



UNITED STATES OF AMERICA  
FEDERAL TRADE COMMISSION  
WASHINGTON, D.C. 20580

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**Prepared Statement of the Federal Trade Commission**

**Market Forces, Competitive Dynamics, and Gasoline Prices:  
FTC Initiatives to Protect Competitive Markets**

**Presented by  
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Chairman**

**Before the  
Committee on Commerce, Science and Transportation  
and the  
Committee on Energy and Natural Resources  
United States Senate**

**November 9, 2005**

## **I. Introduction**

Chairman Stevens, Chairman Domenici, and members of both Committees, I am Deborah Platt Majoras, the Chairman of the Federal Trade Commission. I appear before you to present the Commission's testimony on the impact of recent supply disruptions on petroleum markets; FTC initiatives to protect consumers by safeguarding competitive markets in the production, distribution, and sale of gasoline; and an important recent Commission study on the factors that affect gasoline prices.<sup>1</sup>

Recent events underscore the crucial role played by the energy industry in our economy. Not only do changes in energy prices affect consumers directly, but the price and availability of energy also influence many other economic sectors. No other industry's performance is more deeply felt, and no other industry is so carefully scrutinized by the FTC.

Prior to Hurricane Katrina, increasing crude oil prices had resulted in rising gasoline prices during much of this year. Despite these rising prices, the demand for gasoline during this past summer was strong and exceeded summer demand in 2004. Then, in this already tight market, Hurricanes Katrina and Rita severely disrupted the important Gulf Coast supply of crude oil and gasoline. At one point, over 95 percent of Gulf Coast crude oil production was inoperable, and numerous refineries and pipelines were either damaged or without electricity.<sup>2</sup> In

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<sup>1</sup> This written statement presents the views of the Federal Trade Commission. My oral presentation and responses to questions are my own and do not necessarily represent the views of the Commission or any other Commissioner.

<sup>2</sup> See Minerals Mgmt. Serv., U.S. Dep't of the Interior, Release No. 3328, *Hurricane Katrina Evacuation and Production Shut-in Statistics Report as of Tuesday, August 30, 2005*, at <http://www.mms.gov/ooc/press/2005/press0830.htm>.

the period immediately following Hurricanes Katrina and Rita, gasoline prices rose sharply to \$3.00 per gallon or more in many markets. Although a good portion of Gulf Coast petroleum infrastructure has been put back into production, nearly 68 percent of crude oil production remained shut in as of a week ago.<sup>3</sup>

Substantially in response to the price effects of this massive and continuing supply disruption, demand for gasoline has decreased somewhat. This reduced demand, together with the resumption of a significant fraction of production in the hurricane-damaged region and increased gasoline imports, has brought both wholesale and retail gasoline prices back down to or below pre-hurricane levels. It is important to remember, however, that Katrina and Rita damaged significant parts of the energy infrastructure in the Gulf Coast region, including oil and natural gas production and refining and processing facilities. Some adverse effect on energy prices may persist until the infrastructure recovers fully – a process that could take months.

The Commission is closely scrutinizing prices and examining any activity in the gasoline industry that may decrease competition and thus harm consumers. The Commission and its staff have developed expertise in the industry through years of investigation and research. The agency has carefully examined proposed mergers and has blocked or required revisions of any that have threatened to harm consumers by reducing competition.<sup>4</sup> Indeed, the Commission has challenged

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<sup>3</sup> See Minerals Mgmt. Serv., U.S. Dep't of the Interior, Release No. 3398, *Hurricane Katrina/Hurricane Rita Evacuation and Production Shut-in Statistics Report as of Tuesday, November 1, 2005*, at <http://www.mms.gov/ooc/press/2005/press1101.htm>.

<sup>4</sup> Since 1981, the FTC has filed complaints against 19 large petroleum mergers. In 13 of these cases, the FTC obtained significant divestitures. In one of these, *Exxon/Mobil*, the Commission required the largest divestiture ever, including divestiture of over 2000 retail stations and a refinery. Of the six other matters, the parties in four cases abandoned the transactions altogether after agency antitrust challenges; one case resulted in a remedy requiring

mergers in the oil industry at lower levels of consolidation than in any other industry. In addition, the Commission has conducted investigations of price movements in particular regions of the nation to determine if they result in any part from anticompetitive practices, and investigated and recently settled a complaint against Unocal for monopolization activities that allegedly could have cost consumers billions of dollars in higher gasoline prices. In addition to law enforcement, the Commission places a premium on careful research and industry monitoring to understand current petroleum industry developments and to identify accurately obstacles to competition, whether arising from private behavior or from public policies. The petroleum industry's performance is shaped by the interaction of extraordinarily complex, fast-changing commercial arrangements and an elaborate set of public regulatory commands. A well-informed understanding of these factors is essential if FTC actions are to benefit consumers.

In 2004, the FTC staff published a study reviewing the petroleum industry's mergers and structural changes as well as the antitrust enforcement actions that the agency has taken in the industry over the past 20 years.<sup>5</sup> Then, in early July of this year, the Commission published a study that explains the competitive dynamics of gasoline pricing and price changes.<sup>6</sup> This study

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the acquiring firm to provide the Commission with advance notice of its intent to acquire or merge with another entity; and the Commission sought dismissal of the sixth complaint (*Aloha Petroleum*) based on changed circumstances that restored allegedly threatened competition.

<sup>5</sup> BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT (2004) [hereinafter PETROLEUM MERGER REPORT], available at <http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf>.

<sup>6</sup> FEDERAL TRADE COMMISSION, GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (2005) [hereinafter GASOLINE PRICE CHANGES], available at <http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf>.

is based on years of research and experience, as well as information learned at conferences of industry, consumer, academic, and government participants held by the Commission over the past four years, and explains how gasoline prices are set.

