laws. Most price gouging laws are "triggered" by a declared state of local or national emergency, such as a natural disaster. Following the devastation of hurricane Katrina, for example, Louisiana's price gouging law went into effect. This law prohibits sellers from increasing the prices of products above the price ordinarily charged for comparable goods and services in the same market area, unless the

increase is due to increased costs for reasonable expenses and attendant business risks.⁶ This prevents unscrupulous sellers from preying on consumers in their most difficult times of need.

A few states have price gouging laws that are triggered by an “abnormal market disruption” or “market emergencies” that result from a variety of extraordinary circumstances. During these abnormal conditions or market emergencies, sellers are prohibited from setting “unconscionably excessive prices” which is defined differently by different states. In Connecticut, this means a “gross disparity” between the price before and after the disruption, unless the price increase is due to additional costs of the seller.⁷ Massachusetts defines “unconscionably high prices” to mean the gross disparity between the current price and the price prior to the emergency, or between the price of a vendor and the price of other competitors in the area where higher prices are not attributable to increased supplier costs.⁸

Simply having a high price for gasoline is not price gouging in Alaska, even if those prices are in excess of prices in other parts of the country.

3. Unfair Trade Practice Laws.

Another law that has potential applicability to the pricing of consumer goods is Alaska’s Unfair Trade Practice and Consumer Protection Act (the “Act”).⁹ The Act provides that all unfair or deceptive acts or practices in the conduct of trade or commerce are unlawful. “Unfair” is not specifically defined, but the Act contains a list of 55 acts that are considered unfair. In addition to those listed, *any* unfair act can be illegal. The Alaska Supreme Court has stated that “unfairness” is determined by a variety of factors, including (1) whether the practice, without necessarily having been previously declared unlawful, offends public policy as it has been established by statutes, the common law, or whether, in other words, it is within at least the penumbra of some common-law, statutory, or other concept of unfairness; (2) whether it is immoral, unethical, oppressive, or unscrupulous; and (3) whether it causes substantial injury to consumers (or competitors or other businessmen).¹⁰

⁶ LA R.S. 29:732

⁷ Conn. Gen. Stat. §§ 42-234 and 234a.

⁸ Mass. Code §§ 940.3.01 and 940.3.18.

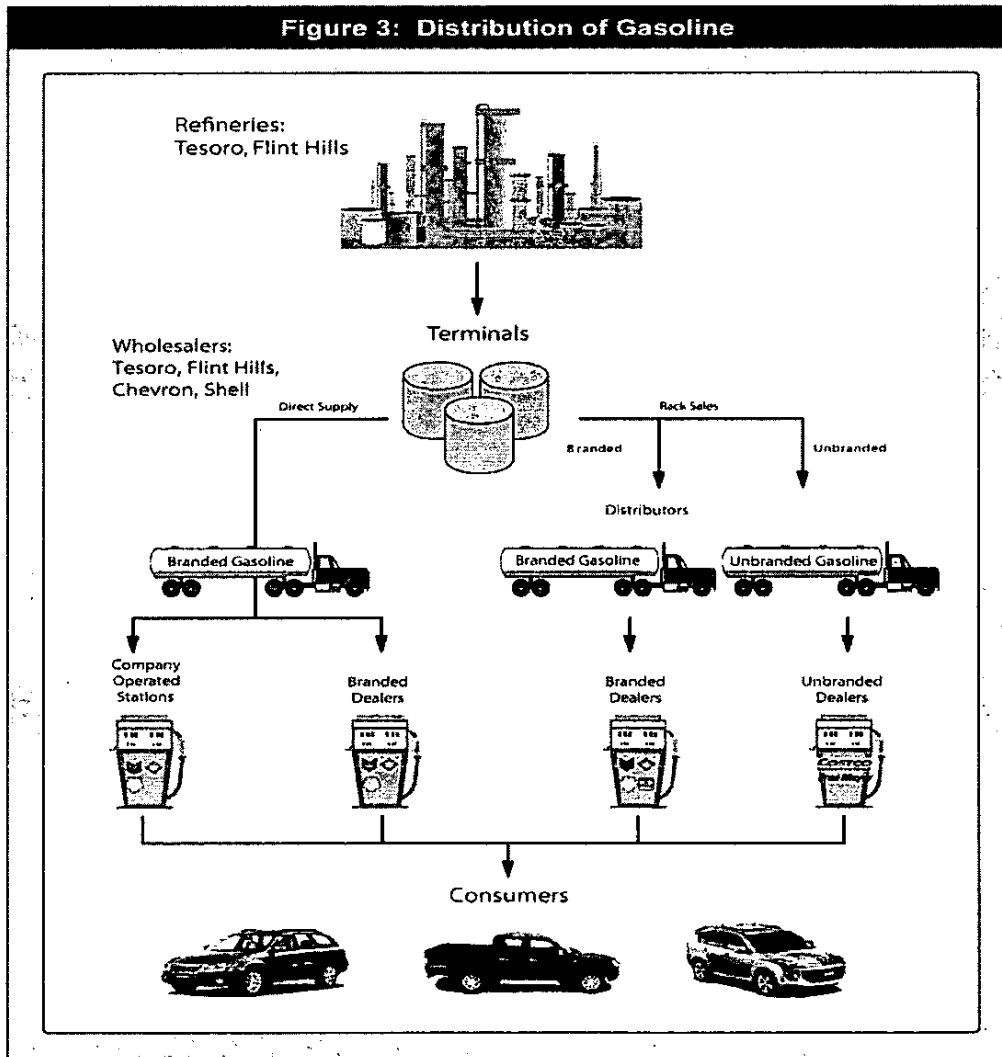
⁹ AS 45.50.471.

¹⁰ *State v. O’Neill Investigations, Inc.*, 609 P.2d 520, 535 (Alaska 1980) (citing *FTC v. Sperry & Hutchinson Co.*, 405 U.S. 233, 244-45 n. 5 (1972)).

No case has applied this test to the price of gasoline except in connection with a price gouging statute that prohibits excessive prices during an emergency. While it may seem that gasoline prices are “unfair” and perhaps “excessive” or “unconscionable,” the Attorney General’s investigation did not uncover evidence that Alaska gasoline prices were unconscionable or oppressive in light of the market structure, the unprecedented volatility in crude oil markets and the duration of the price differences between Alaska and elsewhere.

B. Gasoline Production and Distribution in the U.S and Alaska.

Gasoline, along with other petroleum products, is produced at refineries from crude oil. It is then shipped to bulk storage terminals by pipeline or barge where it is stored temporarily until loaded into trucks at a nearby truck “rack” for distribution to retail gasoline stations. The distribution and marketing of gasoline is depicted graphically in Figure 3.



Wholesale marketers acquire gasoline from refiners at bulk storage terminals. From there, wholesalers load gasoline into trucks at the rack for delivery to the retail stations they supply directly. Wholesalers may also sell gasoline to distributors, known as “jobbers” that operate their own trucks and resell to retail gasoline stations. Wholesale marketers typically purchase gasoline from refiners at a “spot” or “bulk” price. Wholesalers also acquire gasoline from local refiners pursuant to “exchange” agreements under which they receive gasoline at terminals in Alaska in exchange for delivery of an equal volume of gasoline at an agreed upon West Coast terminal in addition to direct purchase agreements.

