UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
Washington, DC 20580

OFFICE OF POLICY PLANNING
BUREAU OF ECONOMICS
BUREAU OF COMPETITION

June 8, 2007

Councilmember Mary M. Cheh
Chairperson, Committee on Public Services and Consumer Affairs
1350 Pennsylvania Avenue NW, Suite 108
Washington, D.C. 20004

Dear Councilmember Cheh:

We[1] are pleased to respond to your request for our comments on the competitive effects of the Retail Service Station Act's ("the Act") divorcement provision, which prohibits the operation of a retail gasoline service station in the District of Columbia by a "jobber, producer, refiner, or manufacturer of motor fuels."[2] Suppliers sell their gasoline through retail service stations that they own and operate and through service stations that are operated by unaffiliated

---

[1] This letter represents the views of the staff of the FTC Office of Policy Planning, Bureau of Economics, and Bureau of Competition. It does not necessarily represent the views of the Federal Trade Commission or any individual Commissioner. However, the Commission has voted to authorize staff to file this comment.

[2] DC St. § 36-302.02(a). The Act defines a "jobber" as "a wholesale supplier or distributor of motor fuel." *Id*. at § 36-301.01(6A). The Act defines a "refiner, producer, or manufacturer" as:

> any person who is engaged in the business of manufacturing, producing, refining, distilling, blending, or compounding motor fuels, petroleum products, or precursors of motor fuels or petroleum products, which are ultimately sold, supplied or distributed to retail service stations in the District of Columbia by such person or any other person, whether or not such manufacturing, producing, refining, distilling blending, or compounding is performed by such person within the District of Columbia, or who is engaged in the business of importing motor fuels or petroleum products.

Id. at § 36-301.01(12). For the remainder of this letter we collectively refer to jobbers, producers, refiners, and manufacturers of motor fuels as "suppliers."

dealers. Empirical studies suggest that suppliers choose whether directly to operate a service station or to sell gasoline through an unaffiliated dealer based on cost considerations. Further, studies have found that when laws prohibit suppliers from operating retail service stations, consumers pay higher prices for gasoline. Based on this evidence, FTC staff believes that the Act's divorcement provision likely causes D.C. residents to pay more for gasoline than they otherwise would. Accordingly, we support your proposal to allow jobbers to operate retail service stations.

Interest and Experience of the FTC

The FTC monitors competition in the petroleum industry and has invoked all the powers at its disposal – including the investigation and the prosecution of suspected antitrust violations, extensive research and the preparation of studies, and advocacy before state legislatures and other government agencies – to protect consumers from anticompetitive conduct and unfair or deceptive acts or practices in the industry.[3] As a result of these efforts, the FTC has developed expertise in competition policy and enforcement matters affecting the production and distribution of gasoline.

The Commission is responsible for reviewing mergers in the petroleum industry, and it routinely challenges transactions and requires divestitures and other relief in an effort to protect competition and consumers.[4] The Commission also has dedicated resources to study and research broader market dynamics in petroleum markets. For example, this spring, the Commission held a three-day conference examining a wide range of energy issues that concern American consumers, and U.S. and global economies.[5] In 2006, the Commission issued a report

---

[3] The FTC is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. *See* Federal Trade Commission Act, 15 U.S.C. § 45.

[4] *See* Federal Trade Commission v. Paul L. Foster, Western Refining, Inc., and Giant Industries, Inc., Civil Action No. 07cv352 JH/ACT (D.N.M. Apr. 12, 2007); TC Group LLC., et al., FTC Dkt No. C-4183 (Mar. 14, 2007); Aloha Petroleum Ltd., FTC File No. 051 0131 (July 27, 2005); Chevron Corp. et al., FTC Dkt. No. C-4144 (July 27, 2005); Valero L.P., Valero Energy Corp., et al., FTC Dkt. No. C-4141 (July 22, 2005); Phillips Petroleum Co., FTC Dkt. No. C-4058 (Feb. 7, 2003); Valero Energy Corp., Docket C-4031 (Feb. 19, 2002); Chevron Corp., Docket C-4023 (Jan. 4, 2002); Exxon Corp., Docket C-3907 (Jan. 26, 2001); British Petroleum Co. p.l.c., 127 F.T.C. 515 (1999); Shell Oil Co., 125 F.T.C. 769 (1998). All of the documents related to these matters are available at the FTC's website, http://www.ftc.gov/os/caselist/index.shtm. In addition, in 2006 Chevron and USA Petroleum abandoned a transaction in which Chevron would have acquired most of USA Petroleum's retail service stations in California. USA Petroleum's president acknowledged that the parties abandoned the transaction due to resistance from the FTC. *See* Elizabeth Douglass, *Chevron Ends Bid to Buy Stations*, L.A. TIMES, Nov. 18, 2006, *available at* http://www.latimes.com/business/la-fichevron18nov18,1,7256145story?coll=la-headlines-business&ctrack=1&cset=true. The Commission also has brought successful actions against marketers engaging in false advertising related to the sales of products claimed to improve fuel efficiency. *See, e.g.*, *FTC v. Int'l Res. & Dev. Corp.*, Stipulated Order for Permanent Injunction, Case No. 04C 6901 (N.D. Il. Aug. 9, 2006), *at* http://www.ftc.gov/os/caselist/0423138/060809irdstipfinaljdgmnt.pdf.

