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Working Party No. 2 on Competition and Regulation

COMPETITIVE EFFECTS OF REGULATIONS OF REAL PROPERTY

-- United States --

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COMPETITIVE EFFECTS OF REGULATION OF REAL PROPERTY

1. Restrictions on land use can affect the competitive process by constraining or altering the supply of what can sometimes be a key input – land – in producing products and providing services. Of course, zoning and other land use restrictions are often imposed to satisfy objectives other than competition. For example, residents often want commercial businesses located outside of residential areas. Assessing the overall effect of land use restrictions requires balancing the effects on competition against the benefits from meeting other objectives, which is often difficult in practice. Based on the Call for Papers, below we present cases based on both public and private land use regulations that have raised competitive concerns.

1. Anticompetitive Public Regulation of Land Use

2. Public land use restrictions often enhance value and have efficiency benefits without harming competition. However, divorce laws and zoning regulation are examples of public regulation of land use that might have a negative effect on competition.

1.1 Divorcement laws

3. Divorcement laws illustrate a type of public regulation of land use that can harm competition and might have an anticompetitive effect. Divorcement laws prohibit oil companies and refineries from operating retail stations, but allow them to own stations as long as they contract them out to independent franchisees. Divorcement is designed to prevent oil companies from using their power within the supply chain to manipulate prices and force independent and franchise gasoline station owners out of business.

4. In the United States, six states and the District of Columbia have adopted so-called divorce laws.¹ Although they do not restrict the land from being used as a gasoline station, divorce laws restrict refiners from operating gasoline stations on land they own. The primary justification for these laws has been to protect “lessee-dealers” (independent operators who lease land and capital from a refiner and sell that refiner’s brand of gasoline) from competition from refiner-owned service stations.² However, as discussed below in more detail, these laws have a negative impact on consumers.

5. Gasoline refiners supply consumers through one of three types of service stations: those that they own and operate; those that they own, but lease to independent operators; and those that are both owned and operated independently. Nationally, 69 percent of the volume (in gallons) of wholesale gasoline is

¹ The states of Hawaii, Connecticut, Delaware, Maryland, Nevada, Virginia, and the District of Columbia have divorce laws.

² See Asher A. Blass & Dennis W. Carlton, *The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice*, 44 J. LAW & ECON. 511, 512 (2001).

sold at the terminal to jobbers who primarily supply independent stations, 17.5 percent is sold directly to company-operated outlets, and 13.5 percent is sold to retailers through dealer tank-wagons.³

6. Depending on local market conditions, a refiner may find it more profitable to vertically integrate or to delegate operation to a lessee-dealer or an independent dealer. When refiners and operators are separate entities, they have different incentives to set prices and provide quality. For example, when both refiners and station operators have the ability to price above cost, each will add a mark-up to the final price. This “double mark-up problem” causes retail prices to be higher than the profit-maximizing price for a vertically-integrated seller that would mark-up the gasoline only once. The result is that consumers purchase less gasoline than they otherwise would and total profits (wholesaler plus retailer) fall below what they would be if gasoline were sold by an integrated firm. In this manner, the double mark-up problem leads to higher prices and lower profits, harming both consumers and producers. Further, because an unaffiliated dealer does not capture the full financial benefit from providing additional quality (e.g., cleaner facilities, friendlier and more knowledgeable staff), he or she may have an incentive to provide a lower level of quality than a supplier would if it operated the retail service station.⁴ Thus, a supplier may want to operate a service station directly to increase profits by charging lower retail prices and providing enhanced service. Direct operation allows a refiner to control – through an employee – pricing and quality decisions. Employees’ incentives, however, are not necessarily aligned with those of the supplier, so a refiner must expend resources to monitor the station manager to ensure that he or she is taking the correct actions. Several empirical studies suggest that refiners choose whether to vertically integrate or to delegate operational decisions to an independent operator based on these efficiency concerns.⁵

7. Empirical evidence indicates that divorcement laws are likely to lead to higher retail prices. This is due both to higher operation costs, which will be passed on to consumers in the form of higher retail gasoline prices, and to the persistence of the double mark-up problem, which also is likely to lead to higher retail prices. Two studies have directly measured the impact of divorcement laws on retail prices and have found gasoline prices to be higher in the presence of bans on supplier operation of retail service stations. The most recent found that divorcement laws tend to increase retail gasoline prices by an average of 2.6

³ See U.S. Department of Energy, Energy Information Administration, *Petroleum Marketing Monthly* at 20 (May, 2007), at http://www.eia.doe.gov/oil_gas/petroleum/data_publications/petroleum_marketing_monthly/pmm.html.