Wholesale marketers that directly supply retail gasoline stations with their own trucks sell to those stations at their “Dealer Tank Wagon” or “DTW” price. Wholesale marketers that sell to distributors at the truck rack do so at a “rack” price. The rack price is lower than the DTW price the retail dealer pays since, among other factors, the distributor takes delivery into its own trucks and bears the costs associated with further distribution to retail stations. Wholesalers may also offer discounts or rebates off their published rack or DTW prices.

Gasoline is ultimately sold to consumers through retail stations. These stations sell either “branded” or “unbranded” gasoline. The major brands in Alaska are Tesoro, Holiday, Shell and Chevron. The physical composition of gasoline that is sold at branded and unbranded stations is virtually identical, with the exception of the types of additives blended into the gasoline. All gasoline sold to consumers contains additives such as anti-gumming agents designed to help keep engines clean. Branded gasoline contains the proprietary additives marketed by the respective brand (e.g., Chevron includes “Techron” in its gasoline) while unbranded gasoline usually contains a “generic” additive package. Branded gasoline typically sells at a premium to unbranded gasoline at both the wholesale and retail levels.

Retail gasoline stations are usually owned directly by a wholesale marketer or by an independent operator. Stations that are owned by a marketer are operated directly by the company itself (known as “company operated” stations) or they are leased to an independent dealer (known as a “lessee-dealer”). In both cases these stations acquire the branded gasoline they sell directly from the marketer. Stations that are not directly owned by a wholesaler are called “open stations” or “open dealers.” Open dealers purchase gasoline directly from wholesale marketers or from jobber-distributors. These dealers often enter into branding agreements to sell the brand of a particular marketer or they sell unbranded gasoline. At the end of its branding agreement an open dealer is free to “re-brand” with another marketer.

C. Gasoline Markets in Alaska.

1. Market Characteristics.

The production and distribution of gasoline in Alaska is similar in many respects to production and distribution in the rest of the country. However, there are factors unique to Alaska that impact our gasoline prices. These are summarized in the following Chart.

Alaska Gasoline Market Characteristics

- Relatively Small Markets
- Only Two Refiners of Gasoline
- Refineries Are Less Efficient Than In Lower-48
- Relatively Few Wholesalers of Gasoline
- Smaller Station Formats Typically
- Distant From Alternative Supply Sources
- Limited Terminal Capacity
- Limited Delivery Windows In Some Parts of State

2. Alaska Market Size.

The State of Alaska is the smallest gasoline consuming state in the U.S. Table 1 shows gasoline sales in Alaska and other western states. Demand for gasoline in Alaska is less than 300 million gallons per year, or just 0.2% of total U.S. gasoline consumption.

**Table 1: Motor Gasoline Sales for Selected States
January - December 2007**

U.S. Rank	State	Volumes (Million Gals.)	As percent of Total U.S. (Percent)
1	California	15,591	11.3%
16	Washington	2,780	2.0%
30	Oregon	1,533	1.1%
43	Hawaii	474	0.3%
50	Alaska	268	0.2%

Source: EIA, Prime Supplier Sales of Motor Gasoline by State.

In comparison, the state of Washington, which is an alternative supply source for gasoline to Alaska, consumes about 10 times that amount. California is the largest consuming state, accounting for 15.6 billion gallons, or more than 11% of total U.S. demand. Hawaii shares many of the market characteristics and pricing behavior as Alaska, including relatively small market size. It consumes close to 500 million gallons per year, or just 0.3% of U.S. demand.

The greater Anchorage area is Alaska's largest gasoline market. Fairbanks is the state's second largest market. Table 2 summarizes publicly available data for gasoline sales in Anchorage, Fairbanks, Seattle and Honolulu. Anchorage accounts for approximately 150 million gallons per year and nearly 60% of state demand, yet those volumes are just 10% of Seattle's 1.6 billion gallons in sales. Fairbanks is the state's second largest market, accounting for approximately 35 million gallons, or a little more than 10% of state demand.

Location	Volumes (Million Gals / Yr)
Anchorage	150
Fairbanks	35
Honolulu	240
Seattle	1,640

Source: MPSI.

3. Alaska's Refineries.

There are two refineries in Alaska that produce gasoline -- Tesoro's refinery in Nikiski and Flint Hills' refinery in North Pole. Petro Star also operates refineries in Alaska, but does not produce gasoline. Tesoro accounts for approximately 80% of Alaska's in-state production; Flint Hills accounts for the balance. Table 3 provides summary information about Alaska's gasoline-producing refineries and refineries in other western states. Alaska's two gasoline producing refineries are smaller than most refineries in the U.S. The average capacity of Alaska's refineries is 60 MBD, which is less than half the size of the average refinery size in Washington. The State of Washington is home to 5 refineries; California has 13 gasoline-producing refineries, giving the West Coast a total of 18 gasoline-producing refineries. Hawaii, like Alaska, is home to just two refineries.

Table 3: Number of Gasoline Producing Refineries by State: Alaska, California, Hawaii and Washington 2008		
State	Number of Refineries	Average Capacity (MBD)
Alaska	2	60
California	13	149
Hawaii	2	75
Washington	5	127

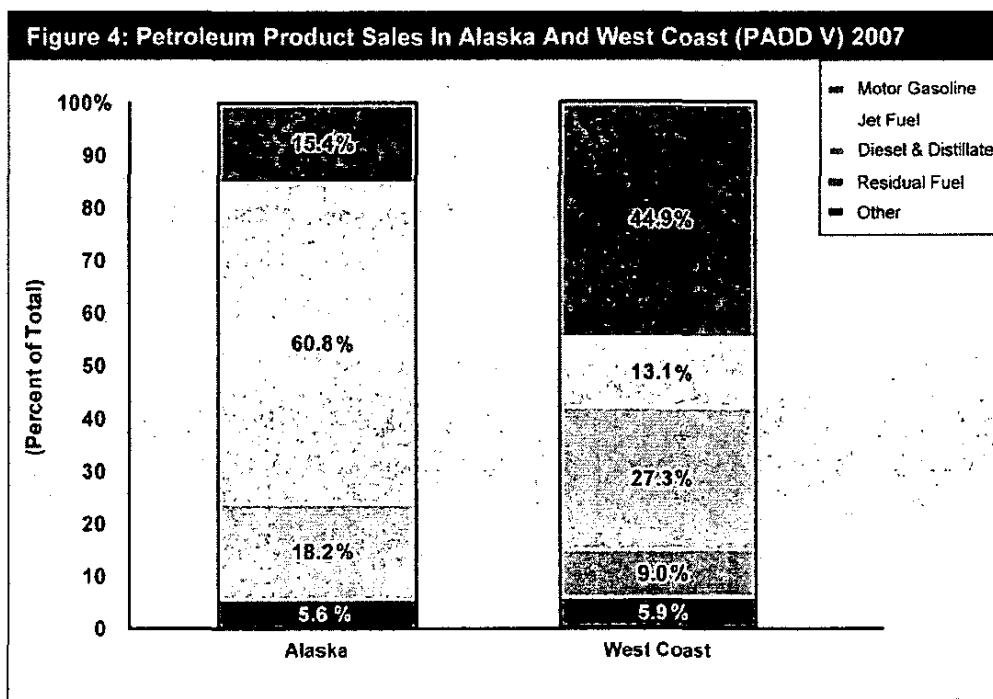
Source: Oil and Gas Journal.

