

FEDERAL TRADE COMMISSION

WASHINGTON, D.C. 20580



July 24, 2003

The Honorable Eliot Spitzer
Attorney General
120 Broadway
New York, New York 10271-0332

Dear General Spitzer:

The staffs of the Federal Trade Commission's Office of Policy Planning and Bureau of Competition are pleased to respond to your request, sent to us on July 1, 2003 by Assistant Attorney General Richard Grimm, for comments on New York's Motor Fuel Marketing Practices Act ("MFMPA"), Bill Nos. A.8398 and S.4947.¹ The MFMPA would prohibit refiners and nonrefiners of motor fuel from selling motor fuels below 98% of the bill's definition of refiner and nonrefiner cost, respectively, where the effect is to injure competition.

We believe that there is a significant risk that the MFMPA could harm consumers. Last August, FTC staff submitted comments to Governor Pataki on a virtually identical bill, S.4522-B, which the governor ultimately vetoed. In those comments (copy attached), FTC staff concluded that the bill was at best unnecessary and at worst could discourage pro-competitive pricing. The current bill suffers from the same flaws. The changes – banning sales below 98% of cost, rather than cost, and creating a *de minimis* exception – do not correct the fundamental problems in the previous bill. In particular, the 98% measure appears arbitrary, with no basis in Supreme Court precedent, federal antitrust law, basic economic theory, or empirical studies. Moreover, the *de minimis* exception, while better than no exception at all, still appears too narrow to allow vigorous competition.

Our views on the entire bill are summarized below:

- Low prices benefit consumers. Consumers are harmed only if, because of low prices, a dominant competitor is able later to raise prices to supracompetitive levels. *See Attached Letter at 6-7.*

¹ This letter expresses the views of the Federal Trade Commission's Bureau of Competition and Office of Policy Planning. The letter does not necessarily represent the views of the Commission or of any individual Commissioner. The Commission has, however, voted to authorize us to submit these comments.

- Economic and legal studies and court decisions indicate that below-cost pricing that leads to monopoly rarely occurs. Below-cost sales of motor fuel that lead to monopoly are especially unlikely. *See* Attached Letter at 8-11.
- The federal antitrust laws deal specifically with below-cost pricing that has a dangerous probability of leading to monopoly. The FTC, the Department of Justice’s Antitrust Division, state attorneys general, and private parties can bring suit under the federal antitrust laws in response to anticompetitive below-cost pricing. *See* Attached Letter at 5-6.
- When there is no danger that a monopoly might later be created, consumers are harmed by public policies that have the effect of increasing low prices that are the product of the competitive process. *See* Attached Letter at 7-8.
- The MFMPA has the potential to discourage pro-competitive price reductions. Under the bill’s definition of “competition,” a supplier likely could face antitrust liability for pricing below a single competitor, even if consumers benefit from the lower prices and even if there is no risk that the supplier could recoup its lost profits. Moreover, the 98% of cost measure appears arbitrary, while the MFMPA’s *de minimis* exception appears too narrow to allow vigorous competition.

Analysis of the MFMPA

The MFMPA bans fuel sales below 98% of the nonrefiner or refiner “cost,” where the effect is to injure “competition.” The Act defines “competition” as “the vying for motor fuel sales between any two or more sellers in the same relevant geographic market.” The Act defines “Refiner Cost” as the refiner’s posted terminal price of motor fuel adjusted for several factors, including taxes, freight charges, direct labor costs, and imputed rental value of the refiner’s retail outlet. It defines “Nonrefiner Cost” as the invoice cost of motor fuel, adjusted for the same factors.

