

COMMISSION AUTHORIZED

PREPARED STATEMENT

OF

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BEFORE THE
STATE, VETERANS, AND MILITARY AFFAIRS COMMITTEE
OF THE
COLORADO STATE SENATE

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Mr. Chairman and Members of the Committee: I am pleased to appear before you today to discuss the potential effects on competition of certain provisions of Senate Bill No. 92-203. This testimony represents the views of the staff of the Denver Regional Office and the Bureau of Competition of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner.¹

This bill would amend the Colorado Unfair Practices Act by adding a number of provisions addressed specifically to practices in the petroleum industry.² We believe this legislation is likely to be anticompetitive, and that its likely result may be that Colorado consumers and visitors could pay higher prices for gasoline.

¹ If you have additional questions, please feel free to contact the Commission's Bureau of Competition. Here are the address and telephone number of the Assistant Director in charge of the Division with the greatest experience at the Commission in analyzing competition in the petroleum industry:

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² Our testimony does not address §§6-9 of the bill, which deal with certain provisions of general application and with the means for investigating and enforcing the Act.

I. Interest and experience of the staff of the Federal Trade Commission.

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.³ Under this statutory mandate, the Commission seeks to identify restrictions that impede competition or increase costs without offering countervailing benefits to consumers. In particular, the Commission and its staff have had considerable experience assessing the competitive impact of regulations and business practices in the oil industry.⁴

³ Federal Trade Commission Act, 15 U.S.C. §45 et seq.

⁴ The staff of the Commission has gained extensive experience with energy competition issues by conducting studies, investigations, and law enforcement actions. FTC staff comments and testimony to legislative bodies have identified the costs of proposed gasoline retailing divorcement, "below-cost selling," and other petroleum marketing legislation for Alabama, Arkansas, Georgia, Hawaii, Kansas, Louisiana, Massachusetts, Montana, Nevada, North Carolina, South Carolina, Tennessee, Virginia, Washington, Utah, and the United States Senate and House of Representatives. The Commission and its staff have also gained considerable experience with gasoline refining and marketing issues affecting consumers from premerger antitrust reviews pursuant to Sections 7 and 7A of the Clayton Act, 15 U.S.C. §§18, 18a. The Commission has twice taken enforcement actions with respect to acquisitions that might have adversely affected competition in Colorado markets. A proposed 1986 acquisition of Asamera's Denver refinery by Conoco, Inc., a competing Denver refinery, was abandoned after the Commission announced that it would sue in federal court to block the transfer. In Texaco's 1984 acquisition of Getty Oil, the Commission required divestiture of petroleum transportation facilities because overlapping ownership of them might have lessened competition for gasoline and fuel oil in eastern Colorado.

II. Description of the proposed legislation.

Provisions of Colorado's Unfair Practices Act ("Act")⁵ already make it unlawful for a vendor to sell or offer to sell a product at a price below the vendor's cost "for the purpose of injuring competitors and destroying competition."⁶ Senate Bill No. 92-203 (the "Bill") would add to the Act several detailed definitions and provisions tailored to apply specifically to the distribution and sale of motor fuel.⁷ The Bill's declared purpose is "to protect independent and small dealers and distributors of petroleum and related products who are vital to a healthy, competitive marketplace but are unable to survive subsidized, below-cost pricing at the retail level."⁸ The Bill declares "subsidized pricing" to be "inherently unfair," "destructive to" competition, and "a form of predatory pricing."⁹

⁵ Colo. Rev. Stat. §§6-2-101 et seq. (1973).

⁶ Colo. Rev. Stat. §6-2-105.

⁷ The Bill would amend the Unfair Practices Act in other respects as well. For the most part, those other changes, not specifically designed for the petroleum industry, are not discussed here, and we take no position about them. We discuss below the implications of the proposal to change "and" to "or" in the phrase quoted in the text at n. 6, which would change fundamentally how the Act's application could affect consumers.

⁸ §1, to amend Colo. Rev. Stat. §6-2-102.

⁹ Id.

