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ROUNDTABLE ON COMPETITION POLICY FOR VERTICAL RELATIONS IN GASOLINE RETAILING

-- United States --

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The attached document is submitted to Working Party No. 2 of the Competition Committee FOR DISCUSSION under item III of the agenda at its forthcoming meeting on 20 October 2008.

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1. Introduction

1. The degree to which refiners are vertically integrated into gasoline retailing in the United States has changed considerably over the past 30 years. Industry changes in the late 1970s led to a sharp reduction in the number of retail gasoline stations operated by franchise dealers and precipitated many regulations relating to vertical integration in gasoline retailing that exist in the United States today. The ranks of franchise dealers began to decline even further in the 1990s as major refiners began to sell many of their retail outlets. Empirical studies on the divorcement experience of the United States suggest that divorcement legislation raises the retail price of gasoline and the Federal Trade Commission ("FTC") has advocated against divorcement and other vertical restrictions on the retailing of gasoline in the United States.

2. Types of Vertical Integration in Gasoline Retailing

2. Gasoline is sold at retail in the United States through company-owned and operated stations ("company-operated"), lessee dealer stations, and open dealer stations. At company-operated stations, the manager of the station is typically a salaried employee of the refiner that owns the station. The refiner sets the retail price at the station as well as the station hours. At lessee dealer stations, or franchise stations, the physical capital of the station is typically owned by the refiner and is leased to the manager of the station. The manager sets the retail price and station hours and is the residual claimant to the station's profit. The lessee dealer station sells only the branded gasoline of its station owner. At open dealer stations, the physical capital of the station is owned either by the station manager or by a "jobber" (an independent wholesaler). The open dealer may contract with any refiner to sell that refiner's gasoline. If the station is branded, however, the dealer may only sell the gasoline of its branded refiner. If the station is unbranded, it may sell the gasoline of any refiner.

3. The degree to which these various forms of vertical integration are present in gasoline retailing in the United States has varied over time. In 1972, the major refiners sold gasoline through 203,101 branded retail outlets. Among those, 5.7 percent were company-owned, 52.4 percent were operated by lessee dealers, and 41.9 percent were operated by open dealers.[1] In 2006, the major refiners sold gasoline through 38,797 branded retail outlets. Among those, 20.4 percent were company-owned, 15.8 percent were operated by lessee dealers, and 63.8 percent were operated by open dealers.[2]

3. Economics of Vertical Integration in Gasoline Retailing

4. Economic theory suggests that the optimal degree of vertical integration is dependent on the characteristics of the retail gasoline station at which the refiner sells its product. A refiner generally has three decisions to make with regard to the retailing of its gasoline. The first decision relates to the location and the characteristics of the station at which its gasoline will be sold. Given the characteristics of the station, the refiner chooses the degree of vertical integration that is most profitable for the refiner. The final decision relates to the contractual terms between the refiner and either the manager of its company-operated station or its dealer. The economics literature on vertical integration in gasoline retailing generally takes the decisions about station location and characteristics as given. That is, the literature

[1] U.S. Department of Energy, Final Report: The State of Competition in Gasoline Marketing (1981), p. 174.

[2] Energy Information Administration, Performance Profiles of Major Energy Producers, Table B30, available at http://www.eia.doe.gov/emeu/perfpro/btab30.html.

focuses on the optimal degree of vertical integration and contract terms once the station location and characteristics have already been determined.[3]

5. Principal-agent theory provides some insight as to the degree of vertical integration likely to be chosen by a refiner. The theory predicts that stations at which manager effort is easily observable, such as stations that have self-service only or that have convenience stores, are more likely to be company-operated. Stations at which unobservable or costly manager effort is important to the profitability are more likely to have lessee dealers or open dealers. Such stations include those that offer full service or have auto repair service. The more important unobservable effort is to the overall profitability of the station, the more likely the station is to be an open dealer rather than a lessee dealer.

6. The share of profits derived from ancillary services (i.e., automotive repair, convenience store, car wash, etc.) also has an important effect on the choice of whether to operate a station with a lessee dealer as opposed to an open dealer. The total profit of a station might be sufficiently high to earn a normal rate of return on the land and invested capital, but the refiner's share of the station profit, as reflected in its profit on gasoline sales and the leasing of the station capital may not be. Therefore, the higher the share of profits derived from ancillary services, the more likely it is that the station will be operated as an open dealer as opposed to a lessee dealer.

