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Federal Trade Commission

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January 29, 1992

David Buhler
Executive Director
Department of Commerce
P.O. Box 45802
Salt Lake City, UT 84145-0802

Dear Mr. Buhler:

The staffs of the Denver Regional Office and the Bureau of Competition of the Federal Trade Commission[1] are pleased to submit this letter in response to your request for comments on the potential effects on small business and on competition of the Utah Motor Fuel Marketing Act and proposed amendments to it. The amendments would broaden the Act's prohibitions.

We believe such legislation is likely to be anticompetitive, and that its likely result may be that Utah consumers and visitors could pay higher prices for gasoline.

I. Interest and experience of the staff of the Federal Trade Commission

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. 15 U.S.C. § 45. Under this statutory mandate, the Commission seeks to identify restrictions that impede competition or increase costs without offering countervailing benefits to consumers. In particular, the Commission and its staff have had considerable experience assessing

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[1] These comments are the views of the staffs of the Denver Regional Office and the Bureau of Competition of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner.

the competitive impact of regulations and business practices in the oil industry.[2]

II. Description of the proposed legislation

Utah adopted the Motor Fuel Marketing Act ("Act")[3] in 1981 and amended it in 1987. The Act prohibits selling or offering to sell motor fuel either below "cost," as that is defined,[4] or at a price lower than the price the seller charges at the same time to other customers at the same level of distribution, with the intent or effect to injure competition.[5] In addition, the Act prohibits refiners from selling or transferring to themselves or affiliates, for resale on a different marketing level, at a transfer price lower than the refiner charges purchasers for resale at the same level, if the intent or effect is to injure competition.[6] The Act permits a degree of cost-justification: the sales price (or transfer price for an affiliate) need not be identical to the price

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[2] The staff of the Commission has gained extensive experience with energy competition issues by conducting studies, investigations, and law enforcement actions. FTC staff comments and testimony to legislative bodies have identified the costs of proposed gasoline retailing divorcement, below-cost selling, and other petroleum marketing legislation for Alabama, Arkansas, Georgia, Hawaii, Louisiana, Massachusetts, Montana, Nevada, North Carolina, South Carolina, Tennessee, Virginia, and Washington, and for the United States Senate and House of Representatives. The Commission and its staff have also gained considerable experience with gasoline refining and marketing issues affecting consumers from premerger antitrust reviews pursuant to Sections 7 and 7A of the Clayton Act, 15 U.S.C. §§ 18, 18a.

[3] Utah Code Ann. Title 13, Ch. 16.

[4] "Cost" is defined by reference to the lowest invoice cost (or, for an "affiliate," the lowest transfer price) charged within the five days before an alleged violation. Utah Code Ann. § 13-16-2(2). Trade discounts, allowances or rebates are subtracted from the invoice cost or transfer price, and freight charges and taxes are added. In addition, the "cost" includes "the reasonable cost of doing business as determined by generally accepted accounting principles," which is presumed to be six percent of posted retail price. Utah Code Ann. § 13-16-2(2).

[5] Utah Code Ann. § 13-16-4.

[6] Utah Code Ann. § 13-16-5. Refiners are required to establish transfer prices for transactions with their affiliates and to disclose them to the public on request. Utah Code Ann. § 13-16-3.

charged at the same level of distribution to a third-party purchaser for resale, if the difference is due to "a difference in shipping method, transportation, marketing, sale [sic], or quantity . . . sold."[7] The law includes exemptions for good faith efforts to meet competition and for liquidation and close-out sales.[8]

The proposed amendments would add another element to support a violation. Now, a violation depends on an intent or effect to injure competition. The amendments would add, as an alternative, "the intent and purpose . . . to induce the purchase of other merchandise, to divert, unfairly, trade from a competitor, or otherwise to injure a competitor." This new criterion would apply to sales below cost and sales at different prices,[9] but would not apply to the section addressed specifically to refiners.[10] In addition, the proposed amendments would require that the determination of whether a person was meeting competition be made without regard to anything, such as other kinds of merchandise, offered for sale in conjunction with motor fuel. Finally, the recordkeeping requirements would be changed; rather than require a record of all sales at different prices and all efforts to meet competition, rules would be adopted requiring records of all price changes.

