Before the
FEDERAL TRADE COMMISSION
Washington, D.C.

In the Matter of	)	
	)	
Market Manipulation Rulemaking	)	Project No. PO82900
	)	

COMMENTS OF THE AMERICAN PETROLEUM INSTITUTE AND THE NATIONAL PETROCHEMICAL AND REFINERS ASSOCIATION

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COMMENTS OF THE AMERICAN PETROLEUM INSTITUTE AND THE NATIONAL PETROCHEMICAL AND REFINERS ASSOCIATION

I. EXECUTIVE SUMMARY

The American Petroleum Institute ("API") and the National Petrochemical and Refiners Association ("NPRA") welcome this opportunity to submit these comments and to offer an industry-wide perspective on the issues raised by the Commission's Advance Notice of Proposed Rulemaking ("ANPR"). The issues presented by the ANPR are of great concern to API, NPRA, and their respective members, and we appreciate this opportunity to share our views.

1. Section 811 of Subtitle B of the Energy Independence and Security Act of 2007 ("EISA") states that the Federal Trade Commission ("FTC" or "Commission") "may prescribe" rules concerning the use, "in connection with the purchase or sale of crude oil[,] gasoline or petroleum distillates at wholesale," of "any manipulative or deceptive device or contrivance," if such rules are "necessary or appropriate in the public interest or for the protection of United States citizens." The statutory language leaves to the FTC the decision whether to propose a rule under Section 811. The FTC's experience with the petroleum industry indicates that any such rule is unnecessary. Repeated investigations of the industry have found no evidence of significant harmful or illegal conduct in petroleum wholesale markets. Much of

the conduct discussed in the ANPR is already governed by the antitrust laws, and adoption of rules pursuant to Section 811 would substantially duplicate an existing enforcement regime under the Commodity Exchange Act (CEA). In addition, a new set of rules has the potential to deter actions that are likely to benefit consumers and to impose regulatory burdens that outweigh any likely benefits.

2. If the FTC decides to propose a rule, it should craft the rule narrowly to avoid deterring pro-competitive conduct or impeding the efficient operation of petroleum markets. Consistent with these principles, any rule should require that, before a party can be held liable under Section 811, it must at a minimum be shown to have: (a) knowingly made a deceptive or fraudulent statement or engaged in a deceptive or fraudulent act; (b) in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale; (c) with the specific intent to affect the market price for a physical crude oil, gasoline or petroleum distillates product; and (d) caused such market price to deviate materially from the market price that would have existed but for the deceptive or fraudulent statement or act.

(a) Section 811's reference to "any manipulative or deceptive device or contrivance" is derived from the Energy Policy Act of 2005 ("EPA") and the Securities Exchange Act of 1934 ("SEA"). The Supreme Court has held that this language "connotes intentional or willful conduct designed to deceive or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976). Other provisions in Subtitle B, and Section 811's limited legislative history, confirm that Congress intended Section 811 to target deceptive or fraudulent conduct.

Although Section 811 is modeled on provisions of the EPA and SEA, Congress delegated broad authority to the FTC to promulgate rules tailored to the nature of the petroleum markets at issue. In exercising this authority, the FTC should retain its long-standing distinction

between pure omissions (which are not considered deceptive under the FTC Act) and omissions that are necessary to correct a misimpression. In addition, the FTC should not impose any disclosure requirements or prohibitions on "insider trading" similar to those imposed on securities market participants by SEC regulations.

(b) Section 811, by its terms, applies only to conduct undertaken "in connection with the purchase or sale of crude oil[,] gasoline or petroleum distillates at wholesale." The provision does not apply to retail sales of petroleum products, and should not be applied to "rack" transactions, Dealer Tankwagon ("DTW") sales to dealers, or to other terminal-level sales, or to supply decisions that are unconnected to wholesale purchase or sale transactions. In addition, Section 811 should apply only to transactions in physical commodities, and not to listed or over-the-counter derivatives contracts, which are regulated exclusively by the CFTC.

(c) The language of Section 811 applies to intentional or knowing misconduct that is designed to deceive or defraud. Other sections of the statute, as well as its legislative history, confirm that Section 811 applies only to statements or acts that are intended to mislead. Absent a specific intent requirement, Section 811 is likely to chill dynamic competitive behavior and deter firms from acting on market indications for fear of inadvertently incurring liability. The CEA's market manipulation provisions have been interpreted to require specific intent. If the FTC proposes a rule, it should adopt the same standard.

(d) Any rule proposed under Section 811 should be limited to deceptive or fraudulent statements or acts that cause market prices to deviate materially from the market price that would have existed but for those statements or acts. Section 811, unlike Section 9(a)(2) of the CEA, does not expressly prohibit attempts to manipulate, and requiring an effect on prices is necessary to distinguish actual from attempted manipulation. Also, unless the FTC requires

proof of a connection between challenged conduct and a material deviation in *market* prices, it could find itself drawn into disputes that are properly the province of commercial contract and anti-fraud law.

3. Section 811 should not be interpreted to prohibit conduct undertaken "for the purpose or with the effect" of causing certain market effects, as set forth in the ANPR's proposed definition. The use of the disjunctive "or" would allow liability to be imposed on a party that did not intend to cause such market effects, and thus would risk deterring a wide range of behavior that is competitively neutral or pro-competitive. In addition, Section 811 liability should not attach where the purpose or effect of a party's actions was to "increas[e] the market price relative to costs." This formulation would create a risk of liability for economically rational behavior that serves to ensure that goods are produced, sold, and distributed to regions and consumers that need them most.

4. The FTC should avoid imposing duplicative or inconsistent regulatory requirements. In particular, it should avoid creating new, industry-specific antitrust laws, and instead should focus on intentionally deceptive or fraudulent conduct. In addition, the derivatives markets, and to a considerable extent the physical petroleum wholesale markets, are already regulated by the CFTC. The FTC should avoid unnecessary inconsistencies between any rule it may propose under Section 811 and the standards applied by the CFTC under the CEA.

5. Congress has provided for substantial penalties, including civil penalties of up to $1 million per day per violation of Section 811. The magnitude of these penalties could cause companies to adopt rigid rules that would restrict their ability to engage in efficient and pro-competitive activities. Accordingly, in the event the FTC proposes a rule, it should consider a

range of factors in determining the appropriate penalty for a violation, including the seriousness of the violation and the magnitude of the harm.

6. Section 811 should not be interpreted to regulate supply decisions – for instance, about which products to produce, how much of each product to produce, and where to supply those products. Such decisions are enormously complex and interrelated, and are made much more efficiently by companies responding to market forces than by a government agency. Any attempt to apply Section 811 to supply decisions is likely to chill rapid responses to market indications and thus have the perverse effect of prolonging supply disruptions.

Section 811 also should not be interpreted to require firms to release inventory during price spikes. Again, such a requirement would substitute the judgment of the Commission for that of individual firms making ordinary business decisions, and would likely dampen the ability of the market to reach equilibrium after supply disruptions.

In addition, Section 811 should not be interpreted to prohibit truthful public announcements by refiners of planned reductions in utilization. Such announcements help market participants react rationally to market conditions, and any improper coordination among refiners through such announcements is already illegal under the antitrust laws. Moreover, Section 811 should not be interpreted to require access to unregulated terminals.

While API and NPRA recognize that false reporting of price data to private reporting firms could be problematic, any prohibition on such conduct should be appropriately tailored to ensure that market participants do not forego reporting to such firms altogether.

Section 811 does not grant the FTC authority to require companies to maintain and submit burdensome cost and volume data, and in any event the burdens of such a requirement would far outweigh any likely benefits. Section 811 also should not be read to grant

the FTC authority to regulate prices. Moreover, the concept of "artificial price" developed by the CFTC is not appropriate for physical commodities markets. The artificial price standard was developed to police futures contracts in which all terms except price are standardized, while Section 811 applies to physical transactions in which many non-standardized contracts are used.

7. Finally, any proceeding to promulgate a rule under Section 811 is subject to the procedures of Section 18(a)(1)(B) of the FTC Act. Section 811 authorizes the FTC to issue rules applicable to acts that are "manipulative or deceptive," and Section 813 specifies that violations of any rules issued under Section 811 "shall be treated as an unfair or deceptive act or practice prescribed under a rule issued under section 18(a)(1)(B)." When Congress has intended to authorize the FTC to use the less demanding rulemaking procedures of the Administrative Procedure Act, 5 U.S.C. § 553, it has said so expressly. Congress did not do so here.

II. API AND NPRA AND THEIR INTEREST IN THIS PROCEEDING

The American Petroleum Institute and the National Petrochemical and Refiners Association are national trade associations representing the U.S. oil and natural gas industry. API's more than 400 members cover all facets of the industry, including exploration, production, transportation, refining, and marketing. NPRA's more than 450 members own or operate virtually all U.S. petroleum refining capacity and include most of the nation's petrochemical manufacturers, which supply the chemicals necessary to produce products ranging from pharmaceuticals to fertilizers to Kevlar. API and NPRA frequently participate in legislative, administrative, and judicial proceedings that present issues of national concern. API and NPRA are able to offer an industry-wide perspective on the issues raised by the ANPR that may be of assistance to the FTC.

The issues presented by the ANPR are of great concern to API, NPRA, and their respective members. We are particularly concerned that an unduly expansive reading of Section 811 could harm the efficient functioning of petroleum markets that are vital to the U.S. economy. If that were to occur, rules intended to protect U.S. consumers and the economy would have the opposite effect.

III. STATUTORY AND REGULATORY BACKGROUND

Subtitle B of the EISA[1] includes provisions respecting certain manipulative or deceptive conduct and the supply of false information to the federal government. Specifically:

- Section 811, entitled "Prohibition on Market Manipulation," makes it "unlawful for any person, directly or indirectly, to use or employ, in connection with the purchase or sale of crude oil[,] gasoline or petroleum distillates at wholesale, any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Federal Trade Commission may prescribe as necessary or appropriate in the public interest or for the protection of United States citizens."

- Section 812, entitled "Prohibition on False Information," prohibits "any person" from reporting information that is "required by law to be reported" and is "related to the wholesale price of crude oil, gasoline or petroleum distillates" to a federal department or agency if the person (1) "knew, or reasonably should have known, the information [was] false or misleading" and (2) intended such false or misleading information "to affect data compiled by the department or agency for statistical or analytical purposes with respect to the market for crude oil, gasoline, or petroleum distillates."

- Section 813 provides that Subtitle B (including Sections 811 and 812) shall be enforced by the FTC "in the same manner, by the same means, and with the same jurisdiction" as though "all applicable terms" of the FTC Act were incorporated into and made a part of Subtitle B.

- Section 814 provides for civil penalties of up to $1 million per day per violation, in addition to any other penalty applicable under the FTC Act.

- Section 815 provides that nothing in the subtitle (1) limits the authority of the FTC under the FTC Act or other laws, (2) "shall be construed to modify, impair,

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[1] Pub. L. 110-140, 121 Stat. 1723, tit. VIII, subtit. B, to be codified at 42 U.S.C. §§ 17301-05.

or supersede the operation of any of the antitrust laws," and (3) preempts any state law.

The Commission's ANPR requests comment on "whether, and if so in what manner" it should promulgate regulations under Section 811.

IV. OVERVIEW OF THE PETROLEUM INDUSTRY

To establish the context for this proceeding, and to aid the FTC in ensuring that any action it undertakes pursuant to Section 811 is appropriately tailored to the petroleum wholesale markets at issue, it is useful to consider certain fundamental aspects of the petroleum industry.