⁴ The difference between supplier and unaffiliated dealer incentives to provide quality stems from two sources. First, when an unaffiliated dealer provides high quality service, consumers may be more likely to return to this particular dealer, and also to patronize other dealers of the same brand. The dealer captures the financial benefits from increased demand for his or her station’s services, but not increased demand for the services of other stations of the same brand. Second, because dealers share a portion of the additional profit from additional sales with the supplier, they do not have the incentive to provide the same level of quality as a vertically integrated firm. See Ralph A. Winter, *Vertical Control and Price versus Non-price Competition*, 63 Q.J. ECON. 61 (1993).

⁵ See Blass & Carlton, *supra* note 4; Margaret E. Slade, *Strategic Motives for Vertical Separation: Evidence from Retail Gasoline Markets*, 14 J.L. ECON. & ORG. 84 (1998); Andrea Shepard, *Contractual Form, Retail Price, and Asset Characterization in Gasoline Retailing*, 24 RAND J. ECON. 58, 64-65 (1993). One study, however, purports to present evidence that one instance of vertical integration led a refiner to charge higher wholesale prices to independent dealers. See Justine S. Hastings & Richard J. Gilbert, *Market Power, Vertical Integration and the Wholesale Price of Gasoline*, 53 J. INDUS. ECON. 469 (2005). Specifically, this study examines Tosco’s purchase of Unocal’s U.S. refining and marketing assets and presents evidence suggesting that Tosco attempted to raise its retail rivals’ wholesale costs following the transaction by increasing the price it charged for unbranded gasoline in markets where its newly purchased retail stations faced competition from independent gasoline marketers.

cents per gallon.⁶ These results imply that repealing existing divorcement laws would generate an annual increase in consumer welfare – which includes substantial consumer savings and the value of additional gasoline purchased at lower prices – of approximately \$112 million.⁷ Another study found that Maryland’s divorcement law, the first in the nation, raised self-service gasoline prices by 1.4 to 1.7 cents and full-service prices by 5 to 7 cents per gallon at stations that were formerly supplier-operated.⁸ Further, this study also found that these stations reduced their operation hours by nine hours per week.⁹ Based on this evidence, the staff of the Federal Trade Commission has recommended against the adoption of divorcement legislation in comments to policy makers.¹⁰

1.2 Zoning

8. In addition to divorcement laws, zoning regulations in the United States may also have an anticompetitive purpose or effect.¹¹ Indeed, the United States Supreme Court noted, in *Columbia v. Omni Outdoor Advertising*, that “the very purpose of zoning regulation is to displace unfettered business freedom in a manner that regularly has the effect of preventing normal acts of competition, particularly on the part of new entrants.”¹² The *Omni* case also made clear that actual, or perceived, anticompetitive zoning regulations are almost invariably protected from successful antitrust challenge based on the state action and Noerr-Pennington doctrines.

9. In *Omni*, the Supreme Court held that state action and Noerr-Pennington defenses protected a municipality and a firm that petitioned for allegedly anticompetitive zoning ordinances from antitrust challenge under the Sherman Act. In 1981, Omni Outdoor Advertising (Omni) entered the billboard market in Columbia, South Carolina. Columbia Outdoor Advertising (COA), which controlled more than 95% of the market and enjoyed close relations with city officials, lobbied these officials to enact zoning ordinances restricting billboard construction. After passage of these ordinances, Omni sued COA and the City of Columbia, alleging, *inter alia*, that the ordinances were the result of an anticompetitive conspiracy in violation of the Sherman Act.

10. On appeal, the Supreme Court held that the city’s restriction of billboard advertising was immune from federal antitrust liability under the state action doctrine, pursuant to which principles of federalism

⁶ Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217 (2000).

⁷ *Id.* at 230. Blass & Carlton, *supra* note 4, estimate that a hypothetical national divorcement law would cost consumers between \$.6 and \$2.1 billion.