III. Analysis of Act and Proposed Amendments

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

The premise of the Act and the proposed amendments appears to be that franchised and independent retail dealers are being victimized by subsidized pricing by the major gasoline marketers. Proponents of legislation that would impose restraints on vertically integrated petroleum refiners have maintained that such laws are necessary to protect dealers from unfair and anticompetitive practices by their suppliers. According to this view, vertically integrated refiners can and do set retail prices charged by their company-owned and operated outlets below the wholesale prices charged to franchised or independent dealers. They allege that the reason for such "subsidization" is to drive

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7 Utah Code Ann. § 13-16-6.

8 See Utah Code Ann. §§ 13-16-6(2), 13-16-6(3), §13-5-12.

9 Utah Code Ann. § 13-16-4.

10 Utah Code Ann. § 13-16-5.

franchised and independent dealers out of business in order to replace them with company-owned stations.

The claims that vertical integration by refiners into gasoline retailing is anticompetitive do not appear to be well founded. Major oil companies have historically been "integrated by contract," relying heavily on franchised dealer networks to sell their refined products. Several studies of competition in gasoline marketing in the United States since 1981 have concluded that gasoline dealers have not been and are not likely to become targets of anticompetitive practices by their suppliers. We briefly summarize the results of these studies below.

1. Federal Studies.

Following enactment of Title III of the Petroleum Marketing Practices Act ("PMPA") in 1978, 15 U.S.C. § 2841, the Department of Energy ("DOE") studied whether vertically integrated refiners were "subsidizing" their retail gasoline operations in a way that might be predatory or anticompetitive. The final report to Congress, published in January of 1981, was based on an extensive study of 1978 pricing data in several Standard Metropolitan Statistical Areas ("SMSAS"), as well as on internal oil company documents subpoenaed by DOE investigations. The study concluded that there was no evidence of such "subsidization."[11]

In 1984, DOE published an updated study that further substantiated and elaborated on its 1981 findings.[12] The study showed that company-operated stations were not increasing as a percentage of all retail outlets, except among the smaller refiners. In the 1984 report, DOE concluded that the increased pressures on gasoline retailers since 1981 were not caused by anticompetitive behavior on the part of the major oil companies. Rather, the decline in the overall number of retail outlets and the intensification of competition among gasoline marketers were attributable to decreased consumer demand for gasoline and a continuing trend toward the use of more efficient, high-volume retail outlets.[13]

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[11] DOE, Final Report: The State of Competition in Gasoline Marketing, 1981.

[12] Department of Energy, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers, March, 1984 ("1984 DOE Report").

[13] 1984 DOE Report at 125-32.

2. **State Studies.**

In 1986, the Washington state attorney general initiated a study of motor fuel pricing in that state to determine whether claims of refiner subsidization were justified. The study focused on whether major oil companies injured competition by charging lessee-dealers higher prices for gasoline than the companies were charging their own company-operated retail stations. The study also sought to examine whether the major oil companies injured competition by establishing a pricing structure between retail and wholesale prices that foreclosed the ability of dealers to cover their costs. Information was gathered on the practices of all eight of the major companies in Washington for a three-year sample period. The study covered regions throughout the state where the companies maintained both retail operations and lessee-dealer operations. The Washington study found that less than one percent of all observed pairs of prices of lessee dealers and company-operated stations disclosed any significant price variations, and concluded that such instances were "clearly too infrequent" to show that lessee dealers were being systematically driven from the market because their gasoline purchase costs were the same as or higher than the retail prices of competing refiner-operated stations.[14]

More recently, in 1987, the Arizona legislature created a Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement. In December 1988 the Committee recommended that no new legislation be enacted, concluding that "(t)he marketplace for petroleum products is very competitive in Arizona."[15]

The state and DOE studies have revealed no instances of predatory behavior by major gasoline refiners. Rather, they show that the fortunes of refiners and their franchised retailers are closely linked, and that these firms "form a mutually supporting system backed by company advertising and promotion."[16] Franchised

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

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

[16] 1984 DOE Report at ii. We do not mean to suggest that the fortunes of refiners and their franchised retailers are linked perfectly in every situation; rather, although the refiners and

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retailers have continued to be by far the predominant form of outlet for the gasoline sales of major, integrated refiners. Indeed, major refiners operate only a small percentage of the gasoline stations in the United States.[17]