First, the U.S. petroleum industry is highly competitive, and petroleum wholesale markets are not highly concentrated.[2] A 2006 FTC investigation found that no U.S. refiner holds a substantial capacity share either nationally or regionally.[3] Likewise, a 2004 FTC study found that, "[d]espite increases in concentration at some production levels over [the last two decades], particularly since the mid-1990s, most sectors of the petroleum industry at the national, regional, or state level generally remain unconcentrated or moderately concentrated."[4]

A close examination of specific segments of the petroleum industry confirms that competition is robust. For instance, concentration in the refining segment of the industry

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[2] *See, e.g.*, Timothy J. Muris & Richard G. Parker, *A Dozen Facts You Should Know About Antitrust and the Oil Industry* (June 2007) (hereinafter, *A Dozen Facts*). Except where otherwise noted, industry facts and statistics in this section are taken from this monograph.

[3] *See* Federal Trade Commission, *Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases* (Spring 2006) at 16 (hereinafter, *Katrina Report*). This study found that, nationally, Valero had the largest share of U.S. crude oil distillation capacity with 13 percent, followed by ConocoPhillips with 12.9 percent and ExxonMobil with 11.4 percent. *Id.*

[4] Bureau of Economics, Federal Trade Commission, *The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement* (August 2004) at 15; *see also id.* at 16 ("In sum, mergers have contributed to the restructuring of the petroleum industry in the past two decades but have had only a limited impact on industry concentration.").

remains well below the levels of many other U.S. industries. Moreover, vertical integration between crude oil production and refining has declined over the past two decades among the major U.S. oil companies.[5] New entry and vertical disaggregation have brought increased competition in many segments of the petroleum industry, including refining.

This high degree of market competition and low levels of industry concentration substantially decrease the risk that any single firm will have the ability to distort market prices.

Second, domestic refining capacity has expanded in recent years. U.S. refiners have invested tens of billions of dollars in recent decades to increase refining capacity, improve output, and meet environmental requirements. As a result, domestic refining capacity is greater than it has ever been. This investment suggests that refiners have a continuing incentive to expand output to extract value from additional capacity, not to engage in manipulative behavior that could decrease output.

While domestic refinery expansion has not kept pace with rising demand over the past twenty years, refiners have made capacity expansion decisions, as the Commission has recognized, based on long-term forecasts about market conditions and the costs of building new refineries as compared to expanding existing refineries, and not as part of an effort to limit capacity and increase prices.[6] Multiple layers of federal and state permitting requirements have

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[5] *See id.* at 20-21 (from 1991 to 1996, asset dispositions were more prevalent than acquisitions among large petroleum companies); *see also Consolidation in the Energy Industry: Raising Prices at the Pump?: Hearing Before the Senate Committee on the Judiciary*, 109th Cong., 2d Sess. (Feb. 1, 2006) (prepared statement of the Federal Trade Commission presented by William E. Kovacic, Commissioner, at 3) ("A number of major integrated firms have restructured to concentrate on one or more segments of the industry, and a number of unintegrated refiners or retailers have entered.").

[6] *See Katrina Report*, *supra* n. 3, at 20 ("No single refiner has a large enough market share to manipulate prices unilaterally through either underinvestment in capacity or reduction of refinery
(continued…)

to some extent delayed expansion efforts, with the costs of these delays serving as an economic disincentive to adding refining capacity. Foreign refining capacity and imports also have expanded, providing another source of supply for the domestic market. For instance, annual imports of finished motor gasoline have increased substantially in the last decade. The United States imported an average of 177 million barrels a year of finished motor gasoline in the years 2000-2007, up from average annual imports of 116 million barrels in the 1990s.[7] Even though imports have receded somewhat from their 2005 high, annual imports in 2007 were still higher than for any year from 1990-1999. Similarly, there has been a dramatic expansion in imports of motor gasoline blending components. Imports averaged 163 million barrels per year in 2000-2007, up from an average of 38 million barrels per year from 1990-1999, a more than fourfold increase.[8]

Third, the FTC has concluded that refineries are not withholding capacity from the market, but operate at high utilization rates of available capacity.[9] The FTC investigated this issue in 2006 following suggestions that refiners might manipulate refinery utilization to reduce supply or raise prices. The FTC discovered just the opposite to be true, finding that "the best available evidence suggests that companies have not restricted the level of capacity below

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output, and the investigation revealed no evidence that any unilateral manipulation was occurring.").

[7] *See* Energy Information Administration, *Petroleum Navigator* data, *at* http://tonto.eia.doe.gov/dnav/pet/hist/mgfimus1a.htm.

[8] *See* Energy Information Administration, *Petroleum Navigator* data, *at* http://tonto.eia.doe.gov/dnav/pet/hist/mbcimus1A.htm.

[9] *See* Energy Information Administration, *Annual Energy Review 2006* at Table 5.9, *available at* http://www.eia.doe.gov/aer/pdf/pages/sec5_21.pdf.

competitive levels and that they have used their capacity to the fullest practical extent."[10] Former Chairman Majoras testified to Congress that internal company documents "reflected efforts to minimize unplanned downtime resulting from weather and other unforeseen calamities."[11] Finally, as the FTC found in its 2006 investigation, exports of refined products from the United States to foreign markets are "relatively rare."[12]

Fourth, the evidence demonstrates that better management of inventory levels, as well as business and technological innovations, have enabled market participants to generate efficiencies and cost savings while responding quickly and flexibly to changing market demands.[13]

In summary, the picture of the U.S. oil industry that emerges from the empirical data is one of a well functioning and competitive market.

V. THE FTC SHOULD NOT PROPOSE A RULE PURSUANT TO SECTION 811

Section 811 delegates to the FTC the authority to decide whether to propose a rule, prohibiting only conduct that is "in contravention of such rules and regulations as the Federal Trade Commission *may* prescribe as necessary or appropriate in the public interest or for

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[10] *Katrina Report*, *supra* n. 3, at 4.

[11] *Price Gouging: Hearing Before the Senate Comm. on Commerce, Science and Transportation* (May 23, 2006) (prepared statement of the Federal Trade Commission presented by Deborah Platt Majoras, Chairman, at 9) *at* http://www.ftc.gov/os/testimony/0510243CommissionTestimonyConcerningGasolinePrices05232006Senate.pdf.

[12] *Katrina Report*, *supra* n. 3, at 13 ("Exports [of refined products] from the US are relatively rare. In 2005, the U.S. consumed 9.125 million barrels per day of finished gasoline and exported only 136,000 barrels per day, or about 1.5% of consumption.").

[13] *See, e.g.*, *A Dozen Facts*, *supra* n. 2, at iv-v.

the protection of United States citizens" (emphasis added).[14] For the following reasons, API and NPRA respectfully submit that the public interest will best be served by an FTC decision not to propose a rule.

A. The FTC's Experience With The Petroleum Industry Indicates That New Regulation Is Not Necessary

Despite repeated investigations of the petroleum industry over the past several decades, the FTC has found no evidence of significant harmful or illegal conduct. For instance, the FTC's careful investigation of petroleum industry practices in the aftermath of the shortages and price spikes following Hurricanes Katrina and Rita found no evidence of price manipulation and concluded that firms had behaved competitively.[15] A subsequent investigation in response to rising gas prices in 2006 again found no evidence of price manipulation in the petroleum or gasoline markets, concluding instead that responses by importers and domestic refiners had prevented even higher price increases.[16] Similarly the FTC's investigation of a retail gasoline price spike in the Midwest in 2000 "found no evidence of illegal collusion to reduce output or raise prices. Rather, each industry participant acted unilaterally and followed individual profit-maximizing strategies."[17] These FTC investigations have concluded that the price increases and

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[14] The ANPR likewise recognizes that the FTC has the authority to determine "whether, and if so in what manner, the Commission should promulgate a rule pursuant to Section 811." Prohibitions on Market Manipulation and False Information in Subtitle B of the Energy Independence and Security Act of 2007, 73 Fed. Reg. 25,616 (May 7, 2008) (hereinafter *ANPR*).

[15] *See, e.g.*, *Katrina Report*, *supra* n. 3, at vi ("The evidence collected in this investigation indicated that firms behaved competitively."); at ix ("Evidence gathered during our investigation indicated that the conduct of firms in response to the supply shocks caused by the hurricanes was consistent with competition.").

[16] Federal Trade Commission, *Report on Spring/Summer 2006 Nationwide Gasoline Price Increases* (Aug. 2007) at 25 (hereinafter *Spring/Summer 2006 Report*).

[17] Federal Trade Commission, *Midwest Gasoline Price Investigation* (Mar. 29, 2001) at 2 (hereinafter *Midwest Gasoline Report*).

price spikes under investigation were caused by forces of supply and demand, not anticompetitive or manipulative actions.[18] These findings are consistent with the determinations of other studies.[19]

In light of its enforcement experience and careful study, the FTC has consistently and correctly reached the conclusion that new regulation is not necessary. For instance, in its *Katrina Report* investigation, although the FTC used a definition of "price manipulation" similar to the definition set forth on page 23 of the ANPR,[20] the Commission expressly concluded that certain conduct falling within this definition is not – and in the FTC's view should not be – illegal. Moreover, the Commission in its *Katrina Report* pointedly recommended that Congress not adopt price gouging legislation and concluded that the antitrust laws remain the appropriate standard for determining whether unilateral pricing behavior is unlawful: "[T]he Commission cannot say that federal price gouging legislation would produce a net benefit for consumers.[21] … [E]nforcing the antitrust laws strictly to prohibit business behavior that has anticompetitive

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[18] *Spring/Summer 2006 Report*, *supra* n. 16, at 25 (market factors explained increases in the national average retail price, including crude and ethanol price increases, increased consumer demand such as the seasonal effect of summer driving, refining reductions due to MTBE-to-ethanol transition and hurricanes and other external causes); *Katrina Report, supra* n. 3, at 20; *Midwest Gasoline Report*, *supra* n. 17, at Sec. III(B)(1)-(2). In its report on gasoline price changes, the FTC made clear that worldwide supply, demand and competition for crude oil are the most important factors in determining domestic national gasoline prices. *See* Federal Trade Commission, *Gasoline Price Changes: The Dynamics of Supply, Demand and Competition* (2005), at 13.

[19] *See, e.g.,* Zmarak Shalizi, *Energy and Emissions: Local and Global Effects of the Rise of China and India* (World Bank Policy Research Working Paper 4209, 2007); *A Dozen Facts, supra* n. 2 at viii (finding that one lesson from Hurricanes Katrina and Rita is that the petroleum market functions efficiently with "massive supply disruption[s] limited to temporary price increases").

[20] *Katrina Report*, *supra* n. 3 at ii.

[21] *Id.* at 196.

effects will have a major impact in keeping markets free so that prices are set by competitive forces, not by manipulation or 'gouging.'"[22]

B. Section 811 Regulation Would Duplicate Other Rules

Other laws and regulatory regimes already govern conduct that is discussed in the ANPR as potentially covered by Section 811 regulations. Given the potential for harm from ambiguous, duplicative, or overreaching regulation, the public interest would best be served by deferring to these existing statutory and regulatory regimes.

Enforcement of the CEA by the CFTC already reaches much of the conduct discussed in the ANPR. In addition to prohibiting manipulation of the price of commodity futures contracts, the CEA prohibits the manipulation "of the price of any commodity in interstate commerce."[23] The CFTC has taken an expansive view of its jurisdictional reach[24] and has indicated that it will continue to exercise its authority broadly in petroleum markets, including the physical wholesale markets that would be covered by any rule proposed pursuant to Section 811.[25] It is unnecessary and undesirable to overlay a parallel system of FTC regulation to address the same conduct and markets already subject to oversight by the CFTC.[26]

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[22] *Id*. at 197.

[23] 7 U.S.C. § 6(c), 6(d), and 13(a)(2).

