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

BUREAU OF COMPETITION

COMMISSION AUTHORIZED

The Honorable Gene Thayer
Chairman
Business and Industry Committee
Montana State Senate
Capitol Station
Helena, Montana 59620

Dear Chairman Thayer:

The staff of the Federal Trade Commission[1] is pleased to submit this letter in response to your request for comments on the potential competitive effects of House Bill 464, a bill that would in general regulate gasoline prices by prescribing minimum price levels and prohibiting price discrimination. Your letter notes that H.B. 464 has already been passed by the Montana House of Representatives and will be taken up shortly by your Committee. We believe that H.B. 464 is anticompetitive and that, if the bill is enacted, Montana consumers and visitors could pay higher prices for gasoline.

Interest and experience of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive practices in or affecting commerce. 15 U.S.C. § 45. 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.[2]

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1 These Comments are the views of the staff of the Bureau of Competition of the Federal Trade Commission, and do not necessarily represent the views of the Commission itself or any individual Commissioner.

2 The Commission's staff 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 and "below-cost selling" legislation for North Carolina, South Carolina, Georgia, Alabama, Tennessee, Washington, Hawaii, Nevada, and for 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

Description of H.B. 464

Section 4 of H.B. 464 would, *inter alia*, prohibit retailers from selling gasoline in Montana at prices below costs, as defined in Section 3, "if the effect is to injure or destroy competition or substantially lessen competition . . . ."[3] "Cost to retailer" is defined as "the current invoice cost of motor fuel to the retailer within 30 days prior to the date of sale or the replacement cost . . . , whichever is lower," less most trade discounts, plus other specified costs of doing business, such as taxes, transportation costs, and a share of overhead costs. Section 4 would also prohibit a vertically integrated producer or wholesaler from selling a petroleum distillate to its own retail outlet at a price lower than the price charged any other, competing retailer. Further, gasoline purchased from others for sale in supplier-owned gasoline stations would have to be sold at retail prices that are at least eight percent above the wholesale prices that those retailers' suppliers charge other customers.

Section 5 of the bill would prohibit suppliers or wholesalers of gasoline from discriminating in price, "if the discrimination substantially lessens competition or tends to create a monopoly or to injure, destroy, or prevent competition with a person in the marketing of motor fuel in the community where the supplier or wholesaler is selling at a lower price." Sections 7 and 8 provide for civil penalties, cease and desist orders, and injunctions to remedy violations of Section 4; the bill appears to contain no remedy for violations of Section 5, the price discrimination provision.

Claims of predatory, monopolistic or collusive activities by refiners against gasoline dealers may not be well-founded

The premise of H.B. 464, as stated in Section 2, is that independent and small retailers and wholesalers are being victimized by "subsidized pricing, which is inherently unfair and destructive." Several studies of competition in gasoline marketing in the United States since 1981 have concluded that gasoline dealers and distributors have not been and are not likely to become targets of anticompetitive practices by their suppliers, although these studies do not contain information about Montana. In light of these studies, discussed below, you may wish to examine any claims by Montana gasoline dealers to be sure that the claims are well-founded.

Act, 15 U.S.C. §§ 18, 18a.

3 Section 4(1)(a)-(b) specifies further exceptions for unusual circumstances, such as isolated sales, clearance sales, or sales to aid charitable causes.

Federal studies

Following enactment of Title III of the Petroleum Marketing Practices Act ("PMPA") in 1978, 15 U.S.C. Sec. 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, as well as on internal oil company documents subpoenaed by the DOE investigating staff. DOE found no evidence of such "subsidization".[4]

In 1984, DOE published an updated study that further substantiated and elaborated on its 1981 findings.[5] The study showed that company-operated stations were not increasing as a percentage of all retail outlets, except among the smaller refiners. 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 due to decreased consumer demand for gasoline and a continuing trend toward the use of more efficient, high-volume retail outlets.[6]

State studies

In 1986, the Washington state attorney general initiated a study of motor fuel pricing in that state to determine whether subsidization had occurred or was occurring. 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 structure of 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 had retail operations and sold to lessee-dealers. The Final Report concluded that instances of significant price variation among lessee-dealers and company-operated retailers were "clearly too infrequent" to support any claim that lessee-

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

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

6 Id. at 125-32.

dealers' gasoline purchase costs were higher than the retail prices of competing company-operated stations, and that these dealers were being systematically driven from the market.[7]

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, after more than a year of extensive inquiry and analysis, the Final Report recommended that no new legislation be enacted, concluding that "[t]he marketplace for petroleum products is very competitive in Arizona."[8]