The Flint Hills refinery uses exclusively Alaska North Slope (“ANS”) crude from the Trans Alaska Pipeline System (“TAPS”) to run its refinery. It produces refined products such as jet fuel and gasoline, then re-injects the remainder of the crude oil back into the pipeline. Flint Hills pays a price to do this. Because re-injecting the “heavy” product back into TAPS lowers the overall quality of the ANS oil stream, Flint Hills pays the TAPS owners a “quality bank differential.” This amount varies by year.

Tesoro uses ANS crude for about 50% of its operations which it must ship from Valdez. The other 50% of its crude oil is purchased. Some of this comes from the Cook Inlet, and the remainder is purchased on the world market from Russia, Asia, and other countries. Tesoro is restricted on what kind of crude oil it can buy. Tesoro’s Alaska refinery was initially designed to refine Cook Inlet crude oil, which was the primary feedstock for the refinery when it opened in 1975. The refinery can also process ANS, and other oil that has similar characteristics to ANS crude. This requires purchasing oil from countries with crude oils of similar quality to Alaskan crude oils. Like Flint Hills, Tesoro refines gasoline, jet fuel, diesel, and heavy oils. Tesoro is the only refinery in Alaska that can produce low-sulfur diesel that meets current EPA standards.

Unlike Flint Hills, Tesoro cannot inject the heavy end products that result from its refining process into TAPS. Instead, these products must be sold. There is a small market in Alaska for some of these heavy products, but for the most part Tesoro must ship the heavy product to markets outside Alaska.

Alaska’s refineries are low-conversion facilities. They have a complexity factor of 3.3, versus an average complexity factor of 10.8 for West Coast facilities. This means that Alaska’s refineries do not produce as much high-value product (like gasoline) as typical West Coast or Lower-48 refineries. Gasoline comprises only about 15% of total product demand in Alaska, compared with nearly 45% on the West Coast. Alaska’s refineries are geared to produce large volumes of jet fuel. Approximately 60% of the volume of petroleum sales in Alaska is jet fuel. Diesel fuel accounts for almost 20% of Alaska sales. Tesoro also produces relatively large volumes of residual fuel oil. This low-valued product is exported out of state to the West Coast refineries that further process it into light products such as gasoline. Figure 4 provides a comparison of the composition of petroleum product sales in Alaska and the West Coast.



Source: EIA.

4. Gasoline Wholesalers.

a. Railbelt Areas.

Tesoro, Flint Hills, Chevron and Shell are the primary gasoline wholesalers operating in Alaska’s railbelt. These four companies sell gasoline to retailers and/or through their own retail stations. Tesoro is the largest wholesaler. It markets gasoline through both channels. Flint Hills, the state’s second largest wholesaler, sells gasoline to other wholesalers and to retailers. It

does not own or operate its own stations. Each of these four wholesalers sets a rack price for gasoline.

Alaska's gasoline markets are more "concentrated" at the wholesale distribution level than markets in most of the U.S. The four largest wholesalers in Alaska account for nearly all of sales in Anchorage and Fairbanks. By way of comparison, the four largest wholesalers in Seattle accounted for approximately 70% of sales in 2008.

b. Barge-Serviced Areas.

Gasoline is supplied by barge in southeast and western Alaska. Not only is this expensive, the markets in southeast and western Alaska are small, with a single supplier in some locations. We estimate that these regions each account for roughly 10% of gasoline demand in Alaska. There are few wholesalers operating in these regions. The primary suppliers include Crowley, Delta Western, Petro Marine and Tesoro.

Wholesalers that deliver by barge purchase gasoline based on wholesale prices (either spot or rack) in Nikiski and the Pacific Northwest (PNW), and transport it to terminals in southeast or western Alaska. Barge delivery schedules, the price paid for the gasoline, and the amount of storage capacity in the area all affect the price of gasoline in these markets. Seasonal weather changes can also effect the scheduling of barge delivered fuel. In some areas of Alaska, gasoline is only brought in once or twice a year. The price in these areas may not change more than one or twice to coincide with barge delivery dates. In other areas, like Juneau, fuel is delivered more often, but not weekly or even monthly.

The markets in southeast and western Alaska are very small compared with Alaska's larger cities. In some locations there are only one or two wholesale suppliers. With few competitors, low volumes and higher costs, prices are naturally higher than they are in larger urban areas of Alaska and other U.S. locations. Fuel delivery schedules can also have a significant impact on gasoline pricing in these markets. The landed cost of the fuel at the terminal includes (1) the wholesale cost of the fuel; (2) the transportation cost; (3) the terminal cost; (4) breathing loss;¹¹ (5) overhead expenses; and (6) a return on investment. Once the fuel is delivered, this cost often does not change until the fuel is depleted and another barge arrives to replenish the supply or change the cost by averaging additional fuel that is added to existing supply.

¹¹ Breathing loss is evaporation.

Total storage capacity among all the suppliers in Juneau is estimated to be about 8 million gallons. Until this supply is replenished, the landed cost does not change. This may not happen for weeks or even months. In parts of western Alaska, new fuel supplies may not be available for several months. Until a supply of fuel at a lower cost arrives, retailers may not be able to lower their prices.

In some areas of Alaska, buying groups or cooperatives pool their purchases of fuel and ask for companies to bid for delivery. These contracts are typically multi-year, and the pricing terms are specified in the bidding proposals and negotiated by the buyers. Several electric cooperatives in western Alaska purchase fuel in this manner.

We are aware of no place in the Lower-48 that has a barge-delivered fuel market like southeast or western Alaska. The closest supply situation in the U.S. is the distribution system to the Hawaiian Islands of Maui, Kauai, Hawaii and Lanai. Gasoline is delivered by barge to these islands from the two refineries on Oahu. However, these deliveries are typically for larger quantities, cover shorter distances and barges operate in much friendlier environments.

5. Retailer Distributors.

Gasoline is sold to consumers through retail outlets. In some cases those retail outlets are owned directly by wholesalers or refiners. Other retail outlets are owned by independent individuals or businesses. Tesoro owns a significant number of stations in the Anchorage-area. Tesoro provides gasoline to these stores as required, and accounts for the sales price as part of the cost to operate each store. Tesoro owns or leases several tanker trucks to make these deliveries.