[24] The CFTC regards its authority as reaching the regulation of wholesale physical product markets (markets for the actual commodity), and as not limited to regulation of financial instruments traded on a futures exchange. *See, e.g.*, *CFTC v. BP Prods. N. Am., Inc.*, 2006 WL 2176919, No. 06CV3503 (N.D.Ill., 2006) (charging BP traders with manipulating and cornering the physical propane market to artificially inflate prices); *U.S. v. Reliant Energy Servs., Inc.*, 420 F. Supp.2d 1043 (N.D. Cal. 2006) (holding that the "criminal manipulation provision of § 9(a)(2) [of the CEA, 7 U.S.C. § 13(a)(2),] is not limited to futures contracts"); *In re Marathon Petroleum Co., LLC,* 2007 CFTC LEXIS 57, CFTC Docket No. 07-09 (Aug. 1, 2007) (settlement order for attempted manipulation of the price of spot crude oil on a single day).

[25] Press Release, Commodity Futures Trading Commission, *CFTC Announces Multiple Energy Market Initiatives* (May 29, 2008) (announcing the CFTC's investigation into "practices
(continued…)

The Sherman Act prohibits suppliers in the petroleum industry and other industries from engaging in anticompetitive conduct, whether it be collusion among competitors or exclusion that may lead to monopoly.[27] The FTC has indicated that it will continue aggressively to enforce the antitrust laws in petroleum markets,[28] and state attorneys general and private plaintiffs also are prepared to bring suits against petroleum suppliers.[29] Much of the conduct discussed in the ANPR as potentially the subject of Section 811 regulation already is governed by the antitrust laws, and in some cases has been expressly determined to be beneficial and lawful under the antitrust laws. Promulgating Section 811 rules that cover, or could be interpreted to cover, the same conduct would create uncertainty among market participants about

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surrounding the purchase, transportation, storage, and trading of crude oil and related derivative contracts") *at* http://www.cftc.gov/newsroom/generalpressreleases/2008/pr5503-08.html [hereinafter *CFTC Press Release*]; *see also* Bart Chilton, Commissioner, CFTC, *Speech before the Futures Industry Association, Law and Compliance Luncheon* (Oct. 16, 2007) at 3 (stating that the CFTC "continue[s] to guard against manipulation" and mentioning BP as a case the agency "vigorously pursued") (hereinafter, *Chilton Speech*).

[26] Any FTC rule that was construed as reaching oil pipelines would, in addition, duplicate FERC regulation, given the jurisdiction that agency already exercises over the oil pipeline industry.

[27] *See, e.g.*, *United States v. Socony-Vacuum Oil Co.*, 310 U.S. 150 (1940).

[28] *See, e.g., Gasoline Prices, Oil Company Profits, and the American Consumer: Hearing Before the Subcommittee on Oversight and Investigations of the House Comm. on Energy and Commerce*, 110th Cong. 1st. Sess. (May 22, 2007) (prepared statement of the Federal Trade Commission presented by William E. Kovacic, Commissioner at 10) (stating that "the Commission aggressively polices anticompetitive conduct" in the petroleum industry and that when the facts suggest anticompetitive behavior, the Commission will challenge such conduct).

[29] *E.g., Marathon Petroleum Co. LLC v. Stumbo*, 528 F. Supp.2d 639 (E.D. Ky. 2007) (dismissing countersuit in attorney general action alleging price gouging); *Madani v. Shell*, No. C07-04296, 2008 WL 268986 (N.D. Cal. Jan. 30, 2008) (action by branded dealers claiming § 1 price fixing violations by Shell and Texaco relating to the companies' joint venture operations); *Sheridan v. Marathon Petroleum Co., LLC*, 2007 U.S. Dist. LEXIS 74022 (S.D. Ind. 2007) (gasoline retailers alleged that refiner and financial institutions engaged in tying and price fixing in violation of Section 1 of the Sherman Act).

whether conduct that today is clearly allowed by the antitrust laws might tomorrow be challenged by the FTC under its market manipulation authority.[30]

C. A New Regulatory Overlay Could Harm The Public Interest

New rules have the potential to over-deter, discouraging beneficial market activity. The ANPR's examples themselves highlight the risk, as they ask for comments on the potential application and effect of Section 811 regulations on such routine and ordinary business action as seasonal inventory planning, routine maintenance planning and announcements, sales to foreign buyers, and other regular and desirable conduct. Without evidence of significant "manipulative" conduct in the petroleum industry, the costs of additional enforcement and their impact on competitive market activity outweigh any benefit to be gained from the FTC applying Section 811 to conduct that is already addressed by other rules.

VI. IF THE COMMISSION DECIDES TO PROPOSE A RULE, IT SHOULD CRAFT IT NARROWLY

For the reasons stated above, API and NPRA believe the public interest would best be served if the FTC did not propose a rule pursuant to Section 811. If the FTC decides nonetheless to propose a rule, such a rule should adhere closely to the statutory text as illuminated by the legislative history, and therefore should target solely manipulation through deceptive or fraudulent statements or conduct. It is also vital that any such rule be crafted narrowly so as to minimize duplication and inconsistency with other applicable laws and regulatory regimes, and to avoid deterring pro-competitive conduct or impeding the normal,

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[30] It is also important to note that parties would have other avenues under state fraud laws for seeking damages caused by misrepresentation or other deceitful behavior. *See generally*, First Amended Complaint at 99, *In re Enron Corp. Securities Litigation*, 465 F. Supp.2d 687 (S.D. Tex. 2002) (No. H-01-3624) (claiming state law fraud violations relating to false and material misrepresentations made by Enron). Section 811 should not be developed in a manner that would be duplicative of those anti-fraud laws.

efficient operation of petroleum markets. Consistent with these principles, any rule should require that, before a party a can be held liable under Section 811, that party must at a minimum be shown to have:

- Knowingly made a deceptive or fraudulent statement or engaged in a deceptive or fraudulent act;
- In connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale;
- With the specific intent to affect the market price for a physical crude oil, gasoline, or petroleum distillates product; and
- Caused such market price to deviate materially from the market price that would have existed but for the deceptive or fraudulent statement or act.

We explain the rationale for each of these elements in further detail below.

A. Deceptive Or Fraudulent Statement Or Act

1. Congress Intended To Limit Section 811 To Deceptive Or Fraudulent Conduct

The core of Section 811 is a prohibition on the use of any "manipulative or deceptive device or contrivance." As the ANPR recognizes, this formulation derives from the market manipulation provisions in Sections 315 and 1283 of the Energy Policy Act of 2005, and ultimately from Section 10(b) of the Securities Exchange Act of 1934. The implementing regulations for both of those statutes have at their core, as a precondition for liability, that a defendant make or engage in a deceptive or fraudulent statement, act or practice.[31] In view of Congress' conscious decision to model Section 811 on these precedents and to entrust its

[31] Securities Exchange Commission, Rule 10b-5, 17 C.F.R. 240.10b-5; Federal Energy Regulatory Commission, 18 C.F.R. Part 1c: Prohibition of Energy Market Manipulation: Final Rule, 71 Fed. Reg. 4,244 (Jan. 26, 2006) (hereinafter "FERC Order No. 670").

enforcement to the FTC, any rule implementing Section 811 should similarly be limited to manipulation involving deceptive or fraudulent conduct.

The legislative history of Subtitle B shows that Congress intended Section 811 to focus on deceptive and fraudulent conduct. Subtitle B's chief sponsor, Senator Cantwell of Washington, made clear that she expects any FTC rule implementing Section 811 to target deceptive or fraudulent conduct. In a letter of April 8, 2008, to the Federal Trade Commission, she wrote:

> [T]he new authority granted to the FTC is modeled on the antimanipulation authorities utilized by other agencies such as the Securities and Exchange Commission (SEC) and the Federal Energy Regulatory Commission (FERC).
>
> . . . [T]he Supreme Court has "read the words 'manipulative or deceptive' used in conjunction with 'device or contrivance'" to cover only "knowing or intentional conduct." *Ernst & Ernst v. Hochfelder*, 425 U.S. at 197. The word "manipulative," it has said, "connotes intentional or willful conduct designed to deceive or defraud . . . by controlling or artificially affecting . . . price[s] . . ." 425 U.S. at 199. It means "practices . . . that are intended to mislead . . . by artificially affecting market activity." *Santa Fe Industries v. Green*, 430 U.S. 462, 476 (1977).[32]

2. The FTC Should Take Account Of The Specific Nature Of The Petroleum Industry

Although Section 811 was modeled on analogous provisions of the EPA and the SEA, Subtitle B does not require the FTC to follow the SEC and FERC models in every respect.

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[32] Similarly, in a floor statement introducing the language that was ultimately enacted as Section 811, Senator Cantwell said that "[t]hese measures are based on provisions in the recently enacted bipartisan energy bill." 151 Cong. Rec. S10238 (daily ed. Sept. 20, 2005).

Subtitle B's other provisions confirm that Congress's intention in Section 811 was to target deceptive or fraudulent conduct. Section 813 states that a violation of Subtitle B is enforceable "as an unfair or deceptive act or practice." Section 815 asserts that nothing in Subtitle B "shall be construed to modify, impair, or supersede the operation of any of the antitrust laws."

While the EPA explicitly requires FERC to interpret "manipulative or deceptive device or contrivance . . . as those terms are used in section 10(b) of the Securities Exchange Act of 1934,"[33] Section 811 contains no such instruction. The petroleum markets covered by Section 811 differ in a number of important respects from the securities markets governed by SEC Rule 10b-5 and the energy markets regulated by the FERC Manipulation Rule. Congress has delegated to the FTC the task of defining any rule proposed pursuant to Section 811 based on the FTC's vast industry-specific expertise developed over the course of numerous investigations of petroleum markets. In doing so, Congress also granted the FTC the flexibility to deviate from the specific courses chosen by the SEC and FERC as needed to suit the particular characteristics of the petroleum markets.

API and NPRA recognize that the SEC and FERC, in interpreting their respective market manipulation rules, have at times adopted a broader view of fraud and prosecuted conduct that goes beyond both the FTC's and the common law definition of deception or fraud.[34] Nevertheless, Section 811 liability should be appropriately tailored to the specific nature of petroleum wholesale markets and reflect the significant differences between those markets and the securities and commodities markets that these other agencies regulate. The broader concept of manipulation employed by these other agencies, which seeks to curtail informed or strategic trading that does not involve fraud, does not translate well to physical markets for petroleum

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[33] Energy Policy Act of 2005, Pub. L. No. 109-58, 109th Cong. 2d Sess., §§ 315, 1283.

[34] *See, e.g.,* Order to Show Cause and Notice of Proposed Penalties re: Amaranth, 120 F.E.R.C. ¶ 61,085 24 (2007) (defining fraud to include "any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market") (citations omitted). A district court recently denied a motion to dismiss a CFTC manipulation complaint "not premised on allegations of fraud." *U.S. Commodity Futures Trading Comm'n v. Amaranth Advisors, LLC*, No. 07 Civ. 6682 (D.D.) 2008 WL 2123323, * 7 (S.D. N.Y. May 21, 2008).

products, where it may result in significant over-deterrence that inhibits pro-competitive conduct and undermines the efficient operation of the price mechanism.[35]

3. Any Rule Should Not Make "Pure Omissions" Unlawful

Consistent with this, API and NPRA urge that the Commission retain its long-standing distinction between pure omissions on the one hand and omissions of information that are necessary to correct a misimpression on the other.36 The Commission historically has not considered pure omissions to be deceptive. It has, however, found an omission to be actionable deception when the representation made would be misleading in a material respect without the omitted information. This balanced approach contrasts with the more extreme position regarding omissions that may constitute market manipulation adopted by FERC in a recent case.37

4. Any Rule Should Not Create New Disclosure Obligations

Any rule that the Commission proposes pursuant to Section 811 should not create new disclosure obligations similar to those imposed on securities market participants by SEC regulations. Obligations of this kind would be entirely inappropriate given the different commercial context in which petroleum wholesale transactions take place. For example, while securities regulations govern the sale of securities to unsophisticated consumers, transactions in the petroleum markets covered by Section 811 generally involve bilateral contracts between experienced, sophisticated market participants dealing with each other at arm's length. Moreover, in the securities context, the availability of accurate information about issuers of

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[35] Moreover, as discussed in Part IX.F of these comments, the concept of an "artificial price," which the CFTC uses in enforcing its market manipulation authority, does not apply well in physical markets for commodities.