The state and DOE studies have revealed no instances of predatory behavior by major gasoline refiners. 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 and promotion."[9] Independent franchised retailers have continued to be by far the predominant form of outlet for the direct gasoline sales of major, integrated refiners.[10] Indeed, major refiners operate only a small percentage of the gasoline stations in the United States.[11] Given the importance of the branded, franchised marketing distribution system, major refiners are unlikely to charge discriminatory prices that would cause their franchised retailers to seek new sources of supply or to go out of business. A refiner that undertook such a course of action would probably

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

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

9 1984 DOE report, <u>supra</u>, at ii. We do not mean to suggest that the fortunes of refiners and their franchised retailers are perfectly linked, only that the studies have found a preponderance of evidence that in general the refiners and their retailers share common goals. Although our information for these propositions comes from 1984 reports and articles, we have no reason to believe that the distribution structure has significantly changed since that time.

10 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. <u>Id</u>. at 146 (Table A-10).

11 <u>Lundberg Letter</u>, Vol. XI, No. 36, July 6, 1984, at 3, where it was reported that the major refiners operated only about 3.3% of all retail stations.

face a decrease in market share, an increase in excess refining capacity, and higher per unit costs. Thus, the major integrated refiners are not likely to engage in predation against the mainstay of their own retail distribution systems, their franchised retailers.

Even if predatory behavior 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, and at the state level, the Montana Unfair Trade Practices Law.[12] These statutes address possible anticompetitive practices in the industry more effectively than would legislation regulating gasoline markets. The existing antitrust laws deter firms from engaging in predatory behavior, but, at the same time, allow them to lower their costs of operation through vertical integration. In contrast, the price regulation envisioned by H.B. 464 would deny firms the flexibility to adjust their prices in response to changing conditions of demand and supply. Such legislation is likely to add costs to the distribution of gasoline in Montana that do not exist in other states, costs that would be borne by Montana consumers and visitors.

In addition, many of the apparent concerns of the sponsors of H.B. 464 in redressing alleged anticompetitive abuses associated with refiner-owned and operated gasoline stations are addressed by the existing federal Petroleum Marketing Practices Act of 1978, supra.[13] The legislative history of the PMPA shows that Congress was concerned about these same alleged abuses of the franchise relationship, and that the PMPA was intended to balance the rights of the respective parties to retail gasoline franchise agreements.[14]

The price and allocation regulatory features of H.B. 464 will lead to higher gasoline prices

Enactment of H.B. 464 is likely to have several adverse consequences for consumers. Because of the uniform mark-up provision of the bill, retailers might be unable to operate

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12 Mont. Code Ann. §§ 30-14-201-224 (1985).

13 The PMPA establishes certain notice requirements with respect to cancellation and nonrenewal of contracts between franchisors and franchisees, and creates a private claim for violation by franchisors, enforceable in federal courts.

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

discount outlets, which trade a smaller profit margin for larger volume. In addition, short term price discounts designed to attract new customers would be deterred. The result is likely to be rigid, uniformly higher, retail gasoline prices within Montana. H.B. 464 may also prevent refiners from capturing the efficiencies of vertical integration, which can often reduce transaction and search costs and lower prices to consumers.[15]

In enforcing the federal price discrimination law, the Robinson-Patman Act, 15 U.S.C. § 13, the Commission is careful to avoid discouraging firms from engaging in lawful price discrimination, which often operates to destroy cartel pricing.[16] Moreover, changing market conditions frequently are manifested in temporary discriminatory pricing patterns. Especially because it prohibits price discrimination that injures competitors, but not necessarily competition in the market, H.B. 464 may have the effect of inhibiting efficient, pro-competitive pricing practices. Firms may become insulated from competition, and pricing may become rigid. The bill, therefore, if enacted, may well result in higher profits for all gasoline refiners and marketers through higher prices for Montana consumers.

Conclusion

For the reasons stated above, we believe that H.B. 464, if enacted, would tend to insulate gasoline refiners and marketers from competition, and thereby could cause gasoline prices in Montana to increase.

We appreciate the opportunity to comment on H.B. 464. Please feel free to contact us if we can be of further assistance.

Sincerely,

Jeffrey I. Zuckerman
Director

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15 For example, vertical integretion reduces the costs of contracting with various retailers and reduces coordination problems between different distribution levels.

16 See generally Schwartz, The Perverse Effects of the Robinson-Patman Act, United States Dept. of Justice, Antitrust Division, Economic Analysis Group Discussion Paper 86-12, July 30, 1986, at 8-10.