TESTIMONY OF

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REPRESENTING

THE NATIONAL ASSOCIATION OF CONVENIENCE STORES

AND

THE SOCIETY OF INDEPENDENT GASOLINE MARKETERS OF AMERICA

AT A HEARING OF THE

SENATE COMMITTEE ON ENVIRONMENT AND PUBLIC WORKS

ON

"THE IMPACT OF THE ELIMINATION OF MTBE"

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Good morning, Mr. Chairman, Ranking Minority Member Jeffords, and members of the Committee. My name is Bill Douglass. I serve as the Chief Executive Officer of Douglass Distributing Company in Sherman, Texas. My company owns and operates 14 motor fuel outlets in the Dallas/Fort Worth area and supplies gasoline and diesel fuel to 165 additional retail outlets in that area under long-term supply contracts.

Thank you, Mr. Chairman, for calling this important hearing this morning. I appear before the Committee representing the National Association of Convenience Stores (NACS) and the Society of Independent Gasoline Marketers of America (SIGMA). I am the former Chairman of NACS' Board of Directors and my company also is an active member of SIGMA. Together, NACS and SIGMA members sell

approximately 80 percent of the gasoline and diesel fuel purchased by motorists in the United States each year. NACS and SIGMA appreciate the opportunity to present testimony this morning on an issue of great importance to our industry and to the entire nation -- the current turmoil and uncertainty in the nation's gasoline markets and the opportunity this uncertainty has to translate into supply shortages and price volatility during the Spring and Summer of 2006.

NACS is an international trade association comprised of more than 2,200 retail member companies operating more than 100,000 stores. The convenience store industry as a whole sold 143.5 billion gallons of motor fuel in 2005 and employs 1.5 million workers across the nation.

SIGMA is an association of more than 240 independent motor fuel marketers operating in all 50 states. Last year, SIGMA members sold more than 58 billion gallons of motor fuel, representing more than 30 percent of all motor fuels sold in the United States in 2005. SIGMA members supply more than 35,000 retail outlets across the nation and employ more than 350,000 workers nationwide.

Over the past three months, I have witnessed such a blizzard of announcements and developments regarding gasoline production and distribution this Spring and Summer that even I, who study and participate in gasoline marketing every day, am uncertain what to expect over the next six months. It would not surprise me if the members of this Committee, who wrestle daily with many issues of national importance far removed from motor fuel issues, are not sure what to make of these developments either. This hearing represents an attempt to sort through these announcements, rumors, and questions.

NACS and SIGMA believe it is a timely examination and we welcome this Committee's interest.

As an initial matter, I would like to review briefly what we know, rather than what we don't know:

- Methyl tertiary butyl ether (MTBE) has been used as an octane enhancer in gasoline since the 1970s when lead was removed from gasoline. Only in the 1990s did its use as an oxygenate in gasoline become common. As a result, when MTBE is removed from gasoline, not only does the nation's gasoline pool lose substantial volume which must be replaced by other products, but the octane MTBE adds to gasoline must be replaced by other products to assure that fuel performance is not degraded.

- In late 2005 and early 2006, several of the nation's pipeline systems, which transport gasoline from the major Gulf Coast refining complexes up the East Coast and through the Mid-West, announced that they would stop accepting shipments of reformulated gasoline (RFG) containing the oxygenate and octane additive methyl tertiary butyl ether (MTBE).

- During the same time period, several major integrated oil refiners announced that they would transition away from blending MTBE into RFG and conventional gasoline early in 2006 due to the pipeline actions and ongoing concerns regarding potential liability resulting from contamination of groundwater by MTBE.

- In late February, the Environmental Protection Agency (EPA) issued a final rule, required by the Energy Policy Act of 2005 (EPAct 2005), to remove the RFG oxygen mandate as of May 8, 2006, thereby permitting non-oxygenated RFG, or clear RFG, to be sold as RFG as long as it met EPA clean fuel standards.

- Also in late February, the Department of Energy's Energy Information Administration (EIA) released a report entitled "Eliminating MTBE in Gasoline in 2006" which raised concerns about shortages in both domestic gasoline and ethanol production capacity in the coming months if such a transition away from MTBE RFG is pursued and concluded that "the complexity of the transition away from MTBE-blended RFG may give rise to local imbalances between supply and demand and associated price surges during the change."