[36] *See re Int'l Harvester*, 104 F.T.C. 949 (1984) (Final Order).

[37] *See Amaranth* Order to Show Cause, *supra* n. 34, at 28 (failure to disclose that market prices are being artificially depressed constitutes a form of market manipulation).

securities is critical to evaluating the securities' market value and to avoiding disparities in market participants' access to such information. For these reasons, the market for securities is heavily regulated and governed by long-standing rules that mandate detailed disclosures by issuers, impose fiduciary relationships on issuers and brokers, and prohibit trading based on "insider" information.

These disclosure obligations, fiduciary relationships, and insider trading prohibitions do not – and should not – apply to the petroleum markets covered by Section 811. Participants in these markets routinely invest substantial resources in order to estimate future supply and demand of key inputs and outputs, and they rely on this confidential proprietary information in deciding whether and at what price to trade in these commodities. Consumers benefit from petroleum market participants making these investments and not sharing forecasts with competitors, which diversifies the effort to develop accurate information and reduces risk. Moreover, sustaining incentives for firms to invest in making these forecasts increases the likelihood that the market as a whole will react efficiently and nimbly to changes in supply and demand.

Significantly, Congress has recently affirmed that the CEA does not impose disclosure requirements akin to those arising in the context of the securities law. Recent amendments to the anti-fraud provision of the CEA in the CFTC Reauthorization Act of 2008 specifically provide that the CEA does not obligate transaction counterparties to disclose to each other "nonpublic information that may be material to the market price . . . of the commodity or transaction, except as necessary to make any statement made to the other person in or in

connection with the transaction not misleading in any material respect."[38] Similarly, the FERC Final Rule indicates that FERC does not interpret its market manipulation provisions as imposing SEC-style disclosure requirements.[39] Any FTC rule should be equally clear that Section 811 does not impose disclosure or related requirements on participants in petroleum markets.

5. The Precautionary Approach To Deceptive Conduct Under The FTC Act Is Inapplicable To Section 811

The differences between petroleum wholesale markets and consumer markets require the FTC to distinguish between deception for the purposes of Section 811 and deceptive practices for purposes of the Commission's consumer protection responsibilities. As discussed above, transactions in petroleum wholesale markets generally take place between experienced and sophisticated parties. A party to a wholesale petroleum transaction that believes it has been misled by its counterparty can pursue common law fraud remedies and generally has the means to do so. The FTC's deception analysis, by contrast, "focuses on risk of consumer harm, and actual injury need not be shown."[40] This precautionary approach makes sense because the FTC Act protects consumers -- who are less well placed to detect and remedy fraud -- and therefore is preventive in nature, with an injunction barring the challenged conduct as the primary remedy. Thus, there is no need, under the Commission's consumer protection responsibilities, to distinguish between actual deception and attempted deception – the Commission seeks to prevent both.

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[38] *Food, Conservation, and Energy Act of 2008*, Pub. L. No. 110-234, 110th Cong. 2d Sess., § 13102(b).

[39] *See* FERC Order No. 670, *supra* n. 31, at 4251-52 (clarifying that its anti-manipulation rule imposes "no new affirmative duty of disclosure" in the "arm's-length, bilateral negotiations that are typical in wholesale energy markets").

[40] *Int'l Harvester*, 104 F.T.C. at 1056.

In contrast, a rule proposal pursuant to Section 811 would be punitive, not preventive, imposing substantial penalties to punish illegal conduct. Also, Section 811 authorizes the Commission only to prohibit actual manipulation, not attempted manipulation. The essential difference between actual and attempted manipulation is whether there in fact is an effect on price. As explained in more detail in Part VI.D of these comments, parties should not be liable under any rule implementing Section 811 unless a deceptive or fraudulent statement or act causes the market price to deviate materially from the price that would have existed but for the deception or fraud.

B. In Connection With Purchase Or Sale At Wholesale

On its face, Section 811 applies only to conduct undertaken "in connection with the purchase or sale of crude oil[,] gasoline or petroleum distillates at wholesale." API and NPRA urge that any rule proposed under Section 811 not reach beyond this statutory language.

1. No Application To Retail Transactions

API and NPRA agree with the statement in the ANPR that "Section 811 does not extend to retail sales of gasoline"[41] – or for that matter to retail sales of any petroleum-based products. Congress expressly limited Section 811 to purchases and sales at wholesale, and nothing in the statutory language or legislative history justifies extending the reach of Section 811 to retail transactions.[42]

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[41] ANPR, *supra* n. 14, at 26; 73 Fed. Reg. at 25620.

[42] In the event the FTC decides to propose a rule, API and NPRA urge it to define the term "petroleum distillates" so as to provide greater clarity as to the scope of covered products for purposes of Section 811. In our view, petroleum distillates should be defined to cover diesel fuel, kerosene, jet fuel, and heating oil, without prejudice to the ability of the Commission and other regulators to prohibit market manipulation affecting other petroleum distillates under other statutory regimes.

2. Exclude Transactions At The Rack And At Or Below The Terminal From The Definition Of "Wholesale"

In the event the Commission proposes a rule, API and NPRA urge the FTC to clarify that the term "wholesale" as used in Section 811 covers only bulk transactions in the spot pipeline, tank or marine market, and does not include so-called "rack" transactions, DTW sales to dealers, or other terminal-level sales.

First, our understanding is that none of the other regulatory agencies have construed their jurisdiction to cover transactions at or below the terminal level. Rather, they confine their enforcement efforts to large, market-based bulk transactions. *Second*, wholesale rack pricing decisions are qualitatively different than those that arise in market-based bulk transactions; they generally are set by the rack supplier and tend to remain in effect for a period of time and apply to a variety of different purchasers. The pricing for sales to individual dealers is even further removed from anything like a commodities "market price." *Third*, the potential for market-manipulation-based harm is considerably less for sales at or below the terminal level, so extending Section 811 to cover these types of transactions would not be a wise use of the Commission's resources. *Fourth*, the Commission already has an effective wholesale price monitoring program.[43]

Typically, traders negotiate prices for bulk transactions based on reference markets such as NYMEX or on prices published by firms such as Platts or Argus. Often, completed deals are reported to these same firms, which collect these data and use them to establish a market assessment for the day. Rack prices, by contrast (which in industry parlance are often referred to as "wholesale rack prices"), are the prices at which a particular petroleum

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[43] *See Katrina Report*, *supra* n. 3, at 2.

supplier is willing to sell a certain product at the terminal load rack in truckload quantities. These prices — and prices for sales to individual branded dealers — are typically based on the supplier's individual view of the market, including its own supply and perceived demand, and such transactions are generally not reported to price publication firms.

Accordingly, API and NPRA urge the FTC to restrict the definition of "wholesale" in Section 811 to bulk spot transactions and to exclude from that definition transactions at the rack, DTW, or otherwise at or below the terminal level.

3. No Application To Supply Decisions Unconnected To Wholesale Transactions

Any rule proposed pursuant to Section 811 also should not apply to supply decisions that are unconnected to wholesale purchases or sales of a covered petroleum product – such as decisions concerning upstream production and operations, refining decisions, facility maintenance and upgrades, the management of inventory levels, whether to supply a market and with which products, and where output should be distributed. Section 811 expressly states that it applies only to conduct undertaken "in connection with the *purchase or sale* of crude oil[,] gasoline or petroleum distillates *at wholesale*" (emphasis added). The only reasonable interpretation of this language is that Section 811 does not apply to decisions or conduct that are *not* connected to a specific "purchase or sale . . . at wholesale." Interpreting Section 811 more broadly would exceed the rulemaking authority granted to the FTC by the statute itself.

Extending Section 811 to such product, operational, and supply decisions would also run a substantial risk of disrupting competitive activity in petroleum markets. As noted above, firms in the petroleum industry necessarily undertake a wide range of business decisions that are unconnected to the "purchase or sale . . . at wholesale" transactions that are the focus of Section 811. If Section 811 does not clearly exclude ordinary production, operational, and

supply decisions, market participants would likely be compelled to factor into every aspect of their business strategy the risk of challenge under Section 811. In an effort to avoid such risks, companies would generally take a more conservative approach, leaving them less able to respond with agility and creativity to market disruptions and market opportunities.

Such a result would have significant adverse consequences for consumers. In the short run, the risk of liability could inhibit the responses of market participants to price changes, resulting in distorted prices and an inefficient distribution of resources across geographic markets. In the longer run, the risk of liability could adversely affect investment decisions because firms might be unwilling to invest in additional facilities if routine production, operational, and supply decisions are subject to potential liability. These risks are best avoided by making clear that ordinary production, operational, and supply decisions are outside the scope of any rule implementing Section 811.

Indeed, if the Commission proposes any rule pursuant to Section 811, it should consider expressly exempting from such rule conduct that is essential to the efficient functioning of petroleum wholesale markets. Express exemptions from such rules would avoid harm to consumers and the economy from over-deterring beneficial conduct. Exemptions might cover categories of conduct such as: (i) performing contractual obligations to supply existing customers; (ii) decisions on the amount of product sold to a particular customer at a particular time; (iii) investments in facility maintenance or capacity upgrades; (iv) day-to-day operational decisions, including choice of a mix of products to refine; and (v) establishment and management of product inventory levels.

4. Application Limited To Physical Transactions

In addition, Section 811 should apply only to transactions in the physical commodities themselves and should not be interpreted to cover listed or over-the-counter

("OTC") derivatives contracts. The CFTC currently has exclusive jurisdiction over listed derivatives (*e.g.*, futures) and actively monitors and prosecutes manipulation in the listed derivatives and OTC energy markets.[44] Extending Section 811 to such transactions would create unnecessary regulatory overlap, potentially divergent obligations, and additional compliance costs on industry – costs that ultimately would be borne by consumers. Thus, the FTC should limit its oversight to deceptive or fraudulent conduct that actually involves purchases or sales of physical products – so-called jurisdictional transactions.[45]

C. Scienter

Any rule proposed under Section 811 should impose liability *only* if a party acts with specific intent to affect the market price for a physical crude oil, gasoline, or petroleum distillates product. A specific intent standard is supported by the text of Section 811 and other provisions in Title B, by the legislative history, and by judicial precedent interpreting nearly identical language in other statutes. Moreover, a specific intent standard would minimize the risk of imposing conflicting legal obligations on market participants or chilling pro-competitive conduct.

Section 811 by its terms limits the FTC to enacting a rule that would prohibit a person from using or employing a "manipulative or deceptive device or contrivance." The terms

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[44] Under the CEA, energy commodities are treated as "exempt" commodities. *See Commodity Exchange Act* § 1a(14). Although transactions in exempt commodities between commercial parties (referred to as Eligible Contract Participants if they meet specific net worth or asset criteria) are exempt from many provisions of the CEA, they remain subject to the CEA's anti-manipulation provisions. *Id.* § 2(h).

[45] The ANPR also invites comment on whether the "in connection with" language of Section 811 should adopt the position of the FERC Final Rule to mean that "'in committing fraud, the entity must have intended to affect, or have acted recklessly to affect, a jurisdictional transaction.'" ANPR, *supra* n. 14, at 26, 73 Fed. Reg., at 25621 (*quoting* 71 Fed. Reg. 4249) (internal quotations omitted). In our view, issues of intent are more appropriately addressed under the scienter requirement, which we discuss in the following section of these comments.

