

**ANALYSIS OF PROPOSED CONSENT ORDER
TO AID PUBLIC COMMENT
In the Matter of Shell Oil Company and Pennzoil-Quaker State Company
File No. 021 0123, Docket No. C-4059**

I. Introduction

The Federal Trade Commission (“Commission” or “FTC”) has issued a complaint (“Complaint”) alleging that the proposed merger of Shell Oil Company (“Shell”) and Pennzoil-Quaker State Company (“Pennzoil”) (collectively “Respondents”) would violate Section 7 of the Clayton Act, as amended, 15 U.S.C. § 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. § 45, and has entered into an agreement containing consent orders (“Agreement Containing Consent Orders”) pursuant to which Respondents agree to be bound by a proposed consent order that requires divestiture of certain assets (“Proposed Consent Order”) and a hold separate order that requires Respondents to hold separate and maintain certain assets pending divestiture (“Hold Separate Order”). The Proposed Consent Order remedies the likely anticompetitive effects arising from Respondents’ proposed merger, as alleged in the Complaint, and the Hold Separate Order preserves competition pending divestiture.

II. Description of the Parties and the Transaction

Shell Oil Company, headquartered in Houston, Texas, is the United States operating entity for the Royal Dutch/Shell Group of Companies (collectively referred to as “Shell”). Shell is engaged in virtually all aspects of the energy business, including exploration, production, refining, transportation, distribution, and marketing. As part of the relief ordered by the Commission in *Chevron/Texaco*, Docket C-4023 (Jan. 2, 2002), Texaco divested its interest in Equilon Enterprises LLC to Shell and its interest in Motiva Enterprises LLC to Shell and Saudi Refining Company. Equilon and Motiva are engaged in the production, distribution and marketing of refined products, including base oil, gasoline, diesel fuel, and other products. During fiscal year 2001, Shell had worldwide revenues of approximately \$135.2 billion and net income of approximately \$10.9 billion.

Pennzoil, headquartered in Houston, Texas, is engaged in the business of manufacturing and marketing lubricants, car care products, base oils, branded and unbranded motor oils, transmission fluids, gear lubricants, greases, automotive polishes, automotive chemicals, other automotive products, and specialty industrial products. Pennzoil manufactures and markets conventional and synthetic motor oils primarily under the Pennzoil and Quaker State brands. Pennzoil is also engaged in the franchising, ownership and operation of quick lube oil change centers under the Jiffy Lube name. During fiscal year 2001, Pennzoil had worldwide revenues of approximately \$2.3 billion.

Pennzoil has a 50/50 joint venture with Conoco Inc. called Excel Paralubes that operates a base oil refinery located in Westlake, Louisiana, adjacent to Conoco's petroleum products refinery at Lake Charles, Louisiana. Pennzoil obtains a substantial portion of its base oil requirements from its interest in Excel Paralubes. Pennzoil also has a 10-year base oil supply agreement with Exxon Mobil Corporation, which became effective August 1, 2000, as a result of the Commission's order in *Exxon/Mobil*, Docket C-3907 (Jan. 26, 2001). Pursuant to that agreement, Pennzoil is entitled to obtain up to 6,500 barrels per day of base oil from ExxonMobil, in grades and quantities that are proportionate to ExxonMobil's Gulf Coast base oil production. Part of this volume consists of Group II paraffinic base oil, which is the relevant market alleged in the Complaint.

Pursuant to an agreement and plan of merger dated March 25, 2002, Shell intends to acquire all of the outstanding voting securities of Pennzoil. The transaction is structured such that Shell ND, a wholly-owned subsidiary of Shell, will acquire the Pennzoil shares and then be merged into Pennzoil, with Pennzoil surviving as a wholly-owned subsidiary of Shell. Each outstanding common share of Pennzoil will be converted into the right to receive \$22 in cash.

III. The Complaint

The Complaint alleges that the merger of Shell and Pennzoil would violate Section 7 of the Clayton Act, as amended, 15 U.S.C. § 18, and Section 5 of the Federal Trade Commission Act, as amended, 15 U.S.C. § 45, by substantially lessening competition in the refining and marketing of Group II paraffinic base oil in the United States and Canada. To remedy the alleged anticompetitive effects of the merger, the Proposed Order requires Respondents to divest Pennzoil's 50% interest in Excel Paralubes, which represents Pennzoil's only base oil ownership position. Respondents also have agreed to freeze at approximately current levels Pennzoil's right to obtain Group II base oil supply under the contract with ExxonMobil that was obtained as part of the relief in the *Exxon/Mobil* merger proceeding.