The Commission makes its expertise in this industry available to the public in other ways as well. Thousands of consumers have visited the Commission's "Oil and Gas Industry Initiatives" website,<sup>7</sup> as well as the website recently established by the Commission's Bureau of Consumer Protection to provide advice on identity theft and other important consumer protection matters in the wake of the hurricanes.<sup>8</sup> As you know, this is the fourth time in recent weeks the Commission has shared its expertise on gasoline markets in testimony before Congressional committees.<sup>9</sup>

Congress has also turned to the Commission to investigate whether businesses have manipulated markets and prices to the detriment of consumers. Section 1809 of the recently enacted Energy Policy Act<sup>10</sup> mandates an FTC investigation "to determine if the price of gasoline is being artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price gouging practices." In response to that legislation and also to the concerns

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<sup>7</sup> See <http://www.ftc.gov/ftc/oilgas/index.html>.

<sup>8</sup> See <http://www.ftc.gov/bcp/online/events/katrina/index.html>.

<sup>9</sup> Previous prepared statements of the Commission are available at <http://www.ftc.gov/os/testimony/050907gaspricetest.pdf> (before the House Committee on Energy and Commerce, Sept. 7, 2005); <http://www.ftc.gov/os/testimony/050921gaspricetest2.pdf> (before the Senate Committee on Commerce, Science and Transportation, Sept. 21, 2005); <http://www.ftc.gov/os/testimony/050922katrinatetest.pdf> (before the House Energy and Commerce Subcommittee on Commerce, Trade, and Consumer Protection, Sept. 22, 2005).

<sup>10</sup> Energy Policy Act of 2005, Pub. L. No. 109-58, § 1809, \_\_ Stat. \_\_ (2005).

raised by the hurricanes, the Commission has launched an investigation to scrutinize whether unlawful conduct affecting refinery capacity or other forms of illegal behavior have provided a foundation for price manipulation. The FTC staff is looking at pricing decisions and other conduct in the wake of Katrina to understand what has occurred and identify any illegal conduct. The Commission recently issued civil investigative demands to a number of companies in this investigation and anticipates reporting to Congress on the findings of this investigation next spring. Any identification of unlawful conduct will result in aggressive FTC law enforcement activity.

The Commission's testimony today addresses gasoline pricing issues in three parts. It first considers the issue of price gouging. In an economy in which producers are generally free to determine their own prices and buyers are free to adjust their purchases, it is unusual when many parties call for some sort of price caps on gasoline. The testimony considers the problems inherent in a price gouging law and describes the current Commission investigation of petroleum industry conduct in the wake of the hurricanes.

The testimony next reviews the basic tools that the Commission uses to maintain competition in the petroleum industry and thereby ensure competitive prices for consumers: challenging potentially anticompetitive mergers, prosecuting nonmerger antitrust violations, monitoring industry prices and behavior to detect possible anticompetitive conduct, and researching petroleum sector developments. The nation's economy is based on the premise that competition produces the lowest prices and highest quantity and quality of goods and services, and the highest rate of innovation, for the betterment of all consumers. This review of the Commission's petroleum industry agenda highlights the FTC's contributions to promote and

maintain competition in the industry.

The final part of this testimony reviews some useful learning the Commission has derived from its conferences and research and its review of recent gasoline price changes. Among other findings, this discussion highlights the paramount role that crude oil prices play in determining both the levels and the volatility of gasoline prices in the United States. It also discusses how demand has increased substantially over the past few years, both in the United States and in the developing economies of China and India. When worldwide supply and demand conditions resulted in crude oil prices in the range of \$70 per barrel after Katrina – a level from which we are doubtless all glad to have seen the price recede by more than \$10 per barrel since the hurricanes – it was not surprising to see higher gasoline prices nationwide.

## **II. Price Gouging**

The Commission is very conscious of the swift and severe price spikes that occurred immediately before and after Katrina and Rita made landfall, and of the pain that these price increases have caused consumers and small businesses. There have been numerous calls in Congress and elsewhere for investigations of “price gouging,” particularly at the retail gasoline level, and for legislation making price gouging (or offenses defined in such alternative terms as “unconscionably excessive prices”) a violation of federal law.

The FTC is keenly aware of the importance to American consumers of free and open markets and intends faithfully to fulfill its obligation to search for and stop illegal conduct, which undermines the market’s consumer benefits. We caution, however, that a full understanding of pricing practices before and since Katrina may not lead to a conclusion that a federal prohibition on “price gouging” is appropriate. Consumers understandably are upset when they face dramatic

price increases within very short periods of time, especially during a disaster. But price gouging laws that have the effect of controlling prices likely will do consumers more harm than good. Experience from the 1970s shows that price controls produced longer lines at the pump – and prolonged the gasoline crisis. While no consumer likes price increases, in fact, price increases lower demand and help make the shortage shorter-lived than it otherwise would have been.

Prices play a critical role in our economy: they signal producers to increase or decrease supply, and they also signal consumers to increase or decrease demand. In a period of shortage – particularly with a product, like gasoline, that can be sold in many markets around the world – higher prices create incentives for suppliers to send more product into the market, while also creating incentives for consumers to use less of the product. For instance, sharp increases in the price of gasoline can help curtail the panic buying and “topping off” practices that cause retailers to run out of gasoline. In addition, higher gasoline prices in the United States have resulted in the shipment of substantial additional supplies of European gasoline to the United States.<sup>11</sup> If price gouging laws distort these natural market signals, markets may not function well and consumers will be worse off. Thus, under these circumstances, sound economic principles and jurisprudence suggest a seller’s independent decision to increase price is – and should be – outside the purview of the law.

To be sure, there may be situations in which sellers go beyond the necessary market-induced price increase. A seller who does not want to run out of a supply of gasoline to sell

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<sup>11</sup> Total gasoline imports into the United States for September and the first three weeks of October were approximately 34 percent higher than imports over the same seven-week period in 2004. See U.S. Dep’t of Energy, Energy Information Admin. (“EIA”), *U.S. Weekly Gasoline Imports* (Oct. 26, 2005), available at [http://www.eia.doe.gov/oil\\_gas/petroleum/info\\_glance/gasoline.html](http://www.eia.doe.gov/oil_gas/petroleum/info_glance/gasoline.html).



might misjudge the market and attempt to charge prices substantially higher than conditions warrant or than its competitors are charging. News stories of gasoline retailers panicking and setting prices of \$6.00 per gallon are evidence of such misjudgments after the hurricanes. But the market – not price gouging laws – is the best cure for this. Temporary prices that are wildly out of line with competitors' prices do not last when consumers quickly discover that other stations are charging lower prices. A single seller in a competitive market cannot unilaterally raise prices for long above the level justified by supply and demand factors. As long as they are not sustained by collusive activity, departures from competitive prices cannot endure for long in such a market. The few retailers who raised prices to the \$6.00 level reduced them just as quickly when it became apparent that they had misjudged the market.