7. Retail prices that maximize the refiner's profit are most easily assured in the case of company-operated stations, since retail prices at those stations can be set directly by the refiner. In the case of dealer-operated stations, the refiner cannot directly control the retail price. If the refiner sets a lease payment equal to its fixed cost of operating the station and sets a price for gasoline equal to the marginal cost of producing gasoline, the joint profits of the refiner and the dealer from the sale of gasoline are maximized, but all of the gains from the retailing of gasoline accrue to the dealer. In order to appropriate a share of those gains, with a lease payment equal to its fixed cost, the refiner charges the dealer a price above marginal cost for gasoline. "Double marginalization" occurs because the dealer's retail price will most certainly include the marginal cost of operating the station.

8. Double marginalization can be avoided, however, by charging a price for gasoline equal to marginal cost and a lease payment in excess of fixed cost. In this way, joint profits from the sale of gasoline are still maximized, but now a share of the gains accrues to the refiner. If the dealer is risk averse, however, the contract terms will likely result in the refiner charging a higher price for gasoline and a lower lease payment in order to reduce the fluctuations in the dealer's income. In the case of an open dealer, prices charged to the dealer for gasoline can be expected to be in excess of marginal cost because, in effect, the lease payment charged by the refiner to open dealers is zero. It is possible to induce dealers to charge lower retail prices for gasoline through minimum quantity requirements. From the perspective of the refiner, however, this is second best to setting the price directly. Since the minimum quantity requirement tends to be in place over a long period of time, it needs to be sufficiently low so as to allow the dealer to meet the requirement under a variety of market conditions. Therefore, even with minimum quantity requirements, prices at dealer-operated stations can be expected to exceed those at company-operated stations.

[3] J. Barron and J. Umbeck, The Effects of Different Contractual Arrangements: The Case of Retail Gasoline Markets, *Journal of Law and Economics* 27 (October 1984): 313-28, and A. Shepard, Contractual Form, Retail Price, and Asset Characteristics in Gasoline Retailing, *RAND Journal of Economics* 24 (Spring 1993): 58-77 both have a good discussion of the economic theory of vertical integration in gasoline retailing and much of this section is drawn from their work.

4. Changes in Gasoline Retailing in the United States which Led to Divorcement

9. Since the late 1970s, there have been numerous proposals in the United States at both the federal and state level, some of which have become law, to affect the vertical relationship between gasoline suppliers and their franchised dealers. Many of these proposals, especially those relating to divorcement, have been in response to changes in supply and demand taking place in the gasoline retailing industry. About 30 years ago, gasoline retailing in the United States began its transformation from low volume, full service stations with auto repair service to high volume, self-service stations with convenience stores. This transformation was driven by changes in consumer preferences and by increased construction and operating costs of retail gasoline stations. One consequence of these industry changes was a reduction in the overall number of retail stations, and a reduction in the number of stations operated by lessee dealers in particular. The total number of branded stations of the major refiners fell from 203,101 in 1972 to 125,713 in 1978. Over this same period, the number of lessee dealers fell from 106,430 to 57,171, while the number of company-operated stations increased from 11,521 to 13,790.[4]

10. The dramatic decline in their numbers and the concomitant increase in the number of company-operated stations led lessee dealers to conclude that refiners must be acting predatorily to drive them from gasoline retailing. The lessee dealers took their claims of predatory behavior to state legislatures, and the result in some states has been the divorcement of gasoline retailing from refining. The evidence bearing on industry behavior at the time that most divorcement laws were enacted suggests that predation did not occur. Absent collusion, the individual refiners did not have sufficient market power to engage in successful predation against their dealers. At the time that the claims of predation were being made, refiners sold far more gasoline through lessee dealers than they did through company-operated stations. In 1978, the major refiners only sold 11.8 percent of their gasoline through company-operated stations, while 25.5 percent of their gasoline sales were made through lessee dealers.[5] It would not make economic sense for refiners to act predatorily toward a group that was responsible for such a large proportion of their retail sales.

