



BUREAU OF COMPETITION

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

V900029
COMMISSION AUTHORIZED

April 9, 1990

The Honorable Daniel E. Bosley
Representative
House of Representatives
Commonwealth of Massachusetts
State House
Boston, Massachusetts 02133

Dear Mr. Bosley:

The staff of the Federal Trade Commission¹ is pleased to submit this letter in response to your request for comments on the potential competitive effects of House Bills 2225 and 2226, proposed "divestiture" and "divorcement" laws. H. 2225 would prohibit petroleum refiners from owning retail gasoline service stations and would mandate open supply and regulate gasoline pricing. H. 2226 would prohibit refiners and other wholesale distributors from operating such stations. We believe that enactment of either of these bills may tend to lessen competition among motor fuel dealers and raise gasoline and diesel prices to Massachusetts consumers and visitors.

Interest and experience of the Staff of the 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. 15 U.S.C. § 45. Under this statutory mandate, the Commission seeks to identify restrictions that impede competition 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.²

¹ These Comments are the views of the staff of the Bureau of Competition of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner. Questions about these comments may be addressed to Ronald B. Rowe, Director for Litigation, Bureau of Competition, 600 Pennsylvania Avenue, N.W., Washington, D.C. 20580. Mr. Rowe's telephone number is (202) 326-2610.

² The staff of the Commission has gained extensive experience with energy competition issues by conducting studies, investigations, and law enforcement actions. Staff comments and testimony to legislative bodies have identified the costs of proposed gasoline retailing divorcement, "below-cost selling," and other petroleum market legislation in North Carolina, South Carolina, Georgia, Alabama, Tennessee, Washington, Hawaii,
(continued...)

Honorable Daniel E. Bosley

Description of H. 2225

H. 2225 would, among other things, prohibit refiners with more than 175,000 barrels per day of aggregate refinery capacity who obtain less than forty percent of their crude oil for refinery input from third parties, from owning or operating any motor fuel service stations in the Commonwealth of Massachusetts [Section 4(a)(1)]. Divested service stations would have to be offered first to the current dealer with a prescribed right of first refusal [Section 4(a)(2)(A) and (C)]. The value of such a divested motor fuel station would be "determined by the Assessor's records in each individual city or town . . . established by the assessed value of the property based on the previous year's tax bill [Section 4(a)(2)(B)].

The bill would require "open supply" by prohibiting refiners from objecting to dealers storing or distributing motor fuel purchased from other suppliers at the refiner's trademarked station as long as "reasonable notice" of that fact is posted at the point of sale to advise motorists [Section 4(d)].

Refiners would be required to have uniform resale prices for motor fuel sold at the same point of transfer, provided that differences in transfer prices could reflect different costs of manufacture, sale, or delivery for motor fuel [Section 4(c)].

The bill also would impose certain information reporting requirements on refiners and create a three person commission to promulgate rules and regulations to implement and enforce the Act. The commission would be empowered to initiate proceedings in state and federal courts to enforce the provisions of the act, to levy fines, to sue for civil penalties, and to seek temporary and permanent injunctive relief [Sections 3(a)(14) and 4].

Description of H. 2226

H. 2226 provides that after July 1, 1989, "no producer, refiner, or wholesale distributor of petroleum products shall open a major brand, secondary brand or unbranded retail service station" in Massachusetts and "operate it with company personnel,

²(...continued)

Nevada, Virginia, 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 review pursuant to Sections 7 and 7A of the Clayton Act, 15 U.S.C. §§ 18, 18a.

Honorable Daniel E. Bosley

a subsidiary company, commissioned agent, or under contract with any person, firm or corporation managing a service station on a fee arrangement" with such a defined person. It also provides that no such producer, refiner, or wholesale distributor shall continue to operate a service station in the specified manner even if the station was opened before the referenced date.

In addition, after July 1, 1989, any supplier of gasoline or special fuels to a retail service station dealer would be required to: "apportion uniformly all gasoline and special fuels on an equitable basis during periods of shortages;" "not discriminate among the dealers in their allotments;" "extend all voluntary allowances uniformly to dealers;" and "apply all equipment rentals uniformly to dealers." A penalty of \$10,000 per day shall be assessed for each violation of the Act, and the Attorney General of Massachusetts is "authorized and directed to enforce compliance with the provisions of this Act."

