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

Office of the Commissioner

July 31, 2007

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
United States House of Representatives
Washington, D.C. 20515

Dear Chairman Dingell:

I am pleased to respond to the questions from Representative Gene Green which you sent to me on July 16 regarding my testimony at the May 22, 2007, hearing of the Subcommittee on Oversight and Investigations on "Gasoline Prices, Oil Company Profits, and the American Consumer."[1]

Question 1: Commissioner Kovacic, in your testimony you state that the Commission has "brought more merger cases at lower levels of concentration in the petroleum industry than in any other industry." Given this statistic, do you feel FTC is particularly vigilant to oil industry mergers?

Answer 1: Yes. I think that the Commission has been particularly vigilant in applying Section 7 of the Clayton Act and Section 5 of the FTC Act to oil industry mergers. The Commission released data earlier this year regarding FTC merger enforcement overall and in certain industries, including the petroleum industry.[2] Among other things, these statistics show that for mergers in which the post-transaction Herfindahl-Hirschman Index[3] would be under 1,800 (that

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[1]As with my responses to the Subcommittee's questions at the hearing, these answers present my personal views and do not necessarily represent the views of the Federal Trade Commission or of any other Commissioner.

[2]Federal Trade Commission Horizontal Merger Investigation Data, Fiscal Years 1996-2005 (Jan. 25, 2007), Table 3.1, et seq., *available at* http://www.ftc.gov/os/2007/01/P035603horizmergerinvestigationdata1996-2005.pdf.

[3]The Horizontal Merger Guidelines used by the Commission and the Department of Justice categorize market concentration into three zones as measured by the HHI, which is a statistical measure of concentration in a relevant market. An HHI below 1,000 is characterized as "unconcentrated" – a circumstance in which an agency would be unlikely to challenge a

is, moderately concentrated), the Commission brought enforcement actions in 24 out of 39 petroleum industry mergers, as opposed to only 56 actions out of 127 total mergers in all industries.

The FTC does not apply different merger standards to different industries. We apply the same standards across the board. We do, however, give particular scrutiny to the petroleum industry because of its paramount importance to the American economy and consumers. The Commission has developed deep and broad expertise in this industry over the years. On a weekly basis, Commission staff monitors prices in this industry looking for evidence of anticompetitive behavior. The Commission has investigated every major petroleum merger in the last twenty-five years, and we use our expertise to challenge and remedy those transactions that present the risk of post-merger anticompetitive behavior. Our unparalleled resource commitment to protecting competition and consumers in this industry results in an active and successful merger program.

Question 2: Another witness today has submitted in their testimony that FTC is "not adequately protecting consumers . . . by allowing too many mergers and taking a stance too permissive to anti-competitive practices." How do you respond to this accusation?

Answer 2: I do not agree that our enforcement program in the petroleum industry is too permissive on any level. As noted in the answer to Question 1, the Commission has taken enforcement actions at lower levels of concentration in the petroleum industry than it has across industries generally. In each enforcement instance, the remedy obtained by the Commission has been sufficient to restore fully the level of competition that existed before the merger occurred. The divestiture ordered in the Exxon/Mobil case, for example, was among the largest divestitures in the history of antitrust enforcement. The divestiture order required, among other things, Exxon/Mobil to sell or assign over 2,400 retail stations and divest an important refinery in California, terminal operations on the East Coast, and a pipeline running from the Gulf Coast to the East Coast.[4] It is Commission policy to insist on a complete remedy in every relevant market in which anticompetitive effects are likely to occur.

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merger. An HHI between 1,000 and 1,800 is considered "moderately concentrated," where a merger resulting in an increase of 100 potentially raises significant antitrust concerns. An HHI over 1,800 reflects a "highly concentrated" market, where a merger resulting in an increase of 50 potentially raises significant concerns, and an increase of 100 creates a rebuttable presumption that the merger creates, enhances, or facilitates the exercise of market power. U.S. Dep't of Justice and Fed. Trade Comm'n, *1992 Horizontal Merger Guidelines* (Section 4 on Efficiencies revised April 8, 1997), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104.