Even if Congress outlaws price gouging, the law likely would be difficult to enforce fairly. The difficulty for station managers, as well as for enforcers, is knowing when the managers have raised prices “too much,” as opposed to responding to reduced supply conditions. It can be very difficult to determine the extent to which any more moderate price increases are necessary. Examination of the federal gasoline price gouging legislation that has been introduced and of state price gouging statutes indicates that the offense of “price gouging” is difficult to define. For example, some bills define “gouging” as consisting of a 10 or 15 percent increase in average prices, while most leave the decision to the courts by defining gouging in nebulous terms such as “gross disparity” or “unconscionably excessive.” Some, but not all, make allowances for the extra costs that may be involved in providing product in a disaster area. Few, if any, of the proposed bills or state laws take account of market incentives for sellers to divert supply from their usual customers in order to supply the disaster area, or incentives for consumers to reduce

their purchases as much as possible, minimizing the shortage. Ultimately, the inability to agree on when “price gouging” should be prohibited indicates the risks in developing and enforcing a federal statute that would be controversial and could be counterproductive to consumers’ best interest.

We note that at least 28 states have statutes that address short-term price spikes in the aftermath of a disaster, and we understand that a number of these states have opened investigations of gasoline “price gouging.” If Congress mandates anti-“gouging” enforcement in spite of the problems discussed above, then state officials – because of their proximity to local retail outlets – can react more expeditiously at the retail level than a federal agency could to the complaints that consumers have filed about local gasoline prices. Most of the reports of alleged gasoline price gouging that the FTC staff has seen involved individual retailers that raised their prices sharply in reaction to dramatic increases in consumer demand or expectations of decreased supply right after the hurricanes – and reduced their prices just as quickly when no other gas stations followed suit, or when their suppliers assured them that their storage tanks would be refilled. It would be far more efficient for state and local officials close to these incidents (and knowledgeable about the local situation) to handle any such complaints.

For all of these reasons, the Commission remains persuaded that federal price gouging legislation would unnecessarily hurt consumers. Enforcement of the antitrust laws is the better way to protect consumers. The FTC will thoroughly investigate gasoline pricing practices and will aggressively respond to any manipulation of gasoline prices we are able to uncover that violates federal antitrust law. The Commission believes that passage of federal price gouging legislation before completion of the Section 1809 investigation is premature at best.

Commission findings regarding possible market manipulation from this study could help inform Congressional committees as they wrestle with the difficult issues presented by rapid price increases in periods of shortage.

### **III. FTC Activities to Maintain and Promote Competition in the Petroleum Industry**

#### **A. The Price Monitoring Project**

Given the importance of the petroleum industry to the U.S. economy, and to the pocketbook of most consumers, the Commission decided it needed more detailed and more timely knowledge of pricing practices in both wholesale and retail markets. Three years ago, the FTC launched a program unique to the petroleum industry to actively and continuously monitor prices of gasoline and diesel fuel in approximately 360 retail areas and 20 wholesale regions.<sup>12</sup> This initiative to monitor gasoline and diesel prices identifies “unusual” price movements<sup>13</sup> and then examines whether any such movements might result from anticompetitive conduct that violates Section 5 of the FTC Act. FTC economists developed a statistical model for identifying such movements.

The staff reviews daily data from the Oil Price Information Service, a private data collection agency, and receives information weekly from the public gasoline price hotline maintained by the U.S. Department of Energy (“DOE”). The staff monitoring team uses an econometric model to determine whether current retail and wholesale prices are anomalous in

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<sup>12</sup> See FTC, *Oil and Gas Industry Initiatives*, at <http://www.ftc.gov/ftc/oilgas/index.html>.

<sup>13</sup> An “unusual” price movement in a given area is a price that is significantly out of line with the historical relationship between the price of gasoline in that area and the gasoline prices prevailing in other areas.

comparison to the historical price relationships among cities. If the FTC staff detects unusual price movements in an area, it researches the possible causes, including, where appropriate, through consultation with the state attorneys general, state energy agencies, and the EIA.

In addition to monitoring DOE's gasoline price hotline complaints, this project includes scrutiny of gasoline price complaints received by the Commission's Consumer Response Center and of similar information provided to the FTC by state and local officials. If the staff concludes that an unusual price movement likely results from a business-related cause (*i.e.*, a cause unrelated to anticompetitive conduct), it continues to monitor but – absent indications of potentially anticompetitive conduct – it does not investigate further.<sup>14</sup> The Commission's experience from its past investigations and from the current monitoring initiative indicates that unusual movements in gasoline prices typically have a business-related cause. The FTC staff further investigates unusual price movements that do not appear to be explained by business-related causes to determine whether anticompetitive conduct may underlie the pricing anomaly. Cooperation with state law enforcement officials is an important element of such investigations.

## **B. Merger Enforcement in the Petroleum Industry**

The Commission has gained much of its antitrust enforcement experience in the petroleum industry by analyzing proposed mergers and challenging transactions that likely would reduce competition, thus resulting in higher prices.<sup>15</sup> In 2004, the Commission released data on

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<sup>14</sup> Business-related causes include movements in crude oil prices, supply outages (*e.g.*, from refinery fires or pipeline disruptions), or changes in and/or transitions to new fuel requirements imposed by air quality standards.

<sup>15</sup> Section 7 of the Clayton Act prohibits acquisitions that may have anticompetitive effects “in any line of commerce or in any activity affecting commerce in any section of the country.” 15 U.S.C. § 18.

all horizontal merger investigations and enforcement actions from 1996 to 2003.<sup>16</sup> These data show that the Commission has brought more merger cases at lower levels of concentration in the petroleum industry than in other industries. Unlike in other industries, the Commission has obtained merger relief in moderately concentrated petroleum markets. Moreover, our vigorous merger enforcement has preserved competition and thereby kept gas prices at a competitive level.