5. Federal and State Laws in the United States Affecting Vertical Relationships in Gasoline Retailing

5.1. Petroleum Marketing Practices Act (PMPA)

11. The PMPA is the main federal law in the United States regulating vertical relationships in gasoline retailing. It stipulates the circumstances under which a supplier can either terminate or choose not to renew a franchise contract with its franchisee. The main circumstances under which a supplier may terminate a franchise contract include noncompliance with important provisions of the contract, lack of good faith effort to carry out the contract terms, mutual agreement between the supplier and the franchisee, and instances in which the supplier no longer serves the market area of the franchisee. The circumstances under which a supplier may choose not to renew a franchise contract include all of the circumstances under which a franchise contract may be terminated. In addition to those circumstances, a supplier may choose not to renew a franchise contract if the franchisee does not agree to changes or additions to the franchise; if there are numerous consumer complaints regarding the franchise; if the franchise is operated in an unsafe or unhealthy manner; if the supplier has decided to change the use of the property, to materially add to or alter the property, or to sell the property; or if continuation of the franchise is uneconomical. The PMPA also grants certain rights to the franchisee at the termination or non-renewal of the franchise contract regarding the disposition of the franchise property. Under certain circumstances, the franchisee has the

[4] U.S. Department of Energy, Final Report: The State of Competition in Gasoline Marketing (1981), pp. xi and 174.

[5] Id., p. ES-6.

right of first refusal on the sale of the property and may be entitled to part of any compensation the supplier receives when the property is taken through eminent domain, or when the supplier loses the right to grant use of the trademark.[6]

5.2. Case Law: State Oil Co. v. Khan

12. In *State Oil Co. v. Khan*, the United States Supreme Court considered the use of a maximum resale price agreement between a lessee dealer (Khan) and a supplier (State Oil). State Oil sold gasoline to Khan at a price equal to a suggested retail price less a specified profit margin. If Khan made sales above the suggested retail price, it was required to rebate the difference to State Oil. If sales were made below the retail price, then Khan's profit margin was reduced. State Oil began eviction proceedings against its lessee dealer when Khan fell behind on lease payments. Khan brought suit under the Sherman Act claiming that the pricing provisions of the lease violated what was then a *per se* rule against maximum resale price maintenance. The Court overturned its previous decision in *Albrecht v. Herald Co.* and held that maximum resale price maintenance should be evaluated under a rule of reason. This means that maximum resale price agreements in gasoline retailing, and generally, are only illegal if the anti-competitive effects of the agreement outweigh the pro-competitive benefits.[7]

5.3. State Regulations

13. Currently, the laws of six states and the District of Columbia require some form of divorcement for retail gasoline stations. Most of the laws were passed in the late 1970s and early 1980s. The state of Maryland has the longest experience with divorcement. Maryland's law requiring divorcement was passed in 1974 but did not become effective until 1979 due to legal challenges. The state laws vary in the degree of divorcement required. The laws in Connecticut, the District of Columbia, and Maryland required divorcement for both new and existing retail stations.[8] The law in Delaware, however, only applied to new stations. The laws in Hawaii and Virginia do not require complete divorcement but instead regulate the distance between company-operated and dealer stations. In Hawaii, there can be no new company-operated stations within one-eighth of a mile of dealer stations in urban areas and within one quarter of a mile elsewhere. In Virginia, new company-operated stations must be at least 1.5 miles from dealer stations. The law in Nevada limits the number of stations that a refiner may operate. A refiner with fewer than 30 company-operated stations may add no more than five company-operated stations per calendar year. A refiner with at least 30 company-operated stations must add one lessee dealer station for every two company-operated stations added.

14. Numerous other proposed and actual state laws affect the vertical relationships between dealers and refiners. Most of these laws are aimed at preventing price discrimination on the part of refiners. Two types of price discrimination are addressed by the legislation. Some of the laws seek to prevent price discrimination based on the ownership of the station. That is, the laws seek to prevent refiners from setting transfer prices at their company-operated stations lower than the price charged to lessee dealers. Other laws are aimed at preventing the use of price discrimination based on the geographic location of the station. That is, the laws seek to prevent the establishment of price zones. With zone pricing, refiners typically charge higher prices to stations with less competitive conditions. Arkansas, California, and

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6 A summary of the main provisions of the PMPA can be found at http://www.cga.ct.gov/2006/rpt/2006-R-0626.htm.