**No reliable evidence supports claims of a need
for laws to alter motor fuel franchise contracts**

Proponents of "divorcement"³ and "open supply" legislation have maintained that such laws are necessary to protect the franchised dealers of major, integrated refiners from unfair and anticompetitive practices by their suppliers. They argue that permitting refiners to own and operate retail gas stations in competition with independent dealers and franchised dealerships of major branded suppliers is unfair. According to this view, the refiners can and do "subsidize" their own retail operations by providing gasoline to those outlets at prices that are both below cost and below the wholesale prices charged to lessee dealers. Refiners' alleged reason for such "subsidization" is to drive their own lessee-dealers out of business in order to replace them with company-owned and operated stations.

The claims that vertical integration by refiners into gasoline retailing is anticompetitive in and of itself or because of refiner subsidization do not appear to be well founded. In fact, although most refiners in the United States are vertically integrated into gasoline retailing because such integration is

³ "Divorcement" laws, existing or proposed laws that call for refiner divestiture of retail gasoline stations, refer to legislation to eliminate or lessen vertical integration between petroleum refining and retail marketing sectors of the petroleum industry.

Honorable Daniel E. Bosley

efficient, the "major"⁴ oil companies targeted by this bill are the least integrated into retailing. Major oil companies have historically been "integrated by contract," relying heavily on franchised dealer networks to sell their refined products. The following 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. We briefly summarize the results of these studies below.

Federal Studies - Following enactment of Title III of the Petroleum Marketing Practices Act ("PMPA") in 1978, 15 U.S.C. § 2841, the Department of Energy ("DOE") studied whether the alleged "subsidization" of retail gasoline operations by the major refiners actually existed, and, if it did, whether the practice was predatory or anticompetitive. The final report to Congress, published in January of 1981, was based on an extensive study of 1978 pricing data in several Standard Metropolitan Statistical Areas ("SMSAs"), as well as on internal oil company documents subpoenaed by DOE investigators. The study concluded that there was no evidence of such "subsidization."⁵

In 1984, DOE published an updated study that further substantiated and elaborated on its 1981 findings.⁶ 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

⁴ "Major" oil companies describe a group consisting generally of the largest fully integrated petroleum firms that, in the aggregate, have the largest shares of most levels of petroleum production, refining, distribution, and marketing. These companies include Exxon, Chevron, Mobil, Texaco, Amoco, Sohio, Shell, and other well-known firms.

⁵ DOE, Final Report: The State of Competition in Gasoline Marketing, 1981.

⁶ DOE, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers, March, 1984 (hereinafter cited as 1984 DOE Report).

Honorable Daniel E. Bosley

continuing trend toward the use of more efficient, high-volume retail outlets.⁷

State Studies - 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 foreclosed the ability of dealers to cover 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 Final Report found that less than one percent of all observed pairs of prices of lessee dealers and company-operated stations disclosed any significant price variations, and concluded that such instances were "clearly too infrequent" to show that lessee dealers were being systematically driven from the market because their gasoline purchase costs were the same as or higher than the retail prices of competing refiner-operated stations.⁸

More recently, an Arizona legislature special committee conducted an extensive inquiry and concluded that special legislation similar to that proposed in Massachusetts was not justified. In December of 1988, that investigative body recommended that no new legislation be enacted, concluding that "[t]he marketplace for petroleum products is very competitive in Arizona."⁹

The state and DOE studies have revealed no instances of predatory behavior on the part of major gasoline refiners; rather, they show that the fortunes of refiners and their franchised retailers are closely linked, and that they "form a mutually supporting system backed by company advertising and

⁷ Id. at 125-32.

⁸ Final Report to the Washington State Legislature on the Attorney General's Investigation of Retail Gasoline Marketing, August 12, 1987, at 14.

⁹ Final Report to the Arizona Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement, December, 1988, at 35.

