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STATEMENT OF FRANK G. ZARB

ADMINISTRATOR

FEDERAL ENERGY ADMINISTRATION

Before the

COMMITTEE ON INTERIOR AND INSULAR AFFAIRS

UNITED STATES SENATE

May 24, 1976

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear today and discuss the FEA modification of the Small Refiner Exemption in the Energy Policy and Conservation Act and the issues that have been raised since the promulgation of FEA's Special Rule No. 6 for Subpart C to implement Section 403(a) of the EPCA on December 31, 1975. First, I would like to provide a brief description of the Entitlements Program, including the current Small Refiner Bias. Second, I will devote a portion of my discussion to the Small Refiner Exemption, including a review of FEA actions to date regarding Special Rule No. 6, a summary of comments from our public hearings on the Rule, and analyses undertaken by FEA since the Rule's promulgation. Last, I would like to discuss FEA's proposed modification of the Small Refiner Bias under the Entitlements Program and its advantages over the current exemption.

The Entitlements Program is designed to substantially reduce disparities in the average costs of crude oil among domestic refiners and to enable refiners who depend heavily upon upper tier, high cost domestic or imported crude oil to remain competitive with those having access to lower cost, lower tier domestic crude oil. The program requires that refiners who have more than the national average of lower tier

oil buy entitlements from refiners who have more than the national average of upper tier and imported oil. In this way all American consumers are enabled to share equitably in the benefits of price-controlled domestic crude production, regardless of which refiner they patronize.

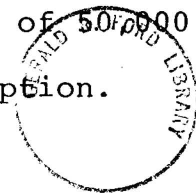
Under the Entitlements Program, small refiners have always been given special consideration. A bias provides for issuance of incremental entitlements over and above those earned under the regular program to refiners whose crude oil processing capacity is less than 175,000 barrels per day.

Issuance of these entitlements is designed to compensate for diseconomies of scale among small refiners. Accordingly, the greatest benefit goes to the smallest refiners. Refiners whose runs are 10,000 barrels per day or less receive added benefits under the current bias of about two and one-half cents per gallon on each barrel of crude runs; this per gallon benefit declines as the refiner's runs increase and drops to zero when runs are over 175,000 barrels per day.

Any program which attempts to apply a general set of rules to about 140 refiners will have to deal with exceptions to the general rule. Those refiners who find that the program creates or fails to mitigate serious hardship or gross inequity may apply for relief to the FEA's Office of Exceptions and Appeals. If this office finds that relief is justified, it is provided in the form of either an exemption from the requirement to purchase all or part of the firm's entitlement

obligation for buyers of entitlements or the award of additional entitlements to refiner sellers. Action on a request for exception generally takes 30 to 45 days, although the period may be longer or shorter depending on the complexity of the case. Relief is granted for a set period of time, normally 90 days, and firms may, of course, apply for further relief if the facts warrant.

In addition to the standard Small Refiner Bias, Section 403(a) of the EPCA exempts all refiners whose capacities did not exceed 100,000 barrels per day from the requirement to purchase entitlements for the first 50,000 barrels per day of crude oil runs or receipts. As required by the law, FEA promptly issued Special Rule No. 6 for Subpart C to implement Section 403(a), effective December 31, 1975. The rule was issued as an emergency amendment and exempted all small refiners whose total refining capacities on January 1, 1975, or any day thereafter, did not exceed 100,000 barrels per day from any purchase requirements they would otherwise have regarding their first 50,000 barrels per day crude oil runs to stills. For small refiners with crude oil run levels between 50,000 and 100,000 barrels per day, the special rule provides for partial exemption from the purchase of entitlements, with a limit of 50,000 barrels per day on the total amount of the exemption.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A public hearing soliciting comments and testimony on Special Rule No. 6 was held on January 22, 1976. A total of 54 organizations and individuals submitted written comments or presented oral testimony on the subject. Thirteen participants supported the exemption, forty opposed it, and one reserved the right to comment in the future.

Those who supported the rule were generally small refiners exempt from entitlement purchase obligations under the rule. These firms said that the exemption was necessary to enable them to continue to compete, that it removed the burdensome requirements and uncertain results of the exceptions and appeals process, and that it did not give them a special advantage in the market, but rather allowed them to compete equitably with the major oil companies. This group also supported extending the same benefits to small refiner sellers of entitlements through an increased entitlement bias.

Opposition to this rule was primarily based on arguments of competitive inequity. The major refiners argued that the exemption was excessive and too broad and that as a result product prices paid by independent marketers supplied by the exempt small refiners would be substantially below those of marketers supplied by nonexempt firms. The rule was said to adversely affect the ability of the branded independent marketers to compete effectively, which is counter to the intent of the EPAA.

