Remarks by

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Petroleum Marketers Association of America
FTC Efforts to Ensure Robust Competition in the Retail Gasoline Market

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I'd like to thank the PMAA and your president, Dan Gilligan, for inviting me to meet with you today. As Director of Policy Planning at the FTC, I've had the opportunity to work on a wide array of oil-related issues. I've also had a long personal interest in the oil industry. I grew up in Texas: my dad was an immigrant from Cuba, and when I was a child, my parents founded and ran a small oil exploration company in Houston. The company prospered for a time, but, like many companies, went under in the oil bust in the 1980s. So at a young age, I learned first-hand the promises and perils of being a small entrepreneur in the oil business. I might add, incidentally, that I also learned not to count on inheriting the family business as a ten-year-old.

I also learned about the important role that entrepreneurs and small businesses play in our economy. Entrepreneurs and small businesses are the risk-takers and innovators who made the petroleum industry what it is today and they're the ones who will make it what it will be tomorrow. Entrepreneurs provide a level of service and quality that consumers want, and the jobs and infrastructure that our economy needs. And as we see multi-billion dollar mergers throughout the petroleum industry, we should remember that a lot of those small businesses go on to become big businesses.

A. Background

As you know, the FTC's statutory mandate is to promote competition and protect consumer welfare. Part of this mandate involves law enforcement. In recent years, the Commission has investigated the mergers of Chevron and Texaco, Exxon and Mobil, and BP and Amoco – the three largest oil mergers in history. We've also investigated the combination of the refining and marketing businesses of Shell, Texaco, and Star Enterprises to create what was, at the time, the largest refining and marketing company in the United States. Last fall, the Commission investigated the proposed merger of petroleum refiners Valero Energy and Ultramar Diamond Shamrock. Where appropriate, the FTC required substantial divestitures in order to preserve competition.

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[1] The views expressed are my own and do not necessarily reflect the views of the Federal Trade Commission or of any individual Commissioner.

Aside from mergers, we've also investigated other aspects of gasoline markets. In March 2001, the Commission used the competition analysis principles in the Merger Guidelines to investigate spikes in reformulated gasoline (RFG) prices in several Midwest states and in West Coast markets. We found many factors were responsible for the prices spikes, which were particularly bad in Chicago and Milwaukee: underlying lack of U.S. refinery capacity, high capacity utilization, low inventory, forecasting errors, production difficulties and pipeline breaks, the sole reliance on ethanol as an oxygenate, and legal, rational decisions by companies to hold product off the market. Neither investigation found any evidence of collusion or other anticompetitive practices from any companies in the distribution chain.

The FTC, however, is more than a law-enforcement organization. Congress created the Commission to be an expert body on ways to promote competition at both the national and state level. As part of this mandate, the FTC has developed some expertise in gasoline markets. So, for example, the FTC has developed a statistical model to identify and monitor "unusual" gasoline price movements in 360 cities across the country. The FTC also held two public conferences to examine petroleum markets, one in August 2001 and another in May 2002. The conferences examined factors that affect prices of refined petroleum products, including things like vertical integration and the supply and transportation of crude oil. Among others, we heard testimony from the Society of Independent Gasoline Marketers of America, which told us about how different fuel requirements, such as low sulfur requirements in California, may create supply problems that ultimately could raise the cost of fuel to consumers.

B. Advocacy

Another part of the FTC's statutory mandate involves using its expertise to promote competition with other policymakers in and out of government. Boutique fuels are a good example. Early last year, Commission staff filed public comments with the Environmental Protection Agency concerning boutique fuel regulations. The comments encouraged the EPA to use a competitive merger-type analysis in amending the nation's boutique fuel regulation. In particular, we urged that the EPA consider that changing clean fuel regulations could impose costs on consumers by increasing the average costs of unique fuel blends, and by increasing the possibility of short-term price spikes. We also told the EPA that changing the regulations could create or enhance market power of certain sellers.

We have also responded to requests for analysis from state officials. Here's how the process works at the state level. Typically, a state official asks the FTC to comment on a proposed bill or regulation, or the state asks the public generally for comments. For instance, we've received requests to comment on particular proposals from state legislators and from members of a state regulatory board.