A. The MFMPA’s definition of competition

As the Supreme Court has recognized, federal antitrust laws are designed “for the protection of competition, not competitors.”² The federal antitrust laws recognize that price-cutting benefits consumers and competition, because it forces producers to minimize costs and prices, and to increase quality. Vigorous price competition promotes consumer welfare, because consumers reap the benefits of lower prices, increased productivity, greater variety, and higher quality goods and services. Accordingly, low prices, and even below-cost prices, do not harm consumers unless sustained above-cost prices can occur later on:

² *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977) (quoting *Brown Shoe Co. v. United States*, 370 U.S. 294, 320 (1962)).

[T]he short-run loss is definite, but the long-run gain depends on successfully neutralizing the competition. Moreover, it is not enough simply to achieve monopoly power, as monopoly pricing may breed quick entry by new competitors eager to share in the excess profits. The success of any predatory scheme depends on maintaining monopoly power for long enough both to recoup the predator's losses and to harvest some additional gain.³

Therefore, even if a below-cost pricing strategy succeeds in temporarily reducing the number of competitors, the price-cutter must find a way to keep competitors from returning after it tries to raise prices again. Otherwise, the below-cost pricing strategy, which requires that the firm incur losses on every sale, will not succeed. When a firm fails to recoup short-run losses (from sales at below-cost prices) in the long run, consumers enjoy a windfall, and without harm to consumers, an antitrust violation does not occur. Along these lines, the Supreme Court has stated that “[t]he second prerequisite to holding a competitor liable under the [federal] antitrust laws for charging low prices is a demonstration that the competitor had a reasonable prospect, or, under § 2 of the Sherman Act, a dangerous probability, of recouping its investment in below-cost prices. . . . Evidence of below-cost pricing is not alone sufficient to permit an inference of probable recoupment and injury to competition. . . . Although unsuccessful predatory pricing may encourage some inefficient substitution toward the product being sold at less than its cost, unsuccessful predation is in general a boon to consumers. . . . That below-cost pricing may impose painful losses on its target is of no moment to the antitrust laws if competition is not injured.”⁴

Like the previous bill, however, the MFMPA defines “competition” in a way that likely would focus on protecting competitors, not consumers and competition. The bill defines “competition” as “the vying for motor fuel sales between any two or more sellers in the same relevant geographic market.” In other states, courts have interpreted similar definitions of harm to competition to include harm to a single competitor.⁵ As Governor Pataki stated, because of this “significant flaw,” a below-cost sale as defined by the MFMPA “could constitute a violation so long as the effect was to ‘injure’ even a single competitor.”⁶ As a result, the MFMPA is likely to discourage pro-competitive price-cutting, which in turn could ultimately harm consumers by increasing the prices they pay at the pump for gasoline.

B. The MFMPA’s arbitrary 98% of “cost” measure

In addition to defining “competition” in a way that does not protect competition or consumers, the MFMPA defines “cost” in a way that is inconsistent with most antitrust precedent and economic and legal literature. The Supreme Court has defined predatory pricing as “pricing below an appropriate measure of [the defendant’s] cost for the

³ *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 589 (1986).

⁴ *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 224, 226 (1993).

⁵ See, e.g., *McGuire Oil Co. v. Mapco, Inc.*, 612 So. 2d 417 (Ala. 1992); *Racetrac Petroleum, Inc. v. Delco Oil, Inc.*, 721 So. 2d 376 (Fla. App. 1998).

⁶ See Veto letter at 1 (copy attached).

purpose of eliminating competitors in the short run and reducing competition in the long run.”⁷ Although the Court has not stated what the appropriate measure of cost should be, prominent antitrust scholars and several federal circuit courts have concluded that the price-cutter’s marginal costs, or a close proxy such as average variable costs, should be the yardstick. Many authorities conclude that average variable cost is the best yardstick, for two reasons. First, a price at or above average variable cost is highly unlikely to drive efficient competitors from the market. Once a firm has invested in fixed assets (such as a service station), it is economically rational for the firm to continue operating as long as it can cover its variable costs, even if prevailing prices sometimes fall below average total cost. Second, a firm can price at average variable cost due to a wide variety of market circumstances; penalizing a firm for doing so would therefore penalize pro-competitive price cutting.⁸