Honorable Daniel E. Bosley

promotion."¹⁰ Independent franchised retailers have continued to be by far the predominant form of outlet for the direct gasoline sales of major, integrated refiners, who operate only a small percentage of the gasoline stations in the United States.¹¹

Given their continuing massive investment in branded, lessee-dealer marketing distribution systems, major refiners are unlikely to charge their lessee-dealers prices that would cause them either to seek new sources of supply or to go out of business. A refiner that undertook such a course of action would probably face a decrease in market share, an increase in unused refining capacity, and higher per unit costs. Put another way, the major integrated refiners are not likely to engage in predation against themselves.

The impact of H. 2225 and H. 2226 on refiners

Furthermore, although the proposed laws are intended to remedy the alleged unfair activities of major, integrated refiners, the legislation may affect them less severely than it would smaller refiners who may want to retain existing retail stations, or compete for new station locations. Although H. 2225 would appear to affect a smaller number of refiners in comparison

¹⁰ 1984 DOE Report, supra, at ii. (Although the information for this proposition comes from 1984 and earlier materials, we have no reason to believe that the distribution structure has significantly changed since that time; gasoline and diesel fuel production and distribution methods have remained the same.)

¹¹ In 1981, the eight largest refiners, who in the aggregate, accounted for about half of all gasoline sales, sold approximately eight times more gasoline through lessee dealers than through company-operated outlets. Id. at 146 (Table A-10). The 1984 DOE Report confirmed a similarly low proportion. So did the Lundberg Letter, Vol. XI, No. 36, July 6, 1984, at 3. A recent study contracted for by the American Petroleum Institute ("API") noted that the 14 largest integrated refiners, representing approximately 67% of the nation's refining capacity, had only about 10% of their gross gasoline sales and 4.5% of their outlets devoted to salary-operated retail stations. Temple, Barker & Sloan, Gasoline Marketing in the 1980s: Structure, Practices, and Public Policy at 2-3 (1988).

Honorable Daniel E. Bosley

with the broader coverage of H. 2226,¹² either proposed law could harm competition and consumers.

Only a minor percentage of the major refiners' branded outlets in Massachusetts are owned and operated by the major refiners themselves.¹³ In contrast, although there do not appear to be very many smaller, independent refiner-owned stations in Massachusetts, such outlets as are present may be company owned and operated.¹⁴ Smaller, independent refiners may find that company operated outlets are more efficient than lessee-dealer outlets. Consequently, refiner-marketing divorcement or divestiture in Massachusetts, which would adversely affect many refiners, may be most harmful to smaller, independent ones, who may want to capture market share in Massachusetts.¹⁵

¹² H. 2225 would exempt from its requirements all refiners who have aggregate refining capacity of less than 175,000 barrels per day or who purchase more than sixty percent of their crude oil from others. H. 2226 does not exempt such refiners from its coverage.

¹³ According to the National Petroleum News ("NPN") 1989 Factbook, at 34-51, providing comparative national data on refiners' company operated and lessee operated retail outlets, the leading branded refiners in Massachusetts appear to have a relatively small number of company-owned or operated stations. For example, the NPN figures show that Mobil's company-operated stations constitute only about 6.5% of its overall retail distribution volume. Texaco stands at about 5.7%, and Exxon has only 5.2%.

¹⁴ In 1988, the Lundberg Letter reported that "Majors lost share to the independents." Vol. XV, No. 11, at 14. One such independent is Southland, who owns Citgo's refinery and gasoline distribution system. Southland has been aggressive in combining its 7-11 convenience stores with gasoline retailing. Another independent is Cumberland Farms, who also has combined convenience stores with gasoline retailing. Cumberland reportedly has a presence that is growing in Massachusetts. Id.

¹⁵ As noted in footnote 11, supra, the "major" oil companies constitute the refining segment with the lowest proportion of gasoline volume in company-operated retail stations. Smaller refiners comprise the refining segment with the highest incidence of company-owned and operated retail stations.

Honorable Daniel E. Bosley

Monopolistic and predatory behavior is presently covered by state and federal antitrust laws; new legislation to regulate gasoline markets is unnecessary

Predatory or monopolistic behavior, including "predatory subsidization" in the petroleum industry, is subject to the Sherman Act, the Clayton Act, and the Federal Trade Commission Act. The Massachusetts state law similarly prohibits monopolistic behavior [Chapter 93, General Laws of Massachusetts, Sections 1-14A].¹⁶ These statutes address possible anticompetitive practices in the industry more effectively than would legislation restricting new entry by potential competitors and regulating contractual relationships between suppliers and purchasers of gasoline.