7 Although not directly related to gasoline retailing, the U.S. Supreme Court also overturned a *per se* rule against minimum resale price maintenance in its *Leegin Creative Leather Products v. PSKS, Inc.* decision.

8 See the discussion on the FTC's advocacy work in section VII below for more detail about the District of Columbia's divorcement law.

Florida have laws aimed at preventing price discrimination based on the ownership status of a station, and the Connecticut legislature recently considered a bill banning the use of price zones.

6. Empirical Studies Relating to the Divorcement Experience of the United States

15. The economics of vertical integration in gasoline retailing suggest that regulations aimed at affecting the degree of vertical integration, such as divorcement, are likely to raise the retail price for gasoline. If a refiner would choose to operate an outlet, but is prevented from doing so by divorcement, economics tend to predict that the retail prices for gasoline will be higher. Inefficiencies are introduced into gasoline retailing by limiting vertical integration to a sub-optimal level and through double marginalization. Several empirical studies find that regulations aimed at affecting vertical relationships in gasoline retailing likely result in higher retail gasoline prices in the United States.

16. Barron and Umbeck used regression analysis to estimate the impact of divorcement on retail gasoline prices in Maryland. Their study was conducted using data from Maryland retail stations from June 1, 1978 to January 15, 1981. Their data set included prices both before and after divorcement as well as prices on affected and non-affected stations. They estimated that prices at stations affected by divorcement were, on average, 9.5 cents lower than non-affected stations prior to divorcement. In addition, they found that at stations affected by divorcement, the full-service price increased by 6.6 cents and the self-service price increased by 1.4 cents. At stations in competition with affected stations, the full-service price increased by 1.0 cent, and the self-service price increased by less than a cent. Their estimates suggest that prices at all stations rose as a consequence of divorcement, but the increase was larger for stations that were previously company-operated.

17. Shepard used regression analysis to explore the implications of the economics of vertical integration in gasoline retailing on the degree of vertical integration and on price. Her study used data on price and the organizational form of 924 stations in eastern Massachusetts in 1987. Since company-operated stations can set retail prices directly, we might expect retail prices at those stations to be lower relative to lessee dealers and open dealers. Shepard estimated that the price of premium full-service unleaded gasoline was five cents lower at company-operated stations that at dealer-operated stations.[9] She also estimated that, on average, the existence of auto repair service reduced the probability that a station would be company-operated from 0.08 to 0.02. In addition, she estimated that the existence of a convenience store increased the probability that a store would be company-operated from 0.03 to 0.08. Although not a direct part of her analysis, these results suggest that requiring divorcement would result in higher retail prices for gasoline.

18. Vita, similarly to Barron and Umbeck, used regression analysis to estimate the impact of divorcement on retail gasoline prices.[10] Vita's study differs from that of Barron and Umbeck in that he used a cross-sectional data set containing retail gasoline prices in both divorcement and non-divorcement states, whereas the Barron and Umbeck study looked only at one state before and after divorcement was introduced. In his study, Vita used data on average monthly retail prices for each state for the period between January 1995 and December 1997. He estimated that the retail price of gasoline was 2.6 cents higher in states with divorcement laws than without these laws. In addition, he estimated the loss to U.S. consumers from divorcement to be over $100 million annually.

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9 Lower prices are also found at company-operated stations for other grades and levels of service. However, those estimates were not statistically significant.

10 M. Vita, Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies, *Journal of Regulatory Economics* 18 (2000): 217-33.

19. Blass and Carlton examined data on the newly constructed stations of 10 integrated refiners for the period 1984-87.[11] Their data included the contractual form used by the refiner in addition to the gasoline volume and number of service bays at each station. They found that only 18 percent of stations without service bays were run by dealers, while more than half of newly constructed stations with service bays were run by dealers. They also estimated the cost of converting all company-operated stations in the United States into lessee dealer stations to be at least $1 billion annually. They argued that the actual cost could be even higher because they only examined data for major refiners, and independent refiners tend to have a larger proportion of company-operated stations. Blass and Carlton also found that investment in new retail stations is lower in divorcement states than in non-divorcement states. They found that new investment increased by 153 percent in non-divorcement states and decreased by eight percent in divorcement states. In addition, investment in newly constructed stations depends on the level of company-operated station sales, and not on the level of dealer sales.