- Earlier this month, the Renewable Fuels Association, the trade association representing domestic ethanol producers, responded to what it perceived to be inaccuracies in the EIA report, stating ". . . we have worked diligently with our customers -- the nation's gasoline refiners -- to ensure that any consumer impact . . . will be temporary."

- Most recently, the Federal Energy Regulatory Commission (FERC) denied a request from Colonial Pipeline Company, which operates one of two major petroleum pipelines serving the East Coast, to amend immediately its tariff schedule to delete MTBE RFG from the list of products it will accept on its pipeline after objections from several MTBE manufacturers.

As you may note, none of these announcements and developments involved gasoline retailers directly. There is a simple reason for this fact. Independent gasoline marketers do not make gasoline or ethanol, we do not own pipelines, and we do not have access to the type of data necessary to produce a report as authoritative as that released by EIA. Instead, we purchase gasoline at wholesale and sell it to motorists at retail. All of these activities have been taking place, so to speak, "far above our pay grade" and their exact effect on independent gasoline marketers and consumers will be known only as events develop over the next six months.

From all of these recent developments, gasoline marketers, and the members of this Committee, can glean several important facts (rather than arguments).

First, use of MTBE as a gasoline additive will decline in the future, whether precipitously as some have predicted this Spring and Summer, or more gradually. This decline is a direct result of Congress' failure to adopt liability reform provisions for MTBE as part of the Energy Policy Act of 2005. Without such liability reform, refiners, pipelines, and marketers are disinclined to extend their potential liability for use of this product in the future. I am not seeking to get into a debate as to whether Congress should have adopted the so-called MTBE safe harbor last year. That debate is over. Rather, this Committee, and Congress as a whole, must understand that the decisions you made, or chose not to make, last year, are having repercussions in the gasoline markets this year. Those repercussions were entirely predictable. Many in Congress wanted to

ban MTBE outright and immediately. NACS and SIGMA supported a gradual phase down of MTBE use over a number of years. Reality will fall somewhere between these two positions. MTBE use will be reduced in the future. The focus of this hearing, however, should be on the effect this reduction will have on domestic gasoline supplies and prices.

Second, ethanol blended with gasoline is the most likely and immediate substitute for MTBE in RFG. Ethanol contains some of the same characteristics that have made MTBE an attractive blending component in the past -- high octane content and a blend rate that dilutes other gasoline properties. However, the use of ethanol in RFG also increases volatility (thereby increasing VOC emissions, which lead to ozone formation) and ethanol contains higher levels of toxics than MTBE -- substances controlled under EPA's mobile source air toxics program. To prepare for blending ethanol with RFG and the resulting volatility surge, refiners must take certain components out of gasoline intended for ethanol blending, reducing the gasoline yield from a barrel of crude oil. EIA has estimated that on average refiners lose approximately five percent of their production capacity when making RFG for ethanol blending when compared to RFG for MTBE blending. This is a significant reduction in domestic gasoline production capacity that should be of concern to policymakers, marketers, and consumers.

Third, in general the nation's refiners are not positioned to produce substantial quantities of clear RFG -- RFG that is not blended with either ethanol or MTBE. Since the RFG program started in 1995, it has been unlawful for a refiner to produce such clear RFG. In fact, it will not be lawful to produce clear RFG until May 8, 2006 -- nine months after the President signed EPAct 2005 into law. It should not be surprising that

the nation's refiners have not been able, during the short period between EPAct's enactment and now, to dramatically alter their production capabilities to produce clear RFG. While undoubtedly many refinery modifications projects are in the works to produce clear RFG from many domestic refineries, the timetable simply has been too short to expect these modifications to be completed before this Spring.

Fourth, it is clear that the domestic ethanol production industry is doing its utmost to maximize the amount of ethanol it will produce and sell this year. Given that prices for ethanol scheduled to be delivered in May and June in recent weeks have fluctuated between $2.40 and $3.00 per gallon, they have every incentive to make every gallon of ethanol they can. Depending on the producer, ethanol costs between $1.00 and $1.50 per gallon to make, not taking into account the production tax credits that these producers enjoy under many state and federal laws. That means their margins are somewhere over $1.00 per gallon -- a margin that I as a gasoline marketer could never hope to achieve and one that makes the "crack spreads" of the nation's integrated refiners look like an amateurish attempt to turn a profit.