[4] *Exxon Corp.*, C-3907 (Jan. 26, 2001) (consent order), *available at* http://www.ftc.gov/os/2001/01/exxondo.pdf.

The Commission has a similarly robust enforcement program with respect to conduct in the petroleum industry. In 2005, the Commission entered into a successful settlement of its monopolization case against Unocal; the FTC's consent order is estimated to save California consumers over $500 million per year in the cost for CARB gasoline.[5] Moreover, in the last 10 years, Commission staff has conducted important and extensive investigations of gasoline prices and industry practices on the West Coast,[6] in markets in the Midwest,[7] and in markets affected by infrastructure damage as a result of Hurricanes Katrina and Rita.[8] During these investigations the Commission did not find credible evidence of unilateral or collusive anticompetitive conduct. It is important to note here that the antitrust laws are not violated simply because prices rise, even if they rise a substantial amount in a short period of time. There are many legitimate reasons why prices rise, including strong and increasing consumer demand and infrastructure problems that reduce supply. The antitrust laws proscribe only those price increases that result from anticompetitive conduct, such as horizontal price-fixing and exclusionary abuse of market power.

Question 3: To the best of your memory, how many investigations or studies has FTC conducted regarding allegations of potential price gouging or price manipulation? Have any of these studies determined any evidence of manipulation?

Answer 3: There is no federal "price gouging" statute. Thus, the Commission's investigation of price gouging itself consisted of one investigation undertaken pursuant to a Congressional directive. The Commission issued a report in May 2006 on its investigation of gasoline price manipulation and the pricing of gasoline following Hurricane Katrina. The investigation found no evidence that petroleum companies were acting to manipulate supply in order to raise gasoline prices. As for post-Katrina pricing, the Commission identified 15 firms that met the technical definition of "price gouging" established in the Congressional legislation that mandated the

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[5] *Union Oil Co. of California*, FTC Docket No. 9305 (Mar. 4, 2003) (complaint), *available at* http://www.ftc.gov/os/2003/03/unocalcmp.htm; *Union Oil Co. of California*, FTC Docket No. 9305 (Aug. 2, 2005) (decision and order), *available at* http://www.ftc.gov/os/adjpro/d9305/050802do.pdf; *Chevron Corp. & Union Oil Co. of California*, FTC Docket No. C-4144 (Aug. 2, 2005) (decision and order), *available at* http://www.ftc.gov/os/caselist/0510125/050802do0510125.pdf.

[6] FTC Press Release, *FTC Closes Western States Gasoline Investigation* (May 7, 2001), *available at* http://www.ftc.gov/opa/2001/05/westerngas.htm.

[7] Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001), *available at* http://www.ftc.gov/os/2001/03/mwgasrpt.htm.

[8] FEDERAL TRADE COMMISSION, INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GASOLINE PRICE INCREASES (Spring 2006), *available at* http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf.

investigation, but reported that regional and local market conditions explained the price increases in virtually all such instances.

As noted above, in connection with its responsibility to enforce the antitrust laws, the Commission has undertaken numerous investigations of the petroleum industry, both merger and nonmerger. Since 1973, the FTC has conducted more than 190 petroleum industry investigations, most of them involving mergers. These investigations have resulted in at least 44 enforcement actions, including final orders, complaints issued or filed in court, and matters in which a transaction was abandoned after initiation of a Commission investigation. Moreover, as my testimony indicated, the FTC continuously monitors gasoline and diesel prices across the country to identify unusual price movements that might result from anticompetitive conduct.

The Commission's nonmerger antitrust investigations have included examining allegations of monopolization, horizontal price fixing, vertical price fixing, and predatory pricing. The agency has reviewed practices and allegations directly focusing on gasoline pricing in a number of specific instances and has conducted analyses of whether anticompetitive behavior might explain gasoline price irregularities. The FTC vigorously investigated West Coast gasoline price practices in the early 1980s, gasoline prices in the spring of 1989, certain West Coast gasoline pricing practices from the late 1990s to 2001, and Midwest gasoline prices in 2000. These investigations did not unearth instances of market manipulation. Inquiries into more recent instances of gasoline price increases are ongoing.