20. A study by Barron, Taylor, and Umbeck, although not dealing with divorcement specifically, examined another aspect of vertical relationships in gasoline retailing.[12] The study focused on the issue of open supply. Open supply proposals typically involve eliminating the restriction on lessee dealers to carry only the gasoline of their contracted refiner and allowing lessee dealers to purchase gasoline from any source. The proponents of open supply argue that such a policy would allow the lessee dealers to pay the lower rack price for gasoline which stations supplied by jobbers pay, and that the savings from doing so would be passed on to consumers. An examination of retail prices in the Los Angeles Basin for the period 1992-95 revealed that the claims of open supply proponents may not be true. Barron, Taylor, and Umbeck estimated that stations supplied by jobbers had retail prices 1.7 to 2.7 cents per gallon higher than stations that were directly supplied by the refiner. In addition, stations that switched from being supplied by jobbers to direct supply by the refiner reduced their prices by 0.6 to 1.0 cents per gallon. These results suggest that lessee dealers would not necessarily pass on cost savings if they were given the right to open supply.

7. Advocacy by the Federal Trade Commission Regarding Vertical Relationships in Gasoline Retailing

21. The FTC has responded to numerous requests since the mid-1980s to comment or provide testimony on proposed or actual state and federal laws aimed at regulating the vertical relationship between suppliers and dealers.[13] At the state level, about half of the requests relate to divorcement and open supply proposals, while the balance relates to prohibitions of price discrimination. The FTC has not supported one method of gasoline retailing over another in its testimony and comments, but has instead opposed restrictions that limit a refiner's choice in how it retails its gasoline. Three main points have been made by the FTC. The first is that the competitive harm that the law is aiming to correct likely does not exist. Second, even if a competitive harm does occur, federal and state antitrust laws are adequate to address the harm. Third, the likely effect of the proposed or actual law is to raise retail gasoline prices for consumers.

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11 A. Blass and D. Carlton, The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice, *Journal of Law and Economics* 44 (October 2001): 511-24.

12 J. Barron, B. Taylor, and J. Umbeck, Will Open Supply Lower Retail Gasoline Prices?, *Contemporary Economic Policy* 22 (January 2004): 63-77.

13 In addition to the advocacies mentioned here, the FTC has also contributed comments to state legislatures in Hawaii (1985 and 2003), Georgia (1987), Virginia (1990), Arkansas (1991), California (1992), Utah (1992), and Kansas (1992). In prior years, the Department of Justice engaged in similar advocacy.

22. The FTC, in the 1980s, testified before the United States Congress in opposition to three proposed bills affecting the vertical relationship between refiners and gasoline retailers.[14] The bills proposed complete divorcement for major refiners, caps on retail station ownership for smaller independent refiners, open supply, uniform pricing, and prohibited sales below cost. The open supply proposal was supported, in principle, by the FTC in that open supply could encourage dealers to provide new products and induce independent refiners and jobbers to enter into new marketing areas. The bill, however, was likely to encourage integration into company-operated stores merely to avoid allowing open supply. The FTC opposed divorcement proposals on the grounds that the evidence did not suggest that predatory subsidization on the part of refiners, at which the proposals were aimed, actually existed. Testimony was also given in opposition to the pricing proposals because they were likely to prevent pro-competitive price decreases.

23. The most recent state level advocacy request relating to divorcement was a request to comment in 2007 on proposed changes to the existing divorcement law in the District of Columbia. The District's *Retail Service Station Act of 1976* originally prohibited the operation of retail service stations in the District by jobbers, producers, refiners, or manufacturers of motor fuels. The proposal on which comments were requested was to amend the law to allow jobbers to operate retail service stations. The FTC opposed the divorcement provision of the *Retail Service Station Act* but supported the proposal to allow for jobber-operated retail stations. The FTC believed that residents of the District were likely paying higher prices and receiving a lower quality of service as a consequence of the divorcement provision. In addition, the FTC suggested that the proposal would enhance retail service station competition (although, the benefits would be greater if the divorcement provision was removed altogether).