Shell and Pennzoil are competitors in the refining and marketing of Group II paraffinic base oil in a geographic market that consists of the United States and Canada. The refining and marketing of Group II paraffinic base oil in this market would be highly concentrated as a result of the merger. Following the proposed merger, Shell would control at least 39% of Group II refining capacity in the United States and Canada. Overall market concentration, as measured by the Herfindahl-Hirschmann Index (HHI), would increase by more than 700 points to a level in excess of 2,300.

The refining and marketing of Group II paraffinic base oil is a relevant line of commerce (*i.e.*, product market). Paraffinic base oil is a refined petroleum product that is the principal component, or "basestock," of finished lubricants used for a variety of applications, including passenger car motor oil, heavy duty engine oil, automatic transmission fluid, and other lubricant products. In the *Exxon/Mobil* investigation, the Commission concluded that paraffinic base oil constitutes a relevant market.

Developments in the industry since the *Exxon/Mobil* merger indicate that a market consisting of Group II paraffinic base oils has evolved. The American Petroleum Institute divides paraffinic base oil into three groups (Groups I, II and III) based on differences in sulfur content, saturates level, and viscosity index. Group II paraffinic base oil has less than 0.03% sulfur by weight, more than 90% saturates by weight, and a viscosity index ranging from 80 to 120. Group II base oil is needed in order to meet current performance standards for lighter-viscosity motor oil formulations (such as 5W-20 and 5W-30), as well as requirements for other lubricants. As new performance standards are adopted, there will be even greater demand for Group II base oil for the production of motor oil and other lubricants. If the price of Group II base oil were to increase by 5-10%, blenders of motor oil and other lubricants would not substitute to other basestocks in sufficient quantities to prevent the increase.

The Complaint alleges that the proposed transaction would lessen competition in a geographic market consisting of the United States and Canada. There is little Group II production outside of the United States and Canada. Further, imports of Group II base oil would be subject to significant freight penalties and would not be competitive with production in the United States and Canada. If the price of Group II base oil in the United States and Canada were to increase by 5-10%, blenders of motor oil and other lubricants would not switch to sources of supply outside the United States and Canada in sufficient quantities to prevent the increase.

There are few significant producers of Group II base oil in the United States and Canada. The proposed merger would eliminate Pennzoil as a major competitor, and would combine Shell, the market leader, into a close partnership with Conoco, another leading producer. As a result of the proposed merger, Shell would control at least 39% of Group II refining capacity in the United States and Canada, and concentration in the relevant market as measured by the Herfindahl-Hirschmann Index would increase by more than 700 points to a level in excess of 2,300.

Entry into the relevant market is difficult and would not be timely, likely or sufficient to prevent the anticompetitive effects that are likely to result from the proposed merger. Constructing a new refinery or converting an existing Group I refinery to make Group II base oil would require substantial investment, would be subject to significant regulatory obstacles, and would take several years to accomplish. As a result, new entry would not be able to prevent a 5-10% increase in Group II base oil prices.

The Complaint charges that the proposed merger, absent relief, is likely to substantially lessen competition and lead to higher prices of Group II paraffinic base oil, by eliminating direct competition between Shell and Pennzoil, by increasing the likelihood that the combined Shell/Pennzoil will unilaterally exercise market power, and by increasing the likelihood of collusion or coordinated interaction among competitors in the refining and marketing of Group II paraffinic base oil.

To remedy the likely competitive harm, the Proposed Order requires Respondents to divest Pennzoil's interest in Excel Paralubes and to freeze Pennzoil's ability to obtain additional Group II

supply under the agreement with ExxonMobil. This relief will effectively remedy any anticompetitive effects that could be expected to arise from this transaction.

IV. Resolution of the Competitive Concerns

The Commission has provisionally entered into an Agreement Containing Consent Orders with Shell and Pennzoil in settlement of the Complaint. The Agreement Containing Consent Orders contemplates that the Commission would issue the Complaint and enter the Proposed Order and the Hold Separate Order for the divestiture of certain assets described below.

In order to remedy the anticompetitive effects that have been identified, Respondents have agreed to divest Pennzoil's 50% interest in Excel Paralubes, and to freeze Pennzoil's right to obtain additional Group II supply under the contract with ExxonMobil at approximately current levels. If the required divestiture has not been accomplished within the required time, then Respondents are required to transfer Pennzoil's interest in Excel Paralubes to a trustee, who will have the responsibility of accomplishing the required divestiture.

Paragraph II.A. of the Proposed Order requires Respondents to divest Pennzoil's interest in Excel Paralubes, at no minimum price, within twelve months after executing the Order, to an acquirer that receives the prior approval of the Commission.

