

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
Washington, DC 20580



OFFICE OF POLICY PLANNING
BUREAU OF ECONOMICS
BUREAU OF COMPETITION

May 2, 2007

Representative Christopher R. Stone
State of Connecticut House of Representatives
Legislative Office Building, Room 4100
State Capitol
Hartford, CT 06106-1591

Dear Representative Stone:

We are pleased to respond to your request¹ for our comments on Senate Bill 1136 (“SB 1136” or the “Bill”), which would regulate retail and wholesale petroleum pricing.² Specifically, the Bill would mandate that retailers sell “gasoline based on the actual price . . . paid for the gasoline located in underground storage tanks located on the premises of the retail gasoline station at which the gasoline is sold,” and would explicitly forbid retailers from raising the retail price of gasoline “in anticipation of market based price increases.”³ SB 1136 also would prohibit petroleum refiners or producers from charging retailers different wholesale prices based on “the geographic location of such retail seller in any geographic zone in [Connecticut],” or otherwise to

¹ See Letter from Connecticut State Representative Christopher R. Stone to Maureen Ohlhausen, Director, Office of Policy Planning, Federal Trade Commission (Mar. 1, 2007).

² 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.

³ SB 1136 § 2.

use any other pricing system “that would prevent retail sellers of gasoline from paying lower prices on an equal basis with other retail sellers of gasoline in [Connecticut].”⁴

FTC staff recommends that the Connecticut legislature not adopt SB 1136. We are concerned that SB 1136 may result in increased retail prices and harm consumers by hindering the market’s ability to respond to supply disruptions. The ban on zone pricing also may reduce the incentives of refiners to establish gasoline stations in areas with relatively weak competition vis-à-vis other areas.

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.⁵ In doing so, the FTC has assembled vast competition policy and enforcement expertise in 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.⁶ The Commission also has dedicated resources to study and research broader market dynamics in petroleum markets. For example, the Commission issued a report in 2006 on its investigation of price manipulation and price increases in the wake of Hurricane Katrina.⁷ In 2005, it released a report examining the factors that affect gasoline prices in the United States.⁸ In 2001, the Commission issued reports on its investigations into spikes in

⁴ SB 1136 § 1, (creating new 16a-23 by (c)).

⁵ 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.

⁶ *See* 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 these orders are available at the FTC’s *Oil and Gas Industry Initiatives* website, at <http://www.ftc.gov/ftc/oilgas/testimony.htm>. 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. Ill. Aug. 9, 2006), at <http://www.ftc.gov/os/caselist/0423138/060809irdstipfinaljdgmnt.pdf>.

⁷ FEDERAL TRADE COMMISSION, INVESTIGATION OF GASOLINE PRICE MANIPULATION AND POST-KATRINA GAS PRICE INCREASES (Spring 2006), at <http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf>.

⁸ FEDERAL TRADE COMMISSION, GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (2005) (“GASOLINE PRICE CHANGES REPORT”), at <http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf>.

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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 Finally, Commission staff is routinely asked by state legislators to comment on proposed state laws covering various aspects of gasoline sales.¹²

Likely Effects of SB 1136

SB 1136’s proposed regulation of retail and wholesale gasoline prices potentially could harm Connecticut consumers.

A. Regulation of Retail Prices

The intent of Section 2 appears to be to prevent gasoline stations from raising the price of

⁹ FTC, Final Report, Midwest Gasoline Price Investigation (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 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>; *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>. 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.

gasoline to reflect higher retail prices before they have had a comparable increase in their wholesale prices.¹³ Such a provision likely will have several related deleterious effects.

First, SB 1136 may interfere with the legitimate role prices play in times of shortages. Prices are an important factor in shaping demand. For example, an increase in price when supply is limited may signal consumers to buy less, that is, to cut back on demand. A decision to use less gasoline is not easy and often is painful for most consumers.¹⁴ Nevertheless, higher prices are unfortunately necessary in times of shortages because they will encourage consumers to cut back on demand. Retail stations should be allowed to respond to market conditions. Artificially low retail prices in times of shortage may cause consumers to purchase more gasoline than they would if prices were being set by the market. In turn, this could exacerbate the problems caused by shortages, with long lines at retail stations and even scarcer supply. These predictable reactions may cause the wholesale price to rise even more sharply than they otherwise would.

Second, the Bill may distort the incentives of the retail gasoline stations to the long-term harm of consumers. For example, if retailers cannot increase prices in anticipation of what they will have to pay at wholesale to refill their underground storage tanks, they may maintain, on average, lower inventories of gasoline in their underground storage tanks. In other words, they may seek to limit their risk of exposure by maintaining smaller inventories. This could cause Connecticut to be more susceptible to supply shocks because the retailers will not have the inventory in their underground tanks to help cover a short-term shortage.