[5] *Energy Markets in the 21st Century: Competition Policy in Perspective*, *at*

on its investigation of price manipulation and price increases in the wake of Hurricane Katrina.[6] In 2005, it released a report examining the factors that affect gasoline prices in the United States,[7] and in 2004 the Commission released a report on mergers and structural changes in the petroleum industry.[8] In 2001, the Commission issued reports on its investigations into spikes in reformulated gasoline prices in several Midwestern states,[9] and of gasoline price increases in West Coast markets.[10] Commission staff also filed public comments with the Environmental Protection Agency concerning the likely competitive effects of "boutique fuel" regulations.[11] Commission staff is routinely asked by state legislators to comment on proposed state laws covering various aspects of gasoline sales,[12] and has provided comments to law makers in

---

http://www.ftc.gov/bcp/workshops/energymarkets/index.shtml.

[6] FEDERAL TRADE COMMISSION, INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GAS PRICE INCREASES (Spring 2006), *at* http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf.

[7] FEDERAL TRADE COMMISSION, GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (2005), *at* http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf.

[8] BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT (Aug. 2004), *at* http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf.

[9] FEDERAL TRADE COMMISSION, MIDWEST GASOLINE PRICE INVESTIGATION FINAL REPORT (Mar. 29, 2001), *at* http://www.ftc.gov/os/2001/03/mwgasrpt.htm.

[10] *FTC Closes Western States Gasoline Investigation,* FTC Press Release (May 7, 2001), *at* http://www.ftc.gov/opa/2001/05/westerngas.htm.

[11] FTC Staff comments, *Study of Unique Gasoline Fuel Blends, Effects on Fuel Supply and Distribution and Potential Improvements,* EPA 420-P-01-004, Public Docket No. A-2001-20 (Jan. 30, 2002), *at* http://www.ftc.gov/be/v020004.pdf.

[12] *See* Letter from FTC Staff to Connecticut State Rep. Christopher R. Stone (May 2, 2007), *at* http://www.ftc.gov/be/V070008.pdf; Letter from FTC Staff to Michigan State Rep. Gene DeRossett (June 17, 2004), *at* http://www.ftc.gov/os/2004/06/040618staffcommentsmichiganpetrol.pdf; Letter from FTC Staff to Kansas State Sen. Les Donovan (Mar. 12, 2004), *at* http://www.ftc.gov/be/v040009.pdf; Letter from FTC Staff to Demetrius Newton, Speaker Pro Tempore of the Alabama House of Representatives (Jan. 29, 2004), *at* http://www.ftc.gov/be/v040005.htm; Letter from Letter from FTC Staff to Wisconsin State Rep. Shirley Krug (Oct. 15, 2003), at http://www.ftc.gov/be/v030015.htm; Letter from FTC Staff to Eliot Spitzer, Attorney General of New York (July 24, 2003), at http://www.ftc.gov/be/nymfmpa.pdf; Letter from FTC Staff to Roy Cooper, Attorney General of North Carolina (May 19, 2003), *at* http://www.ftc.gov/os/2003/05/ncclattorneygeneralcooper.pdf; *See also* Letter from Ronald B. Rowe, Director for Litigation, FTC Bureau of Competition, to Hon. David Knowles, California State Assembly (May 5, 1992); Prepared Statement of Claude C. Wild III, Director, FTC Denver Regional Office, before the State, Veterans, and Military Affairs Committee of the Colorado State Senate (Apr. 22, 1992); Letter from Claude C. Wild III, Director, FTC Denver Regional Office, to Hon. Bill Morris, Kansas State Senate (Feb. 26, 1992); Letter from Claude C. Wild III, Director, FTC Denver Regional Office, to David Buhler, Executive Director, Utah Department of Commerce (Jan. 29, 1992); Letter from Thomas B. Carter, Director, FTC Dallas Regional Office, to Hon. W.D. Moore, Jr., Arkansas State Senate (Mar. 22, 1991); Letter from Jeffrey I. Zuckerman, Director, FTC Bureau of Competition, to Hon. Jennings G. McAbee, Chairman, Other Taxes and Revenues Subcomm., Ways and Means Comm., South Carolina House of Representatives (May 12, 1989). All of these letters are on file at the FTC.