3. **Gasoline marketing in Utah.**

The national pattern is reflected in the distribution systems of the leading branded refiners in Utah. The 1984 DOE study indicates that vertically integrated gasoline marketers accounted for just under seven percent of total sales in Utah in 1981; this was only half of the national average, 13.1 percent.[18] None of the twelve leading branded marketers in Utah for which data are available use company-owned and operated outlets as the predominant form of retailing on a national basis.[19] However, company operated outlets may be a predominant form of retailing for smaller independent refiners. For example, the largest refiner that

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[16](...continued)
their retailers generally share common goals, on occasion their interests and fortunes may not coincide. Although our information for these propositions comes from 1984 reports and articles, we have no reason to believe that the distribution structure has significantly changed since that time.

[17] Lundberg Letter, Vol XI, No. 36, July 6, 1984, at 3, where it was reported that the major refiners operated only about 3.3% of all retail stations. The 1984 DOE Report confirmed a similarly low proportion. A recent study conducted for the American Petroleum Institute noted that the fourteen largest integrated refiners, representing approximately 67% of the nation's refining capacity, had only about 10% of their gross gasoline sales and 4.5% of their outlets devoted to company-operated retail stations. Temple, Barker & Sloan, Gasoline Marketing in the 1980's: Structure, Practices, and Public Policy. 2-3 (1988).

[18] 1984 DOE Report at 82.

[19] National Petroleum News 1991 Factbook 34-51. The firm with the largest number of outlets in Utah, Sinclair, operates only 10 percent of its branded outlets itself (nationwide); the second largest in Utah, Texaco, operates 7.5 percent; the third largest, Phillips, operates none. The only firm selling at retail in Utah that operates more than 11 percent of its branded outlets (nationwide) itself is V-1 Oil Co., which has six outlets in Utah and a total of 36 in the entire country.

operates most of its own outlets is Clark, which ranks 24th nationwide in number of retail outlets (with 937).[20]

The major integrated refiners are not likely to engage in predation against the mainstay of their own retail distribution systems, their franchised retailers. Major refiners would have little incentive to charge discriminatory prices that would cause their franchised retailers to move to different suppliers or to go out of business. A refiner that discriminated in ways that injured its franchisees and dealers would probably lose sales, leading to a lower market share, greater excess refining capacity, and higher per unit costs.

B. Even if predatory behavior or price discrimination were found, it is already subject to prosecution under existing state and federal laws.

Predatory conduct in the petroleum industry is subject to the Sherman Act, the Clayton Act, and the Federal Trade Commission Act. In addition, price discrimination that injures competition is subject to the Robinson-Patman Act.[21] These statutes address possible anticompetitive practices in the industry and deter firms from engaging in predatory behavior or illegal price discrimination. In contrast, the Utah Motor Fuel Marketing Act and the proposed amendments may make it more difficult for firms to adjust their prices in response to changing conditions of demand and supply. Their prohibitions are broader than those in the Robinson-Patman Act.[22] The legislation may inhibit vigorous

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[20] National Petroleum News 1991 Factbook 34-51.

[21] 15 U.S.C. § 13 (Section 2 of the Clayton Act). See Texaco, Inc. v. Hasbrouck, _____ U.S. _____, 110 S. Ct. 2535 (1990), in which franchised gasoline retailers successfully challenged price discrimination by a vertically integrated refiner.

[22] To the extent that the Utah Act, as amended, would proscribe offering lower prices with the intent or effect of winning sales from a competitor, without reference to injury to competition, see proposed Sections 13-16-4(1)(b) and (2)(b), we believe that the Act could harm competition. Under these proposed sections, establishing a prima facie violation would require showing only an offer to sell below "cost," as defined, with the intent of winning business. No showing of actual or threatened competitive effect would be required. Because "cutting price in order to increase business often is the very essence of competition," the Act may "chill the very conduct the antitrust laws are designed to protect." Matsushita Elec. Indus. Co. v.
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competition and add costs to the distribution of gasoline in Utah that do not exist in other states, costs that would be borne by Utah consumers and visitors.