"manipulative" and "deceptive" are generally understood to denote conduct that is deliberately intended to deceive. As the Supreme Court held, in interpreting identical language in Section 10(b) of the Securities Exchange Act, "[t]he words 'manipulative or deceptive used in conjunction with 'device or contrivance' strongly suggest that § 10b was intended to proscribe knowing or intentional misconduct. . . . It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[46]

The conclusion that Section 811 requires specific intent also finds support in Sections 812 and 814 of Subtitle B. Section 812 makes it unlawful for a person to report false or misleading information to a Federal department or agency, but only if "the person *intended* the false or misleading data to affect data compiled by the department or agency . . ." (emphasis added). Given that Congress requires the FTC to establish a specific intent to manipulate with respect to statements made to Federal agencies – which rely on the good faith and honesty of reporting parties – it is illogical to think that Congress would have simultaneously intended the FTC, pursuant to Section 811, to adopt a more lenient standard of scienter in regulating arm's-length transactions between sophisticated commercial parties. The fact that Section 814 authorizes penalties of $1 million per day reinforces the conclusion that Congress intended Section 811, like Section 812, to apply only to intentionally deceptive or fraudulent statements and conduct.

The legislative history supports this reading of Subtitle B. As noted above, Senator Cantwell, one of the principal sponsors of Section 811, has described Congress's intent

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[46] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, 199 (1976); *accord Aaron v. SEC*, 446 U.S. 680, 690 (1980).

in adopting Section 811 and its focus on "manipulative or deceptive device[s] or contrivance[s]" as follows:

> [T]he Supreme Court has "read the words 'manipulative or deceptive' used in conjunction with 'device or contrivance'" to cover only "knowing or intentional conduct." *Ernst & Ernst v. Hochfelder*, 425 U.S. at 197. The word "manipulative," it has said, "connotes intentional or willful conduct designed to deceive or defraud . . . by controlling or artificially affecting . . . price[s] . . ." 425 U.S. at 199. It means "practice . . . that are intended to mislead . . . by artificially affecting market activity." *Santa Fe Industries v. Green*, 430 U.S. 462, 476 (1977).[47]

A specific intent requirement for Section 811 would also help minimize regulatory conflicts by ensuring that both physical and derivatives transactions for petroleum products are subject to identical scienter standards. Courts have interpreted the CEA's market manipulation provisions to require proof of specific intent.[48] Thus, adopting a specific intent standard in the implementing rules of Section 811 would ensure that a consistent standard is applied to transactions over which the FTC and the CFTC may exercise overlapping jurisdiction.

Finally, a specific intent standard would appropriately target situations in which parties actively seek to manipulate market prices, while minimizing the risk that parties would be chilled from engaging in lawful competitive commercial behavior that merely affects market prices.

Some federal courts of appeals, interpreting similar language in Section 10(b) of the SEA, have held that liability may be imposed on a showing of "recklessness." However, the

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[47] Letter from Sen. Cantwell to FTC Commissioners (Apr. 8, 2008).

[48] *See, e.g.*, *Cargill, Inc. v. Hardin*, 452 F.2d 1154, 1163 (8th Cir. 1971); *In re Ind. Farm Bureau Coop. Ass'n,* [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,796, 1982 CFTC LEXIS 25, at *14 (Dec. 17, 1982); *In re Hohenberg Bros. Co.*, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,271, 1977 CFTC LEXIS 123, at *22-23 (Feb. 18, 1977); *Frey v. Commodity Futures Trading Comm'n*, 931 F.2d 1171, 1175 (7th Cir. 1991).

rationale for adopting a recklessness standard under Section 10(b) does not apply here. The value of securities is closely linked to the publicly available information about the issuer; therefore, the securities laws seek to ensure that information is accurate and to limit use of material, non-public information. These interests also underlie the fiduciary duties the SEA imposes on brokers and issuers. Given these disclosure obligations and fiduciary duties, imposing liability for "recklessness" arguably serves the underlying purposes of Section 10(b).

The nature of transactions in physical commodities markets, such as petroleum wholesale markets, does not call for similar disclosure obligations or fiduciary duties.[49] Importing a "recklessness" standard from the highly regulated securities markets into unregulated petroleum wholesale markets would create new market uncertainty. It would also impose a novel "industry standard of care" on participants in a market that is currently marked by vigorous competition.[50]

Furthermore, simple recklessness is not a sufficient basis for liability even under Section 10(b). Rather, most courts have held that this Section reaches only highly unreasonable conduct that is effectively tantamount to an intent to deceive.[51] Likewise, although FERC, in its Final Rule implementing the market manipulation provisions of the Energy Policy Act of 2005, adopted a similar recklessness standard, it emphasized that this standard "is not intended to

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[49] *See* Part VI.A, *supra*.

[50] We recognize that FERC recently adopted a recklessness standard in its Final Rule implementing the market manipulation provisions of the Energy Policy Act of 2005. *See* FERC Order No. 670, *supra* n. 31, 71 Fed. Reg. at 4254. FERC's historical role as a rate-setting agency, and its broad authority to ensure "just and reasonable rates" in regulated energy markets, distinguishes it from the FTC's role should it decide to propose a rule pursuant to Section 811.

[51] *See*, *e.g.*, *Sundstrand Corp. v. Sun Chem. Corp*, 553 F.2d 1033, 1045 (7th Cir. 1977) (en banc) (defining recklessness under the securities laws as "an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.").

regulate negligent practices or corporate mismanagement, but rather to deter or punish fraud in wholesale energy markets."[52] Thus, if the Commission, contrary to the recommendation offered here, were to adopt a recklessness standard in its implementing rules for Section 811, it should ensure that the standard it adopts is at least as strict as that adopted by the courts under Section 10(b).

In summary, given that Congress explicitly limited Section 811 to markets comprised exclusively of sophisticated commercial parties dealing with each other at arm's length, anything less than a specific intent standard would chill dynamic competitive behavior and would likely deter firms from acting on accurate market indications for fear of inadvertently incurring liability.

D. Effect On The Market

Any rule proposed pursuant to Section 811 should impose liability only if the deceptive or fraudulent conduct at issue caused the market price of a physical crude oil, gasoline, or petroleum distillates product to deviate materially from the market price that would have existed but for the deceptive or fraudulent statement or act. Applying Section 811 to conduct that does not cause a material deviation in market prices would unduly expand the FTC's regulatory oversight and would likely harm consumer welfare in the long run by chilling competitive market behavior, thereby potentially increasing prices.

Section 811 should not be viewed as imposing federal regulatory oversight on conduct that is, and properly should be, the province of anti-fraud and contract law. Allegations of fraud and deception are not uncommon in commercial and contract disputes. Unless the FTC

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[52] FERC Order No. 670, *supra* n. 31 at ¶ 5, 73 Fed. Reg. at 25617.

requires an appropriate connection between challenged conduct and a material deviation in *market* prices, it runs the risk of having to police every routine commercial dispute as a potential violation of Section 811.

Such a requirement is also consistent with the statutory framework of Subtitle B. As discussed in Part VI.A of these comments, in enacting Section 811, Congress specifically sought to target the actual manipulation of prices in petroleum wholesale markets. Section 811 does not prohibit attempted market manipulation. In this respect, Section 811 differs from Section 9(a)(2) of the CEA, which expressly prohibits an "attempt to manipulate." The fact that Congress chose not to create an "attempt" violation in Section 811 reflects Congress' focus on deceptive or fraudulent conduct that actually causes a material deviation in market prices.

VII. CONCERNS WITH THE FTC'S PROPOSED DEFINITION

For the reasons set forth above, we believe the elements set forth herein appropriately reflect the statutory text and legislative history of Section 811 and minimize the risks of imposing conflicting obligations on market participants or impeding the normal, competitive operation of petroleum wholesale markets. The proposed definition set forth in the ANPR, on the other hand, would be inconsistent with the statutory language and would not advance the public interest.[53] We are particularly concerned with two aspects of that definition.

A. "For The Purpose Or With The Effect."

The definition set out in the ANPR would encompass conduct undertaken "for the purpose or with the effect" of causing certain market effects. The use of the disjunctive "or" in

[53] *See* ANPR, *supra* n. 14 at 23, 73 Fed. Reg. at 25620 (requesting comment on whether to define market manipulation as "knowingly using or employing, directly or indirectly, a manipulative or deceptive device or contrivance — in connection with the purchase or sale of crude oil, gasoline, or petroleum distillates at wholesale — for the purpose or with the effect of increasing the market price thereof relative to costs").

this phrase suggests that liability could be imposed upon a party even if it did not intend to cause such market effects or could not reasonably have anticipated such effects.

As discussed in Part VI of these comments, API and NPRA believe that liability should attach under Section 811 only upon proof of deceptive or fraudulent conduct engaged in with the specific intent to affect the market price for a covered petroleum product and where that conduct causes such market price to deviate materially from the market price that would have existed but for the deception or fraud. Imposing liability based solely on market effects could penalize firms for actions or statement made without any deceptive intent and undercut legitimate efforts to respond to market prices or other market indications.[54] Such a broad, effects-based liability standard runs a serious risk of deterring a wide range of profit-maximizing behavior that is competitively neutral or pro-competitive.

Conversely, imposing liability based solely on intent risks penalizing conduct by entities that have no realistic prospect of manipulating the market, whether through deceptive conduct or otherwise. It would also empower the Commission to impose massive penalties of up to $1 million per day absent any proof of effect on market prices.

B. "Increasing Market Price Relative To Costs"

The definition set out in the ANPR would also impose liability where the purpose or effect of a party's actions was to "increas[e] the [wholesale] market price [of crude oil, gasoline, or petroleum distillates] relative to costs." This aspect of the definition likewise raises

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[54] *See, e.g.*, CFTC Commissioner Sharon Brown-Hruska, *Market Manipulation in Energy Markets,* 23 Futures & Derivatives L. Rpt. 8 (Nov. 2003), at 3 (stating that CFTC requires proof of specific intent to manipulate because "it is not unusual to see prices bend as a result of one market participant's [non-manipulative] trading").

the specter of liability merely for engaging in economically rational commercial behavior of the type one would expect in a competitive marketplace.

Situations may arise in a competitive market where goods become more scarce and prices rise relative to costs despite the fact that the market is functioning properly – *i.e.*, in the absence of market manipulation. The aftermath of Hurricanes Katrina and Rita serve as good examples of this. Each hurricane took considerable refining capacity off line. As a result, certain petroleum products became scarce, prices rose relative to costs, and product was distributed to those regions and consumers that needed them most. The effect of the price rise encouraged more supply of that product to enter the region and to reduce demand, which in turn rendered it less scarce and tended to restore prices to pre-hurricane levels. Thus, the existence of prices rising relative to costs is not evidence of market failure or manipulation. Rather, it can be an essential market indication that gives firms financial incentives to increase production of the good – to the benefit of consumers – and serves to ensure that goods are distributed where they are most needed.