The Bill's regulation of petroleum pricing is accomplished by a special definition of "cost" to be applied to motor fuel, so that selling at a price below that "cost" could be illegal.¹⁰ Generally, "cost" is defined as the lowest recent price charged to the purchaser that was allegedly reselling illegally. If that reseller bought its supplies in an arm's length sale, "cost" would be its invoice cost, while if the reseller was an affiliate of another entity, such as a refiner, "cost" would be the lowest recent transfer price charged to it, plus the reseller's cost of doing business, which the Bill presumes to be six percent.¹¹ "Transfer price," defined as a refiner's price to its affiliate or other operating unit for resale at another level,¹² is deemed to be the refiner's loading rack price plus wholesale costs, which the Bill presumes to be four percent.¹³

Under the Bill, one or more below-cost sales would establish a prima facie case, shifting the burden to the defendant to show

¹⁰ §3, to amend §6-2-105(3)(b).

¹¹ "Cost" so determined would be adjusted if necessary to reflect freight and taxes. Generally, the reference "cost" under the Act is invoice cost plus the cost of doing business. §6-2-105(3)(a). The new definition that would apply to motor fuels would include the cost of doing business in the reference "cost" for transfers, but not for arm's-length sales. S.B. 92-203, §3, proposed new §6-2-105(3)(b)(II)(C).

¹² §3, to amend §6-2-105(16).

¹³ Where the refiner makes no loading rack sales, the transfer price is deemed to be the weighted average of other refiners' posted terminal prices, plus wholesale costs, again presumed to be four percent.

lack of intent to injure or destroy competition. The defendant could establish lack of intent by demonstrating its need to meet, in good faith, the equally low or lower legal price of a competitor.¹⁴ All efforts to meet competition must be documented within 24 hours in a detailed notification to the Colorado Attorney General. In determining whether a price is set to meet competition, only competitors' motor fuel prices would be considered (including credit terms), not the value of other merchandise offered in conjunction with motor fuel. It is not clear whether the defendant would be permitted to show that its actual costs were lower than the six percent and four percent rates that the law would presume.

III. Analysis of S. B. 92-203

A. No reliable evidence supports claims of predatory or monopolistic activities by refiners of motor fuel.

The Bill's premise is that competition in the petroleum industry is being reduced because independent motor fuel marketers cannot survive predatory "subsidized" pricing by major refiners and marketers. This view is shared by proponents of

¹⁴ §4, to amend §6-2-107. Here, the competition being met would be presumed to be within a one-mile radius of the alleged below-cost sale.

similar legislation that would impose restraints on vertically integrated petroleum refiners and marketers in other jurisdictions. They have maintained that such laws are necessary to protect dealers from unfair and anticompetitive practices by their suppliers. According to this view, vertically integrated refiners can and do set retail prices charged by their company-owned and operated outlets below the wholesale prices charged to franchised or independent dealers. They allege that the reason for such "subsidization" is to drive franchised and independent dealers out of business in order to replace them with company-owned stations. It is similarly charged that major gasoline marketers often have subsidized "below cost" pricing at one location with high prices at another location, and that such practices harm competitors and consumers.

Such claims do not appear to be well founded. Major oil companies have historically been "integrated by contract," relying heavily on franchised dealer networks to sell their refined products. Several studies of competition in gasoline marketing in the United States since 1981 have concluded that gasoline dealers have not been and are not likely to become targets of anticompetitive practices by their suppliers. I will briefly summarize the results of these studies.

The Department of Energy ("DOE") has studied whether vertically integrated refiners were "subsidizing" their retail

gasoline operations in a way that might be predatory or anticompetitive.¹⁵ DOE's final report to Congress, published in January, 1981, was based on an extensive study of 1978 pricing data in several Standard Metropolitan Statistical Areas, as well as on internal oil company documents subpoenaed by DOE investigations. The study concluded that there was no evidence of such "subsidization."¹⁶

In 1984, DOE published an updated study that further substantiated and elaborated on its 1981 findings.¹⁷ The study showed that company-operated stations were not increasing as a percentage of all retail outlets, except among the smaller refiners. In the 1984 report, DOE concluded that the increased pressures on gasoline retailers since 1981 were not caused by anticompetitive behavior on the part of the major oil companies. Rather, the decline in the overall number of retail outlets and the intensification of competition among gasoline marketers were attributable to decreased consumer demand for gasoline and a

¹⁵ This study was undertaken following enactment of Title III of the Petroleum Marketing Practices Act in 1978, 15 U.S.C. §2841.