Numerous small refiner sellers of entitlements also opposed the rule on the grounds that they should be granted a corresponding change in the Small Refiner Bias to keep them on a competitive basis with the exempt small refiners. There was also general concern about the use of the cutoff at 100,000 barrels per day as this might serve as a severe disincentive to expanding capacity above that point. Opponents of the rule said that FEA's Exceptions and Appeals Office was a more effective mechanism for assuring the competitive viability of the small refiners than the blanket exemption because each case could be treated on its individual merits rather than trying to frame a single solution to a complex series of individual circumstances.

On the basis of the evidence obtained from the January 22 hearing, as well as hearings conducted by FEA as to the general reevaluation of its regulations in various regions on February 17, 18, and 19, 1976, and proprietary data FEA has on each refiner, FEA has tentatively determined that the exemption from payments for certain refiners does result in an unfair economic and competitive advantage with respect to other small refiners and large refiners and does seriously impair FEA's ability to provide in its regulations for the attainment of the objectives specified in Section 4(b)(1) of the EPAA. Specifically, FEA believes that Special Rule No. 6 does not conform with the objectives of the EPAA for the following reasons:

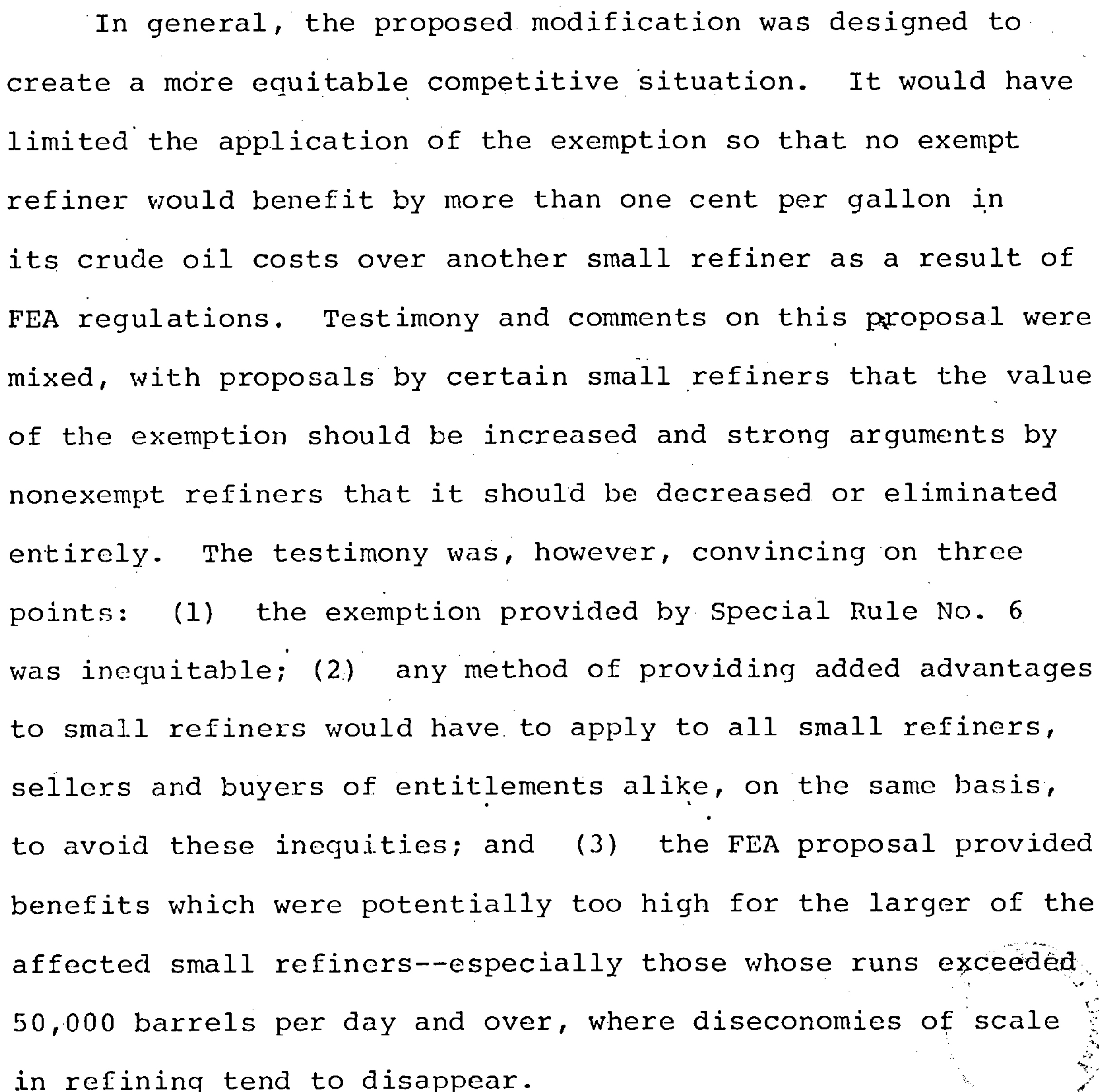
- First, the special rule grants certain small refiners benefits disproportionate to their actual needs, thereby providing them with an unwarranted competitive advantage over other refiners (including many small refiners) to such an extent as to be inconsistent with the objectives set forth in Section 4(b)(1) of the EPAA.
- Second, the resulting cost disparities place independent marketers supplied by nonexempt refiners, small and large, at a serious competitive disadvantage vis-a-vis marketers supplied by exempt refiners.
- Third, it provides incentives for small refiners benefiting from the exemption to curtail their crude runs in certain marketing situations by reducing purchases of domestic upper tier and imported crude oils, thus acting to decrease the availability of certain products in certain market areas served by small refiners.
- Fourth, it acts as a disincentive for small refiners to expand their refining capacity beyond the limit of 100,000 bbls/day set forth in the special rule.