The question is not whether the domestic ethanol industry is doing its best to maximize production, but whether these best efforts will be sufficient to meet the demand for ethanol in the next six months as the nation transitions away from MTBE as a fuel additive. Depending on the assumptions one makes as to the pace and extent of MTBE de-selection as a blending component, as EIA's report accurately points out, the domestic ethanol industry's best efforts may fall far short of supplying the amount of ethanol required to meet the demand of refiners and marketers. If this is the case, the primary source of additional ethanol supply will be from foreign countries, including

Jamaica, Mexico, and Brazil. As EIA's report also notes, however, much of this foreign ethanol is subject to a $0.53 per gallon duty unless it has been processed in certain Caribbean Basin Initiative (CBI) countries. Thus, the option to look toward foreign ethanol to fill the shortfall in domestic production is limited by this tariff -- unless domestic ethanol prices rise to such high levels that importers are able to pay the huge per gallon duty and still offer competitively-priced ethanol to refiners and marketers. If such ethanol price spikes occur over the next six months, it will be interesting to see if the producers of ethanol will be called before congressional committees or placed under federal investigation for collusion and price gouging and for visiting on motorists hundreds of millions of dollars of increased prices at the gasoline pump.

Fifth, the continuing role of boutique fuels in complicating the supply and distribution of gasoline in 2006 must not be ignored. While it is true that Congress took effective steps in EPAct to cap the number of boutique fuels across the nation, to date this cap has not had the desired effect of reducing the number of unique gasoline and diesel fuel blends across the nation and restoring fungibility to the motor fuel supply and distribution industries. Thus, the problem of boutique fuels and the price volatility they cause during short supply situations remains.

Of greater immediate importance relative to this issue, as noted in the EIA study, is the lack of federal legislative action to limit state boutique *renewable fuel mandates*. EIA noted that state ethanol mandates, such as the one currently in place in Minnesota and those under consideration or being implemented for ethanol in other states, constrain the ability of ethanol producers to respond to ethanol demand in other areas of the nation. Congress enacted the Renewable Fuel Standard (RFS) as part of EPAct last year

to assure a minimum demand for ethanol and bio-diesel in the coming years. At the same time, however, Congress built into the RFS certain flexibilities to assure that renewable fuels would be used efficiently and economically under the RFS and would not be concentrated in any particular area of the nation. These state boutique renewable fuel mandates directly undercut the EPAct RFS flexibility by preventing renewable fuels, including ethanol, from moving to the areas of highest demand. NACS and SIGMA believe that this Committee and others must look into the role these boutique renewable fuel mandates play in decreasing the fungibility of product and increasing wholesale and retail price volatility for consumers -- much the way Congress looked into the negative effect of state boutique gasoline and diesel fuel blends on these factors under EPAct. If state boutique renewable fuels mandates are allowed to proliferate unchecked, then all of the work Congress put into restoring fungibility in the gasoline and diesel fuel markets will ultimately go for naught.

Sixth, the bulk gasoline storage and terminaling infrastructure in many parts of the nation is not prepared for a transition from MTBE to ethanol. Because ethanol generally can not be transported via pipelines, it must be trucked, barged, or shipped via rail to wholesale gasoline terminals for blending into gasoline. These terminals' storage capacity for different gasoline and diesel fuels already is stretched to the limit. Many terminals in the mid-Atlantic states and Texas, where the potential effect of the transition from MTBE to ethanol will be the greatest, simply do not have an "extra" storage tank in which to store ethanol. And it is not likely that they will be able to obtain the permits and build additional storage capacity in a two or three month timeframe. As a result, gasoline suppliers and marketers seeking to blend ethanol into gasoline this Spring --

assuming they can locate the ethanol at a reasonable price -- will be forced to scramble to find storage for this ethanol at bulk terminals or will locate separate and at times distant ethanol storage facilities at which they will blend ethanol with gasoline. These bulk storage infrastructure constraints will result in an added level of complexity in an already stressed gasoline supply distribution system.

Seventh, this transition away from MTBE comes during the yearly transition from winter to summer gasoline -- a transition that has in past years repeatedly resulted in supply shortages and wholesale and retail price spikes. In 2006, not only must terminals and retailers complete the switch from winter to summer gasoline, but they must also switch from MTBE RFG to ethanol RFG. This transition to ethanol will require terminals and retailers to draw down their gasoline inventories aggressively to complete the transition as quickly as possible and to avoid offering gasoline that does not comply with EPA's clean gasoline programs. And as with any commodity, when inventories are low, the opportunities for supply shortages and price volatility increases.