Question 4: FTC Chairman, Deborah Platt Majoras, testified to Congress last year on FTC's investigation of Post-Katrina Gasoline Price Increases. She commented on proposed Federal price gouging legislation and stated that several factors should be considered to enact a price gouging statute to have the smallest adverse impact on rational price incentives. These factors include the need for the legislation to clearly define the price gouging statute, account for increased business costs, provide for consideration of local, national, and international market conditions, and account for a market-clearing price.

- **Can you elaborate on why FTC considers these provisions so critical to any proposed price-gouging bill? What are the implications if these provisions are omitted from any legislation Congress may enact?**

Answer 4: As I noted above, there has never been a federal statute prohibiting "price gouging." There is a reason for that. Federal antitrust law is designed to prevent the abuse of private market power that may empower sellers to charge prices other than those that they would charge in a competitive market. This is based on the assumption that competition, and market prices, provide the greatest quantity and quality of goods and services for consumers. Thus, even though market prices sometimes may be higher than consumers would like, we should hesitate to make it a violation of law for sellers to charge a price that is the result of the interplay of competitive

market conditions – even if that price is higher than we would like.

During times of unusual product shortage, such as occurred in many parts of the country after the hurricanes, market prices will naturally rise as demand temporarily outstrips supply. These rising prices help clear the market – that is, equalize supply and demand – without the need to resort to long lines or other inefficient methods of product allocation. They do this by providing the incentive for suppliers to take the financial risk to bring extra product into the market – as the petroleum companies did by shipping additional supplies of gasoline from Europe (and other foreign locations) into the United States after the hurricanes – and by providing the incentive for consumers to consume less gasoline by forgoing or postponing unnecessary automobile trips while product is short – which they did after the hurricanes in response to higher prices.

Thus, if price gouging legislation is to be enacted, Congress should take care not to destroy the incentives inherent in the natural price flexibility of the American economy that ameliorate price spikes during disaster periods by dampening demand and increasing supply. By taking account of the factors enumerated in Chairman Majoras's May 2006 testimony, Congress would acknowledge that not all price increases in the face of temporary product shortages should be deemed to constitute gouging. Even some advocates of price gouging legislation have recognized that a wholesaler or retailer needs to recover its increased costs and must be able to respond to unusual market conditions. Any legislation should account for these factors.

Another issue raised by price gouging legislation is how to define the offense. The offense must be defined so that wholesalers and retailers can comply with the statute. I strongly believe that Congress has the duty to define the conduct that it would prohibit – especially when criminal penalties may be involved. Because price flexibility is crucial for the efficient functioning of the economy (perhaps even more so during disaster periods), defining the offense of price gouging has proved particularly challenging. The definitions contained in the numerous state price gouging statutes and in various forms of proposed federal legislation have varied widely and would capture or leave out vastly different kinds and amounts of business conduct. It is a policy decision for Congress to decide where to draw the line between legal and illegal conduct, particularly criminal conduct, in an area where the distinction is difficult to discern and where it is important not to discourage conduct that ultimately is benign or procompetitive.

I think there would be serious implications if Congressional price gouging legislation failed to take account of the factors addressing costs and market conditions. Such legislation would severely restrict price flexibility in times of market disruption caused by natural disaster. The result might be that the period of supply/demand imbalance would extend beyond what it would have been if businesses were able to price according to market conditions. Although it is impossible to predict exactly how affected businesses may react, a possible consequence of a bill that does not account for increased costs or market conditions is that small businesses lacking sophisticated legal counsel – particularly gasoline retailers – may temporarily shut down rather than risk violating the price gouging statute, especially if the offense is punishable as a serious crime and offenders are subject to imprisonment and large fines. That result would benefit no one.

Question 5: As you know, GAO commissioned a report which analyzed the effects of petroleum industry mergers from 1997-2000, which alleged that in six of the eight transactions examined, mergers caused gasoline prices to increase. Did FTC agree with these findings, and if not, what problems did FTC have with the study?

