V920006

Federal Trade Commission

COMMISSION AUTHORIZED

Denver Regional Office

Suite 2900
1405 Curtis Street
Denver, Colorado 80202
(303) 844-2271

February 26, 1992

The Honorable Bill Morris
Kansas State Senate
State House, Room 143 North
Topeka, KS 66612

Dear Senator Morris:

The staffs of the Denver Regional Office and the Bureau of Competition of the Federal Trade Commission[1] are pleased to submit this letter in response to your request for comments on the potential competitive effects of proposed legislation, House Bill No. 2628, for a Kansas Motor Fuel Marketing Act. The bill would, in general, prohibit selling motor fuel "below cost" (as "cost" is defined) or selling it at a price below the price charged to others at the same marketing level, in the same area, at the same time.

We believe such legislation is likely to be anticompetitive, and that its likely result may be that Kansas consumers and visitors could pay higher prices for gasoline.

I. Interest and experience of the staff of the Federal Trade Commission.

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.[2] Under this statutory mandate, the Commission seeks to identify restrictions that impede competition or increase costs without offering countervailing benefits to consumers. In particular, the Commission and its staff

[1] These comments are the views of the staffs of the Denver Regional Office and the Bureau of Competition of the Federal Trade Commission. They are not necessarily the views of the Commission or any individual Commissioner.

[2] Federal Trade Commission Act, 15 U.S.C. §45 *et seq*.

have had considerable experience assessing the competitive impact of regulations and business practices in the oil industry.[3]

II. Description of the proposed legislation.

House Bill No. 2628 rests on proposed findings that "unfair competition" results when costs associated with marketing fuel are recovered from other operations, so the fuel is sold at "subsidized" prices.[4] It describes three sources of these "subsidies": first, a refiner's use of profits from refining to compensate for below-normal (or negative) profits from marketing; second, a marketer's use of profits at one location to cover losses from below-cost selling at another location; and third, any business's use of profits from sales of other products to cover losses from below-cost sales of motor fuel. The bill would find that independent marketers "are unable to survive" these practices, which are said to be "inherently predatory."[5] Thus, to safeguard against monopolies or unfair methods of competition, the bill declares that "the advertising, offering for sale or sale of motor fuel below cost or at a cost lower than charged other persons on the same marketing level, which has the effect of injuring competitors or destroying or substantially lessening competition, is an unfair and deceptive trade practice," whose prohibition would be in the public interest.[6]

Any sale of any grade of motor fuel below cost, or at a price different from the price charged other customers in the same market area, at the same distribution level, on the same day, would be

---

[3] The staff of the Commission has gained extensive experience with energy competition issues by conducting studies, investigations, and law enforcement actions. FTC staff comments and testimony to legislative bodies have identified the costs of proposed gasoline retailing divorcement, "below-cost selling," and other petroleum marketing legislation for Alabama, Arkansas, Georgia, Hawaii, Louisiana, Massachusetts, Montana, Nevada, North Carolina, South Carolina, Tennessee, Virginia, Washington, Utah, and the United States Senate and House of Representatives. The Commission and its staff have also gained considerable experience with gasoline refining and marketing issues affecting consumers from premerger antitrust reviews pursuant to Sections 7 and 7A of the Clayton Act, 15 U.S.C. §§18, 18a.

[4] H. B. No. 2628 ("Bill 2628"), §2(b).

[5] Bill 2628, §§2(c), (d).

[6] Bill 2628, §§3(b), (c).

prohibited, "where the effect is to injure competition."[7] Liability could be based on injury to particular firms or individuals as well as injury to competition, because "competition" is defined to mean individual competitors.[8] In the bill's basic prohibitory section, "cost" is not defined; however, another section of the bill describes the requirements for a plaintiff to make out a prima facie case, which use several defined terms related to costs.[9] In addition, Section 7 of the bill prohibits transferring motor fuel to an affiliate for resale on a different marketing level at a transfer price lower than the price charged purchasers for resale at the same level, where the effect is to injure competition.[10]

The bill includes several separately defined offenses. It would be unlawful to use motor fuel as a "loss leader," that is, to sell it at less than "cost" to encourage the purchase of

---

[7] Bill 2628, §6. Exemptions are set out for isolated transactions, discontinued products, imperfect or damaged fuel, liquidation of a business, or sales pursuant to a court order. §§12(a)(1)-(5).