⁸ John M. Barron & John R. Umbeck, *The Effect of Different Contractual Arrangements: The Case of Retail Gasoline Markets*, 27 J.L. & ECON. 313 (1984).

⁹ *Id.*

¹⁰ See Letter from FTC Staff to D.C. Councilmember Mary Cheh (June 8, 2007), at <http://www.ftc.gov/os/2007/06/V070011divorcement.pdf>; *Competition and the Effects of Price Controls in Hawaii’s Gasoline Market: Before the State of Hawaii, J. Hearing House Comm. On Energy and Environmental Protection et al.* (Jan. 28, 2003) (testimony of Jerry Ellig, Deputy Director, FTC Office of Policy Planning), at <http://www.ftc.gov/be/v030005.htm>; Letter from FTC Staff to Gov. George E. Pataki of New York (Aug. 8, 2002), at <http://www.ftc.gov/be/v020019.pdf>; Letter from FTC Staff to Hon. Robert F. McDonnell, Commonwealth of Virginia House of Delegates (Feb. 15, 2002), at <http://www.ftc.gov/be/V020011.htm>.

¹¹ See generally, E. Thomas Sullivan, *Antitrust Regulation of Land Use: Federalism’s Triumph Over Competition, The Last Fifty Years*, 3 WASH U. J.L. & POL’Y 473 (2000).

¹² See *Columbia v. Omni Outdoor Advertising*, 499 U.S. 365, 373 (1991).

and state sovereignty render the Sherman Act inapplicable to anticompetitive restraints imposed by the States “as an act of government.” The Court held that this immunity could be extended to municipal restrictions of competition in an authorized implementation of state policy.¹³ In the *Omni* case, South Carolina had unquestionably authorized the city to regulate the size, location, and spacing of billboards, and the city also had clearly been delegated authority to suppress competition, a foreseeable result of zoning regulations.

11. The *Omni* Court rejected a “conspiracy exception” to the state action doctrine, holding that with the possible exception of the situation in which the State is acting as a “market participant,” any action that qualifies as state action is *ipso facto* exempt from the antitrust laws.¹⁴ COA, in turn, was immune from liability under the Noerr-Pennington doctrine, which holds that the federal antitrust laws do not regulate the conduct of private individuals in seeking anticompetitive action from the government.

12. In another case dealing with public land use restrictions, *Love Terminal Partners, L.P. v. City Of Dallas*,¹⁵ the issue was legislation limiting competition among airports serving the Dallas/Fort Worth area in Texas. The City of Dallas owns Love Field, located near the Dallas downtown business district. Southwest Airlines, a low-cost carrier that began service in 1971 as an intrastate airline, had always operated out of Love Field. The neighboring cities of Dallas and Fort Worth opened Dallas Fort Worth Airport (DFW) for commercial service in 1974. DFW had long been the major hub for American Airlines. Beginning in 1973, Dallas, Fort Worth, and DFW filed a series of lawsuits in an unsuccessful effort to block Southwest from operating out of Love Field.

13. With the Airline Deregulation Act of 1978, Congress deregulated the domestic airline industry, allowing airlines to operate from any commercial airport and to serve any domestic route without prior regulatory approval. After airline deregulation, when Southwest gained the ability to provide service beyond the state of Texas, Congress adopted the Wright Amendment as a measure to protect DFW and the high-cost carriers serving it from unregulated expansion by Southwest. The 1980 Wright Amendment, as amended, restricted airline service from Love Field, prohibiting carriers serving Love Field (primarily Southwest) from providing any form of air service (including connecting service) by aircraft with more than 56 seats between Love Field and any point outside the states of Texas, New Mexico, Oklahoma, Kansas, Arkansas, Louisiana, Mississippi, Missouri, or Alabama.

14. In 2006, Congress passed the Wright Amendment Reform Act of 2006, which had the support of Dallas, Fort Worth, DFW, Southwest, and American Airlines. The Reform Act repealed the Wright Amendment eight years after the Reform Act’s enactment and allowed immediate through service and ticketing to or from Love Field to all 50 states or any foreign destination, provided one stop is made in one of the original 9 Wright Amendment states.