Answer 5: In May 2004, the Government Accountability Office released a report that purported to analyze how eight petroleum industry mergers or joint ventures carried out during the late 1990s affected gasoline prices.[9] The Commission regards evaluations of past enforcement decisions as valuable elements of responsible antitrust policymaking,[10] and it supports the goal of the GAO inquiry – to evaluate the consequences of past decisions by the federal antitrust agencies. Accordingly, our own staff has conducted retrospective analyses of past merger decisions.[11]

Nevertheless, I believe the GAO report suffered from a number of significant technical deficiencies that cause us to question its findings. Although I will not recount here all of the problems that FTC staff identified in the GAO report, I will describe three significant deficiencies. First, the GAO's econometric models did not properly control for the numerous factors that cause gasoline prices to increase or decrease. These omissions undermine the GAO report's estimates of the effects of concentration and mergers on wholesale gasoline prices. Second, the GAO report did not measure concentration in any properly defined geographic market. Instead, GAO used markets defined to be coextensive with Petroleum Administration for Defense Districts ("PADDs") – a concept that Commission economists have found not to contribute usefully to the sound analysis of a petroleum merger's competitive effects.[12] Third, by

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[9]GAO, *Energy Markets: Effects of Mergers and Market Concentration in the U.S. Petroleum Industry* (May 2004).

[10]For my own views on this subject, *see* William E. Kovacic, *Using Ex Post Evaluation to Improve the Performance of Competition Policy Authorities*, 31 J. CORP. L. 503 (2006).

[11]*See, e.g.,* John Simpson and Christopher T. Taylor, *Michigan Gasoline Pricing and the Marathon – Ashland and Ultramar Diamond Shamrock Transaction* (Bureau of Economics Working Paper 278) (July 2005) (forthcoming as *Do Gasoline Mergers Affect Consumers' Prices,?* J. LAW & ECON.); Christopher T. Taylor and Daniel S. Hosken, *The Economic Effects of the Marathon – Ashland Joint Venture: The Importance of Industry Supply Shocks and Vertical Market Structure* (Bureau of Economics Working Paper 270), published in 25 J. OF INDUS. ECON. 421 (Sept. 2007 No. 3).

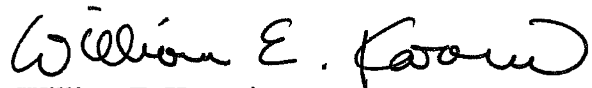
[12]The correct definition of a market in merger review is a detailed, fact-intensive inquiry that involves both product and geographic components. We must ascertain for which product (or products) the transaction may harm competition, and we also must determine the geographic area over which any anticompetitive effects will be felt. In our analysis of petroleum mergers,

focusing exclusively on *wholesale* prices, the GAO report failed to address the effects of concentration and mergers on *retail* gasoline prices. FTC staff's research indicates that wholesale price effects are not necessarily indicative of retail price effects – the effects that concern consumers buying gasoline at the pump. These mistakes and omissions significantly undermine the results of the GAO study.

For a more complete discussion of these and other issues with the GAO report, please see the Commission's technical staff report, *available at* http://www.ftc.gov/ftc/workshops/oilmergers/ftcstafftechnicalreport122104.pdf. In that report, our staff replicated the results in the GAO report and then showed that those results are not robust to alternative specifications. The FTC also hosted a conference, "Estimating the Price Effects of Mergers and Concentration in the Petroleum Industry: An Evaluation of Recent Learning," on January 14, 2005, where a panel of eminent independent economists discussed the GAO report as well as FTC work on merger retrospectives. Information on that conference, including the transcript, is available at http://www.ftc.gov/ftc/workshops/oilmergers/index.shtm.

Mr. Chairman, thank you for the opportunity to participate in the hearing on May 22, 2007, and to respond to Representative Green's questions.

Sincerely,



William E. Kovacic
Commissioner

national, state, or PADD-wide "markets" rarely correspond to properly defined geographic markets. (PADD I consists of the East Coast. PADD II consists of the Midwest. PADD III includes the Gulf Coast. PADD IV consists of the Rocky Mountain region. PADD V is made up of the West Coast plus Alaska and Hawaii.)