¹⁶ DOE, Final Report: The State of Competition in Gasoline Marketing, p. xi (1981).

¹⁷ DOE, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers (March, 1984) ("1984 DOE Report").

continuing trend toward the use of more efficient, high-volume retail outlets.¹⁸

In 1986, the Washington state Attorney General initiated a study of motor fuel pricing in that state to determine whether claims of refiner subsidization were justified. The study focused on whether major oil companies injured competition by charging lessee-dealers higher prices for gasoline than the companies were charging their own company-operated retail stations. The study also sought to examine whether the major oil companies injured competition by establishing a pricing structure between retail and wholesale prices that prevented dealers from covering their costs. Information was gathered on the practices of all eight of the major companies in Washington for a three-year sample period. The study covered regions throughout the state where the companies maintained both retail operations and lessee-dealer operations. The Washington study found that less than one percent of all observed pairs of prices of lessee dealers and company-operated stations disclosed any significant price variations. The study concluded that such instances were "clearly too infrequent" to show that lessee dealers were being systematically driven from the market because their gasoline

¹⁸ 1984 DOE Report at 125-32.

purchase costs were the same as or higher than the retail prices of competing refiner-operated stations.¹⁹

More recently, in 1987, the Arizona legislature created a Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement. In December 1988 the Committee recommended that no new legislation be enacted, concluding that "(t)he marketplace for petroleum products is very competitive in Arizona."²⁰

The DOE studies, based on data from the 1970's and early 1980's, and the state studies done more recently have revealed no instances of predatory behavior by major gasoline refiners.²¹ Rather, they show that the fortunes of refiners and their franchised retailers are closely linked and that these firms "form a mutually supporting system backed by company advertising

¹⁹ Final Report to the Washington State Legislature on the Attorney General's Investigation of Retail Gasoline Marketing, p. 14 (August 12, 1987).

²⁰ Final Report to the Arizona Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement, p. 35 (December, 1988).

²¹ The 1984 DOE Report is based on data that is now a decade old. But information gathered from industry publications, such as the National Petroleum News Factbook (published annually), as well as the results of continuing investigations by the Commission's staff into competition in the petroleum industry give us no reason to believe that the distribution structure has significantly changed since that time.

and promotion."²² Franchised retailers have continued to be by far the predominant form of outlet for the gasoline sales of major, integrated refiners. Indeed, major refiners operate only a small percentage of the gasoline stations in the United States.²³

The national pattern is reflected in the distribution systems of the leading branded refiners in Colorado. The 1984 DOE study indicates that vertically integrated gasoline marketers accounted for 12.4 percent of total sales in Colorado in 1981; this was slightly below the national average, 13.1 percent.²⁴ None of the twelve leading branded marketers in Colorado for which data are available use company-owned and operated outlets as the predominant form of retailing on a national basis.²⁵

²² 1984 DOE Report at ii. We do not mean to suggest that the interests and incentives of refiners and their franchised retailers are linked perfectly in every situation. Although the refiners and their retailers generally share common goals, on occasion their interests and fortunes may not coincide.

²³ Lundberg Letter, Vol XI, No. 36, July 6, 1984, at 3, where it was reported that the major refiners operated only about 3.3 percent of all retail stations. The 1984 DOE Report found a similarly low proportion. A recent study conducted for the American Petroleum Institute noted that the fourteen largest integrated refiners, representing approximately 67 percent of the nation's refining capacity, had only about 10 percent of their gross gasoline sales and 4.5 percent of their outlets devoted to company-operated retail stations. Temple, Barker & Sloan, Gasoline Marketing in the 1980's: Structure, Practices, and Public Policy, pp. 2-3 (1988).