After we receive the request, we analyze the proposed bill or regulation with a view toward determining its effect on competition. We use whatever expertise or empirical evidence we have to analyze the proposal and its impact on competition, prices, output, and, ultimately, consumer welfare. The FTC has over 75 PhD economists on staff, so we often have someone who has examined the relevant issues or conducted his own studies. We also compare the proposal with similar regulations in other states, to see if any of those other systems are better or worse for competition.

After we've reviewed the proposal, commission staff write comments and submit them to a vote of the FTC's five commissioners. If the commissioners vote to authorize staff to provide the comments, we send the comments to the state official that requested them. We also routinely forward copies of the comments to the FTC's oversight committees in Congress.

C. Virginia and New York Advocacy

During the past two decades, FTC staff has commented on proposed state bills or regulations several hundred times. In particular, FTC staff has commented on state gasoline pricing and marketing legislation on more than two dozen occasions. Staff has devoted special attention to legislation that would affect price competition because price competition is crucial to the competitive process. Since at least 1989, FTC staff has analyzed state legislation that would limit price-cutting at the request of officials in nine different states, including, most recently, Virginia and New York.

In Virginia, the Senate passed a bill that, with a few exceptions, would have prevented retailers from selling motor fuels below cost. The bill's supporters argued that they needed the bill to prevent large retailers and convenience stores from driving independent stations out of business. Importantly, though, the bill banned below-cost pricing even when there was no possibility of recoupment and no threat of monopolization.

After passing the Senate, the bill moved to the Virginia House of Delegates, where a legislator asked us to comment on the proposal. We analyzed the bill at length. We had several economists review the bill and all of the available economic literature and data. We also drew on our experience with similar bills from the 1990s.

After reviewing all the evidence, we concluded that the bill was bad for consumers. In a nutshell, we found that anticompetitive below-cost pricing rarely happens, especially for motor fuels, and that the bill could discourage retailers from cutting prices. We also found that the bill was unnecessary, because federal antitrust law specifically prohibits below-cost pricing that has a dangerous probability of leading to monopoly. The FTC's commissioners voted 5-0 to authorize commission staff to write a comment making these points. We then filed our comments with the Virginia House, where the bill was voted down in committee 12-9.

We had a similar experience in New York. Like the Virginia bill, the bill in New York would make it unlawful for refiners and nonrefiners to sell motor fuels below their cost, where the effect is to injure competition. The bill would make exceptions for inadvertent transgressions and for meeting competition.

The bill passed both houses of New York's legislature and went to Governor Pataki's desk. The governor asked the FTC to comment on the bill. As in Virginia, we concluded that the bill would be bad for consumers, and the FTC's commissioners voted unanimously to authorize staff to write a comment making these points. We sent our comments to the governor, who, as of today, is still evaluating the bill.

Incidentally, the governor also asked us to comment on another New York bill. That bill would have made it unlawful for a crude oil producer or refiner to compete directly with its own franchised dealers by operating a retail station within one-and-a-half miles of a franchised dealers in large counties, or within two miles in smaller counties.

We looked closely at the bill and the empirical economic evidence and found that, based on the evidence, the bill would raise prices for consumers. Economic studies show that these types of distribution restrictions have the tendency to raise prices and reduce investment in retailing assets. A cross-sectional study by a senior FTC economist found that such restrictions can raise retail gas prices by 2.6 cents per gallon compared to states without these restrictions. Other studies have similar findings. We submitted these comments to the governor, who vetoed that bill.

D. Representative LaHood's Letter

I'd now like to talk to you a little more about the FTC's reasoning in concluding that the below-cost bills were bad for consumers. As some of you may know, Congressman Ray LaHood has raised some issues about the prevalence of below-cost pricing, and Dan Gilligan asked me to speak about those issues here today.

Central to our conclusion was the empirical evidence that anticompetitive below-cost pricing rarely happens. The Supreme Court has found that "predatory pricing schemes are rarely tried, and even more rarely successful," mainly because firms generally cannot expect to recoup the profits they lose by selling a product below cost. Likewise, Frank Easterbrook, now a judge on the U.S. Court of Appeals for the Seventh Circuit, exhaustively reviewed studies and court cases and found almost no evidence of profitable predatory practices in the United States or abroad.[2]

It's important to recognize up front the difference between below-cost pricing and anticompetitive below-cost pricing. Retailers can sell gasoline that is below some definition of cost for a variety of reasons that may not harm competition, such as by using gasoline in a short-

[2] Frank H. Easterbrook, "Predatory Strategies and Counter-Strategies," 48 *U. of Chicago L. Rev.* 313 (1981).

term promotion or as a loss leader. Under antitrust standards, however, below-cost pricing is anticompetitive only if the price-cutter is likely to succeed in driving competitors from the market *and* keep them out long enough that it can earn monopoly profits above to the amount of profit it gave up when it cut prices. In other words, below-cost pricing does not hurt consumers unless the price-cutter can sustain above-cost prices down the road.