¹³ *Id.* at 370-74. With regard to the state action doctrine, in *New Motor Vehicle Board Of California v. Orrin W. Fox Co.* (“*NMVB*”), 439 U.S. 96 (1978), a state statute required an automobile manufacturer to obtain approval of a state board before opening or relocating a retail dealership within the market area of an existing franchisee if the latter protested. The Supreme Court held that this statute was constitutional and did not conflict with the Sherman Act: “[T]he Automobile Franchise Act’s regulatory scheme is a system of regulation, clearly articulated and affirmatively expressed, designed to displace unfettered business freedom in the matter of the establishment and relocation of automobile dealerships. The regulation is therefore outside the reach of the antitrust laws under the ‘state action’ exemption.” 439 U.S. at 412.

¹⁴ Even when the municipality acts as a market participant, a court will distinguish between distinct government functions and market participant actions, applying the market participant exception only to those actions that do not qualify as distinct government functions. *Pennsylvania v. Susquehanna Area Regional Airport Authority*, 423 F. Supp. 2d 472, (M.D. Pa. 2006).

¹⁵ See *Love Terminal Partners, L.P. v. City Of Dallas*, 2007-2 Trade Cas. ¶ 75,964 (N.D. Tex. 2007).

15. On October 31, 2007, the federal district court for the Northern District of Texas dismissed a private antitrust suit filed by plaintiffs who held leasehold interests in land located on Love Field on which a passenger terminal was situated. In 2006, the plaintiffs had negotiated with Pinnacle Airlines, a possible new entrant at Love Field, to transfer their interests in the leases on the land and the terminal, but the deal collapsed when it became clear that the proposed Reform Act would erode the possibility of new competition from Love Field. The plaintiffs sued American, Southwest, DFW, and the two cities, alleging antitrust conspiracies leading up to the Reform Act and later in conduct pursuant to that Act.

16. Without reaching a state action defense, the court concluded that the defendants' negotiations and agreements concerning the desired outcome of the legislation were "clearly a part of their efforts to petition Congress" and that a Noerr-Pennington defense thus appeared on the face of the complaint. With respect to defendant's conduct after adoption of the Reform Act, the court held that the Act compelled the defendants to implement the terms of their agreement and thus immunized them from antitrust liability. "By reducing the flight output at Love Field through a 20-gate restriction, allocating the gates at Love Field to uphold Southwest's dominance over the short-haul market, and requiring that the [plaintiffs'] terminal be abolished, the Reform Act almost undoubtedly conflicts with the Sherman Act. But the Sherman Act and the Reform Act are capable of coexistence. Considered together, it is clear that Congress intends as the default rule that anticompetitive conduct be broadly prohibited by law. But in the case of airline competition in the North Texas region, Congress is willing to tolerate and sanction some anticompetitive behavior as a means of effecting the eventual end to the Wright Amendment restrictions that hamstringing domestic flights to and from Love Field."¹⁶

2. Anticompetitive Private Land Use Restrictions

17. Most private restrictions upon land use are not anticompetitive, for the simple reason that the availability of sufficient alternative parcels of land for a given purpose usually prevents the use restrictions of any single private landowner from having an anticompetitive effect on prices.¹⁷ Still, although the exception and not the rule, there are occasions when either placing a restriction on land use or making a particular land purchase will be harmful to competition.

18. *United States v. Eastern Mushroom Marketing Cooperative*,¹⁸ is one of those rare instances. In December 2004, the DOJ filed a complaint and proposed consent decree, later approved by the district court, involving land use restrictions imposed by the Eastern Mushroom Marketing Cooperative (EMMC). The EMMC, representing 15 of the largest U.S. mushroom producers, controlled more than 90% of the common mushrooms grown in the Eastern U.S. It was organized under the Capper-Volstead Act, 7 U.S.C. §291 et seq., which gives farmers limited antitrust immunity to act together voluntarily in collectively processing, preparing for market, handling, and marketing their products. In January 2001, shortly after its formation, the EMMC and its members agreed to set increased minimum prices at which they would sell fresh mushrooms in different geographic regions, raising prices on average by 8%.