Hawaii and New York on the likely competitive effects of divorcement laws similar to the Retail Service Station Act.[13]

Background on Gasoline Distribution

Suppliers sell gasoline to consumers through retail service stations that they own and operate and to service stations that are operated by unaffiliated dealers. If a supplier chooses to own and operate a service station (*i.e.*, vertically integrate), the manager of the service station is an employee of the supplier, receiving a salary and possibly some performance incentives. An unaffiliated dealer may operate a service station that is leased from a supplier. This type of dealer (a "lessee-dealer") purchases gasoline from the supplier, pays it rent to use the station, and retains the station's profits. The lease terms typically require the lessee-dealer to maintain certain quality standards and to purchase a specified minimum amount of gasoline from the supplier per period. Rather than leasing a service station from a supplier, an "open dealer" owns the retail service station he or she operates. An open dealer may contract to sell a particular supplier's branded product (*e.g.*, Shell or Exxon gasoline) or may operate as an "independent," selling an unbranded product.[14]

There are two basic means by which gasoline is distributed to retail services stations: direct supply and jobber supply. A supplier that is a branded refiner typically will directly supply the stations it operates and supply the stations it leases to dealers with gasoline at "dealer tank-wagon" prices.[15] Jobbers are independent distributors that purchase gasoline at a terminal and resell it at a delivered wholesale price to open dealers, including stations that they own and operate or that they lease to dealers. Nationally, 69 percent of the volume (in gallons) of wholesale gasoline is sold at the terminal to jobbers, 17.5 percent is sold directly to company operated outlets, and 13.5 percent is sold to retailers through dealer tank-wagons.[16]

The Competitive Effects of Divorcement Laws

---

[13] *See Competition and the Effects of Price Controls in Hawaii's Gasoline Market: Before the State of Hawaii, J. Hearing House Comm. On Energy and Environmental Protection et al.* (Jan. 28, 2003) (testimony of Jerry Ellig, Deputy Director, FTC Office of Policy Planning), *at* http://www.ftc.gov/be/v030005.htm; Letter from FTC Staff to Gov. George E. Pataki of New York (Aug. 8, 2002), *at* http://www.ftc.gov/be/v020019.pdf; Letter from FTC Staff to Hon. Robert F. McDonnell, Commonwealth of Virginia House of Delegates (Feb. 15, 2002), *at* http://www.ftc.gov/be/V020011.htm.

[14] An open dealer who contracts to sell a particular supplier's product will display that supplier's branding at his or her station. Independent stations typically can purchase gasoline from any refiner that sells unbranded or branded gasoline, but they do not display the brand name that they are selling.

[15] The "dealer tank-wagon" price is the bundled price of gasoline and delivery to the lessee-dealer's station. Some open dealers may also purchase directly from a refiner at dealer tank-wagon prices.

[16] *See* U.S. Department of Energy, Energy Information Administration, *Petroleum Marketing Monthly* at 20 (May 2007), *at* http://www.eia.doe.gov/oil_gas/petroleum/data_publications/petroleum_marketing_monthly/pmm.html.

As discussed above, a supplier can vertically integrate or delegate operations to an unaffiliated dealer (either a lessee-dealer or an open dealer). Both direct operation and delegation to unaffiliated retail dealers have advantages and disadvantages. Direct operation allows a supplier to control – through an employee – pricing and quality decisions. Employees' incentives, however, are not necessarily aligned with those of the supplier, so a supplier must expend resources to monitor the station manager to ensure that he or she is taking the correct actions. When suppliers and retail dealers are separate firms, they have different incentives to set prices and provide quality. For example, when both suppliers and station operators have the ability to price above cost, each will add a mark-up to the final price. This "double mark-up problem" reduces supplier profits because retail prices are higher than they would be if the supplier set them, causing business to be lost to lower-priced retailers. Further, because an unaffiliated dealer does not capture the full financial benefit from providing additional quality (*e.g*., cleaner facilities, friendlier and more knowledgeable staff, more reliable repair work), it may have an incentive to provide a lower level of quality than a supplier would if it operated the retail service station.[17] Thus, a supplier may want to operate a service station directly to increase profits by charging lower retail prices and providing enhanced service. Several empirical studies suggest that suppliers choose whether to vertically integrate or to delegate operational decisions to an unaffiliated dealer based on efficiency concerns.[18]

Limiting the ability of suppliers to operate service stations when it is efficient to do so is likely to lead to higher retail prices.[19] Two studies have directly measured the impact of

---

[17] The difference between supplier and unaffiliated dealer incentives to provide quality stems from two sources. First, when an unaffiliated dealer provides high quality service, consumers may be more likely to return to this particular dealer, and also to patronize other dealers of the same brand. The dealer captures the financial benefits from increased demand for his or her station's services, but not increased demand for the services of other stations of the same brand. Second, because dealers share a portion of the additional profit from additional sales with the supplier, they do not have the incentive to provide the same level of quality as a vertically integrated firm. *See* Ralph A. Winter, *Vertical Control and Price versus Non-price Competition*, 63 Q.J. ECON. 61 (1993).