[8] Compare Bill 2628, §3(c) and §4(d).

[9] A prima facie violation, shifting the burden to the defendant, is made out by plaintiff's showing that:

> its purchase price (from a refiner or wholesaler) is greater than the refiner's transfer price, §18(a), or
>
> the sum of its purchase price (from a refiner or wholesaler supplier) and "cost of doing business" (overhead, §4(e)) is greater than the supplier's retail posted price, §18(b), or
>
> the sum of its "basic cost of motor fuel" (cost of goods sold, §4(b)) and "cost of doing business" is greater than the posted retail price of a competitor suspected of selling below cost. §18(c).

It is not clear whether the "competitor" in §18(c) must be the defendant in the particular action.

[10] Bill 2628, §7. Refiners are required to establish transfer prices for transactions with their affiliates and to disclose them on request. §5.

something else,[11] or to offer a rebate or concession,[12] where the effect is to injure competition. In addition, a retailer would be prohibited from inducing a wholesaler to sell below the wholesaler's cost;[13] this would be an offense regardless of whether there is any effect on competition. The combination of sales of motor fuel with some other merchandise or with coupons or gifts could not be made or advertised at prices below "cost," where "cost" for all such items would be determined according to the same definitions the law applies to motor fuel;[14] here too, these acts would be offenses without regard to the effect on competition.

A difference in cost could justify charging a different price to a purchaser for resale, but only if the cost difference is due to a difference in shipping method.[15] A price set to meet competition would not violate the proposed act, but only if it is set to meet, and not be lower than, a specific price.[16]

The law would be enforced by injunctions and civil penalties of up to $10,000 for each offense. The bill would also permit private actions for injunctive relief, civil penalties, and actual and special damages.

---

[11] Bill 2628, §9(a); see §4(j), defining "loss leader".

[12] Bill 2628, §9(b).

[13] Bill 2628, §9(c).

[14] Bill 2628, §10.

[15] Bill 2628, §8(a). Differences among its customers' costs can affect a supplier's potential liability. This is because, under §§18(b) and (c), prima facie liability is determined by reference to a plaintiff's actual overhead costs, so customers with different costs could have different claims.

[16] Bill 2628, §8(b). Another section of the bill would permit a wholesaler or retailer to meet the competition of a specific party selling to it (at the same level of distribution) at cost. §13(a). Whether the sales are at "cost" can be determined by a market survey; the lowest cost disclosed by such a survey may be presumed to be the relevant "cost". §13(b), §15.

III. <u>Analysis of House Bill No. 2628</u>.

A. <u>No reliable evidence supports claims of predatory, monopolistic or collusive activities by refiners or marketers of gasoline</u>.

Bill 2628's premise is that competition in the petroleum industry is being reduced becayse independent motor fuel marketers cannot survive predatory "subsidized" pricing by major refiners and marketers. This view is shared by proponents of similar legislation that would impose restraints on vertically integrated petroleum refiners and marketers in other jurisdictions. They have maintained that such laws are necessary to protect dealers from unfair and anticompetitive practices by their suppliers. According to this view, vertically integrated refiners can and do set retail prices charged by their company-owned and operated outlets below the wholesale prices charged to franchised or independent dealers. They allege that the reason for such "subsidization" is to drive franchised and independent dealers out of business in order to replace them with company-owned stations. It is similarly charged that major gasoline marketers often have subsidized "below cost" pricing at one location by high prices at another location, and that such practices harm competitors and consumers.