These market dynamics apply with particular force in petroleum wholesale markets because the marginal costs for most firms that purchase and sell petroleum products at wholesale are essentially their anticipated future costs. In other words, the prices these firms charge are based on clearing the market and the costs they anticipate they will incur in replacing the inventory they are currently selling, rather than on the costs they have already incurred in producing or procuring that inventory.[55] Thus, if the anticipated future costs of inputs rise (*e.g.*,

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[55] A definition of market manipulation that required an analysis of price relative to past costs would be unworkable in practice because the industry has no way to record the cost of a specific product or gallon of gasoline already in its inventory. Similarly, for gasoline and distillates sold by a supplier directly from its own refinery production, establishing cost would be difficult if not (continued…)

rising crude oils prices), the current prices of outputs (*e.g.*, refined petroleum products) will rise as well, which in turn will often mean a higher price in relation to the costs actually incurred in producing that product.[56]

In its *Katrina Report*, the FTC defined "price manipulation" in terms similar to those set out in the ANPR – namely, as covering transactions and practices "that tend to increase prices relative to costs and to reduce output."[57] The FTC expressly noted, however, that this definition would capture conduct that was not – and in its view should not be – illegal. As the *Katrina Report* noted,

> Under this definition, 'price manipulation' includes instances in which one or more firms temporarily may each have an incentive and ability to raise prices relative to costs and reduce output because markets have been disrupted by supply problems arising from natural disasters or by sudden and unanticipated changes in demand. In our view, this type of conduct should not be illegal because it entails each firm's independent decisions about how to allocate sales of its products among markets.[58]

The *Katrina Report* also raised the concern that an overly broad prohibition of price manipulation or price gouging could distort market competition and operate in effect as a price control.[59] These concerns apply with equal force to the prohibition on "increasing . . . market price[s] . . . relative to costs" set out in the ANPR's proposed definition.

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impossible. It is also worth noting that different accounting conventions may also lead to different evaluations of cost.

[56] It is worth noting that replacement costs can be particularly difficult to predict in cases of supply disruptions or other abnormal market volatility.

[57] *See Katrina Report*, *supra* n. 3, at ii.

[58] *Id.*

[59] *Id.* at 183 ("[D]istortions caused by controls on prices would be harmful to consumers' economic well-being . . . [I]f there is a 'right' price for a commodity, it is not necessarily the low price; rather, it is the competitively determined market price.")

As indicated above, however, API and NPRA agree that an effect on market prices should be a necessary element for liability under Section 811. The correct standard for determining the existence of an effect on price is whether challenged conduct causes a material deviation in market prices as compared to the market price that would have existed but for the deceptive or fraudulent conduct.

VIII. OTHER ISSUES

A. "In The Public Interest"

The ANPR invites comment on how the FTC may best ensure that any rule it proposes under Section 811 satisfies the statutory requirement that it be "necessary or appropriate in the public interest or for the protection of United States citizens." Specifically, the ANPR asks whether, in view of this language, a Section 811 rule should conform to traditional antitrust analysis.

As discussed in Part V, there are solid grounds to conclude that adoption of a market manipulation rule for petroleum wholesale markets is neither necessary nor appropriate. Numerous FTC investigations have found that the petroleum industry is highly competitive and have further found no evidence of market manipulation. Proposing a rule pursuant to Section 811 is therefore unnecessary and risks making U.S. petroleum markets less efficient, to the ultimate detriment of U.S. consumers.

If the FTC does implement a rule, it should not overlap with existing antitrust rules. Congress made clear that nothing in Subtitle B should be construed to modify, impair, or supersede existing antitrust laws. It is also vital that any such rule be crafted narrowly so as to avoid deterring pro-competitive conduct or impeding the efficient operation of petroleum markets.

B. Penalties

The ANPR also requests comment on how the penalties provided for in Subtitle B should affect the FTC's implementation of Section 811. In an action under Section 13(b) of the FTC Act, the FTC could seek equitable relief in the form of disgorgement from any person who violates Subtitle B. Likewise, in an action under Section 19 of the FTC Act, the FTC could seek relief against any person who violates a rule promulgated under Section 811 or who violates Section 812 as needed to redress injury to consumers, including the refund of money or return of property and the payment of damages. Section 5(m)(1)(A) of the FTC Act permits the Commission to file a federal court civil action against any person who knowingly violates a rule promulgated under Section 811 or knowingly violates Section 812 to recover civil penalties of up to $11,000 per violation. Finally, Section 814(a) of Subtitle B provides that "any supplier that violates section 811 or 812 shall be punishable by a civil penalty of not more than $1,000,000," while Section 814(c) provides that each day of a continuing violation shall be considered a separate violation.

These sanctions, including the risk of substantial civil penalties, represent a significant deterrent. API and NPRA are concerned that, unless any proposed rule contains the elements and safeguards described above, the magnitude of these sanctions could cause firms to implement rigid, burdensome compliance systems that would substantially restrict their ability to engage in efficient and pro-competitive activities.

While many of the sanctions available through the FTC Act can be imposed on "any person," civil money penalties under Section 814(a) are limited to "any supplier" that violates Section 811 or 812. The limitation of civil money penalties under Section 814(a) to "suppliers" rather than "any person" reflects a clear intent by Congress to limit the application of the higher civil money penalties available under Section 814(a) to situations in which firms

supplying wholesale petroleum products to the market engage in deceptive or fraudulent conduct. The focus on suppliers reflects an intent to provide special penalties for firms bringing wholesale petroleum products to market. Therefore, the FTC should construe the penalties provided in Section 814(a) to apply only to violations committed by firms through their sales of covered petroleum products at wholesale and not to actions of firms in connection with their purchases of petroleum products. In order to provide clarity and notice, the FTC should also provide an express definition of the meaning of "suppliers" in connection with Section 814(a). In the event the FTC proposes a rule, API and NPRA propose that "supplier" be defined to mean a person who sells or offers to sell a covered petroleum product at wholesale.

In addition, Section 5(m)(1)(C) of the FTC Act constrains the Commission's ability to obtain penalties against any person. It states: "In determining the amount of such a civil penalty, the court shall take into account the degree of culpability, any history of prior such conduct, ability to pay, effect on ability to continue to do business, and such other matters as justice may require."[60] These considerations should apply to suppliers under any rule proposed pursuant to Section 811 as well.

As the FTC Act requires, the Commission should consider the firm's "history of prior such conduct," including prior enforcement actions against it under Subtitle B of EISA. Moreover, in assessing the impact of a penalty on a firm's "ability to continue to do business," the Commission should consider the potential collateral consequences of significant penalties on the public, on the market, on the firm, and on firm employees not involved in the violation.

[60] 15 U.S.C. § 45(m)(1)(C).

The Commission should consider a number of factors when assessing the "degree of culpability" for a violation. Moreover, EISA provides that in assessing penalties, the court must consider "the efforts of the person committing the violation to remedy the harm caused by the violation in a timely manner." Factors relevant to culpability and efforts at timely remediation include:

- the pervasiveness of wrongdoing within the firm, including the complicity in the violation by senior management;
- the firm's timely and voluntary disclosure of the violation and its willingness to cooperate in the investigation of the violation;
- the existence and adequacy of the firm's pre-existing compliance program;
- the firm's remedial actions, including any efforts to implement an effective compliance program or to improve an existing one, to replace responsible management, and to discipline or terminate employees involved in the violation, to pay restitution, and to cooperate with the relevant government agencies; and
- actions taken by the firm to correct any deceptive statements or conduct.

Finally, and perhaps most importantly, among "such other matters as justice may require," the Commission should consider the nature and seriousness of the violation, including the risk of harm to the public and the extent of harm to the public caused by the violation. Moreover, Section 814(c) of EISA explicitly provides that in assessing penalties, the court must take into account the seriousness of the violation. Justice, deterrence, and the language of EISA all require that penalties should be reasonably related to the magnitude of the harm that the violation caused.

API and NPRA propose that, in the event the FTC proposes a rule, that the FTC explain its approach to balancing these factors in assessing what civil money penalty to seek and

in weighing bases for enhancing or mitigating the appropriate penalty.[61] Such delineation of the factors considered by the FTC in assessing penalties would have beneficial effects for the implementation of the rule by firms in the petroleum industry.

C. Overlapping Jurisdiction

Duplicative or inconsistent regulatory requirements can impose substantial burdens on industry and deter competitive conduct, thereby undermining market efficiency and harming consumers. If the FTC decides to propose a rule pursuant to Section 811, it should be especially careful to avoid two potential sources of regulatory overlap or inconsistency.

First, the FTC should not construe Section 811 to cover the same conduct as the antitrust laws or to create new, industry-specific antitrust rules. Any new FTC regulations should focus on intentional and deceptive conduct that hinders the operation of markets, not business activities that may harm competition in markets, which is covered by the antitrust laws. The text and legislative history of Section 811 show that Congress intended to target deceptive or fraudulent conduct. In contrast, the antitrust laws cover certain unilateral or collusive use of market power, taking advantage of supply and demand conditions, where there is an anticompetitive effect. There is no indication that Congress intended Section 811 to supplement the antitrust laws; on the contrary, Section 815 makes clear that Subtitle B shall not "be construed to modify, impair, or supersede the operation of any of the antitrust laws."

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[61] As explained in Part VI.C, the FTC should require a finding of specific intent in order to establish a violation of Section 811. However, to the extent the FTC proposes a rule with a different scienter standard, the FTC should also consider the level of intent on the part of the perpetrators of the violation and of senior management in assessing the appropriate level of civil money penalties.

Second, the FTC should avoid unnecessary inconsistencies between any rule it issues pursuant to Section 811 and the standards applied by the CFTC in enforcing the market manipulation provisions of the CEA. As indicated in Parts V.B and VI.B.4, the listed derivatives and OTC energy markets, and to a considerable extent the physical petroleum wholesale markets, are already subject to anti-manipulation enforcement by the CFTC. If the FTC decides to prescribe a rule pursuant to Section 811, it is essential that it do everything possible to reduce the potential for duplicative or inconsistent regulation on the petroleum industry. A rule that incorporated at a minimum the elements set forth in Part VI of these comments would, in our view, be most likely to achieve this.[62]

IX. POTENTIAL PRACTICES

The following section comments on the "potential practices" outlined in the ANPR.

A. Examples Relating To Product Supply Decisions

1. The FTC Cannot Make Supply Decisions More Efficiently than Market Participants

Firms in the petroleum industry, as in other industries, routinely make decisions about which products to produce, how much of each product to produce, and where to supply those products. Such production, supply, and distribution decisions in the petroleum industry are enormously complex. The characteristics of the crude oil obtained by a particular refinery will influence the yield of different refined products. Because U.S. refineries usually operate at a high rate of utilization, they typically are forced to decide which products to produce and where to ship them, rather than "how much" to produce. Particular fuels with special characteristics are

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[62] *See, e.g.*, *Chilton Speech*, *supra* n. 25.

acceptable only in certain markets because of regulatory constraints. Transportation networks may constrain the ability to deliver product to certain locations. Moreover, any supply decision has multiple consequences – some products and/or geographic areas receive more supply, while others receive less. One cannot focus exclusively on one area when assessing supply choices.

Competition among firms responding to market demand is the most efficient mechanism for ensuring that supplies are made available and distributed to those markets where they are in greatest demand. Price changes are an essential part of these dynamics – without a change in price, firms would lack a market indication to increase or decrease supplies to the market. Consequently, a supplier generally is free under the antitrust laws to decide to sell or not to sell as it chooses.[63]

The reactions following supply disruptions highlight the way in which firms react to market indications to shift supply. For example, following Hurricanes Katrina and Rita, available supply from the Gulf Coast decreased substantially as many refineries were disabled by the hurricanes. Following the hurricanes, less product was shipped to the East from Gulf Coast refineries and imports from Europe were increased to compensate. Midwest refineries (as well as operating Gulf Coast refineries) increased production, sometimes operating above long term sustainable rates, delaying maintenance, or shifting to other fuels to achieve greater production.

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[63] *See Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko*, *LLP*, 540 U.S. 398, 408 (2004) ("[A]s a general matter, the Sherman Act 'does not restrict the long recognized right of [a] trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to the parties with whom he will deal.'" (quoting *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1966); Statement of Commissioners Anthony, Swindle & Leary, *In re BP Amoco & Atlantic Richfield Co.*, FTC Docket No. C-3938 (Aug. 29, 2000) (noting that exporting crude oil for purpose of increasing domestic prices was lawful and declining to impose restriction on the practice that would be difficult to enforce and ineffective: "[P]eople will be cruelly disappointed if they are led to believe that the export restriction would have a detectable effect on the situation.").

