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UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
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Office of the Regional Director

March 22, 1991

The Honorable W.D. Moore, Jr.
Arkansas Senate
General Assembly
Little Rock, AR 72201

Dear Mr. Moore:

The staffs of the Dallas 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 competitive effects of proposed legislation that would create the "Arkansas Petroleum Trade Practices Act." The bill would, in general, prohibit "below cost" retail pricing, as "cost" is defined in the bill, and price discrimination in the sale of gasoline.

It is our understanding from conversations with your office that, although the bill has not yet been filed, you would like our analysis and comments on the competitive effects both of the legislation as well as any similar legislative proposals that may be introduced. As we discuss below, we believe that this bill and similar legislation that we have previously reviewed are likely to be anticompetitive and that, if enacted, Arkansas consumers and visitors could pay higher prices for gasoline.

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

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[1] These comments are the views of the staff of the Dallas 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.

offering countervailing benefits to consumers. In particular, the Commission and its staff have had considerable experience assessing the competitive impact of regulations and business practices in the oil industry.[2]

Description of the proposed legislation

The proposed legislation, the Arkansas Petroleum Trade Practices Act, would address below-cost retail pricing and discrimination by vertically-integrated petroleum refiners in prices, allocations, and rebates.

Section 4(a)(i) of the bill would prohibit retail sales of gasoline below the retailer's cost of motor fuel, "where the effect may injure competition."[3] The retailer's cost is defined to include the sum of (1) the lesser of the purchase price, less trade discounts, and the replacement cost of the fuel; (2) transportation costs; (3) taxes; and (4) the reasonable cost of overhead.[4] Section 4(a)(ii) provides that a retailer who stores motor fuel in one-hundred gallon or larger containers and who makes or offers to make "below cost" sales to the public may not refuse to make sales to another dealer or distributor at the same 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 Virginia, Massachusetts, Louisiana, Montana, North Carolina, South Carolina, Georgia, Alabama, Tennessee, Washington, Hawaii, Nevada, 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] The bill would permit sales below cost when made in good faith to meet competition and includes specific exemptions for unusual circumstances, such as sales of discontinued products, liquidation of a business, or sales pursuant to a court order. Section 4(c),(d).

[4] Section 2(d). "Cost of overhead" is defined in Section 2(c) to mean the fully allocated costs of conducting business, including but not limited to labor, executive salaries, rent, interest, depreciation, and all sales, general, and administrative costs.

Section 4(b) of the proposed law would prohibit vertically integrated refiners from transferring motor fuel to refiner-owned or affiliated[5] retail dealers at a price lower than the price charged to franchised or independent dealers within the same competitive area. Section 5 would enjoin refiners from discriminating in allocations of gasoline between refiner-owned or affiliated retailers and franchised dealers, unless the allocations are "reasonable" and "nondiscriminatory." Section 6 would make it illegal for a refiner to discriminate in rebates and concessions "where the effect may injure competition."[6] Section 7 of the bill would require all vertically integrated refiners doing business in Arkansas to disclose, upon request, the transfer prices charged to their own business units and affiliates.

Violations of the Arkansas Petroleum Trade Practices Act would be subject to prosecution by the state attorney general and would subject the violator to injunctions and civil penalties of up to $1000 per day. The bill would also permit private actions for injunctive relief, civil penalties, and actual and special damages. Treble damages could be awarded for willful or knowing violations.[7]

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

The premise of the proposed law 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 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

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[5] An "affiliate" is a dealer (other than by franchise) controlled by the refiner. Section 2(a).

[6] The bill would allow refiners to meet rebates and concessions granted by competitors. Section 6.

[7] Section 8(a)-(c), (e).

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.

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 the alleged "subsidization" of retail gasoline operations by the major refiners actually existed, and, if it did, whether the practice was 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 investigators. The study concluded that there was no evidence of such "subsidization."[8]

In 1984, DOE published an updated study that further substantiated and elaborated on its 1981 findings.[9] 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.[10]

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

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

[9] DOE, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers, March, 1984 (hereinafter cited as 1984 DOE Report).

[10] *Id*. at 125-32.

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.[11]

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, after more than a year of extensive inquiry and analysis, the Committee recommended that no new legislation be enacted, concluding that "[t]he marketplace for petroleum products is very competitive in Arizona."[12]

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."[13] Franchised 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

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

[12] Final Report to the Arizona Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement, December, 1988, at 35. Some data contained in the 1984 DOE study indicate that gasoline markets in Arkansas are unconcentrated. <u>See</u> 1984 DOE Report at 90-91. Generally, as a market becomes less concentrated, the likelihood of anticompetitive conduct in the market declines.

[13] 1984 DOE Report at ii. We do not mean to suggest that the fortunes of refiners and their franchised retailers are perfectly linked, only that the studies have found that in general the refiners and their retailers share common goals. 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.

of the gasoline stations in the United States.[14] In 1981, the eight largest refiners nationally, who in the aggregate accounted for about half of all gasoline sales, sold approximately eight times more gasoline through lessee dealers than through company-operated outlets.[15]

Gasoline Marketing in Arkansas - The national pattern is reflected in the distribution systems of the leading branded refiners in Arkansas. The 1984 DOE study indicates that vertically integrated gasoline marketers accounted for only 3.3 percent of total sales in Arkansas in 1981.[16] None of the eight leading branded refiners in Arkansas for which data are available use company-owned and operated outlets as the predominant form of retailing on a national basis.[17] However, company operated outlets may be a predominant form of retailing for smaller independent refiners. For example, Total Petroleum, which has a presence in Arkansas, has more than three times as many company-owned outlets as franchised dealers selling its product.