Holiday is also a large owner of retail stations. It purchases gasoline from either Tesoro or Flint Hills, and delivers the gas to Holiday stations for an additional per-gallon charge consistent with the delivery service provided. The other major marketers of gasoline do not own their own retail stations.

Branded distributors contract with a wholesaler to purchase fuel and sell it under a brand name such as Tesoro to stores that are independently owned. They may also sell gasoline through their own stores. The majority of Tesoro stations, in addition to the Chevron and Shell stations in Alaska are operated by independent dealers or branded distributors.

Unbranded distributors contract with a wholesaler to purchase fuel at the truck rack. They then sell that fuel to independent unbranded stations, or they sell it through their own stations. Safeway, Costco, and Fred Meyers are examples of large independent distributors.

They purchase fuel from wholesalers on a delivered basis, paying the wholesaler a per-gallon delivery charge consistent with the cost of the service provided.

Once gasoline is delivered to the retail distributor, the retail price is determined by the distributor in light of current market conditions, including the price competitors set for their gasoline. Retail stations in Alaska are also typically smaller than stations in the Lower-48 states, resulting in higher average per-gallon costs. In areas where the supply of fuel can be replenished weekly, or even daily, the price may change frequently as market conditions change.

Many consumers assume there is collusion among gasoline stations when prices increase and decrease at nearly the identical time. While this seems to suggest competitors are colluding with each other, this kind of "parallel pricing" is common in markets where pricing is transparent. For retail gasoline, prices are the most transparent of just about any consumer product. Prices are displayed for everyone to see, and competitors know almost immediately what price changes are occurring in the market. Public internet sites that track prices have also become more common, and allow competitors to track the pricing behavior of each other easily. In markets with fewer competitors, this becomes even easier, and identical price adjustments that occur nearly instantly are not uncommon. This is not illegal so long as competitors are making independent pricing decisions without communicating with each other.

Hypermarketers - Safeway, Costco, and Fred Meyers - have grown tremendously over the past decade in Alaska. Our investigation indicates that there has been vigorous competition between the in-state refiners for hypermarketer accounts as these outlets have grown over the last several years.

6. Out of State Supply Alternatives for the Railbelt.

Alaska's refineries produce enough gasoline to supply the state's needs in the railbelt, so there is no physical need to bring supplies in from sources outside the state. Given the limited number of in-state refiners and wholesalers of gasoline, however, the potential for supply entering the Alaska market from outside the region can provide a check on prices. The nearest alternative supply source to Alaska is the Pacific Northwest, specifically the refineries and terminals in the Seattle area. Wholesalers regularly ship product to western and southeast Alaska and have shipped gasoline to Anchorage terminals from Seattle as recently as the mid-1990s. No one has shipped gasoline into the Anchorage area during the past 10 years.

Short term or "spot" shipments into Anchorage, while theoretically possible, are generally not viewed as economic by existing or potential marketers, even in the face of short-

term prices that are relatively high. There are several reasons for this. First, shipping can be more expensive to obtain on a spot basis. Second, storage is difficult, if not impossible to arrange without long-term commitments. Third, most, if not all gasoline is sold in Alaska on a long-term basis, so there is no "ready market" to sell the gasoline into even if one were to arrange for a shipment. Finally, as discussed above, the overall market for gasoline is relatively small in Alaska. A typical tanker-size shipment of gasoline is 250,000 barrels (10.5 million gallons). This represents approximately 20 days supply for the entire railbelt area. Assuming a would-be marketer had 10% of the Anchorage-area market, a typical shipment of gasoline would account for more than 6 months worth of sales. This is a relatively long inventory turn over period and exposes the marketer to the risk that prices could change dramatically before the product is sold.

Gasoline supply into western and southeast Alaska is typically shipped up from Pacific Northwest refineries, though product can and does originate from Tesoro's Nikiski refinery as well. Shipments to these areas come up on smaller barges, with volumes in the range of 40,000 barrels. The small communities served in these areas means that marketers often will make several stops and that shipments are sporadic. Shipment to these areas is lined up many months in advance of delivery. Short-term or spot shipments to take advantage of periods of high prices are even less feasible for these areas.

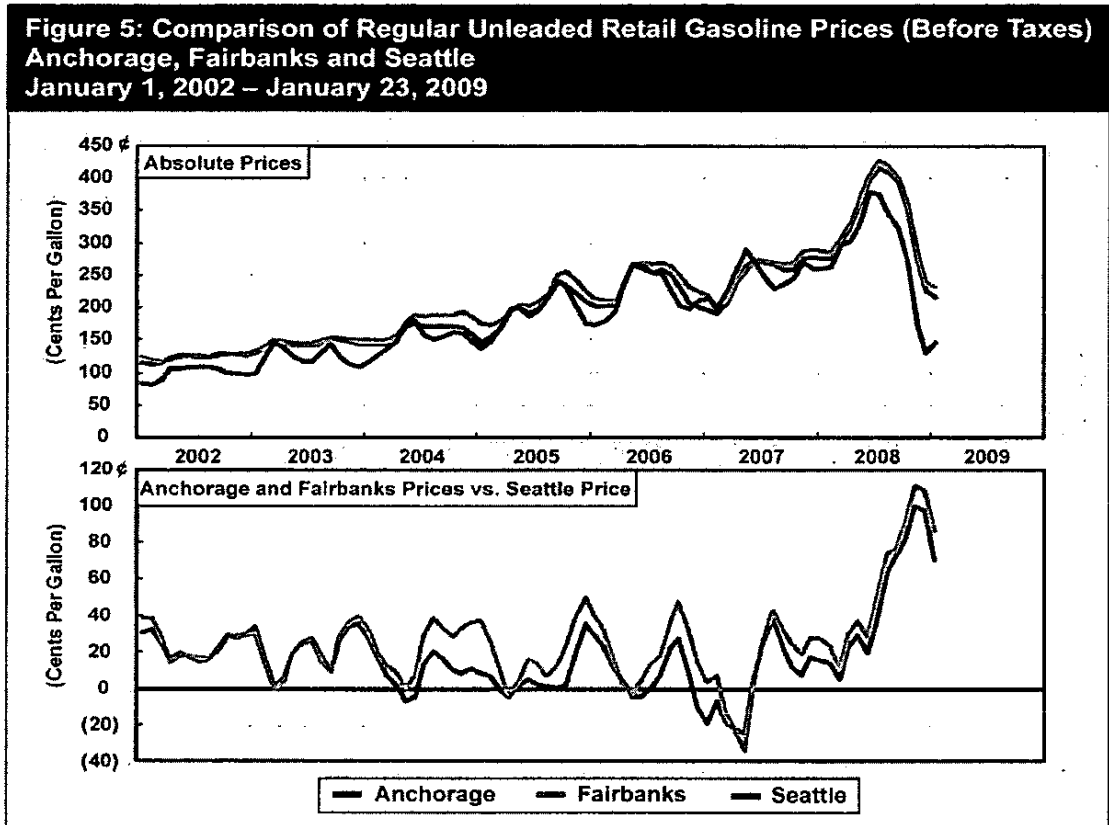
D. Performance of Alaska's Gasoline Markets.