[18] *See* Asher A. Blass & Dennis W. Carlton, *The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice*, 44 J. LAW & ECON. 511 (2001); Margaret E. Slade, *Strategic Motives for Vertical Separation: Evidence from Retail Gasoline Markets*, 14 J.L. ECON. & ORG. 84 (1998); Andrea Shepard, *Contractual Form, Retail Price, and Asset Characterization in Gasoline Retailing*, 24 RAND J. ECON. 58, 64-65 (1993). One study, however, purports to present evidence that one instance of vertical integration led a refiner to charge higher wholesale prices to independent dealers. *See* Justine S. Hastings & Richard J. Gilbert, *Market Power, Vertical Integration and the Wholesale Price of Gasoline*, 53 J. INDUS. ECON. 469 (2005). Specifically, this study examines Tosco's purchase of Unocal's U.S. refining and marketing assets and presents evidence suggesting that Tosco attempted to raise its retail rivals' wholesale costs following the transaction by increasing the price it charged for unbranded gasoline in markets where its newly purchased retail stations faced competition from independent gasoline marketers. The authors did not show that average wholesale prices increased or that retail prices increased. Without examining retail prices it is impossible to determine whether consumers were harmed by the transaction.

[19] This is due both to higher operation costs, which will be passed on to consumers in the form of higher retail gasoline prices, and to the persistence of the double mark-up problem, which also is likely to lead to higher retail prices.

divorcement regulation on retail prices and have found gasoline prices to be higher in the presence of bans on supplier operation of retail service stations. The most comprehensive study of this kind, conducted by a senior FTC economist, found that divorcement laws tend to increase retail gasoline prices by an average of 2.6 cents per gallon.[20] His empirical work implied that repealing the divorcement laws that then existed in six states and the District of Columbia would generate an annual increase in consumer welfare – which includes substantial consumer savings and the value of additional gasoline purchased at lower prices – of approximately $112 million.[21] Another study found that Maryland's divorcement law, the first in the nation, raised self-service gasoline prices by 1.4 to 1.7 cents and full-service prices by 5 to 7 cents per gallon at stations that were formerly supplier-operated.[22] Further, this study also found that these stations reduced their operation hours by nine hours per week.[23]

In light of the existing empirical evidence that allowing supplier operation of retail gasoline stations can lead to lower gasoline prices, we believe it likely that the District of Columbia's current divorcement law is causing D.C. residents to pay more for gasoline than they otherwise would. Repealing the Act's divorcement provision and allowing suppliers to operate retail gasoline stations likely would lead to lower operation costs for some stations, which would benefit consumers in the form of lower prices. Further, supplier operation to reduce the double mark-up problem can lead to lower retail prices as well. Lower prices at supplier-operated service stations, moreover, would likely cause rival service stations that are not supplier-operated to lower their prices to compete. Accordingly, we believe that repeal of the District's ban on supplier operation of stores would likely reduce the prices that D.C. residents pay for gasoline.

* * *

Based on the existing empirical evidence, FTC staff believes that the District of Columbia's current divorcement law is likely causing D.C. residents to pay higher prices for gasoline than they otherwise would. We support your proposal to repeal the current prohibition on jobbers operating retail service stations and believe that it may improve competition among retail service stations. However, we believe that total repeal of the District's divorcement law, which would allow all suppliers to operate retail stations, would provide the D.C. residents greater benefits than the partial repeal that you have proposed.

---

[20] Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217 (2000).

[21] *Id*. at 230. Blass & Carlton, *supra* note 18, estimate that a hypothetical national divorcement law would cost consumers between $.6 and $2.1 billion.

[22] John M. Barron & John R. Umbeck, *The Effect of Different Contractual Arrangements: The Case of Retail Gasoline Markets*, 27 J.L & ECON. 313 (1984).

[23] *Id*.

We appreciate this opportunity to provide our views and welcome any additional questions you may have.

Respectfully submitted,

Maureen K. Ohlhausen, Director
Office of Policy Planning

Michael A. Salinger, Director
Bureau of Economics

Jeffrey Schmidt, Director
Bureau of Competition