Turning to the petroleum industry, past studies suggest that anticompetitive below-cost sales of motor fuels are especially unlikely. In 1984, the Department of Energy investigated pricing in gasoline markets at length to determine whether vertically integrated refiners were "subsidizing" their retail gasoline operations in a way that might be predatory. After examining pricing data and internal oil company documents, the Department of Energy found no evidence of predation.

We've also looked into pricing at the FTC. Since 1996, the FTC has investigated the pricing practices of virtually every major oil company, and like the Department of Energy, we have found no convincing evidence of predatory pricing in the retail gasoline market. Instead, we've expressed concern that unduly high concentration levels in certain gasoline markets could lead to *higher*, not lower, gasoline prices.

Several states have also conducted their own studies. In 1986, the Washington State Attorney General examined whether refiners were subsidizing company-owned service stations. The Attorney General found that lessee-dealers paid essentially the same prices as company-owned stations more than 99 percent of the time.[3] Arizona found the same thing. In 1987, a committee in the Arizona legislature found that "The marketplace for petroleum products is very competitive in Arizona."[4] More recently, Pennsylvania's Legislative Budget and Finance Committee studied "sales below cost" laws and didn't recommend that Pennsylvania enact one. In fact, the Pennsylvania study concluded that such sales below-cost laws "may serve to deter, rather than enhance, competition," because the threat of litigation would encourage firms to charge higher prices.[5]

As we consider these studies, it's important to understand what below-cost pricing means. Below-cost pricing does not mean simply having low prices, or pricing below the competition, or pricing below what some might consider to be a "fair" profit. The Supreme Court

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[3] Final Report to the Washington State Legislature on the Attorney General's Investigation of Retail Gasoline Marketing 14 (Aug. 12, 1987).

[4] Final Report to the Arizona Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement 35 (Dec. 1988).

[5] Commonwealth of Pennsylvania, Legislative Budget and Finance Committee, *Factors Affecting Motor Fuel Prices and the Competitiveness of PA's Motor Fuels Market* 35 (Oct. 2000).

has defined predatory pricing as "pricing below an appropriate measure of [the price-cutter's] cost for the purpose of eliminating competitors in the short run and reducing competition in the long run."[6] Although the Court has not stated what the appropriate measure of cost should be, prominent antitrust scholars and several federal circuit courts have concluded that the price-cutter's marginal costs, or a close proxy such as average variable costs, should be the yardstick.

Even if a below-cost pricing strategy succeeds in temporarily reducing the number of competitors, the price-cutter must be able to find a way to keep competitors from returning after it tries to raise prices again. If other retailers can get into the market fairly easily, the price-cutter will never be able to recoup his losses, because if the price-cutter tries to sell gasoline at unduly high prices, it is likely that other competitors will get into the market. This is part of why the Supreme Court and empirical studies have found that anticompetitive below-cost pricing rarely happens: a prospective predator loses on every sale, with only uncertain prospects for recouping that money at some point in the future.

Setting aside the findings that anticompetitive below-cost pricing happens very rarely, we had another important reason for opposing the below-cost bills. We found that the bills actually could discourage price cutting. Some studies suggest that the laws raise retail gasoline prices by one or two cents per gallon. As the Pennsylvania study found, retailers may decide to raise prices to eliminate the threat of lawsuits from other companies or prosecution by the state.

Some studies reach slightly different conclusions. Many studies find that these laws leave gasoline prices unchanged, and some studies have found that below-cost laws may actually reduce prices over the long-term. However, the most carefully-controlled study, conducted by a senior economist in the FTC's Bureau of Economics, found that the laws had no effect on retail prices.[7] FTC economists have carefully reviewed the other studies and found that they suffer from methodological problems that make it unclear whether they are measuring the impact of sales below cost laws or something else.