19. The Capper-Volstead Act provides no immunity, however, for cooperative members to conspire to prevent independent, nonmember farmers from competing with the cooperative or its members. Within three months of instituting the price increases, the EMMC launched a campaign to acquire and subsequently dismantle non-EMMC mushroom growing operations in the eastern U.S. Through membership dues and a "Supply Control Assessment," the EMMC collected approximately \$6 million

¹⁶ *Id.*, at 109,786.

¹⁷ *See United States v. Syufy Enterprises*, 903 F.2d 659, 665 (9th Cir. 1990).

¹⁸ *See United States v. Eastern Mushroom Marketing Cooperative*, 2005-2 Trade Cas. (CCH) ¶ 74,933 (E.D. Pa. 2005).

from its members in 2001-2002 and purchased four mushroom farms and acquired lease options on two additional mushroom farms in the eastern U.S. for the purpose of shutting them down, thus reducing the mushroom production capacity available for nonmembers to grow mushrooms in competition with the EMMC. The purchased farms were resold at a loss with permanent deed restrictions prohibiting the conduct of any business related to the growing of mushrooms; similar deed restrictions were placed on the other two farms as permitted under the lease options.

20. The DOJ's complaint noted that these actions removed approximately 8% of total mushroom growing capacity in the eastern U.S., and that building a new facility takes much longer to generate revenue than purchasing or leasing an existing growing operation. "By eliminating the existing available productive capacity," the DOJ argued in its complaint, "the EMMC effectively forestalled competitive entry by at least 18 months."¹⁹ The complaint alleged a violation of §1 of the Sherman Act that would harm actual and potential competition and deprive consumers of the benefits of competition. The consent decree required EMMC to nullify existing deed restrictions and prohibited EMMC from creating, filing, or enforcing in the future any similar deed restrictions on any real property in which it had an ownership or leasehold interest of any kind.

21. Zoning restrictions, community hostility to certain uses of land, and the scarcity of land can combine to make the existence of suitable real estate a significant issue in some merger cases. The competitive impact of waste management mergers, for example, often turns on the availability of alternative disposal sites that would allow likely and timely entry to undermine an anticompetitive price increase by the merged parties.²⁰ *U.S. v. Central Parking Corporation*,²¹ is an example, in which a land purchase or use restriction can harm competition (as opposed to just competitors).

22. In *Central Parking*, the Department challenged the merger of Central Parking Corporation and Allright Holdings, the two largest private parking management companies in the United States, in terms of parking facilities, spaces, and parking revenues. The relevant market alleged was the provision of off-street parking services in the central business districts in 18 cities, where Central and Allright were direct and substantial head-to-head competitors. The district court subsequently entered a consent decree that required divestitures in each of these cities to restore competition. The Competitive Impact Statement filed by the DOJ described the critical significance of the shortage of parking spaces:

Entry into the relevant markets is unlikely to occur in response to a small but significant price increase. To enter a relevant market and discipline a non-competitive price increase, a firm must add to the supply of parking spaces that motorists view as substitutes. Creation of new parking spaces in a [central business district], however, is most often a by-product of construction or tearing down of buildings. Given the local character of competition, the cost of land, the limited availability of substitutable parking facilities, and the alternative options for the use of convenient land in the market, entry cannot be viewed as a likely and timely response that would undermine an anticompetitive price increase.

23. It is imperative with regard to private land use restrictions to remember that the antitrust laws are designed to protect competition, not individual competitors. A number of private antitrust cases have involved claims concerning the competitive significance of real estate. Plaintiffs sometimes allege that competitors conspire to deny access to land or real estate considered essential to compete, either by

¹⁹ Complaint at ¶ 12; for documents related to this case see <http://www.usdoj.gov/atr/cases/eastern.htm>.

²⁰ See *United States v. Waste Management, Inc.*, 743 F.2d 976, 82-83.

²¹ See *U.S. v. Central Parking Corporation*, 2000-1 Trade Cas. (CCH) ¶ 72,809 (D.D.C. Feb. 11, 2000).

acquiring all the available options and thus eliminating the possibility of new entry, or by securing agreements that eliminate possible competing uses of the land or property. With regard to such allegations, it is critical to discern whether the allegations, assuming they are true, would lead to consumers having to pay more for the goods they want, and not just to a rival competitor being inconvenienced or disadvantaged.