²⁴ 1984 DOE Report at 82.

²⁵ National Petroleum News 1991 Factbook 34-51. The firm with the largest number of outlets in Colorado, Conoco, operates
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However, company operated outlets may be a predominant form of retailing for smaller independent refiners. For example, the largest refiner that operates most of its own outlets is Clark, which ranks 24th nationwide in number of retail outlets (with 937).²⁶

The major integrated refiners are not likely to engage in predation against the mainstay of their own retail distribution systems, their franchised retailers. Major refiners would have little incentive to charge discriminatory prices that would cause their franchised retailers to move to different suppliers or to go out of business. A refiner that discriminated in ways that injured its franchisees and dealers would probably lose sales, leading to a lower market share, greater excess refining capacity, and higher per unit costs.

²⁵ (...continued)

only eleven percent of its branded outlets itself (nationwide); the second largest in Colorado, Texaco, operates eight percent; the third largest, Sinclair, operates ten percent. Some of the lower-ranking firms operate more of their own branded outlets (nationwide) than the national average rate of 13.1 percent; these include Diamond Shamrock (seventh largest in Colorado), operating 35 percent, and Total Petroleum (eighth largest in Colorado), operating 23 percent. The vast majority (84 percent) of retail outlets in Colorado are operated by firms that operate fewer of their own outlets than the national average rate.

²⁶ National Petroleum News 1991 Factbook 34-51. In Colorado, the largest refiner that operates most of its own branded outlets (nationwide, 70 percent) is Coastal Corp., which ranks 13th in Colorado (24 outlets) and 26th nationwide (807 outlets). Id.

B. Even if predatory behavior or price discrimination were found, it is already subject to prosecution under existing state and federal laws.

Predatory conduct in the petroleum industry is subject to the Sherman Act, the Clayton Act, and the Federal Trade Commission Act. In addition, price discrimination that injures competition is subject to existing Colorado law²⁷ and to the federal Robinson-Patman Act.²⁸ These statutes address possible anticompetitive practices in the industry and deter firms from engaging in predatory behavior or illegal price discrimination.

By contrast, even though there appears to be no competition problem in the petroleum industry that is not subject to existing laws, the Bill's prohibitions appear to be broader than those in the Robinson-Patman Act. The Bill's apparent purpose, to protect competitors without regard to effects on competition and consumers, would extend beyond the reach of existing federal law.²⁹ The Bill would permit liability based solely on an

²⁷ Unfair Practices Act, Colo. Rev. Stat. §6-2-103 (1973).

²⁸ 15 U.S.C. §13 (Section 2 of the Clayton Act). See Texaco, Inc. v. Hasbrouck, _____ U.S. _____, 110 S. Ct. 2535 (1990), in which franchised gasoline retailers successfully challenged price discrimination by a vertically integrated refiner.

²⁹ §3, to amend §6-2-105(1) to permit a finding of liability for pricing below cost where the purpose is either to injure competitors or to destroy competition. By contrast, illegality under the Robinson-Patman Act requires that the effect of the

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intent to injure a competitor, but the Unfair Practices Act and the Bill do not further define "injury." Thus a plaintiff might claim "injury" based on an actual or threatened loss of sales to a competitor that offered a lower price. Because "cutting price in order to increase business often is the very essence of competition," the Bill may "chill the very conduct the antitrust laws are designed to protect."³⁰

C. The Bill may lead to higher gasoline prices because it will discourage price competition and facilitate uniform pricing.

The Bill may inhibit vigorous competition and add costs to the distribution of gasoline in Colorado that do not exist in other states, costs that would be borne by Colorado consumers and visitors. The Bill may make firms less inclined to reduce their prices in response to changing conditions of demand and supply and may deter short term price discounts designed to attract new

²⁹(...continued)
pricing action be either "substantially to lessen competition or tend to create a monopoly ... or to injure, destroy, or prevent competition with any person" who grants or receives the benefit of price discrimination (or with customers of either of them). 15 U.S.C. §13(a). Under federal law, the effect of the conduct on competition, as distinguished from effects on a single competitor, is the more relevant consideration. But under the Bill, no showing of actual or threatened competitive effect would be required.