Finally, the transition from MTBE additized gasoline to ethanol additized gasoline will be problematic for motor fuel retailers like me. Due to ethanol's characteristics, many marketers will be forced to pump out their retail underground storage tanks to convert to RFG with ethanol to prevent clogged fuel dispenser filters or clogged motor vehicle fuel filters. Retailers will be undertaking these preparations at the same time that they are preparing to switch from winter to summer gasoline blends. Most marketers, myself included, are confused by the various announcements and predictions being made about the transition from MTBE to ethanol in RFG and have not been able to make concrete operational plans to carry one product or another.

NACS and SIGMA members have been selling gasoline blended with ethanol for decades. The challenges of selling gasohol at retail are well-known: securing appropriate gasoline blendstock and ethanol supplies and the facilities to blend these products; phase separation if any water makes its way into the blend; cleaning storage tanks before adding ethanol to prevent clogged fuel filters; and, educating consumers about gasohol in areas where it may never have been sold previously. As a result, given sufficient time to effect this transition from MTBE to ethanol, such a transition would be transparent to our customers. However, many retailers like myself are making this transition for the first time and I can tell you that the conversion is rather daunting. For example, one of my gasoline suppliers provided me a document to walk me through the conversion process—it is a 20 page document! That is a lot of information for retailers to absorb and implement.

Unfortunately, this transition is happening on a much tighter timetable than any previous transition from MTBE to ethanol. In California and New York, where MTBE was banned several years ago, retailers in those states had two to three years to plan for an orderly transition to ethanol. This is not the case with this transition. In most cases, retailers began hearing about the planned transition in January and only recently have received confirmation from their suppliers regarding the details and timing of the transition.

In short, such transitions have been accomplished before with little disruption to gasoline supplies or significant price volatility. But this transition is being undertaken much more quickly and in larger geographic areas.

This Committee's inquiry on this issue could not be more timely. The gasoline refining and distribution industry is in turmoil in many areas of the nation as each participant makes decisions concerning which products to offer, carry and sell. Suffice it to say that this turmoil will resolve itself in the near future. However, the question for policymakers must be how high gasoline prices will have to rise before sufficient quantities of gasoline blendstocks are attracted from foreign sources to make up for shortfalls in domestic production? And what role will ethanol supply and prices play in influencing retail gasoline prices in the next six months? Neither of these questions can be answered authoritatively at this time. However, to quote again from EIA's recent report: "[T]he complexity of the transition away from MTBE-blended RFG may give rise to local imbalances between supply and demand and associated price surges during the change. As the summer progresses and demand grows, the right supply situation is not likely to ease significantly, leaving the market exposed to the increased potential for price volatility in the East Coast and Texas RFG regions."

Unfortunately, there are few public policy options open to Congress to mitigate these potential supply shortages and price volatility in the short-term. NACS and SIGMA propose the action that would have the most significant positive effect on supply and dampening effect on price increases in the next six months would be the temporary suspension of the tariff on imported ethanol. This suspension would be adopted to ease the transition of the domestic ethanol industry through the period of increased ethanol demand caused by decreased MTBE use and its inability, despite its best efforts, to totally fill the supply gap left by MTBE.

In the medium term, NACS and SIGMA suggest that Congress consider two additional actions. The first would be to extend the boutique fuels cap under EPAct to limit state boutique renewable fuel mandates. Such an extension would prevent such state mandates from undermining the policy goals and the flexibility of the RFS in EPAct and would halt the renewed proliferation of unique fuel blends across the nation.

Second, NACS and SIGMA again urge Congress to pass legislation to encourage the expansion of domestic refining capacity. Mr. Chairman, the legislation you introduced last year to encourage such expansions was a very good effort to achieve this goal. Unfortunately, it was not approved by this Committee. NACS and SIGMA urge you and your colleagues to redouble your efforts to pass such legislation. Without it, American motorists will continue to face the supply and price uncertainties that are so widespread this Spring and Summer.

Last year, the subject of numerous congressional hearings was the destruction of Hurricanes Katrina and Rita and their effect on gasoline and diesel fuel supplies and prices. This year, the subject is the transition away from MTBE and the effect this transition will have on gasoline supplies and prices. Next year, it may be a different set of developments, but the underlying issue will be the same. Until domestic refining capacity is increased in this nation, gasoline and diesel fuel supply shortages and price volatility will be the norm rather than the exception.

I appreciate the opportunity to present NACS' and SIGMA's views at this hearing. I would be pleased to answer any questions that my testimony may have raised.