The MFMPA, however, defines refiner and nonrefiner “cost” to include costs other than average variable costs, including factors such as “direct labor costs” and the imputed rental value of the retail outlet.⁹ By including these factors, the MFMPA (like the previous bill) defines “cost” in a way that is higher than economically sensible, which could have the effect of deterring pro-competitive price-cutting. Although the bill tries to separate “direct labor costs” attributable to motor fuel sales from other sales, and thereby to approximate average variable costs for motor fuel sales, as a practical matter, this figure would be very difficult (and expensive) for retailers to calculate. For these reasons, the MFMPA’s definition of cost would deter pro-competitive price-cutting.

Finally, the MFMPA’s use of a 98% measure appears completely arbitrary. FTC staff could locate no support for the 98% measure from any authority on competition policy, including Supreme Court precedent, federal antitrust law, basic economic theory, or empirical studies. Nothing suggests that the 98% measure would benefit consumers or promote competition. Moreover, that measure does nothing to address the MFMPA’s more fundamental problem, which is that it defines cost inappropriately.

⁷ *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 117 (1986).

⁸ See *Kelco Disposal, Inc. v. Browning-Ferris Indus.*, 845 F.2d 404, 407 (2d Cir. 1988), *aff’d on other grounds*, 492 U.S. 257 (1989) (finding that “[p]rices that are below reasonably anticipated marginal cost, and its surrogate, reasonably anticipated average variable cost . . . are presumed predatory”); *International Air Indus. v. American Excelsior Co.*, 517 F.2d 714, 724 (5th Cir. 1975) (holding that plaintiff must show that “either (1) a competitor is charging a price below his average variable cost . . . or (2) the competitor is charging a price below its short-run, profit maximizing price and barriers to entry are great enough to enable the discriminator to reap the benefits of predation before new entry is possible”); P. Areeda and H. Hovenkamp, *Antitrust Law*, ¶ 724; P. Areeda and D. Turner, “Predatory Pricing and Related Practices under Section 2 of the Sherman Act,” 88 *Harv. L. Rev.* 697 (1975). In *Brooke Group*, the parties both agreed that average variable cost should be the appropriate measure. See *Brooke Group*, 509 U.S. at 222 n.1.

⁹ Labor costs can be considered variable if the number of hours worked varies with the level of sales. For large changes in sales this may occur, but for small changes it is unlikely that labor costs will vary with the level of sales. In addition, the legislation specifies that the labor cost included in the cost calculation must at a minimum include the cost of one full-time employee, which effectively treats at least a portion of labor costs as fixed costs.

C. The MFMPA's *de minimis* exception

The second principal difference between the MFMPA and S.4522-B is the creation of a *de minimis* "exception." The bill would grant authority to the state consumer protection board to dismiss complaints that, in the board's view, result from a *de minimis* injury to competition. As a practical matter, however, the exception likely would not encourage pro-competitive price cutting, and instead likely would simply increase uncertainty about the scope of the bill's "below-cost" sales ban. This uncertainty, in turn, could lead to higher prices for consumers. The bill provides no guidance to the consumer protection board or to suppliers about how to evaluate *de minimis* injuries. There is no information about how much of an injury, in terms of dollar amount or percentage of sales, should be considered *de minimis*, nor is there any information on whether an injury to a single competitor should be considered *de minimis* (the bill's text suggests that injury to one competitor would constitute a violation of the MFMPA, even if there are dozens of competitors in the relevant geographic market). The MFMPA's narrow, ambiguously defined *de minimis* exception would not encourage vigorous competition. Accordingly, it does not alleviate the significant risk that the bill could harm consumers.

Conclusion

For these reasons, and the reasons outlined in the attached letter, FTC staff concludes that this version of the MFMPA, like its predecessor, is more likely to harm than to promote competition.

Sincerely,

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