Existing law deters firms from engaging in monopolistic behavior, but, at the same time, allows them to lower their costs of operation through their gasoline distribution systems. Manufacturers selling in multi-regional, national, or broader markets typically impose standardized distribution requirements across markets to insure that customers will be able to receive the same product no matter where they shop. Lessee-dealer contract requirements imposed by refiners similarly reflect branded refiners' competitive strategies. Traditionally, such strategies have emphasized service and other non-price forms of competition. Unbranded marketers, by way of contrast, have competed solely on a price basis, and they are usually refiner-owned and operated. H. 2225 and 2226 would therefore restrict the ability of firms to realize increased market efficiencies and to adjust to changing market conditions. Because both types of marketing provide price and service options for consumers, competition and consumers would be harmed by legislation restricting entry and expansion.¹⁷

The proposed laws are likely to result in higher fuel prices

Massachusetts is presently among the majority of states that does not limit competition between refiner operated stations and lessee-dealers of the same brand. The proposed laws would place Massachusetts among only a few states that limit refiner retail motor fuel operations. In competitive markets, savings from vertical integration between refining and marketing levels of the petroleum industry are usually passed on to consumers in the form

¹⁶ See CCH Trade Reg. Rep., Vol. 6, ¶ 32,401 et seq. (1988).

¹⁷ See Temple, Barker & Sloan, supra at 23-54.

Honorable Daniel E. Bosley

of price competition. The proposed Massachusetts divorcement and divestiture provisions would deny consumers such opportunities for lower prices attributable to affiliated refining/marketing operations.

Because "low" prices typically benefit consumers, calls for their abolition should be viewed with skepticism, especially in the absence of reliable evidence of illegal behavior. Legislation such as H. 2225 and 2226 is likely to add costs to the distribution of gasoline in Massachusetts that do not exist in other states, costs that would be passed on to Massachusetts consumers and visitors. The potential harm of divorcement and other regulatory legislation may be illustrated by the experience of the State of Maryland, which in the early 1970s enacted divorcement legislation similar to that now proposed by H. 2225 and H. 2226. One economic study, described by DOE as perhaps "the best empirical analysis of the effects of Maryland's divorcement law,"¹⁸ estimates that Maryland consumers may be paying millions of dollars more per year for gasoline primarily because of that law.¹⁹

A study commissioned by the Maryland State Comptroller's Office and the state attorney general to defend the divorcement law against a legislative proposal for its repeal concluded that the law benefitted consumers, saving them nearly \$117 million.²⁰ The study, however, contained serious flaws that undermined its conclusion. It compared average prices for full and self service gasoline in Baltimore to average prices in six cities outside

¹⁸ 1984 DOE Report, supra, at 105, describing a study by Barron and Umbeck.

¹⁹ See Barron and Umbeck, A Dubious Bill of Divorcement, Regulation, Jan.-Feb., 1983, at 29. See also Hearings on S. 326, Before the Senate Comm. on the Judiciary, 97th Cong., 1st Sess. (Oct. 21, 1981) (Testimony of Pester Corp. and Crown Central Petroleum Corp.); Barron and Umbeck, The Effects of Different Contractual Arrangements: The Case of Retail Gasoline Markets, 27 J. Law & Econ. 313 (1984). See also, S. 1140 Hearing at 305-306, where Crown stated that "retail divorcement in Maryland has been a disaster for both small and independent refiners and others who do not have the brand recognition or the benefit of millions of credit card holders that the major refiners have." Crown complained that, because of divorcement, it lost over 25% of its market share between 1979 (when divorcement became effective) and 1984. Id.

²⁰ See Putnam, Hayes & Bartlett, Gasoline Prices in Maryland Following Divorcement (1987).