Such claims do not appear to be well founded. Major oil companies have historically been "integrated by contract," relying heavily on franchised dealer networks to sell their refined products. Several studies of competition in gasoline marketing in the United States since 1981 have concluded that gasoline dealers have not been and are not likely to become targets of anticompetitive practices by their suppliers. We briefly summarize the results of these studies below.

1. <u>Federal Studies</u>.

The Department of Energy ("DOE") has studied whether vertically integrated refiners were "subsidizing" their retail gasoline operations in a way that might be predatory or anticompetitive.[17] DOE's final report to Congress, published in January, 1981, was based on an extensive study of 1978 pricing data in several Standard Metropolitan Statistical Areas, as well as on internal oil company documents subpoenaed by DOE investigations.

---

[17] This study was undertaken following enactment of Title III of the Petroleum Marketing Practices Act in 1978, 15 U.S.C. §2841.

The study concluded that there was no evidence of such "subsidization."[18]

In 1984, DOE published an updated study that further substantiated and elaborated on its 1981 findings.[19] The study showed that company-operated stations were not increasing as a percentage of all retail outlets, except among the smaller refiners. In the 1984 report, DOE concluded that the increased pressures on gasoline retailers since 1981 were not caused by anticompetitive behavior on the part of the major oil companies. Rather, the decline in the overall number of retail outlets and the intensification of competition among gasoline marketers were attributable to decreased consumer demand for gasoline and a continuing trend toward the use of more efficient, high-volume retail outlets.[20]

2. State Studies.

In 1986, the Washington state Attorney General initiated a study of motor fuel pricing in that state to determine whether claims of refiner subsidization were justified. The study focused on whether major oil companies injured competition by charging lessee-dealers higher prices for gasoline than the companies were charging their own company-operated retail stations. The study also sought to examine whether the major oil companies injured competition by establishing a pricing structure between retail and wholesale prices that prevented dealers from covering their costs. Information was gathered on the practices of all eight of the major companies in Washington for a three-year sample period. The study covered regions throughout the state where the companies maintained both retail operations and lessee-dealer operations. The Washington study found that less than one percent of all observed pairs of prices of lessee dealers and company-operated stations disclosed any significant price variations. The study concluded that such instances were "clearly too infrequent" to show that lessee dealers were being systematically driven from the market

---

[18] DOE, Final Report: The State of Competition in Gasoline Marketing, p. xi (1981).

[19] DOE, Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers (March, 1984) ("1984 DOE Report").

[20] 1984 DOE Report at 125-32.

because their gasoline purchase costs were the same as or higher than the retail prices of competing refiner-operated stations.[21]

More recently, in 1987, the Arizona legislature created a Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement. In December 1988 the Committee recommended that no new legislation be enacted, concluding that "(t)he marketplace for petroleum products is very competitive in Arizona."[22]

The DOE studies, based on data from the 1970's and early 1980's, and the state studies done more recently have revealed no instances of predatory behavior by major gasoline refiners.[23] Rather, they show that the fortunes of refiners and their franchised retailers are closely linked and that these firms "form a mutually supporting system backed by company advertising and promotion."[24] Franchised retailers have continued to be by far the predominant form of outlet for the gasoline sales of major, integrated refiners. Indeed, major refiners operate only a small percentage of the gasoline stations in the United States.[25]

---

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

[22] Final Report to the Arizona Joint Legislative Study Committee on Petroleum Pricing and Marketing Practices and Producer Retail Divorcement, p. 35 (December, 1988).

[23] Much of the information cited here in support of these propositions comes from the 1984 DOE Report, and thus on data that is now a decade old. But the results of continuing investigations by the Commission's staff into competition in the petroleum industry give us no reason to believe that the distribution structure has significantly changed since that time.

[24] 1984 DOE Report at ii. We do not mean to suggest that the interests and incentives of refiners and their franchised retailers are linked perfectly in every situation. Although the refiners and their retailers generally share common goals, on occasion their interests and fortunes may not coincide.