24. The FTC was last asked to comment on a state level open supply proposal in 1990 by the legislature of the Commonwealth of Massachusetts. The open supply proposal was part of a pair of bills pending before the legislature that also included divorcement and uniform pricing provisions. The open supply provision would have prohibited refiners from preventing dealers from storing or distributing the motor fuel purchased from other suppliers at the refiner's branded station, provided the dealer posted appropriate notice of such activity to the station's customers. The FTC opposed the open supply provision for two reasons. The first was that, in the presence of open supply, refiners would likely abandon franchised retail stations in favor of making more commodity sales at the terminal or refinery gate. The second reason was that refiners would be less likely to make sizeable capital investments at their leased stations if they are not able to guarantee sales of their products at those stations. Both of these implications of the open supply provision suggested that it would lead to a less efficient distribution system for gasoline.

25. The FTC, in 2007, was asked to comment on a proposal before the Connecticut legislature to prohibit geographic price discrimination at the wholesale level on the part of refiners. The proposal, which ultimately did not pass, was aimed at eliminating the practice of zone pricing on the part of refiners. As mentioned previously, refiners using zone pricing charge higher prices in geographic areas with less competitive conditions. The FTC opposed the proposal to prohibit zone pricing because the practice has the potential to benefit consumers. Zone pricing may encourage entry into less competitive areas by refiners since the practice allows refiners to capture more of the return from ownership of more profitable retail stations.

[14] The proposed bills on which the FTC offered testimony were House Resolution 1362 (1981), House Resolution 5023 (1984), and Senate Bill 1140 (1985).

8. Recent Trends in Gasoline Retailing in the United States

26. Consolidation among major refiners beginning in the 1990s and the low profitability of their marketing assets led to the conversion of a large number of lessee dealers to open dealers. In 1991, 40.9 percent of retail stations of the major refiners were lessee dealers, while 22.1 percent were company-operated and 37 percent were open dealers. By 2001, only 21 percent of stations were lessee dealers, while company-operated stations fell to 21.2 percent and open dealer stations increased to 57.7 percent. This trend has continued into 2006 with 15.8 percent of stations operated as lessee dealers, 20.4 percent company-operated and 63.8 percent operated as open dealers.[15] The percentage of stations operated as open dealers might be expected to increase even further in 2008 with recent announcements by ExxonMobil, ConocoPhillips, and BP that they are selling large numbers of their company-owned stations. ExxonMobil announced plans to sell over 2,200 stations, of which 1,400 are currently operated by dealers.[16]

27. Most of the stations that are part of the recent sell-off by major refiners will continue to be operated as retail gasoline outlets. This suggests that overall the stations are profitable but that the refiner's share of the profit (i.e. its profit from gasoline sales) is not sufficiently high to maintain an ownership interest in those assets. Statistics on the profitability of convenience stores which also sell gasoline seem to support this conclusion. The average gross margin on their in-store sales for 2006 was 29.9 percent, while their average gross margin for motor fuel sales was only 5.5 percent giving an overall average gross margin of 12.3 percent.[17] As refiners continue to reduce the degree to which they are vertically integrated into gasoline retailing, we might expect restrictions on vertical integration, such as divorcement, to become less binding over time.

9. Conclusion

28. All of the empirical studies on the divorcement experience of the United States suggest that divorcement raises the retail price of gasoline. The FTC, in its testimony before Congress and in its comments to state legislatures, has consistently advocated against restrictions, such as divorcement, on the vertical integration of refiners into the retailing of gasoline. Industry changes in the late 1970s motivated many of the restrictions on vertical integration in gasoline retailing in place today. If more recent trends are maintained, and refiners continue to reduce the extent to which they are vertically integrated into gasoline retailing, regulations restricting that integration may become less binding over time.

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15 Energy Information Administration, *U.S. Downstream Independents Acquire National Prominence in the 1990s*, available at http://www.eia.doe.gov/emeu/finance/sptopics/restructure/highlite4.html and Energy Information Administration, *Performance Profiles of Major Energy Producers*, Table B30, available at http://www.eia.doe.gov/emeu/perfpro/btab30.html.

16 J. Franco, ExxonMobil to Quit Retail Gasoline Business, *Octane Week* 23 (June, 23, 2008): 11; P. Merolli, Conoco to Exit Low-Margin U.S. Retail Market, *Oil Daily* (August 28, 2008).

17 National Petroleum News, *Marketfacts* (2007), p. 95.