Several recent merger investigations illustrate the FTC's approach to merger analysis in the petroleum industry. An important recently completed case involved Chevron's acquisition of Unocal. When the merger investigation began, the Commission was in the middle of an ongoing monopolization case against Unocal that would have been affected by the merger. The Commission settled both the merger and the monopolization matters with separate consent orders that preserved competition in all relevant merger markets and obtained complete relief on the monopolization claim.<sup>17</sup>

Another merger case that resulted in a divestiture order resolved a complaint concerning the acquisition of Kaneb Services and Kaneb Pipe Line Partners, companies that engaged in petroleum transportation and terminaling in a number of markets, by Valero L.P., the largest petroleum terminal operator and second largest operator of liquid petroleum pipelines in the

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<sup>16</sup> Federal Trade Commission Horizontal Merger Investigation Data, Fiscal Years 1996-2003 (Feb. 2, 2004), Table 3.1, et seq.; FTC Horizontal Merger Investigations Post-Merger HHI and Change in HHI for Oil Markets, FY 1996 through FY 2003 (May 27, 2004), available at <http://www.ftc.gov/opa/2004/05/040527petrolactionsHHIdeltachart.pdf>.

<sup>17</sup> *Chevron Corp.*, FTC Docket No. C-4144 (July 27, 2005) (consent order), at <http://www.ftc.gov/os/caselist/0510125/050802do0510125.pdf>; *Union Oil Co. of California*, FTC Docket No. 9305 (July 27, 2005) (consent order), at <http://www.ftc.gov/os/adjpro/d9305/050802do.pdf>. The nonmerger case is discussed *infra* at 16-17.

United States. The complaint alleged that the acquisition had the potential to increase prices in bulk gasoline and diesel markets.<sup>18</sup> The FTC's divestiture order succeeds in maintaining import possibilities for wholesale customers in Northern California, Denver, and greater Philadelphia and precludes the merging parties from undertaking an anticompetitive price increase.<sup>19</sup>

Most recently, the Commission filed a complaint on July 27, 2005, in federal district court in Hawaii, alleging that Aloha Petroleum's proposed acquisition of Truststreet Properties' half interest in an import-capable terminal and retail gasoline assets on the island of Oahu would have reduced the number of gasoline marketers and could have led to higher gasoline prices for Hawaii consumers.<sup>20</sup> To resolve this case, the parties executed a 20-year throughput agreement that will preserve competition allegedly threatened by the acquisition.<sup>21</sup>

In the past few years, the Commission has brought a number of other important merger cases. One of these challenged the merger of Chevron and Texaco,<sup>22</sup> which combined assets located throughout the United States. Following an investigation in which 12 states participated, the Commission issued a consent order against the merging parties requiring numerous

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<sup>18</sup> *Valero L.P.*, FTC Docket No. C-4141 (June 14, 2005) (complaint), at <http://www.ftc.gov/os/caselist/0510022/050615comp0510022.pdf>.

<sup>19</sup> *Valero L.P.*, FTC Docket No. C-4141 (July 22, 2005) (consent order), at <http://www.ftc.gov/os/caselist/0510022/050726do0510022.pdf>.

<sup>20</sup> *Aloha Petroleum Ltd.*, FTC File No. 051 0131 (July 27, 2005) (complaint), at <http://www.ftc.gov/os/caselist/1510131/050728comp1510131.pdf>.

<sup>21</sup> FTC Press Release, *FTC Resolves Aloha Petroleum Litigation* (Sept. 6, 2005), available at <http://www.ftc.gov/opa/2005/09/alohapetrol.htm>.

<sup>22</sup> *Chevron Corp.*, FTC Docket No. C-4023 (Jan. 2, 2002) (consent order), at <http://www.ftc.gov/os/2002/01/chevronorder.pdf>.

divestitures to maintain competition in particular relevant markets, primarily in the western and southern United States.<sup>23</sup>

Another petroleum industry transaction that the Commission challenged successfully was the \$6 billion merger between Valero Energy Corp. (“Valero”) and Ultramar Diamond Shamrock Corp. (“Ultramar”).<sup>24</sup> Both Valero and Ultramar were leading refiners and marketers of gasoline that met the specifications of the California Air Resources Board (“CARB”), and they were the only significant suppliers to independent stations in California. The Commission’s complaint alleged competitive concerns in both the refining and the bulk supply of CARB gasoline in two separate geographic markets – Northern California and the entire state of California – and the Commission contended that the merger could raise the cost to California consumers by at least \$150 million annually for every one-cent-per-gallon price increase at retail.<sup>25</sup> To remedy the alleged violations, the consent order settling the case required Valero to divest: (a) an Ultramar refinery in Avon, California; (b) all bulk gasoline supply contracts associated with that refinery; and (c) 70 Ultramar retail stations in Northern California.<sup>26</sup>

Another example is the Commission’s 2002 challenge to the merger of Phillips Petroleum Company and Conoco Inc., alleging that the transaction would harm competition in the Midwest and Rocky Mountain regions of the United States. To resolve that challenge, the Commission

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<sup>23</sup> *Id.*

<sup>24</sup> *Valero Energy Corp.*, FTC Docket No. C-4031 (Feb. 19, 2002) (consent order), at <http://www.ftc.gov/os/2002/02/valerodo.pdf>.

<sup>25</sup> *Valero Energy Corp.*, FTC Docket No. C-4031 (Dec. 18, 2001) (complaint), at <http://www.ftc.gov/os/2001/12/valerocmp.pdf>.

<sup>26</sup> *Valero Energy Corp.*, *supra* note 24.

required the divestiture of: (a) the Phillips refinery in Woods Cross, Utah, and all of the Phillips-related marketing assets served by that refinery; (b) Conoco's refinery in Commerce City, Colorado (near Denver), and all of the Phillips marketing assets in Eastern Colorado; and (c) the Phillips light petroleum products terminal in Spokane, Washington.<sup>27</sup> The Commission's order ensured that competition would not be lost and that gasoline prices would not increase as a result of the merger.