We want to be very careful about prosecuting companies for cutting prices, or even discouraging companies from cutting prices, because low prices obviously benefit consumers. The Supreme Court has strongly cautioned against setting "the standards for predatory pricing ... so low that antitrust suits themselves [become] a tool for keeping prices high."[8]

The New York bill is a good example of why we're concerned. As you recall, the New York bill would make it unlawful for refiners and nonrefiners to sell motor fuels below their cost,

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[6] *Cargill, Inc. v. Monfort of Colorado, Inc*., 479 U.S. 104, 117 (1986).

[7] *See* Michael G. Vita, "Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies," 18 *J. of Reg. Econ.* 217 (2000).

[8] *Brooke Group,* 509 U.S. at 226-27.

where the effect is to injure competition. It isn't clear what the term "injure competition" means. If it means "injure consumers" and is interpreted by courts that way, then the New York bill basically duplicates federal antitrust law. Unfortunately, however, the term "injure consumers" often gets interpreted as "injure competitors." We've seen this happen in some states interpreting similar laws. As a result, this sort of language can end up making retailers raise their prices, because they don't want to get sued by competitors who don't like their low prices.

We had one other major reason for opposing the below-cost bills. We found that, to the extent that there is any risk of anticompetitive below-cost pricing of gasoline, the below-cost bills merely duplicated existing federal laws against predatory pricing. Both the Federal Trade Commission and the Antitrust Division of the United States Department of Justice may bring enforcement actions against anticompetitive below-cost pricing. The federal government has launched several predatory pricing investigations and predatory unilateral conduct cases during the past several years.[9] In addition, private plaintiffs and state attorneys general have the right to bring predatory pricing cases. Under Section 4 of the Clayton Act, any person who has been injured in his business or property as a result of conduct forbidden by the antitrust laws can seek treble damages for that injury.[10] State attorneys general, acting as *parens patriae*, may also bring such actions.

E. Cooperation between PMAA and the FTC

If the PMAA or its members believe that retailers are engaged in anticompetitive below-cost pricing, I encourage you to provide that evidence to the FTC. For example, a question has been raised as to whether predatory pricing is more likely to be successful in rural areas, perhaps because there aren't as many competitors in rural markets. Hypothetically, such circumstances could occur, and I invite the PMAA to provide the FTC with specific evidence and data that these circumstances are present. Here are some of the factors that could show that a retailer is engaged in predatory pricing:

> First, the particular rural area or small town must constitute a relevant geographic market. In other words, the area must be one that consumers generally will not leave to avoid the higher gas prices;
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> Second, the alleged predator must price below its own costs, not merely price below its competitors or its competitors' costs;
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> Third, the below-cost pricing must cause, or be likely to cause, competitive rivals to leave

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[9] Notable examples include *American Airlines* and *Microsoft*. *See*, e.g., *United States v. AMR Corp*., 2001-1 Trade Cas. (CCH) ¶ 73,251 (D. Kan. 2001); *United States v. Microsoft Corp*., 253 F.3d 34 (D.C. Cir. 2001).

[10] 15 U.S.C. § 15.

the market in sufficient numbers to give the alleged predator monopoly power; and

Fourth, and critically, the barriers to entry or other market conditions must be such that the predator could subsequently raise its prices above competitive levels long enough to recoup its investment in predation.

Such conditions, creating monopolies or oligopolies in small geographic markets, could render predation successful and anticompetitive. The Supreme Court has stated that such circumstances would constitute unlawful behavior under the federal antitrust laws. If the PMAA has or finds evidence of such conduct and circumstances, I would encourage you to share that evidence with the FTC.

I also believe that there are other areas in which the PMAA and the FTC can work together to promote competition. In particular, I invite the PMAA to notify us of other developments in the petroleum industry that could affect competition. The FTC follows developments on an ongoing basis. We want to know about public policies, or industry practices, that increase prices or decrease consumer convenience, either by increasing costs to marketers or reducing their flexibility.

The FTC's statutory mandate is to protect competition and consumer welfare. We believe, like the PMAA believes, that governments should adopt policies that promote competition, and that policymakers should incorporate well-grounded economic evidence into their laws and regulations. We look forward to working with the PMAA to promote those goals.