[25] Lundberg Letter, Vol XI, No. 36, July 6, 1984, at 3, where it was reported that the major refiners operated only about 3.3 percent of all retail stations. The 1984 DOE Report confirmed a similarly low proportion. A recent study conducted for the American Petroleum Institute noted that the fourteen largest integrated refiners, representing approximately 67 percent of the (continued...)

3. Gasoline marketing in Kansas.

The national pattern is reflected in the distribution systems of the leading branded refiners in Kansas. The 1984 DOE study indicates that vertically integrated gasoline marketers accounted for 13.3 percent of total sales in Kansas in 1981; this was almost exactly equal to the national average, 13.1 percent.[26] Only one of the eight leading branded marketers in Kansas for which data are available uses company-owned and operated outlets as the predominant form of retailing on a national basis.[27] However, company operated outlets may be a predominant form of retailing for smaller independent refiners. For example, the largest refiner that operates most of its own outlets is Clark, which ranks 24th nationwide in number of retail outlets (with 937).[28]

The major integrated refiners are not likely to engage in predation against the mainstay of their own retail distribution systems, their franchised retailers. Major refiners would have little incentive to charge discriminatory prices that would cause their franchised retailers to move to different suppliers or to go out of business. A refiner that discriminated in ways that injured its franchisees and dealers would probably lose sales, leading to a lower market share, greater excess refining capacity, and higher per unit costs.

---

[25](...continued) nation's refining capacity, had only about 10 percent of their gross gasoline sales and 4.5 percent of their outlets devoted to company-operated retail stations. Temple, Barker & Sloan, Gasoline Marketing in the 1980's: Structure, Practices, and Public Policy, pp. 2-3 (1988).

[26] 1984 DOE Report at 82.

[27] National Petroleum News 1991 Factbook 34-51. The seventh ranked firm in Kansas, Coastal Corporation, operates 70 percent of its branded outlets itself (nationwide). Of the other top eight firms in Kansas, only two operate more than 8 percent of their own outlets (nationwide). Total Petroleum, Inc., with the largest number of outlets in Kansas (19 percent), operates 23 percent of its branded outlets itself; the second largest in Kansas, Phillips 66 Company, operates none; the third largest, Conoco, Inc., operates 11 percent.

[28] National Petroleum News 1991 Factbook 34-51. Clark is the 16th-ranked marketer in Kansas, with ten outlets. Id.

B. <u>Even if predatory behavior or price discrimination were found, it is already subject to prosecution under existing state and federal laws</u>.

Predatory conduct in the petroleum industry is subject to the Sherman Act, the Clayton Act, and the Federal Trade Commission Act. In addition, price discrimination that injures competition is subject to existing Kansas law[29] and to the federal Robinson-Patman Act.[30] These statutes address possible anticompetitive practices in the industry and deter firms from engaging in predatory behavior or illegal price discrimination. In contrast, the proposed Kansas Motor Fuel Marketing Act may make it more difficult for firms to adjust their prices in response to changing conditions of demand and supply. Its prohibitions are broader than those in the Robinson-Patman Act.[31] Bill 2628 may inhibit vigorous competition and add costs to the distribution of gasoline in Kansas that do not exist in other states, costs that would be borne by Kansas consumers and visitors.

---

[29] <u>See</u> Kansas Statutes Ann., Art. 50-149 (prohibiting geographic price discrimination intended to destroy competition).

[30] 15 U.S.C. §13 (Section 2 of the Clayton Act). <u>See Texaco, Inc. v. Hasbrouck</u>, _____ U.S. _____, 110 S. Ct. 2535 (1990), in which franchised gasoline retailers successfully challenged price discrimination by a vertically integrated refiner.