1. Alaska Retail Gasoline Relative to Lower-48.

Retail gasoline prices in Alaska have historically been higher than in the rest of the U.S. Adjusted for taxes, Anchorage prices averaged \$0.21 per gallon more than the U.S. average between 2002 and 2007. Anchorage retail prices averaged \$0.13 per gallon over Seattle during the same period. Fairbanks prices typically run higher than Anchorage prices. Between 2002 and 2007 Fairbanks retail prices were \$0.07 per gallon above Anchorage on average.

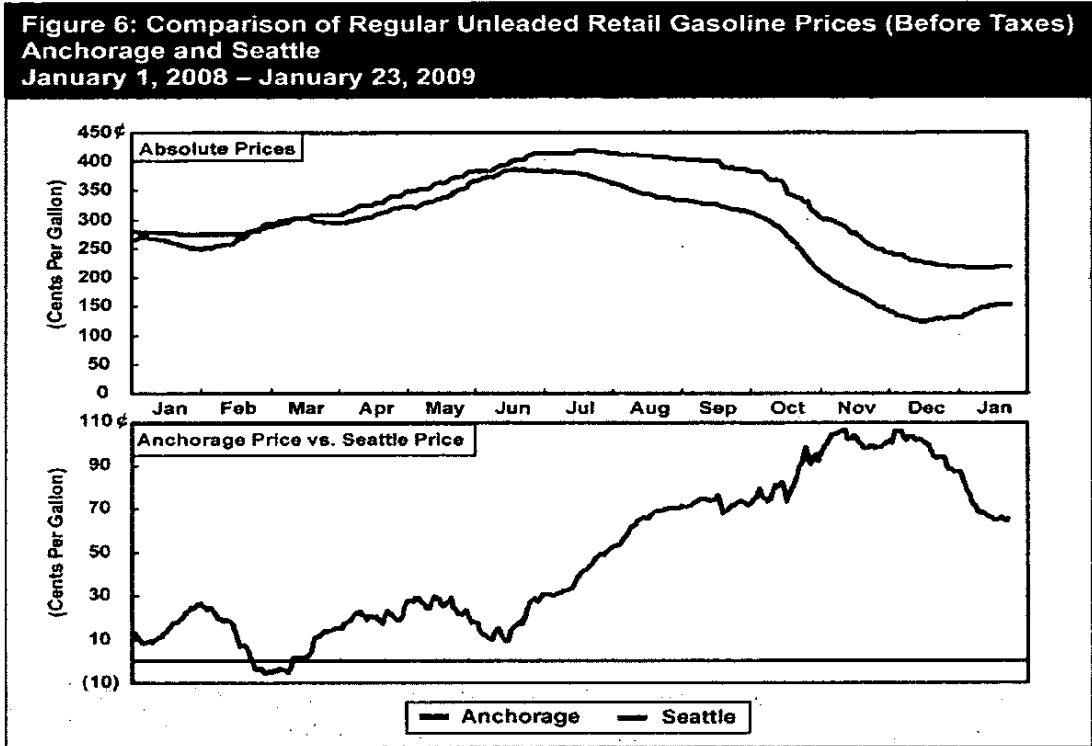
During 2008 the difference between Anchorage and Seattle prices was \$0.49 per gallon for the year. The spread during the first half of the year was \$0.18 per gallon, which is not much different than the long-run average. The spread during the second half of the year was \$0.76 per gallon, considerably higher than historical norms. The maximum spread between Anchorage and Seattle reached \$1.06 per gallon in November of 2008, at which point it began to narrow. By late January, the spread was \$0.65 a gallon. As of February 9, 2009, the spread had closed to

less than \$0.60 per gallon. While this is still above historical levels, it represents a substantial drop in the spread (\$0.41 per gallon) during a relatively short (two-month) period. The spread between Anchorage and Fairbanks remained relatively unchanged during 2008. Figure 5 shows Anchorage, Fairbanks and Seattle retail prices (before taxes) from January 2002 through January 2009. Based on current trends, we expect the spread to continue to narrow.



Source: AAA; Energy Information Administration; OPIS.

Figure 6 compares Anchorage and Seattle retail prices from January 2008 through January 2009 on a daily basis. As seen in these figures, gasoline prices in Anchorage were within historical norms through June. The dramatic growth in the spread between Alaska gasoline prices and prices in most of the rest of the U.S. began during July and peaked in November before starting to fall toward historical levels.



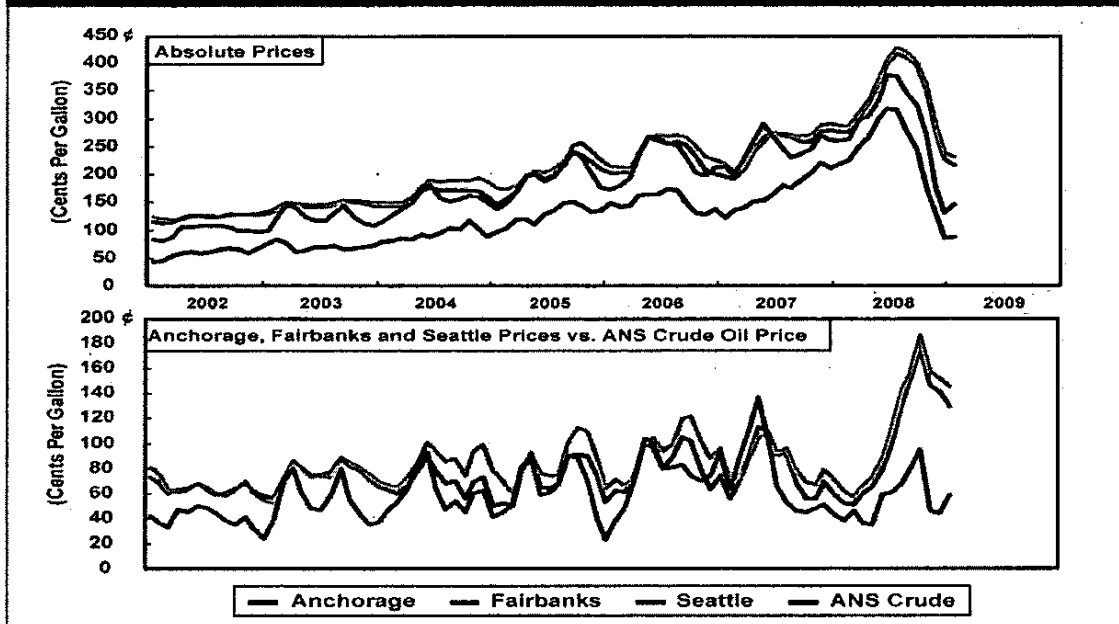
Source: AAA; Energy Information Administration; OPIS.