### **C. Nonmerger Investigations into Gasoline Pricing**

In addition to scrutinizing mergers, the Commission aggressively polices anticompetitive conduct. When it appears that higher prices might result from collusive activity or from anticompetitive unilateral activity by a firm with market power, the agency investigates to determine whether unfair methods of competition have been used. If the facts warrant, the

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<sup>27</sup> *Conoco Inc. and Phillips Petroleum Corp.*, FTC Docket No. C-4058 (Aug. 30, 2002) (Analysis of Proposed Consent Order to Aid Public Comment), at <http://www.ftc.gov/os/2002/08/conocophillipsan.htm>. Not all oil industry merger activity raises competitive concerns. For example, in 2003, the Commission closed its investigation of Sunoco's acquisition of the Coastal Eagle Point refinery in the Philadelphia area without requiring relief. The Commission noted that the acquisition would have no anticompetitive effects and seemed likely to yield substantial efficiencies that would benefit consumers. *Sunoco Inc./Coastal Eagle Point Oil Co.*, FTC File No. 031 0139 (Dec. 29, 2003) (Statement of the Commission), at <http://www.ftc.gov/os/caselist/0310139/031229stmt0310139.pdf>. The FTC also considered the likely competitive effects of Phillips Petroleum's proposed acquisition of Tosco. After careful scrutiny, the Commission declined to challenge the acquisition. A statement issued in connection with the closing of the investigation set forth the FTC's reasoning in detail. *Phillips Petroleum Corp.*, FTC File No. 011 0095 (Sept. 17, 2001) (Statement of the Commission), at <http://www.ftc.gov/os/2001/09/phillipstoscostmt.htm>.

Acquisitions of firms operating mainly in oil or natural gas exploration and production are unlikely to raise antitrust concerns, because that segment of the industry is generally unconcentrated. Acquisitions involving firms with de minimis market shares, or with production capacity or operations that do not overlap geographically, are also unlikely to raise antitrust concerns.



Commission challenges the anticompetitive behavior.

Several petroleum cases of recent years are illustrative. On March 4, 2003, the Commission issued the administrative complaint against Unocal discussed earlier, stating that it had reason to believe that Unocal had violated Section 5 of the FTC Act.<sup>28</sup> The Commission alleged that Unocal deceived the California Air Resources Board (“CARB”) in connection with regulatory proceedings to develop the reformulated gasoline (“RFG”) standards that CARB adopted. Unocal allegedly misrepresented that certain technology was non-proprietary and in the public domain, while at the same time it pursued patents that would enable it to charge substantial royalties if CARB mandated the use of Unocal’s technology in the refining of CARB-compliant summertime RFG. The Commission alleged that, as a result of these activities, Unocal illegally acquired monopoly power in the technology market for producing the new CARB-compliant summertime RFG, thus undermining competition and harming consumers in the downstream product market for CARB-compliant summertime RFG in California. The Commission estimated that Unocal’s enforcement of its patents could potentially result in over \$500 million of additional consumer costs each year.

The proposed merger between Chevron and Unocal raised additional concerns. Although Unocal had no horizontal refining or retailing overlaps with Chevron, it had claimed the right to collect patent royalties from companies that had refining and retailing assets (including Chevron). If Chevron had unconditionally inherited these patents by acquisition, it would have been in a position to obtain sensitive information and to claim royalties from its own horizontal

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<sup>28</sup> *Union Oil Co. of California*, FTC Docket No. 9305 (Mar. 4, 2003) (complaint), at <http://www.ftc.gov/os/2003/03/unocalcmp.htm>.

downstream competitors. Chevron, the Commission alleged, could have used this information and this power to facilitate coordinated interaction and detect any deviations.

The Commission resolved both the Chevron/Unocal merger investigation and the monopolization case against Unocal with consent orders. The key element in these orders is Chevron's agreement not to enforce the Unocal patents.<sup>29</sup> The FTC's settlement of these two matters is a substantial victory for California consumers. The Commission's monopolization case against Unocal was complex and, with possible appeals, could have taken years to resolve, with substantial royalties to Unocal – and higher consumer prices – in the interim. The settlement provides the full relief sought in the monopolization case and also resolves the only competitive issue raised by the merger. With the settlement, consumers are benefitting immediately from the elimination of royalty payments on the Unocal patents, and potential merger efficiencies could result in additional savings at the pump.

The FTC undertook another major nonmerger investigation during 1998-2001, examining the major oil refiners' marketing and distribution practices in Arizona, California, Nevada, Oregon, and Washington (the "Western States" investigation).<sup>30</sup> The agency initiated the

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<sup>29</sup> *Chevron Corp.*, *supra* note 17.

<sup>30</sup> FTC Press Release, *FTC Closes Western States Gasoline Investigation* (May 7, 2001), available at <http://www.ftc.gov/opa/2001/05/westerngas.htm>. In part, this investigation focused on "zone pricing" and "redlining." See *Statement of Commissioners Sheila F. Anthony, Orson Swindle and Thomas B. Leary*, available at <http://www.ftc.gov/os/2001/05/wsgpiswindle.htm>, and *Statement of Commissioner Mozelle W. Thompson*, available at <http://www.ftc.gov/os/2001/05/wsgpithompson.htm>, for a more detailed discussion of these practices and the Commission's findings. See also Cary A. Deck & Bart J. Wilson, *Experimental Gasoline Markets*, Federal Trade Commission, Bureau of Economics Working Paper (Aug. 2003), available at <http://www.ftc.gov/be/workpapers/wp263.pdf>, and David W. Meyer & Jeffrey H. Fischer, *The Economics of Price Zones and Territorial Restrictions in Gasoline Marketing*, Federal Trade Commission, Bureau of Economics Working

Western States investigation out of concern that differences in gasoline prices in Los Angeles, San Francisco, and San Diego might be due partly to anticompetitive activities. The Commission's staff examined over 300 boxes of documents, conducted 100 interviews, held over 30 investigational hearings, and analyzed a substantial amount of pricing data. The investigation uncovered no basis to allege an antitrust violation. Specifically, the investigation detected no evidence of a horizontal agreement on price or output or the adoption of any illegal vertical distribution practice at any level of supply. The investigation also found no evidence that any refiner had the unilateral ability to raise prices profitably in any market or reduce output at the wholesale level. Accordingly, the Commission closed the investigation in May 2001.