[31] For example, under Bill 2628 liability could be based solely on injury to a competitor. The Bill does not require that the "injury" be related to effects on competition generally; rather, "competition" means an individual competitor. Bill 2628, §4(d). By contrast, illegality under the Robinson-Patman Act requires that the effect of the pricing action be either "substantially to lessen competition or tend to create a monopoly or to injure, destroy, or prevent competition with any person" who grants or receives the benefit of price discrimination (or with customers of either of them). 15 U.S.C. §13(a). Under federal law, the effect of the conduct on competition, as distinguished from effects on a single competitor, is the more relevant consideration. And, although Bill 2628 would allow setting a price to meet competition, it limits that to meeting a specific price of a competitor in the same market area on the same day. By contrast, the Robinson-Patman Act permits a seller to meet the prevailing competitive circumstances in a market, <u>Falls City Indus. v. Vanco Beverage</u>, 460 U.S. 428 (1982).

C. The bill may lead to higher gasoline prices because it will discourage price competition and facilitate uniform pricing.

Bill 2628 may have adverse consequences for consumers. Short term price discounts designed to attract new customers may be deterred. The legislation may also limit the availability of certain functional discounts.[32] Refiners may be prevented from realizing all the efficiencies of vertical integration, which can often reduce transaction and search costs and lower prices to consumers.[33] As a broad generalization, economic theory suggests that vertical integration is likely to harm consumers only when market power exists in at least one stage of production.[34]

An unintended effect may be to encourage vertically-integrated refiners who distribute gasoline in Kansas to change otherwise lawful pricing practices. In enforcing the federal price discrimination law, the Robinson-Patman Act, the Commission is careful to avoid discouraging firms from engaging in lawful price competition and from setting price differences, which often operate to destroy cartel pricing.[35] However, such lawful price competition may be discouraged by a number of provisions in the bill. Firms

---

[32] In Texaco, Inc. v. Hasbrouck, the Supreme Court said that "a functional discount that constitutes a reasonable reimbursement for the purchasers' actual marketing functions will not violate the Act." 110 S. Ct. at 2550.

[33] For example, a vertically integrated refiner may be able to achieve greater efficiency in coordinating its different levels of distribution than is possible in market transactions. In a competitive industry, such as retail gasoline sales, it may be expected that these cost savings would be at least partially passed on to the consumer. However, Bill 2628 may inhibit such firms from using these savings to lower prices to consumers. The exemption for certain price differences based on cost differences does not recognize the likely cost savings due to coordination efficiencies of vertical integration. Indeed, Bill 2628 recognizes only one source of cost differences, shipping methods.

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

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

may simply decide to set uniform prices across broad geographic regions to avoid violations.[36]

IV. Conclusion.

For the reasons stated above, we believe that Bill 2628 would tend to insulate gasoline refiners and marketers from competition, and thereby could cause gasoline prices in Kansas to increase. We

---

[36] To the extent that individual firms would have an incentive to set a single price in a geographic area to avoid violating the law, the bill would resemble "uniform price laws," whose possible effects were discussed in the 1984 DOE Report, at 122:

> In a market where there are no restrictions on pricing, price reductions tend to spread throughout the geographic area providing lower prices for consumers. If the geographic area within which the price cutting occurs is limited, it is very likely that the refiners will respond in kind. Thus, a price cut in one area often will lead to price cuts across broad market areas. In this situation, competition has worked effectively and consumers in all areas affected are better off.
>
> In markets where there are uniform price restrictions, it is more likely that the responses will be different. Again, a refiner may decide to lower prices in a geographic area where sales traditionally have been weak. Refiners' responses must now take into account the uniform price law. [R]efiners must lower prices throughout the area covered by the law. In this situation, the refiners are more than likely to maintain their prices, since they may decide it is less costly to forego some sales in the initial market where price cutting is occurring than lower prices throughout the region. Competition has been adversely affected and most consumers are no better off, since price reductions have not occurred in areas where they would have without the uniform price law.

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

Sincerely,

Claude C. Wild III
Director
Denver Regional Office