In some instances, products from Midwest refineries were shipped south to the Gulf Coast rather than the usual, and opposite, pattern. The ability to respond quickly to the disruption and price increases was a crucial factor in helping prices stabilize in the affected areas. Within four weeks of Hurricane Rita, price levels had returned to their pre-hurricane levels.[64]

Any rule proposed pursuant to Section 811 that increased the scrutiny of a firm's unilateral decisions would likely chill this behavior and have the perverse effect of prolonging the effects of supply disruptions. If U.S. petroleum companies had faced liability under anti-manipulation regulations for their supply decisions at the time of Hurricanes Katrina and Rita, the price mechanism would not have operated so efficiently, likely resulting in widespread shortages in some areas that could have been avoided if markets had been allowed to function freely, and in delaying the return of normal market conditions.

As discussed in Parts IV and V of these comments, numerous FTC investigations of the petroleum industry have found no evidence that market participants use supply decisions to manipulate market prices. Given the competitive structure of the industry, this is not surprising. In most cases, any individual firm has a relatively small share of supply to a given market and thus lacks a unilateral incentive to restrict output (since restricting output, without the ability to impose a more-than-offsetting increase in market prices, would result in lower profits for the firm).

A rule permitting the FTC to proscribe product supply decisions as market manipulation would effectively substitute the judgment of a regulatory decision maker for that of market participants. The FTC could not exercise such responsibility effectively without a

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[64] *See Katrina Report*, *supra* n. 3, at viii-ix.

tremendous amount of information that the Commission does not have and cannot reasonably obtain. To make product supply decisions in this context, the Commission must know how much of each type of product should be produced at each location, the precise destination to which each type of product should be sent, and whether it should be sent now or later.

For example, a U.S. petroleum company may adopt an internal strategy to store gasoline components during the winter to augment supplies of gasoline during the summer driving season. Imposing liability for "manipulation" if companies decided to withhold supply in the short term frequently would risk creating shortages and price spikes in the longer term. To accurately second-guess decisions about, for example, how much product should be withheld during the winter, the Commission would need perfect knowledge of present and future supply and demand conditions and the precise distribution of product over time that would maximize consumer welfare. Such calculations are beyond the capacity of any individual or organization. That is why we rely on markets to make such decisions and on the profit motive to encourage individual firms to supply the products that consumers value most.

Far from advancing the interests of consumers, a market manipulation rule exposing normal supply decisions to regulatory risk has the potential to undercut firms' efficient reactions to market events. Efficient markets optimize consumer welfare by enabling firms to make supply decisions in response to market indications guided only by their respective self-interest. If firms had to weigh the risk of future regulatory challenge and exposure to the significant penalties authorized by Section 811, supply decisions would be distorted, resulting in a sub-optimal production and supply of products over geographical markets and time.

The risk of liability under Section 811 would also undermine the ability of market participants to plan efficiently for the long term, including through the conclusion of term

contracts. For example, a market manipulation rule that subjected supply decisions to liability might deter a firm from entering into a term contract that was in its overall economic interest, if it would be obligated under the contract to supply product to a particular buyer at a price that may appear from time to time to fall below current spot prices. The risk of potential liability posed by such a broad rule would interfere with the freedom of market participants to enter into long-term supply arrangements, with significant costs for the industry's efficiency and for economic welfare generally.[65] Even without binding contractual commitments, a firm may decide as a matter of business judgment to continue supplying established customers, or market segments and areas that it regards as having higher long-term commercial potential, despite the existence of shortages elsewhere.

Moreover, the ability to produce and supply products across markets requires investment throughout the product chain from refining, pipeline, and terminals to the ultimate delivery of product to consumers. These are unilateral decisions of a firm that are made in response to the market indicators of supply and demand. Through skill, hard work, and investment, firms may find themselves in a position to use those resources and investments profitably. The government should not punish success under the guise of proscribing manipulation, any more than antitrust monopolization law punishes similar success. For example, consider a supply disruption in which, as a result of past investments, a firm has more product to supply than other firms. That firm should be allowed to make supply decisions regarding the sale and distribution of product to maximize its profits; the desire for profit

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[65] The fact that regulators had prohibited long-term contracts for electricity contributed to the meltdown of California's electricity markets. When supplies tightened, utilities could not rely on stable supplies at stable prices that long term contracts would have provided.

motivated the investment in the first place. To second guess such supply decisions would undermine the incentives of market participants to engage in similar, pro-competitive investments.

2. No Affirmative Obligation To Release Inventory During Price Spikes

The ANPR asks whether a firm should be under an affirmative obligation to release inventory following a price spike when the firm knows or should know that the release of the products would be profitable. Again, such a requirement would substitute the judgment of the Commission for that of individual firms making ordinary business decisions, and most likely would make matters worse, not better.

Decisions to build and release inventories are complex. Inventory may be held simply for safety reasons; a certain amount of inventory is necessary, for example, to keep storage tanks from failing under certain conditions. Inventory holdings involve significant storage expenses and substantial working capital expenses. Firms maintain inventories of crude oil and refined product to provide reliable, continuous supply to customers without incurring unnecessary costs. Because refiners and wholesalers have commitments to many, if not most, of their customers, quickly exhausting available inventory is an undesirable option. Indeed, firms often put customers on allocations during supply disruptions to avoid running out of product for any particular customers and thereby harming their relationships with those customers.

During a price spike, the opportunity cost of carrying inventory increases substantially, which provides firms with a significant incentive to sell before the price decreases. In most cases, although prices increase in the short run following a disruption, there is a quick reaction as supplies are diverted from other areas. How long a disruption will last, and how quickly other supplies will become available, however, is often unknown. If inventory is

released too early and the disruption persists, the likely result will be significantly higher prices and much greater scarcity later.

Firms inevitably operate on limited information, and decisions that, with the benefit of hindsight, seem unusual or irrational may simply reflect actions based on limited information available at the time of the decision. The risk that regulators might second-guess such real-time decisions would necessarily make firms more cautious in their building of inventory, search for additional supply, or their willingness to enter into long-term contracts or commitments. Moreover, interpreting Section 811 to impose what would amount to an "inventory release requirement" could pose a serious threat to the normal industry practice of accumulating inventory on a seasonal basis to anticipate peaks in demand for particular products.

Deciding whether and how much inventory to release at any point is a complex judgment that regulators are ill-equipped to second guess. A rule giving the FTC such authority would necessarily require the Commission to decide a host of complex ancillary questions such as the size and duration of a price increase triggering an obligation to release inventory, the appropriate cost basis for assessing whether a release of inventory is profitable (in many disruptions, replacement cost may be unknown), and how much inventory and to whom it should be released. Nothing in the text or legislative history of Section 811 suggests that Congress intended to grant the FTC authority to make such determinations.

B. Public Announcements Relating To Refinery Utilization

The ANPR asks whether public announcements by refiners of planned reductions in overall utilization of refinery plants or reductions due to maintenance or other factors should

be regarded as manipulative under Section 811.[66] Announcements of this type should not be subject to liability under Section 811 unless they at a minimum satisfy the elements set out in Part VI of these comments – in particular that they are deceptive or fraudulent, are made in connection with the purchase or sale of crude oil, gasoline or petroleum distillates at wholesale, with the specific intent to affect the market price of a physical crude oil, gasoline, or petroleum distillates product, and that they cause such market prices to deviate materially from the market price that would have existed but for the deception or fraud. Truthful announcements of downtime, extended or unplanned maintenance, or other statements about capacity utilization increase the efficiency of the market.

A new rule that permitted non-deceptive, non-fraudulent public announcements of downtime to be condemned as market manipulation would do more harm than good. As an initial matter, while announcements other than those related to maintenance are not routine, no standard industry practice exists for making announcements about reductions in refinery utilization. The provision of truthful, accurate information is often helpful for market participants to react rationally to future conditions — knowledge that a market could be undersupplied is in fact a market indication for more product to flow to that market, and for customers to consider how to adjust. Accurate information allows firms to identify potential product shortfalls, and for customers to plan for alternative spot purchases (if necessary) or enter

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[66] Firms typically are careful about announcing capacity reductions (either short term or long term) because of potential liability under the antitrust laws, and some firms have a practice of not making public announcements at all regarding refinery utilization. As discussed below, however, firms have competing responsibilities with respect to some utilization decisions, and, in any event, their actions may indicate they are taking some portion of their refining capacity down.

into short term contractual commitments to ensure consistent supply. In addition, such announcements may achieve other goals, including notices related to safety and security.

The FTC's apparent concern is that announcements might facilitate coordination among refiners to reduce supply. Such coordination is unlikely; in a market where underlying demand factors have not changed, firms will usually have an incentive to respond to a competitor's diminished output by increasing their own output to optimize the value of their inventories. Historical experience in the industry is supportive. Expected production shortfalls generally do not substantially affect prices because suppliers adjust by building up inventories to satisfy contractual commitments, find alternative sources of supply, and increase imports. Incremental refinery economics provide strong incentives to keep refineries running at close to full capacity in the United States. In the last decade, in conditions of both high and low margins, most refineries have run at very high utilization rates.[67]

Moreover, the antitrust laws already prohibit, in appropriate circumstances, efforts by one firm through public communications to signal another firm and thereby collude to reduce output. The Commission should not extend its new authority under Section 811 to prohibit truthful announcements of refinery downtimes or drops in capacity utilization; the effect of such prohibition would likely be to hinder the normal market adjustment process, resulting in greater, not lesser, dislocations of supply.

C. False Reporting Of Price Data To Private Reporting Entities

The ANPR asks whether false or misleading reports to private reporting agencies in thinly traded markets exist, whether these reports are likely to affect market prices, and

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[67] *See Katrina Report*, *supra* n. 3, at 21-22 and 24 (figure 1.1 and tables 1.1 and 1.3).

whether a manipulation rule would be effective and beneficial in policing such practices. We agree that the provision of false or misleading pricing information to private reporting entities could be problematic. Firms rely to varying extents on reporting services to understand industry trends and as a basis for contract pricing. Thus, accurate information from these services is important.

A specific intent requirement is critical if suppliers are not to be deterred by the risk of liability for inadvertently inaccurate or misleading reports. Indices are valuable tools that promote efficiency by disseminating pricing information widely across the petroleum markets. Firms provide data to these indices on a voluntary basis. If the risk of manipulation liability for inadvertently delayed or incomplete reporting were to make some market participants forego reporting altogether, the indices -- and especially those in thinly traded markets -- would be rendered less reliable, thereby decreasing market transparency and detracting from market efficiency.

In practice, the CFTC already polices false reporting and manipulation through false market reports and is increasingly prepared to assert its authority to do so in both the futures and the physical markets for petroleum and other commodities. If the FTC chooses to propose an anti-manipulation rule pursuant to Section 811, it should require proof that a party engaged in a deceptive or fraudulent act specifically intending to create a price for a wholesale petroleum transaction that would not have existed but for the deceptive or fraudulent act.[68]

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[68] *See also Policy Statement on Natural Gas & Electric Price Indices*, 104 F.E.R.C. ¶ 61,121 (2003). This FERC Policy Statement provides a "safe harbor" that presumes accurate and good faith transaction data-reporting by data providers that adopt and follow FERC-established standards for trade data reporting. FERC does not penalize such providers for inadvertent errors in reporting.

D. Denial Of Access To An Unregulated Terminal

The ANPR asks whether denial of access to a non-regulated terminal may be an act of market manipulation subject to Section 811. In view of the many legitimate justifications for such denials of access, API and NPRA urge the FTC to ensure that any rule implementing Section 811 makes clear that it does not apply to such conduct.