Honorable Daniel E. Bosley

Maryland during a four year period. Such comparisons of average prices in different areas, however, fail to take adequate account of any differences in the proportions of full and self service gasoline purchased in those areas. Thus, if the purchase of high price, full service gasoline in Baltimore constituted a smaller percentage of total gasoline than in other areas, the average price of gasoline might well appear to be less in Baltimore. However, more consumers in Baltimore would be choosing a lower quality product and service mix, with an attendant lower price, than that chosen by consumers in other areas.

In fact, the data indicate that an unusually small proportion of purchases in Baltimore is full service gasoline sales, perhaps because the price differential in Baltimore between full and self service gasoline is unusually large.²¹ For this reason, the \$117 million figure calculated in the study does not represent consumer savings associated with the purchase of a comparable product and service combination. If and to the extent that divorcement is responsible for the unusually high full service price in Baltimore, divorcement may have diminished the variety of product, service, and price combinations and choices available for Maryland consumers and visitors.

The study also included southern cities in its comparison, but "full service" in southern cities typically is more extensive than full service in northern cities.²² Therefore, even if the proportions of full and self serve gasoline purchases were the same in the two areas, a higher average price in a southern city may be associated with a higher quality product and service mix than that sold in Baltimore.

The Maryland study was also flawed in that it did not compare prices in Maryland before and after divorcement. One scholar made such a comparison and, using data that was otherwise

²¹ During the period examined in the study, the full service consumption rate in Baltimore ranged from 14 to 17 percent, the lowest rate of any northern city. Baltimore also had the highest premiums for full service over self service, approximately 33 cents per gallon for unleaded regular, of any northern city. See Lundberg Letter, Vols. XII, XIII, and XIV, "Price/Margin Report," 1985-1987.

²² See Sorenson, "The Cost To Consumers in Maryland of the Divorcement of Refiners from Retail Gasoline Marketing 1979-1986," Florida State University, January, 1988, at 11. In southern cities, full service typically includes checking tire pressure, washing windows and an under-the-hood inspection.

Honorable Daniel E. Bosley

the same, concluded that divorcement significantly increased Maryland gasoline prices.²³

The proposed laws may weaken branded marketing systems

The provisions of H. 2225 and 2226 that would require "open supply" would alter contractual relationships between refiners and their franchised retailers in a manner that is likely to weaken the branded marketing system of petroleum distribution. In response to such legislation, major refiners may abandon relatively efficient franchised retailer operations in favor of commodity sales of gasoline at the refinery gate or at wholesale terminals. Refiners may have less incentive to continue sizable investments in their lessee-dealer networks if they are unable to guarantee by contract that they will be able to sell their products and services through an efficient distribution system.²⁴

To the extent that the proposals are intended to redress perceived gasoline retailer grievances against their refiner-suppliers, we suggest that you consider the extent to which these concerns have been addressed in existing federal legislation, the Petroleum Marketing Practices Act of 1978 ("PMPA"), 15 U.S.C. § 2841. The legislative history of the PMPA shows that Congress was concerned over similar allegations of abuses of the franchise relationship, and that the PMPA was intended to balance the rights of the respective parties to retail gasoline franchise agreements.²⁵

Conclusion: The passage of H. 2225 and 2226 is not necessary in Massachusetts motor fuel distribution

For the reasons stated above, we believe that H. 2225 and 2226, if enacted, could injure competition and consumers in Massachusetts. We believe that the bill would tend to insulate lessee-dealers from competition by potential entrants and by expansion of the existing refiner-operated networks. This could therefore cause higher motor fuel prices and fewer choices for Massachusetts consumers and visitors.

²³ Sorenson estimated that divorcement imposed an annual cost on Maryland consumers of between \$32 million and \$75 million. Id. at 20-21.

²⁴ See attached copy of DOE testimony on similar legislation in the United States Senate (S. 1140) in 1985.

²⁵ See Senate Report No. 95-731, 95th Cong., 2d Sess., 15-19, 29-43, reprinted in 1978 U.S. Code Cong. & Ad. News 873.

Honorable Daniel E. Bosley

We appreciate the opportunity to comment on H. 2225 and 2226. Please feel free to call on us if we can be of further assistance.

Sincerely,

A handwritten signature in black ink, appearing to read 'R. B. Rowe', written over the word 'Sincerely,'.

Ronald B. Rowe
Director for Litigation