Paragraph II.B. requires Respondents to negotiate with the acquirer, at the acquirer's option, a supply agreement for Respondents to purchase Group II base oil. Such agreement may not exceed one year, may not contain renewal or evergreen rights, and is subject to prior approval by the Commission. Paragraph II.C. provides that, prior to the effective date of divestiture, Respondents may not enter into any agreement to purchase Group II base oil from the acquirer other than one made pursuant to Paragraph II.B.

Paragraph II.D. of the Proposed Order explicitly provides that Respondents may not divest the Pennzoil Excel Paralubes Interest to Conoco, and must enforce a letter agreement with Conoco relating to Excel Paralubes. Conoco already has a significant share of the Group II market, and the addition of Pennzoil's share of Excel Paralubes would result in a significant increase in concentration. In addition, under the Joint Venture Agreement forming the Excel Paralubes partnership, Conoco may, under certain circumstances, have a right of first refusal or a first option to purchase Pennzoil's interest in Excel Paralubes. Conoco has entered into an agreement with Respondents dealing with its waiver of such rights, and consenting to the assignment of a supply agreement pursuant to which Pennzoil purchases base oil from Excel Paralubes.

Paragraph III limits Respondents' use of their rights to purchase Group II base oil from ExxonMobil under the ExxonMobil/Pennzoil Base Oil Agreement. That agreement allows Pennzoil to obtain base oil from ExxonMobil in the proportionate types and amounts corresponding to

production at designated ExxonMobil refineries. Pennzoil currently is taking approximately 1,500 barrels per day of Group II under this contract. Any significant increase in that amount could unduly increase concentration. Accordingly, Paragraph III prevents Respondents from increasing their share of the market for Group II Base Oil through additional supply under this agreement.

If Respondents have not accomplished the divestiture within the required time period, Paragraph IV provides that the Commission may appoint a trustee to divest the Pennzoil Excel Paralubes Interest, at no minimum price, to a buyer approved by the Commission. The trustee will have the exclusive power and authority to accomplish the divestiture within twelve months, subject to any necessary extensions by the Commission. Paragraph IV.C.5 requires that the trustee will have access to information related to Atlas and Excel Paralubes as necessary to fulfill his or her obligations. (Atlas is the wholly-owned subsidiary of Pennzoil that holds Pennzoil's interest in the Excel Paralubes partnership.) The trustee shall use his or her best efforts to negotiate the most favorable price and terms for the divestiture, subject to the Respondents' absolute and unconditional obligation to divest expeditiously at no minimum price. If the trustee receives more than one bona fide offer from entities approved by the Commission, the trustee will divest to the party selected by the Respondents.

Other provisions of Paragraph IV.C. generally provide that Respondents are responsible for management expenses incurred by the trustee, that the trustee has authority to employ other persons necessary to carry out his or her duties and responsibilities, and that Respondents indemnify and hold the trustee harmless against any liabilities or expenses arising out of, or in connection with, performance of the trustee's duties. Respondents may require the trustee to sign a customary confidentiality agreement, provided that such agreement may not restrict the trustee from providing any information to the Commission.

Paragraphs V - VIII of the Proposed Order contain certain general provisions. Pursuant to Paragraph V, Respondents are required to provide the Commission with a report of compliance with the Proposed Order every thirty days until the divestiture is completed and annually for nine years after the first year the Order becomes final. Paragraph VI provides for notification to the Commission in the event of any corporate changes in the Respondents. Paragraph VII requires that Respondents provide the Commission with access to their facilities and employees for the purposes of determining or securing compliance with the Proposed Order. Finally, Paragraph VIII terminates the Order ten years from the date it becomes final.

V. Opportunity for Public Comment

The Proposed Order has been placed on the public record for thirty (30) days for receipt of comments by interested persons. The Commission, pursuant to a change in its Rules of Practice, has also issued its Complaint in this matter, as well as the Hold Separate Order. Comments received during this thirty day comment period will become part of the public record. After thirty (30) days, the Commission will again review the Proposed Order and the comments received and will decide whether it should withdraw from the Proposed Order or make final the agreement's Proposed Order.

By accepting the Proposed Order subject to final approval, the Commission anticipates that the competitive problems alleged in the Complaint will be resolved. The purpose of this analysis is to invite public comment on the Proposed Order, including the proposed divestiture, and to aid the Commission in its determination of whether it should make final the Proposed Order contained in the agreement. This analysis is not intended to constitute an official interpretation of the Proposed Order, nor is it intended to modify the terms of the Proposed Order in any way.