2. Gasoline Prices Relative to Crude Oil.

The growth in the spread between Alaska gasoline prices and prices in the Lower-48 coincided with the unprecedented decline in crude oil prices that began in July. Crude oil prices rose by \$60 per barrel during the first half of the year, before peaking in July, at which point they proceeded to drop by more than \$100 per barrel over the course of the year. The volatility seen in crude oil markets during the year is unprecedented.

The margin between Anchorage retail gasoline prices and ANS crude oil typically ranged from \$0.60 to \$0.80 per gallon prior to 2008, though at times the margin reached more than \$1.00 per gallon. Figure 7 shows Anchorage, Fairbanks, and Seattle retail prices (before taxes) compared to ANS crude oil starting in January 2002.

Figure 7: Comparison of Regular Unleaded Retail Gasoline Prices (Before Taxes) Anchorage, Fairbanks and Seattle and ANS Crude Oil January 1, 2002 – January 23, 2009

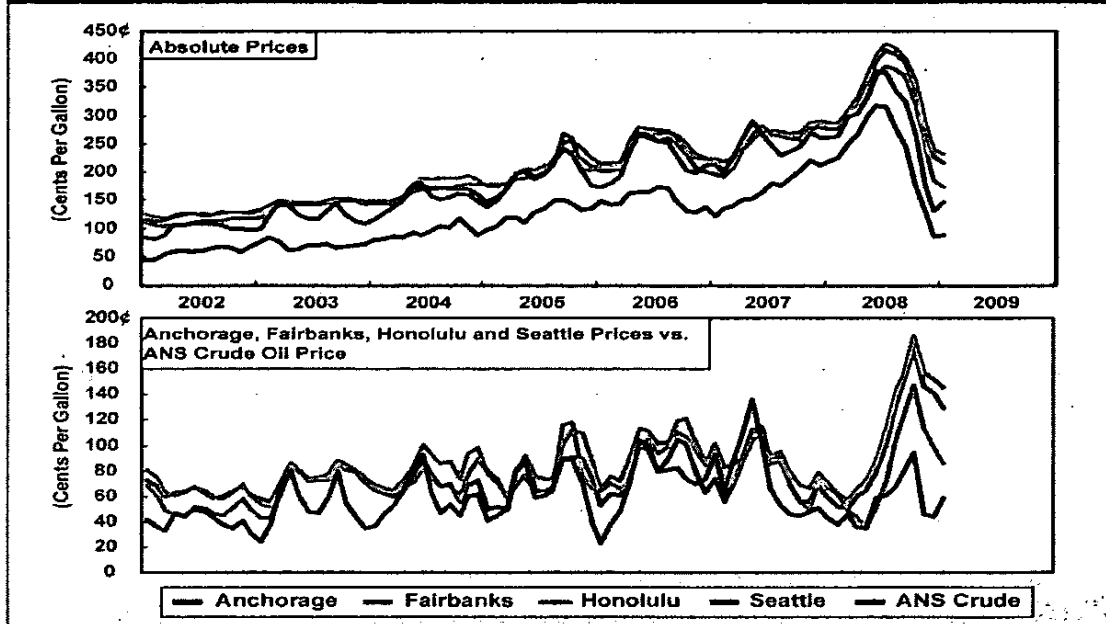


Source: AAA; Energy Information Administration; OPIS; Platts; State of Alaska Revenue Department.

As seen here, the gasoline-crude oil price margin remained in a relatively narrow range until mid-2008. At that point the margin in Alaska increased sharply as crude oil prices fell. The margin between Seattle prices and crude oil also rose during the second half of 2008, though not nearly as much as it did in Alaska. Figure 7 also highlights the fact that while gasoline prices move over time with crude oil prices, they do not move in lock-step and they move with a time lag.

Figure 8 shows the same information contained in Figure 7, but with the addition of Honolulu retail prices. Alaska and Hawaii gasoline markets share many of the same characteristics. Figure 8 shows that the relationship between gasoline and crude oil followed similar patterns in Anchorage and Honolulu during 2008, with gasoline-crude oil price margins rising sharply in the second half of the year to record levels in both markets. Neither behaved like Seattle.

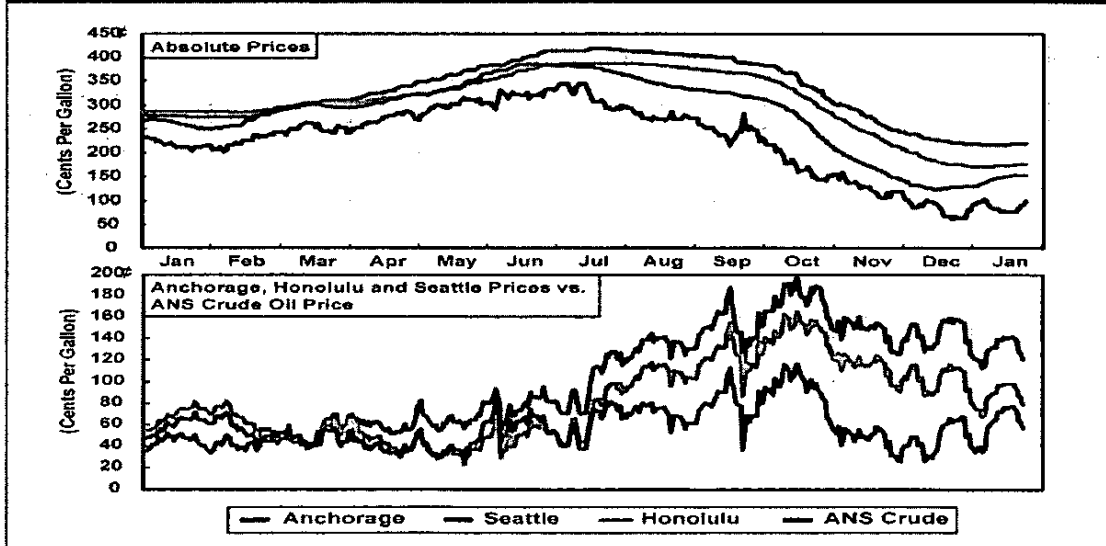
Figure 8: Comparison of Regular Unleaded Retail Gasoline Prices (Before Taxes) Anchorage, Fairbanks, Honolulu, Seattle and ANS Crude Oil January 1, 2002 – January 23, 2009



Source: AAA; Energy Information Administration; OPIS; Platts; State of Alaska Revenue Department.