Section 455 of the EPCA permits the FEA to modify the exemption, subject to Congressional disapproval, where this exemption is determined to result in an unfair economic or competitive advantage with respect to other small refiners,

or otherwise to have the effect of seriously impairing the FEA's ability to meet the objectives of the EPAA.

In order to determine the specific impact of the exemption, FEA analyzed post-entitlements crude oil costs for small refiners prior to suggesting a modification. Using the entitlements program data for December 1975 transactions (the first month of the exemption), FEA determined the post-entitlement crude oil costs under the exemption of all small refiners under 175,000 barrels per day in each of the Bureau of Mines refining districts. Not surprisingly, we discovered wide differences among post-entitlement crude oil costs of small refiners. These costs ranged from a low of $3.39 per barrel to a high of $13.52 per barrel, generating a difference in feedstock costs on the order of those which existed among refiners before the entitlements program was adopted. Within BOM refining districts, the difference between the highest and lowest small refiners was $1.13 per barrel, or 2.7 cents per gallon, in the district showing the least difference and $7.47 per barrel or 17.8 cents per gallon in the district showing the greatest difference. This analysis clearly pointed out the gross crude oil cost disparities among small refiners created by the exemption and the resulting undue competitive advantage possessed by certain exempt small refiners.

With this in mind, FEA in March proposed a modification to the purchase exemption. A public hearing was held on March 23 and 24, 1976, giving interested parties an opportunity to present their views concerning the proposed modifications.



In general, the proposed modification was designed to create a more equitable competitive situation. It would have limited the application of the exemption so that no exempt refiner would benefit by more than one cent per gallon in its crude oil costs over another small refiner as a result of FEA regulations. Testimony and comments on this proposal were mixed, with proposals by certain small refiners that the value of the exemption should be increased and strong arguments by nonexempt refiners that it should be decreased or eliminated entirely. The testimony was, however, convincing on three points: (1) the exemption provided by Special Rule No. 6 was inequitable; (2) any method of providing added advantages to small refiners would have to apply to all small refiners, sellers and buyers of entitlements alike, on the same basis, to avoid these inequities; and (3) the FEA proposal provided benefits which were potentially too high for the larger of the affected small refiners--especially those whose runs exceeded 50,000 barrels per day and over, where diseconomies of scale in refining tend to disappear.

Furthermore, FEA's analysis discloses that many of those firms which have been fully exempted from entitlements purchases by Special Rule No. 6 have not even requested exception relief, and a number who have requested exception relief have been unable to justify such relief. Of the 56 firms exempted from entitlements purchases on the entitlements list issued in April for February crude runs:

- 24 firms or 43 percent of the total had never requested exception relief from entitlements purchase requirements during the period April 1 through September 30, 1975;
- 6 firms had applied for exception relief which had been denied; and
- 26 firms had been granted full or partial exception relief prior to the time Special Rule No. 6 became effective.

These exceptions and appeals decisions were the result of careful and comprehensive analyses of the competitive position and earnings situation of each firm. These analyses focused especially on the rate of profitability as a percentage of sales volume and cash flow positions of the firms concerned.

Moreover, each decision was made only after parties likely to be aggrieved by the granting of relief had been notified

of the possibility of relief and given an opportunity to comment on its impact on their own operations.

These matters cannot be taken lightly, nor should they be dealt with in an arbitrary manner when the prosperity and very survival of the affected refiners and the marketing firms they supply are at stake, particularly when small changes in product prices can dramatically affect market shares among the firms concerned.

The FEA modification of the exemption would increase the Small Refiner Bias for all small refiners whose crude runs average less than 100,000 barrels per day for any given month and revoke Special Rule No. 6. The FEA modification will increase the Bias by two cents per gallon to a total of about 4.4 cents per gallon for the smallest refiners having runs of 10,000 barrels per day or less and will decrease rapidly as the refiner's runs approach 50,000 barrels per day, where economies of scale improve. At 100,000 barrel per day runs, there is no addition to the existing bias of about one-quarter cent per gallon.