Companies that own and operate terminals for storing their own product have made substantial capital investments. To mandate that companies make terminal space available to third parties would effectively punish companies that had the foresight to make these investments and would reward those that did not. Moreover, expanding existing storage to accommodate third parties may require a financial commitment from such parties that they are unable or unwilling to meet. If space in a terminal is already fully utilized, mandating that others be allowed access to the terminal might interfere with customer supply relationships. For example, terminals operated by integrated companies are often tied to refinery production, so mandating that terminal space be allocated to third parties might disrupt refinery production and available product supply in the marketplace. If, on the other hand, space is available in a terminal, the operator will often make this space available to third parties so that the terminal is not underutilized. The operator might, however, have a host of valid reasons for denying access to particular users. For example, a "through-putter" seeking access might lack creditworthiness, or the specifications of the particular petroleum product proposed to be stored might render it unsuitable for commingling.

In addition, the market is capable of responding to any genuine shortage of terminal capacity without burdensome regulation. For many years, there has been a trend for independent logistics companies to own and operate not just pipelines, but terminals. These firms generally exist to serve all qualified market participants by providing storage and

infrastructure connectivity for a fee. The growth of these logistics firms, which are not part of the integrated oil companies, underscores the ability of market forces to provide additional terminal capacity as needed.[69]

E. Whether The FTC Has Authority To Require Submission Of Cost And Volume Data

The ANPR invites comment on whether the FTC possesses the authority to promulgate a rule under Section 811 requiring a person to maintain and submit cost and volume data for wholesale transactions at all levels of trade, refinery or pipeline outage data, and import and inventory volumes. The clear answer is no. On its face, Subtitle B of EISA grants the FTC authority only to promulgate a rule barring the use of certain manipulative or deceptive devices or contrivances, and to enforce provisions prohibiting the supply of certain types of false information to a federal department or agency. Subtitle B does not grant the Commission the authority to impose new reporting requirements on the petroleum industry.

Even if Congress had granted the FTC the authority to require submission of such data, it would be extremely burdensome for companies to maintain and submit enough data to be useful to the FTC, if they could do it at all. And as explained above, even with huge amounts of data, it is beyond the capacity of any organization accurately to second-guess product supply decisions.

F. How Should The Commission Determine An "Artificial Price"?

The ANPR asks how the Commission should determine an "artificial" price and in particular whether prices above competitive levels should be considered "artificial prices." As

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[69] Requiring access to unregulated terminals would also be contrary to antitrust principles, which generally recognize that competitors are not required to share resources with rivals. *See, e.g.*, *Verizon Commc'ns, Inc.*, 540 U.S. at 408.

explained above, API and NPRA believe that any rule prescribed by the Commission should be limited to regulating certain forms of deceptive or fraudulent conduct. We agree that an effect on market prices should be a necessary element for liability under Section 811 and that the standard for determining the existence of an effect on price should be whether the challenged conduct causes a material deviation in market prices as compared to the market price that would have existed, but for the deceptive or fraudulent conduct. Section 811 should not be read, however, to grant the FTC broad authority to regulate prices, whether or not those prices are designated "artificial." Moreover, defining prices above the competitive level as artificial is inappropriate.

Although the CFTC uses the concept of "artificial price" in enforcing its market manipulation authority, this standard originally developed to police the manipulation of futures contracts in which all terms except price are standardized. The wholesale petroleum distribution markets governed by Section 811, by contrast, use many non-standardized contracts and therefore are substantially less-well suited to price-based regulation than the commodities futures markets.

The term "artificial price" does not translate well to physical markets for commodities. Indeed, as the FTC's experience with antitrust enforcement shows, determining the "competitive price" in actual markets is very difficult. The FTC also should not focus on the extent to which prices exceed costs. Textbook economics states that the perfectly competitive price equals marginal cost, but most markets are not perfectly competitive, and the marginal cost standard is extremely difficult to apply in practice. In addition, because petroleum products' prices are volatile due to the unique short run inelasticity of demand and relative inelasticity of

supply, the "competitive" price is a moving target.[70] Moreover, outside of an economics textbook, even the most competitive market will take some time to reach a new equilibrium in response to changed market conditions. Thus, temporary deviations from the longer-term competitive equilibrium price are both normal and expected.

Deeming prices above long-run competitive levels to be "artificial" and market manipulation would amount to price regulation. Long experience, however, shows that price regulation does not benefit consumers. Indeed, experience in the United States and elsewhere demonstrates that such an approach would harm consumers. In the 1970s, when gasoline supplies were reduced, price controls were used with predictably bad results. Instead of allowing prices to respond to market demand and allocate scarce resources appropriately (including by encouraging expansion and new development), the policies during the 1970s resulted in long lines for gasoline and reduced investments.

G. When Should Liability Turn On Purpose, Intent, Or Knowledge?

As indicated above, API and NPRA believe that specific intent to affect market prices always should be required for liability under Section 811.

X. CASE STUDIES

A. BP Amoco/ARCO

The ANPR poses a series of questions about the conditions in which decisions to supply or not to supply a market might violate Section 811, citing as an example the decision of an oil company to export Alaska North Slope ("ANS") crude oil to the Far East "in order to

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[70] Given short run inelastic demand and relatively inelastic supply, competitive prices should be expected to rise substantially during a market disruption. Thus, price increases following disruptions do not imply that firms are exercising market power, even though prices have increased relative to "normal" costs. That is because the relevant costs – the opportunity cost of the marginal source of supply - also rises substantially.

increase spot prices for ANS crude oil on the West Coast."[71] As explained throughout these comments, API and NPRA believe that subjecting product supply decisions to potential liability under Section 811 risks deterring potentially pro-competitive behavior and causing disequilibrium in the petroleum wholesale markets.

There are numerous reasons why a producer of ANS oil might export product to the Far East rather than supply it to the West Coast. For example, if the producer could obtain a higher price in the Far East for the product then, other things being equal, it would be economically irrational to sell it for use on the West Coast. A regulatory scheme that encouraged such irrationality on a large scale would undermine the operation of the price mechanism as a tool for distributing resources efficiently across regions and over time in accordance with underlying forces of supply and demand. Nor should it make any difference that a producer chooses to supply a foreign market in preference to a domestic one in order to secure a better price. As a net importer of crude oil, the United States benefits from the existence of competitive international markets. Indeed, in the weeks following Hurricanes Katrina and Rita, the ability of higher U.S. prices to attract increased supplies of foreign crude oil and gasoline was critically important in helping the country overcome severe disruptions in domestic supply.

There may also be commercial, pro-competitive reasons why a producer of ANS crude oil would export product to the Far East even though prices were higher for supply to the West Coast. For example, the producer might be contractually bound to do so under a long-term

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[71] The ANPR observes that, during its review of the proposed BP Amoco/Atlantic Richfield merger, the FTC had reason to believe that BP had occasionally engaged in this practice. API notes that the FTC ultimately determined that the practice in question did not constitute an antitrust violation.

supply contract with a customer in the Far East. Alternatively, a supplier may be making an investment for future business with new customers to diversify the outlets for its crude supplies and to establish, within those new markets, a reputation as a reliable supplier. A regulatory framework for the implementation of Section 811 that cast doubt on the freedom of producers to make such supply decisions and to honor supply commitments would also undermine the efficiency and competitiveness of U.S. and international wholesale petroleum distribution markets. Profit maximization is a necessary and desirable feature of competitive markets: Long-term contracts are one means by which participants in the petroleum markets strive to maximize their profits. Regulations that constrained the ability of market participants to make decisions on how to distribute crude supplies would inevitably detract from the efficiency of the market, resulting in higher prices for consumers over the longer term.

Although the ANPR's hypothetical does not suggest a pro-competitive rationale for exporting product to the Far East, it also does not suggest that the producer engaged in deceptive or fraudulent conduct. Absent such conduct, the firm's actions would not be subject to liability under the definition proposed in these comments. Moreover, any attempt to impose liability under these circumstances raises a host of analytic challenges. Doing so would require the FTC to determine how much crude oil the producer should have pumped at any particular point in time, the optimal distribution of crude oil between the West Coast and the Far East, both at a particular moment and over time, and the likely responses of its competitors, in both the short and the long run. The FTC cannot make these judgments effectively, and thus should not seek to decide whether shipping more crude oil to one market than another amounted to the use of a "manipulative or deceptive device or contrivance" in violation of Section 811.

B. Enron

In a second case study, the ANPR asks for comments on the relevance to Section 811 of the manipulation of California's energy markets in 2000 and 2001 by Enron and others. While API and NPRA do not condone the type of illegal conduct surrounding Enron's business that has been widely publicized, API and NPRA believe that the activities described in this case study are not especially relevant to a rulemaking under Section 811. For example, the ANPR describes several important characteristics of the markets for electricity and natural gas that facilitated manipulation by Enron and others, which are not shared by wholesale petroleum distribution markets:

- Electricity cannot be economically stored for more than a few seconds. Crude oil, gasoline and petroleum distillates can all be stored for long periods of time.
- Electricity suppliers can increase profits by withholding capacity during peak demand periods when other rival facilities are already committed to production and cannot respond. In part because of the ease of storage of petroleum products, competitors in the wholesale petroleum distribution markets can respond swiftly to decisions by competitors to withhold supplies.

The one manipulative practice described in the Enron case study that is relevant to the wholesale petroleum distribution markets is the submission of false data to private reporting entities. As described on page 36 of the ANPR, California energy market participants provided false reports of natural gas prices and trade volumes to industry publications. As noted above, API and NPRA believe this appropriately could be covered by Section 811, where at a minimum the elements set forth in Part VI of these comments are satisfied.

XI. A PROCEEDING TO PROMULGATE A RULE PURSUANT TO SECTION 811 IS SUBJECT TO THE RULEMAKING PROCEDURES OF SECTION 18 OF THE FTC ACT

The ANPR asserts (p. 4 n.4), 73 Fed. Reg. at 25615 that the issuance of any rule under Section 811 is subject to the notice and comment procedures of Section 553 of Title 5,

U.S.C. (the Administrative Procedures Act), rather than the more demanding procedures of Section 18(a)(1)(B) of the FTC Act.[72] We recommend that the FTC reconsider this issue and conclude that any rules issued under Section 811 are subject to Section 18 rulemaking procedures.

The language of Subtitle B demonstrates that Congress intended the FTC, if it deemed it necessary to promulgate any rule, to do so pursuant to the agency's authority to regulate deceptive acts and practices. Section 811 authorizes the FTC to issue rules applicable to practices that are "manipulative or deceptive." That language tracks the FTC's authority under Section 18 of the FTC Act to "define with specificity acts or practices which are unfair or deceptive acts or practices."[73] Moreover, Section 813 of EISA specifies that violations of any rules promulgated pursuant to Section 811 "shall be treated as an unfair or deceptive act or practice prescribed under a rule issued under section 18(a)(1)(B)." Tellingly, when Congress has intended to allow the FTC to use APA procedures to issue consumer protection rules, it has said so expressly.[74] Congress included no such express authorization for Section 811, thus reinforcing the conclusion that Congress intended the FTC to follow Section 18's rulemaking procedures.

The ANPR contends that APA procedures apply because any rule that the FTC promulgates will be issued under Section 811 of EISA, and not under Section 18 of the FTC Act. But consistent with the language in Sections 811 and 813 of EISA discussed above, any such rule will be issued under *both* Section 811 *and* Section 18, which accordingly triggers the

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[72] 15 U.S.C. § 57a(a)(1)(B).

[73] 15 U.S.C. § 57a(b).

[74] *See, e.g.,* 15 U.S.C. §§ 5711, 6102, 6502, 7607, 7711.

obligation to use Section 18's consumer protection procedures. Moreover, even if the regulations were issued exclusively under Section 811, the obligation under Section 813 to "treat" such regulations "as" consumer protection regulations would require the FTC to use Section 18 procedures.