Figure 9 shows daily retail gasoline prices in Anchorage, Honolulu and Seattle relative to crude oil from January 2008 forward. This figure shows the rise in the gasoline-crude oil margin in Anchorage and Honolulu during the second half of the year. As seen in the prior figure as

Figure 9: Comparison of Regular Unleaded Retail Gasoline Prices (Before Taxes) Anchorage, Honolulu, Seattle and ANS Crude Oil January 1, 2008 – January 23, 2009

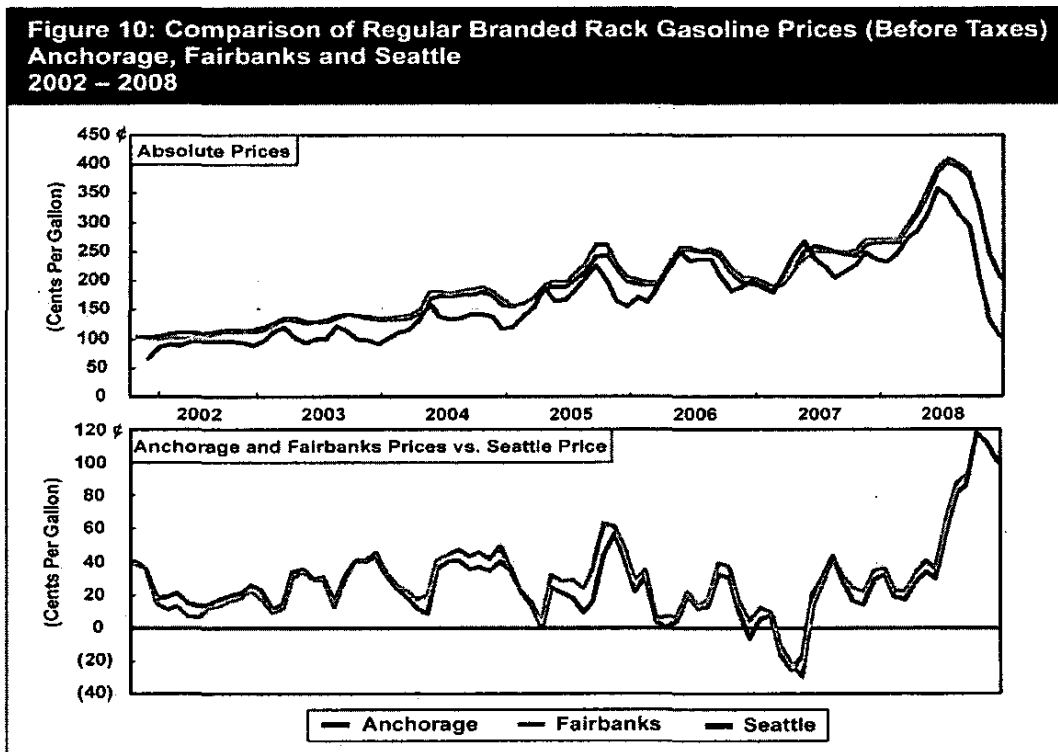


Source: AAA; Energy Information Administration; OPIS; State of Alaska Revenue Department.

well, gasoline-crude oil margins in Anchorage and Honolulu rose sharply during the second half of 2008, before declining toward the end of the year. Anchorage and Honolulu followed similar patterns, which were different from the pattern in Seattle.

3. Alaska Rack (Wholesale) Prices.

The rise in Alaska retail gasoline prices relative to the Lower-48 follows the rise in wholesale rack prices set by Alaska’s marketers. Figure 10 shows rack prices in Anchorage, Fairbanks and Seattle relative to crude oil prices since January 2002.



Note: Fairbanks prices go through September 2008.
Source: OPIS.

Rack prices in Alaska historically have been higher than rack prices in Seattle. Between January 2002 and December 2007 the average gross Anchorage rack price was \$0.16 per gallon over the average Seattle rack price. Fairbanks was \$0.08 per gallon over Anchorage during this same period. These differences approximate the differences seen in retail gasoline prices between these locations.

During the first half of 2008 Anchorage rack prices averaged \$0.23 per gallon over Seattle. The spread grew to \$0.90 per gallon during the second half of the year. Again, the

relationship between rack prices in Alaska and Seattle is consistent with the relationship seen in retail prices.

4. Retail Margins.

Our review concluded that the margin between retail and gross rack prices was typically lower in Anchorage than in Seattle. Retail margins do not account for the increase in Alaska gasoline prices relative to Lower-48 prices during the second half of 2008.

E. Economics of Pricing in Alaska.

As discussed above, gasoline prices are not regulated in Alaska (or elsewhere in the United States). Prices are determined in the market and dictated by the fundamental economic laws of supply and demand. In markets with many buyers and sellers, these economic laws work to ensure that the prices charged by sellers are competitive. That is, they will be at a level that covers sellers' costs over time, including a competitive return on investment for efficient sellers. In markets where there are relatively few suppliers and limited supply sources outside the area, prices can rise above sellers' costs, providing them with "supra-competitive" returns or profits.

Sellers in all markets offer their products to consumers in an attempt to earn a profit. The amount of profit that a seller can earn depends on existing competition from other sellers, potential entry into the market from others seeking profitable opportunities and the extent to which consumers have the ability to substitute products for the one in question.

1. Competitive Markets and Prices.

Competitive markets are characterized by a large number of sellers offering the same or similar products to consumers that have the ability to choose freely among the products or services offered. The larger the number of sellers, the more likely a market will perform competitively. This is because no single seller has the power to influence prices in the market on its own (i.e., no single seller has market power). Nor does any individual seller take into account its rivals or their decisions. Due to their relatively large numbers it is unwieldy for sellers to coordinate their behavior or agree to volume or price restrictions without being detected, or without some number of sellers "cheating" on the agreed restrictions.

In a competitively structured market, the motivation of sellers to earn profits through expanded sales coupled with the desire of buyers to seek out low-priced sellers in order to minimize their costs leads to prices that are "competitive." In a competitive market, prices will tend over time to equal sellers' costs, including the cost of attracting invested capital to the

venture. If prices begin to rise above costs, sellers will see additional opportunities to earn profits and will offer additional product into the market. This in turn serves to drive prices down to the point where they cover sellers' costs. If prices fall to a level that does not cover sellers' costs, some will exit the market or offer less product until the decline in volume serves to increase prices to a level that does cover costs.

2. Oligopoly Markets and Prices.

Oligopoly (or concentrated) markets, like Alaska's, are characterized by the presence of relatively few sellers. Oligopoly markets can function competitively even with few sellers (or even just one seller) as long as it is not expensive for potential new sellers to enter the market when prices rise above competitive levels. In this situation, the presence of potential competition serves to cap the price available to existing sellers. If there are high costs associated with entering a market (entry barriers), either because of large up-front investments or regulatory issues, existing sellers may be able to increase prices above competitive levels, at least in the short term, without much concern about attracting new competition.

Where there is little threat of attracting new competitors, an individual seller may be able to exercise market power and impact prices through its own conduct. By offering a smaller volume to the market, a seller may be able to raise prices above costs and competitive levels. In competitive markets, this increase would attract supply from rival firms. In oligopoly markets, however, the few rival firms may not be as aggressive in increasing supply to the market in this situation because each recognizes it can affect the market price and its competitors' sales (and profits) through its own actions. A seller contemplating a price reduction in an attempt to expand its sales recognizes that it will take sales away from its competitors, which may prompt them to cut prices as well in order to keep from losing sales.

The ability of sellers to maintain prices above competitive levels in oligopoly markets is dependent upon their exercise of restraint in light of profitable opportunities for each to expand sales. The more certain a seller is that its competitors will exercise restraint, the more likely it will do so itself. Without the expectation of restraint by its rivals, a seller has little reason to show restraint itself, since it may simply result in increased business for its competitors at its own expense.