In addition to the *Unocal* and Western States pricing investigations, the Commission conducted a nine-month investigation into the causes of gasoline price spikes in local markets in the Midwest in the spring and early summer of 2000.<sup>31</sup> As explained in a 2001 report, the Commission found that a variety of factors contributed in different degrees to the price spikes, including refinery production problems, pipeline disruptions, and low inventories. The industry responded quickly to the price spike. Within three or four weeks, an increased supply of product had been delivered to the Midwest areas suffering from the supply disruption. By mid-July 2000, prices had receded to pre-spike or even lower levels.

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Paper (Mar. 2004), available at <http://www.ftc.gov/be/workpapers/wp271.pdf>.

<sup>31</sup> Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001), available at <http://www.ftc.gov/os/2001/03/mwgasrpt.htm>; see also Remarks of Jeremy Bulow, Director, Bureau of Economics, Federal Trade Commission, *The Midwest Gasoline Investigation*, available at <http://www.ftc.gov/speeches/other/midwestgas.htm>.

#### **IV. Commission Report on Factors That Affect the Price of Gasoline**

Identifying the causes of high gasoline prices and gasoline price spikes requires a thorough and accurate analysis of the factors – supply, demand, and competition, as well as federal, state, and local regulations – that drive gasoline prices, so that policymakers can evaluate and choose strategies likely to succeed in addressing high gasoline prices.

The Commission addressed these issues by conducting extensive research concerning gasoline price fluctuations, analyzing specific instances of apparent gasoline price anomalies, and holding a series of conferences<sup>32</sup> on the factors that affect gasoline prices. This work led to the publication of a report<sup>33</sup> that draws on what the Commission has learned about the factors that can influence gasoline prices or cause gasoline price spikes. The report makes numerous significant findings, but three basic lessons emerge from this collective work.

First, in general, the price of gasoline reflects producers' costs and consumers' willingness to pay. Gasoline prices rise if it costs more to produce and supply gasoline, or if people wish to buy more gasoline at the current price – that is, when demand is greater than supply. Second, how consumers respond to price changes will affect how high prices rise and how low they fall. Limited substitutes for gasoline restrict the options available to consumers to respond to price increases in the short run. Because gasoline consumers typically do not reduce their purchases substantially in response to price increases, they are vulnerable to substantial price increases. Third, producers' responses to price changes will affect how high prices rise and

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<sup>32</sup> FTC Press Release, *FTC to Hold Second Public Conference on the U.S. Oil and Gasoline Industry in May 2002* (Dec. 21, 2001), available at <http://www.ftc.gov/opa/2001/12/gasconf.htm>.

<sup>33</sup> GASOLINE PRICE CHANGES, *supra* note 6.

how low they fall. In general, when there is not enough gasoline to meet consumers' demands at current prices, higher prices will signal a potential profit opportunity and may bring additional supply into the market.

The vast majority of the Commission's investigations and studies have revealed market factors as the primary drivers of both price increases and price spikes. A complex landscape of market forces determines gasoline prices in the United States.

#### **A. Worldwide Supply, Demand, and Competition for Crude Oil Are the Most Important Factors in the National Average Price of Gasoline in the United States**

The world price of crude oil, a commodity that is traded on world markets, is the most important factor in the price of gasoline in the United States and all other markets. Over the years from 1984 through 2003, changes in crude oil prices explained approximately 85 percent of the changes in the price of gasoline. United States refiners compete with refiners all around the world to obtain crude oil. The United States now imports more than 60 percent of its crude from foreign sources, and these costs are passed on to retailers and then consumers. If world crude prices rise, then U.S. refiners must pay higher prices for the crude they buy.

Crude oil prices are not wholly market-determined. Since 1973, decisions by OPEC have been a significant factor in the prices that refiners pay for crude oil. Over time, OPEC has met with varying degrees of success in raising crude oil prices. However, when demand surges unexpectedly, as in 2004, OPEC decisions on whether to increase supply to meet demand can have a significant impact on world crude oil prices.

Overall, the long-run trend is toward significantly increased demand for crude oil. Over the last 20 years, United States consumption of all refined petroleum products increased on

average by 1.4 percent per year, leading to a total increase of nearly 30 percent.<sup>34</sup>

Although they have receded from the record levels they reached immediately after Hurricanes Katrina and Rita, crude oil prices have been increasing rapidly in recent months. Demand has remained high in the United States, and large demand increases from rapidly industrializing nations, particularly China and India, have made supplies much tighter than expected.<sup>35</sup>

### **B. Gasoline Supply, Demand, and Competition Produced Relatively Low and Stable Prices From 1984 Until 2004, Despite Substantial Increases in United States Gasoline Consumption**

Consumer demand for gasoline in the United States has risen substantially, especially since 1990.<sup>36</sup> Although consumption fell sharply from 1978 to 1981, by 1993 consumption rose above 1978 levels, and it has continued to increase at a fairly steady rate since then. In 2004, U.S. gasoline consumption averaged about 9 million barrels per day.

Despite high gasoline prices across the nation, demand generally has not fallen off in 2005. Although there are reports of some diminution in demand in the wake of the hurricanes, it remains to be seen whether this is a long-term reduction. Gasoline demand this summer driving season was above last year's record driving-season demand and well above the average for the previous four years. Higher prices post-Katrina finally resulted in some falloff in demand. A preliminary estimate indicates that gasoline demand for September of 2005 was approximately

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<sup>34</sup> *Id.* at 19.

<sup>35</sup> This phenomenon was not limited to crude oil: other commodities that form the basis for expanded growth in developing economies, such as steel and lumber, also saw unexpectedly rapid growth in demand, along with higher prices. *Id.* at 27.

<sup>36</sup> *Id.* at 48.