³⁰ Matsushita Elec. Indus. Co. v. Zenith, 475 U.S. 574, 594 (1986).

customers, because these actions risk inciting allegations of below-cost pricing.

The Bill may prevent refiners from realizing all the efficiencies of vertical integration that can often reduce transaction and search costs and lower prices to consumers. As a broad generalization, economic theory suggests that vertical integration is likely to harm consumers only when market power exists in at least one stage of production.³¹ A vertically integrated refiner may be able to achieve greater efficiency in coordinating its different levels of distribution. In a competitive industry, such as retail gasoline sales, it may be expected that these cost savings would be at least partially passed on to the consumer. However, the Bill may inhibit such firms from using these savings to lower prices to consumers if the savings are difficult to demonstrate as reductions in the "cost of doing business," which the Bill and the existing Unfair Practices Act characterize in terms of normal overhead items.³²

³¹ See, e.g., U. S. Department of Justice, Merger Guidelines, Section 4.21-4.213 (1984), incorporated by reference in the joint Merger Guidelines issued by the Department of Justice and the Federal Trade Commission earlier this month.

³² Unfair Practices Act, §6-2-105(2); as proposed to be amended, 6-2-105(4). The Bill's section addressed to motor fuel also uses the term "cost of doing business," referring to "generally accepted accounting practices," in setting that cost presumptively at six percent. Proposed §6-2-105(3)(b)(II)(c).

An unintended effect may be to encourage vertically-integrated refiners who distribute gasoline in Colorado to change otherwise lawful pricing practices. For example, the Bill may limit the availability of certain functional discounts.³³ In enforcing the federal price discrimination law, the Robinson-Patman Act, the Commission is careful to avoid discouraging firms from engaging in lawful price competition and from setting price differences that, rather than injure competition, may operate to destroy cartel pricing.³⁴ However, such lawful price competition may be discouraged by the threat of liability under the Bill's proposals. Firms may simply decide to set uniform prices across broad geographic regions to avoid violations.³⁵

³³ In Texaco, Inc. v. Hasbrouck, a case arising under the federal Robinson-Patman Act, the Supreme Court said that "a functional discount that constitutes a reasonable reimbursement for the purchasers' actual marketing functions will not violate the [Robinson-Patman] Act." 110 S. Ct. at 2550.

³⁴ See, e.g., F.M. Scherer & D. Ross, Industrial Market Structure and Economic Performance, p. 515 (3d ed. 1990).

³⁵ To the extent that individual firms would have an incentive to set a single price in a geographic area to avoid violating the law, the bill would resemble "uniform price laws," whose possible effects were discussed in the 1984 DOE Report, at 122:

In a market where there are no restrictions on pricing, price reductions tend to spread throughout the geographic area providing lower prices for consumers. ... If the geographic area within which the price cutting occurs is limited, it is very likely that the refiners will respond in kind. ... Thus, a price cut in one area often will lead to price cuts across broad market areas. In this situation, competition has worked effectively and consumers in all areas affected are better off.

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IV. Conclusion.

For these reasons, we believe that the Bill's proposed amendments dealing with motor fuel sales and distribution would tend to discourage competition and thereby could cause gasoline prices in Colorado to increase.

Thank you again for the opportunity to comment on S. B. 92-203. I hope you find these comments to be helpful.

³⁵(...continued)

In markets where there are uniform price restrictions, it is more likely that the responses will be different. Again, a refiner may decide to lower prices in a geographic area where sales traditionally have been weak. Refiners' responses must now take into account the uniform price law. ... [R]efiners must lower prices throughout the area covered by the law. In this situation, the refiners are more than likely to maintain their prices, since they may decide it is less costly to forego some sales in the initial market where price cutting is occurring than lower prices throughout the region. ... Competition has been adversely affected and most consumers are no better off, since price reductions have not occurred in areas where they would have without the uniform price law.