The fewer the number of sellers in a market, the easier it is for each to observe the other and develop expectations as to the way in which each will likely react to the other's decisions

regarding output and prices. In these markets, each seller will naturally take into account the potential impact of its own actions on market prices, including the potential responses that its actions might elicit from other sellers. This type of “competitive” behavior is often referred to as oligopolistic pricing or “oligopolistic interdependence” because the decisions that each make are “dependent” in part on the expected actions (or reactions) of other sellers. In this environment, it is easier for sellers to develop a “live and let live” attitude toward their rivals that would not be possible to maintain in competitively structured markets with more sellers. As a result, oligopolistic or interdependent behavior can result in prices that are above competitive levels over extended periods of time.

Interdependent behavior on the part of sellers is not generally regarded as a violation of antitrust law as long as firms develop and implement their pricing and output decisions independently. That is, in determining what volumes to produce or what prices to offer firms can incorporate their expectations about a rival firm’s likely competitive actions or reactions as long as those expectations are developed independently and without the aid of rivals.

3. Alaska’s Gasoline Prices Reflect Oligopoly Pricing.

Alaska’s gasoline markets can fairly be characterized as oligopolies at the wholesale level. Oligopoly markets can produce a wide range of prices, high or low, without there ever being any illegal behavior or collusion by sellers. Absent collusive behavior, the ability of sellers to maintain high prices and supra-competitive profit levels is dependant on their individual restraint or discipline in the face of profit opportunities. In addition, it is dependant on the existence of some sort of entry barrier that prevents non-incumbent suppliers from entering the market and taking advantage of the higher profit opportunities. As discussed above, these entry barriers exist in parts of Alaska, limiting competition from outside suppliers, particularly during short-term periods or periods such as the second half of 2008 characterized by extreme market volatility and uncertainty.

Gasoline prices in Alaska have been slower to adjust to falling crude oil prices since oil prices began falling in July 2008. The slower reaction in Alaska does not come as a surprise in light of history. This behavior is not limited to Alaska’s gasoline markets. Hawaii’s gasoline markets, which are structured similarly to Alaska’s, also tend to lag price changes in the rest of

the U.S. . In addition, academic research indicates that wholesale gasoline prices in markets that are less competitively structured respond more slowly to changes in crude oil prices.¹²

Given the structure of the market in Alaska, prior experience during crude price declines, economic theory and available academic research into gasoline markets, it is not surprising that Alaska's gasoline prices respond more slowly than prices in other markets. This accounts for the large spread between gasoline prices in Alaska and the Lower-48 during the second half of 2008. History suggests that after price declines Alaska gasoline prices continue to fall as prices in other markets start to rise again with the next increase in crude oil prices. Indeed, this is just the type of pricing behavior we have seen over the last two months, with the spread between Anchorage and Seattle narrowing significantly.

The events of 2008 do not fit neatly into any historical pattern. There has never been a market for crude oil at any time to rival the extreme price swings seen in 2008. It is impractical to expect that pricing would follow any kind of historical pattern during the past six months.

Economic theory does not tell us the magnitude of the price difference we should expect in Alaska during a period of price dislocation such as 2008. It does tell us, however, that given the differences in the market conditions in Alaska relative to most Lower-48 markets, large price differences can arise and be sustained absent any illegal behavior. Oligopoly markets are capable of a wide range of outcomes, particularly during periods of extreme volatility and uncertainty.

IV. Conclusion.

The Attorney General's office found no evidence of collusion or other illegal antitrust behavior among Alaska's refiners, wholesale marketers or retailers to fix output or prices. Our investigation indicates that the spread between Alaska gasoline prices and prices in the Lower-48 markets that began to widen during July 2008 is likely the result of market-related conditions in Alaska, combined with the unprecedented price volatility and uncertainty that occurred in crude oil markets during the year.

¹² Severin Borenstein and Andrea Shepard, "Sticky Prices, Inventories, and Market Power in Wholesale Gasoline Markets," August 2000.

ALASKA STATE LEGISLATURE



REPRESENTATIVE PETE PETERSEN

Re: Draft Judiciary Committee Report Conclusions on HB 68

The draft committee report makes several negative conclusions regarding House Bill 68 (HB 68), the proposed bill to protect Alaskan consumers and small businesses from excessive or exorbitant fuel prices. I believe some of these conclusions to be either not supported by the evidence, contrary to basic economic principles, or represent misunderstandings of certain provisions of HB 68 and their purpose.

First, the report is correct in noting that Alaska and Washington's refined petroleum markets are similar in some ways, and different in others. This is why the Washington market was chosen by the sponsors of the bill. Washington refineries have similar expenses as Alaskan refineries, but, unlike Alaska, Washington has a competitive market for refined petroleum so their prices more closely reflect fair market value.

It is also worth noting that under HB 68, it would still be legal for Alaskan refineries to charge prices in excess of 10% more than Washington refineries if they can show their prices to be reasonable in light of their expenses.

The draft report implies that HB 68 would "directly [tie] Alaska's refiners pricing structure to Washington's." This is not accurate. HB 68 would simply prohibit Alaskan refineries from charging excessive or exorbitant price, and create an objective standard- based on the Washington prices- over which the burden of proof would shift to the refineries to show their prices to be justified.

The report's analysis of how jet fuel prices relate to other refined petroleum products is not compatible with basic economic principles. The report implies that Alaska's refineries need to charge excessive prices for other products because they take losses selling jet fuel. Basic economics indicates that for-profit businesses will continue selling a product if it is more profitable to continue production than to shut it down. The business would make the same economic analysis for other products. This does not mean that a business will never sell a product at a loss, but the two decisions are independent. There are rational reasons why a refiner would sell jet fuel at a loss, and as the report notes the refineries are often able to make a profit on jet fuel even though they are forced to sell it at a fair market value.

The report indicates that HB 68 could drive refiners out of Alaska, but again the report fails to realize that HB 68 would not prohibit refiners from making reasonable profits. The report also compares HB 68 to Hawaii's failed price setting law. Here the report simply misrepresents HB 68. HB 68 in no way sets or caps price, it simply prohibits excessive or exorbitant pricing.

It is also troubling that the report implies that it is better to hurt Alaska's small businesses- the state's biggest job creators- who are suffering from high fuel prices, than to outlaw excessive pricing by the large Outside owned refiners.

Finally, the report implies that this legislation has been hastily prepared; to the contrary the sponsors have spent many hours deliberating and researching all aspects of the crisis, and determined this to be the best approach to protect Alaskan small businesses, consumers, and municipalities from excessive fuel prices. The report's conclusions are particularly baffling as the testimony the Committee heard before preparing this report was very influential in persuading the sponsors, and other unbiased observers, that legislation like HB 68 was needed.

The bottom line is: Alaskan small businesses, communities, and individuals need protection from excessive or exorbitant fuel pricing and HB 68 would provide that protection.