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[14] 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).

[15] 1984 DOE Report at 146 (Table A-10).

[16] 1984 DOE Report at 82. This contrasts with a nationwide figure of 13.1 percent.

[17] National Petroleum News 1989 Factbook 34-51. Of the major branded refiners, Chevron has the largest-selling brand in Arkansas, followed by Exxon, Phillips 66, Texaco, Kerr-McGee, Citgo, Conoco, and American Petrofina. Nationally, Chevron, Exxon, Texaco, and American Petrofina use company-owned stations in fewer than 6% of their branded outlets, while Conoco operates 9.8% of its branded stations. Kerr-McGee operates 30% of its branded stations nationally but is a relatively small refiner, with a market share of refining capacity at 1.09% and only one-sixth as many branded outlets as Chevron or Exxon. 1989 Factbook at 140. Phillips 66 is exceptional in favoring company-operated service stations, operating four times as many as Chevron or Exxon. (Data are unavailable for Citgo.)

Given the importance of the branded, franchised marketing distribution system, major refiners lack incentives to charge discriminatory prices that would cause their franchised retailers to seek new sources of supply or to go out of business. A refiner that undertook such a course of action would probably face a loss in sales, a decrease in market share, an increase in excess refining capacity, and higher per unit costs. Thus, the major integrated refiners are not likely to engage in predation against the mainstay of their own retail distribution systems, their franchised retailers. Moreover, it would be difficult for major refiners to target independent dealers without injuring their own franchised retailers.

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.[18] In addition, price discrimination that injures competition is subject to the Robinson-Patman Act, 15 U.S.C. § 13, (which is Section 2 of the Clayton Act).[19] These statutes address possible anticompetitive practices in the industry and deter firms from engaging in predatory behavior and/or illegal price discrimination. In contrast, the proposed legislation may make it more difficult for firms to adjust their prices in response to changing conditions of demand and supply. Such legislation is likely to add costs to the distribution of gasoline in Arkansas that do not exist in other states, costs that would be borne by Arkansas consumers and visitors.

The price and allocation regulatory features of the bill may lead to higher gasoline prices

Enactment of the proposed legislation 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.[20]

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[18] The Arkansas Antitrust Statutes, Ark. Code Ann. § 4-75-201 et seq. (1987), may also address predatory behavior.

[19] See Texaco, Inc. v. Hasbrouck, _____ U.S. _____, 110 S. Ct. 2535 (1990), a Supreme Court case where franchised gasoline retailers successfully challenged price discrimination by a vertically integrated refiner.

[20] The Supreme Court recognized in the recent case of Texaco, Inc. v. Hasbrouck, that it does not violate the antitrust laws for a gasoline wholesaler to charge different prices to (continued...)

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.[21] As a broad generalization, economic theory says that vertical integration is likely to harm consumers only when market power exists in at least one stage of production.[22]

An unintended effect of the proposed legislation may be to encourage vertically-integrated refiners who distribute gasoline in Arkansas 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.[23] However, such lawful price competition may be discouraged by a number of provisions in the proposed bill, including the recordkeeping and disclosure obligations imposed by Section 7 thereof. Firms may simply decide to set uniform prices across broad geographic

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[20](...continued) distributors for retail gasoline if the wholesaler can show that the buyer performs a wholesale function that reduces the wholesaler's cost. 110 S. Ct. at 2545, 2550. Such a "functional discount" will normally qualify as legitimate and will not injure competition. As the court notes, "[a]t the least, a functional discount that constitutes a reasonable reimbursement for the purchasers' actual marketing functions will not violate the Act." 110 S. Ct. at 2550.

[21] 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 proposed legislation may inhibit such firms from using these savings to lower prices to consumers. This is a result of Section 4(b), which may effectively prohibit vertically integrated refiners from passing their cost savings on to company operated outlets (because they would be prohibited from transferring gasoline to these outlets at prices below that charged to competing outlets) and Section 4(a)(i), which would further preclude such savings from being passed through to the consumer (because retail sales below the transfer cost to the outlet would be prohibited).

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

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

regions to avoid violations.[24] The bill, therefore, if enacted, could result in higher profits for all gasoline refiners and marketers through higher prices for Arkansas consumers and visitors.

Conclusion

For the reasons stated above, we believe that the bill, if enacted, would tend to insulate gasoline refiners and marketers from competition, and thereby could cause gasoline prices in Arkansas to increase.

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[24] To the extent that individual firms would have an incentive to set a single price in a geographic area to avoid violating the proposed bill, the law would resemble "uniform price laws," the possible effects of which were discussed as follows in the 1984 DOE report, _supra_, n. 9, 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 now take into account the uniform price law. . . . [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.

We appreciate the opportunity to comment on this bill. Please feel free to contact us if we can be of further assistance.

Sincerely,

Thomas B. Carter
Director
Dallas Regional Office