3.5 percent lower than demand during September 2004.<sup>37</sup>

Notwithstanding these substantial demand increases in the pre-hurricane time periods, increased supply from U.S. refineries and imports kept gasoline prices relatively steady until 2004. A comparison of “real” average annual retail gasoline prices and average annual retail gasoline consumption in the United States from 1978 through 2004 shows that, in general, gasoline prices remained relatively stable despite significantly increased demand.<sup>38</sup> The data show that, from 1986 through 2003, real national average retail prices for gasoline, including taxes, generally were below \$2.00 per gallon (in 2004 dollars). By contrast, between 1919 and 1985, real national average retail gasoline prices were above \$2.00 per gallon (in 2004 dollars) more often than not.<sup>39</sup>

Average U.S. retail prices have been increasing since 2003, however, from an average of \$1.56 in 2003 to an average of \$2.27 in the first ten months of 2005.<sup>40</sup> In the last several months,

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<sup>37</sup> EIA, DOE/EIA-0208(2005-34), Weekly Petroleum Status Report, Oct. 28, 2005, at 17, tbl.11, *at* [http://www.eia.doe.gov/oil\\_gas/petroleum/data\\_publications/weekly\\_petroleum\\_status\\_report/wpsr.html](http://www.eia.doe.gov/oil_gas/petroleum/data_publications/weekly_petroleum_status_report/wpsr.html).

<sup>38</sup> “Real” prices are adjusted for inflation and therefore reflect the different values of a dollar at different times; they provide more accurate comparisons of prices in different time periods. “Nominal” prices are the literal prices shown at the time of purchase.

<sup>39</sup> See GASOLINE PRICE CHANGES, *supra* note 6, at 43-47.

<sup>40</sup> The higher prices in 2005 appear to be the result of market factors that have uniformly affected the entire country. At least for the part of this year that preceded Hurricane Katrina, the FTC’s Gasoline Price Monitoring Project has detected no evidence of significant unusual local or regional gasoline pricing anywhere in the United States during this summer driving season. This contrasts with the past two summers, during which various regional supply shocks, such as the Arizona pipeline shutdown and the Northeast blackouts of August 2003, and the several unanticipated regional refinery outages and late summer hurricanes during the summer of 2004, significantly increased prices in some areas above levels that might be expected

the prices have moved even higher. Setting aside whatever short-term effects may be associated with Hurricanes Katrina and Rita, it is difficult to predict whether these increases represent the beginning of a longer-term trend or are merely normal market fluctuations caused by unexpectedly strong short-term worldwide demand for crude oil, as well as reflecting the effects of instability in such producing areas as the Middle East and Venezuela.

One reason why long-term real prices have been relatively contained is that United States refiners have taken advantage of economies of scale and adopted more efficient technologies and business strategies. Between 1985 and 2005, U.S. refineries increased their total capacity to refine crude oil into various refined petroleum products by 8.9 percent, moving from 15.7 million barrels per day in 1985 to 17.133 million barrels per day as of August 2005 through the expansion of existing refineries and the use of new technologies.<sup>41</sup> This increase – approximately 1.4 million barrels per day – is roughly equivalent to adding approximately 10 to 12 average-sized refineries to industry supply.

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based on historical price patterns.

Because of the hurricane-induced shocks to supply, historical price relationships from one area to another no longer held in many instances after Katrina. The pattern of post-Katrina price relationships, however, does appear to be generally consistent with the specifics of Katrina's and Rita's impact on the supply infrastructure and with the degree to which particular regions depend on or compete with supplies from the Gulf Coast region. Those few areas in which pricing patterns are not consistent are part of our ongoing investigation pursuant to Section 1809 of the Energy Policy Act of 2005.

<sup>41</sup> PETROLEUM MERGER REPORT, *supra* note 5, at 196, tbl.7-1; EIA, DOE/EIA-0340(04)/1, 1 PETROLEUM SUPPLY ANNUAL 2004, at 78, tbl.36 (2005), *at* [http://www.eia.doe.gov/pub/oil\\_gas/petroleum/data\\_publications/petroleum\\_supply\\_annual/psa\\_volume1/current/pdf/volume1\\_all.pdf](http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/petroleum_supply_annual/psa_volume1/current/pdf/volume1_all.pdf). EIA, DOE/EIA-0208(2005-33), WEEKLY PETROLEUM STATUS REPORT, August 24, 2005, *at* [http://www.eia.doe.gov/pub/oil\\_gas/petroleum/data\\_publications/weekly\\_petroleum\\_status\\_report/historical/2005/2005\\_08\\_24/pdf/wpsrall.pdf](http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/weekly_petroleum_status_report/historical/2005/2005_08_24/pdf/wpsrall.pdf).



Offsetting some of the observed efficiency gains, increased environmental requirements since 1992 have likely raised the retail price of gasoline by a few cents per gallon in some areas. Because gasoline use is a major factor in air pollution in the United States, the U.S. Environmental Protection Agency – under the Clean Air Act<sup>42</sup> – requires various gasoline blends for particular geographic areas that have not met certain air quality standards. Although available information shows that the air quality in the United States has improved due to the Clean Air Act,<sup>43</sup> costs come with the benefits (as they do with any regulatory program). Estimates of the increased costs of environmentally mandated gasoline range from \$0.03 to \$0.11 per gallon.<sup>44</sup> A recognition that environmental requirements can increase gasoline prices came in the post-Katrina period when the EPA temporarily suspended certain boutique fuel requirements in order to increase the supply of conventional gasoline into affected areas.<sup>45</sup>

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<sup>42</sup> Beginning with the Clean Air Act Amendments of 1970 (Pub. L. No. 91-604, 84 Stat. 1698) and continuing with further amendments in 1990 (Pub. L. No. 101-549, 104 Stat. 2468) and the Energy Policy Act of 1992 (Pub. L. No. 102-486, 106 Stat. 2776), Congress has mandated substantial changes in the quality of gasoline, as well as diesel, that can be sold in the United States.

<sup>43</sup> Robert Larson, Acting Director of the Transportation and Regional Programs, Environmental Protection Agency, Remarks at the FTC Conference on Factors that Affect Prices of Refined Petroleum Products 79-80 (May 8, 2002).