C. <u>The price and allocation regulatory features of the bill may lead to higher gasoline prices</u>.

The Act and the proposed amendments may have adverse consequences for consumers. Short term price discounts designed to attract new customers may be deterred. The legislation may also limit the availability of certain functional discounts.[23] Refiners may be prevented from realizing all the efficiencies of vertical integration, which can often reduce transaction and search costs and lower prices to consumers.[24] As a broad generalization,

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Zenith, 475 U.S. 574, 594 (1986). If the Act is amended as proposed, gasoline retailers in Utah may try to avoid liability by refraining from competition, to the detriment of Utah consumers. Under federal law, although purpose is important, in particular to illuminate ambiguous conduct, the effect of the conduct on competition (as distinguished from effects on a single competitor) is the more relevant consideration. Thus illegality under the Robinson-Patman Act requires that the effect of the pricing action be either "substantially to lessen competition or tend to create a monopoly or to injure, destroy, or prevent competition with any person" who grants or receives the benefit of price discrimination (or with customers of either of them). 15 U.S.C. §13(a). Illegality under the Robinson-Patman Act may also require establishing many factors in addition to effect or intent, such as those relating to meeting competition and cost justification.

[23] In Texaco, Inc. v. Hasbrouck, the Supreme Court said that "a functional discount that constitutes a reasonable reimbursement for the purchasers' actual marketing functions will not violate the Act." 110 S. Ct. at 2550.

[24] For example, a vertically integrated refiner may be able to achieve greater efficiency in coordinating its different levels of distribution than is possible in market transactions. In a competitive industry, such as retail gasoline sales, it may be expected that these cost savings would be at least partially passed on to the consumer. However, the Act and the proposed amendments may discourage such firms from using these savings to lower prices to consumers. The exemption for certain price differences based on cost differences, §13-16-6(1), does not recognize the likely cost savings due to coordination efficiencies of vertical integration. The Act contains several provisions that would
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economic theory suggests that vertical integration is likely to harm consumers only when market power exists in at least one stage of production.[25]

An unintended effect may be to encourage vertically-integrated refiners who distribute gasoline in Utah to change otherwise lawful pricing practices. In enforcing the federal price discrimination law, the Robinson-Patman Act, the Commission is careful to avoid discouraging firms from engaging in lawful price competition and price differences, which often operate to destroy cartel pricing.[26] However, such lawful price competition may be discouraged by a number of provisions in the Act, including the recordkeeping and disclosure obligations. Firms may simply decide to set uniform prices across broad geographic regions to avoid violations.[27]

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[24](...continued)
discourage firms from lowering prices. For example, §13-16-4 (1) prohibits retail prices below the transfer cost to the outlet; under §13-16-2(2), "cost" includes a mandatory markup over adjusted invoice or transfer price, so a firm risks violating the law if it wants to set a lower margin.

[25] See, e.g., Department of Justice Merger Guidelines, Section 4.21 (1984).

[26] See, e.g., F.M. Scherer & D. Ross, Industrial Market Structure and Economic Performance 515 (3d ed. 1990).

[27] To the extent that individual firms would have an incentive to set a single price in a geographic area to avoid violating the law, the law would resemble "uniform price laws," whose possible effects were discussed as follows in the 1984 DOE Report, at 122:

> In a market where there are no restrictions on pricing, price reductions tend to spread throughout the geographic area providing lower prices for consumers. . . . If the geographic area within which the price cutting occurs is limited, it is very likely that the refiners will respond in kind. . . . Thus, a price cut in one area often will lead to price cuts across broad market areas. In this situation, competition has worked effectively and consumers in all areas affected are better off.
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> In markets where there are uniform price restrictions, it is more likely that the responses will be different. Again, a refiner may decide to lower prices in a geographic area where sales traditionally have been weak. Refiners' responses must

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IV. Conclusion.

For the reasons stated above, we believe that the Act and the proposed amendments would tend to insulate gasoline refiners and marketers from competition, and thereby could cause gasoline prices in Utah to increase. We appreciate the opportunity to comment on this matter. Please feel free to contact us if we can be of further assistance.

Sincerely,

Claude C. Wild III
Director
Denver Regional Office

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[R]efiners must lower prices throughout the area covered by the law. In this situation, the refiners are more than likely to maintain their prices, since they may decide it is less costly to forego some sales in the initial market where price cutting is occurring than lower prices throughout the region. . . . Competition has been adversely affected and most consumers are no better off, since price reductions have not occurred in areas where they would have without the uniform price law.