The FEA modification to the small refiner bias is intended to achieve equity by providing added benefits to all 112 small refiners rather than to just the 56 firms exempted under the EPCA. Moreover, the modification provides a wider distribution

of benefits to similar-sized refiners, while it avoids giving extremely large benefits to a select few refiners as does the current exemption. The total value of added benefits for small refiners having crude runs of 30,000 barrels per day or less under the FEA modification amounts to 60 percent of the value of the present EPCA exemption. However, for refiners whose runs are over this amount, the value of the additional benefits is proportionately much less under the FEA modification, and we believe that this is essential to fair competition at levels at which diseconomies of scale are significantly reduced.

Because it is applicable to both small refiner sellers and purchasers of entitlements, the FEA modification to the present Small Refiner Bias eliminates the competitive disadvantages created among small refiners by the EPCA exemption. Under the exemption, certain refiners under 10,000 barrels per day receive benefits of as much as 21.4 cents per gallon more than other refiners of the same size. This disparity is intolerable over any length of time and could lead to the financial failure of nonbenefiting small refiners, and the erosion of small refiners as a competitive influence in the market.

Because the FEA modification is scaled to provide the greatest added benefits to the smallest refiners, it will sharply reduce any competitive disadvantages they may still

have vis-a-vis the larger independent and major refiners. Through this, the intent of Congress to preserve a competitive market is enhanced.

Extreme difficulties are now being faced by independent marketers supplied by refiners who do not benefit from the exemptions when they are in direct competition with marketers supplied by refiners who benefit heavily from the exemption. The FEA modification will alleviate these difficulties and restore fairer competitive conditions in the retail market.

The total value added by the FEA modification over and above the existing small refiner bias will be about $17 million per month. This is somewhat less than the value of about $39.4 million added by the EPCA exemption, but it is far more fairly distributed among small refiners. As shown in Table 1, all categories of small refiners will benefit compared to the existing small refiner bias, with over three-fourths of the total amount of the benefit accruing to small refiners with runs under 30,000 barrels per day. The EPCA exemption results in refiners of this size receiving only half of the added benefits, and less than half of the members of this class receive any benefit at all under the EPCA exemption. The modification thus provides for greater equity among small refiners as well as between small and large refiners.

Mr. Chairman, I believe that the foregoing discussion, taken in conjunction with other materials which the FEA has

provided comparing the effects of the exemption with those of the FEA modification to the Small Refiner Bias, support a compelling argument for approving FEA's proposed modification to the Section 403(a) exemption.

It may be argued by some that the exemption has not created the disparities at retail that would flow from the crude cost disparities identified to date. It is important to keep in mind that there is a big difference between competitive advantage and retail pricing. A refiner with a 10-cent-per-gallon cost advantage and a large bank of unrecovered product costs can undersell his competitors by 3 to 4 cents per gallon, enough to attract all the business he can handle, and use the rest of his advantage to recover maximum margins and all his allowable increased costs.

We believe that the facts that we have already presented make it evident that severe distortions are occurring which will continue to run counter to the objectives of the EPAA if the exemption is allowed to stand. The FEA modification of the Small Refiner Bias will, on the other hand, promote the continued achievement of these objectives and will ensure that small refiners remain an increasingly viable competitive force in the petroleum industry.

That concludes my remarks, Mr. Chairman. If the Committee has any questions, I will be happy to attempt to answer them.

Table 1

COMPARISON OF TOTAL VALUE OF ADDED BENEFITS BETWEEN CURRENT SMALL REFINER EXEMPTION AND FEA MODIFICATION

- 112 small refiners would benefit, rather than just 56.

  -- This will assure competitiveness among small refiners.

  -- It would provide additional advantages to small refiners vis-a-vis large refiners.

- While the total value of current additional benefits would be reduced under the FEA modification, approximately three-quarters of the small refiners -- those with runs of less than 30,000 BPD -- would receive three-quarters of the benefits, whereas under the current exemption, firms under 30,000 BPD receive only one-half of the benefits.

TOTAL VALUE OF ADDED BENEFITS*

Refiner Runs (MB/D)	EPCA Exemption		% of Total Value	FEA Modification		% of Total Value
	No. of Firms	Value		No. of Firms	Value	
0-10	27	$ 7,432,357	18.9	58	$ 4,954,791	29.1
10-30	15	12,861,141	32.7	30	8,280,524	48.6
30-50	9	12,871,198	32.7	12	2,942,538	17.3
50-100	5	6,191,554	15.7	12	858,745	5.0
TOTAL	56	$39,356,250	100.0	112	$17,036,598	100.0

* From April list, based on February data.