<sup>44</sup> See EIA, *1995 Reformulated Gasoline Market Affected Refiners Differently*, in DOE/EIA-0380(1996/01), PETROLEUM MARKETING MONTHLY (1996), and studies cited therein. Environmental mandates are not the same in all areas of the country. The EPA requires particular gasoline blends for certain geographic areas, but it sometimes allows variations on those blends. Differing fuel specifications in different areas can limit the ability of gasoline wholesalers to find adequate substitutes in the event of a supply shortage. Thus, boutique fuels may exacerbate price variability in areas, such as California, that are not interconnected with large refining centers in other areas.

<sup>45</sup> U.S. Environmental Protection Agency, Fuel Waiver Response to Hurricanes 2005, available at <http://www.epa.gov/compliance/katrina/waiver/index.html>.

FTC studies indicate that higher retail prices are generally not caused by excess oil company profits. Although recent oil company profits may be high in absolute terms, industry profits have varied widely over time, as well as over industry segments and among firms.

EIA's Financial Reporting System ("FRS") tracks the financial performance of the 28 major energy producers currently operating in the United States. Between 1973 and 2003, the annual average return on equity for FRS energy companies was 12.6 percent, while it was 13.1 percent for the Standard & Poor's Industrials.<sup>46</sup> The rates of return on equity for FRS companies have varied widely over the years, ranging from as low as 1.1 percent to as high as 21.1 percent during the period from 1974 to 2003.<sup>47</sup> Returns on equity vary across firms as well.

High absolute profits do not contradict numbers showing that oil companies may at times earn less (as a percentage of capital or equity) than other industrial firms. This simply reflects the large amount of capital necessary to find, refine, and distribute petroleum products.

### **C. Other Factors, Such as Retail Station Density, New Retail Formats, and State and Local Regulations, Also Can Affect Retail Gasoline Prices**

The interaction of supply and demand and industry efficiency are not the only factors that impact retail gasoline prices. State and local taxes can be a significant component of the final price of gasoline. In 2004, the average state sales tax was \$0.225 per gallon, with the highest state tax at \$0.334 per gallon (New York).<sup>48</sup> On average, about 9 percent of a gallon of gasoline

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<sup>46</sup> See GASOLINE PRICE CHANGES, *supra* note 6, at 61.

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at 111 (noting that the other four states with the highest average taxes on gasoline in 2004 were Wisconsin (\$0.33 per gallon), Connecticut (\$0.325 per gallon), Rhode Island (\$0.306 per gallon), and California (\$0.301 per gallon)).

is accounted for by state taxes. Some local governments also impose gasoline taxes.<sup>49</sup>

Local regulations may also have an impact on retail gasoline prices. For example, bans on self-service sales or below-cost sales appear to raise gasoline prices. New Jersey and Oregon ban self-service sales, thus requiring consumers to buy gasoline bundled with services that increase costs – that is, having staff available to pump the gasoline.<sup>50</sup> Some experts have estimated that self-service bans cost consumers between \$0.02 and \$0.05 per gallon.<sup>51</sup> In addition, 11 states have laws banning below-cost sales, so that a gas station is required to charge a minimum amount above its wholesale gasoline price.<sup>52</sup> These laws harm consumers by depriving them of the lower prices that more efficient (*e.g.*, high-volume) stations can charge.

One of the biggest changes in the retail sale of gasoline in the past three decades has been the development of such new formats as convenience stores and high-volume operations. These new formats appear to lower retail gasoline prices. The number of traditional gasoline-pump-and-repair-bay outlets has dwindled for a number of years, as brand-name gasoline retailers have moved toward a convenience store format. Independent gasoline/convenience stores – such as RaceTrac, Sheetz, QuikTrip, and Wawa – typically feature large convenience stores with

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<sup>49</sup> *Id.* For example, all areas in Florida also have a local tax between \$0.099 and \$0.178 per gallon. Similarly, Honolulu has a local tax of \$0.165 per gallon.

<sup>50</sup> *See, e.g.*, OREGON REV. STAT., ch. 480, § 480.315.

<sup>51</sup> *See* Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217 (2000); *see also* Ronald N. Johnson & Charles J. Romeo, *The Impact of Self-Service Bans in the Retail Gasoline Market*, 82 REV. ECON. & STAT. 625 (2000); Donald Vandegrift & Joseph A. Bisti, *The Economic Effect of New Jersey's Self-Service Operations Ban on Retail Gasoline Markets*, 24 J. CONSUMER POL'Y 63 (2001).

<sup>52</sup> *See* GASOLINE PRICE CHANGES, *supra* note 6, at 113.

multiple fuel islands and multi-product dispensers. They are sometimes called “pumpers” because of their large-volume fuel sales. By 1999, the latest year for which comparable data are available, brand-name and independent convenience store and pumper stations accounted for almost 67 percent of the volume of U.S. retail gasoline sales.<sup>53</sup>

Another change to the retail gasoline market that appears to have helped keep gasoline prices lower is the entry of hypermarkets. Hypermarkets are large retailers of general merchandise and grocery items, such as Wal-Mart and Safeway, that have begun to sell gasoline. Hypermarket sites typically sell even larger volumes of gasoline than pumper stations – sometimes four to eight times larger.<sup>54</sup> Hypermarkets’ substantial economies of scale generally enable them to sell significantly greater volumes of gasoline at lower prices.

This list of factors that have an impact on retail gasoline prices is not exhaustive, but it shows that prices are set by a complex array of market and regulatory forces working throughout the economy. In the long run, these forces have combined to produce relatively stable real prices in the face of consistently growing demand. Short-run variations, while sometimes painful to consumers, are unavoidable in an industry that depends on the demand and supply decisions of literally billions of people.

## **V. Conclusion**

The Federal Trade Commission has an aggressive program to enforce the antitrust laws in the petroleum industry. The Commission has taken action whenever a merger or nonmerger conduct has violated the law and threatened the welfare of consumers or competition in the

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<sup>53</sup> PETROLEUM MERGER REPORT, *supra* note 5, at 246 tbl.9-5.

<sup>54</sup> *Id.* at 239.

industry. The Commission continues to search for appropriate targets of antitrust law enforcement, to monitor retail and wholesale gasoline and diesel prices closely, and to study this industry in detail.

Thank you for this opportunity to present the FTC's views on this important topic. I would be glad to answer any questions that the Committees may have.