Third, limiting the flexibility to raise prices paradoxically gives retailers an incentive to charge higher prices than they otherwise would. Suppose, for example, that a gasoline station was considering cutting its price from \$2.50 to \$2.45 in response to current market conditions. The proposed legislation would limit the gas station's flexibility to raise its price back to \$2.50 should market conditions change. That restriction might cause it to forego the price decrease altogether. Moreover, the effect of the proposed legislation on pricing incentives would not be limited to periods when a gasoline station is cutting prices. Whenever a gasoline station makes a

¹³ The statute would require a gasoline station to "base" its prices for gasoline on its historical cost, but fails to specify what if any other factors it might consider, making the statute somewhat ambiguous. The statute could be read to prevent a gasoline station from lowering its prices when retail market prices drop before wholesale prices do. It could also be read to limit the ability of a retailer with multiple stations to charge different mark-ups depending on location and other gasoline station characteristics, such as the presence of a convenience store or car wash. In these comments, we will assume that the effect of the legislation is simply to prevent a gasoline station from raising the retail price prior to getting a new shipment for which it must pay a higher wholesale price.

¹⁴ In retail gasoline markets, a substantial body of empirical literature has shown that even if the price of gasoline increases quickly and sharply (as will happen during a severe shortage) the short-run demand for gasoline does not decline much. See, e.g., Kilke A. Kayser, *Gasoline Demand and Car Choice: Estimating Gasoline Demand Using Household Information*, 22 ENERGY ECON. 331 (2000). Relatively small reductions in gasoline consumption are possible if consumers consolidate or skip some trips, carpool or take public transportation.

pricing decision, a restriction on subsequent price increases means that choosing a higher price "today" preserves the option to charge a higher price "tomorrow."

To summarize, Commission staff believes that if the Connecticut legislature approves this amendment, retail gasoline prices will be higher in normal times, and the system will be less able to minimize the undesirable effects of shortages when supply disruptions occur.

B. Regulation of Wholesale Prices

Zone pricing is a practice whereby refiners set different wholesale prices for branded retail gasoline stations that operate in different areas served by a common gasoline terminal.¹⁵ The area of effective local competition is the basis for price zones, and refiners that practice zone pricing typically charge higher wholesale prices to retailers located in less competitive environments than they do to those that face more intense retail competition.¹⁶

The FTC has considered the competitive issues raised by zone pricing in the past and does not believe that a *per se* ban of the practice is necessary. First, FTC studies have "revealed no evidence of coordination by refiners in their use of price zones or in the zones' geographic locations or dimensions."¹⁷ Second, zone pricing has the potential to *benefit* consumers. Zone pricing creates incentives for refiners to add retail stations in less competitive areas because it permits refiners to capture more of the return from owning desirable retail sites.¹⁸ Zone pricing

¹⁵ A price zone "typically is a contiguous set of gasoline stations of the same brand that face a common set of competitive factors, including competing brands." GASOLINE PRICE CHANGES REPORT at 126. The size of a zone may be as small as a specific station. See Cary A. Deck & Bart J. Wilson, *Experimental Gasoline Markets*, at 3-4 (2006) (forthcoming J. ECON. BEHAVIOR & ORG.), at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=445721#PaperDownload. The wholesale price to gasoline lessee-dealers is generally a delivered price, also known as a "dealer tank wagon" (DTW) price. Dealers who pick up gasoline from the terminal pay the "rack" price and pay their own transportation costs. Unless noted otherwise, in this letter, the wholesale price refers to the DTW price.

¹⁶ See GASOLINE PRICE CHANGES REPORT at 126; Gasoline Cary A. Deck & Bart J. Wilson, *Economics at the Pump*, 27 REGULATION 22, 22 (Spring 2004).

¹⁷ Statement of Commissioner's Shelia F. Anthony, Orson Swindle, and Thomas B. Leary, No. 981-0187 (May 7, 2001), at <http://www.ftc.gov/os/2001/05/wsgpiswindle.htm>. See also GASOLINE PRICE CHANGES REPORT at 127 ("Variations in wholesale gasoline prices further suggest that branded refiners are not using zone pricing to collude on wholesale gasoline prices.").

¹⁸ See David W. Meyer and Jeffrey H. Fischer, *The Economics of Price Zones and Territorial Restrictions in Gasoline Marketing*, FTC Working Paper No. 271, 25-27 (Mar. 2004), at <http://www.ftc.gov/be/workpapers/wp271.pdf>. Connecticut law prohibits refiners from "operat[ing]" retail service stations "with employees of such producer or refiner, a subsidiary company, commissioned agent or under a contract with any person, firm or corporation managing a service station on a fee arrangement with such producer or refiner. Any such station shall be operated only by a retail service station dealer." See CT. CODE, CHP. 250a § 14-344b. However, it does not appear to prohibit refiners from owning retail sites and leasing these sites to unaffiliated retail operators.

also reduces transaction costs through better alignment of retailer and refiner incentives.¹⁹ Thus, by banning zone pricing, SB 1136 has the potential to reduce entry in what currently are less competitive areas. To the extent that there is reduced entry, and thus less competition and less choice among brands, consumers are worse off. Further, a ban on zone pricing may make it harder to align incentives in the retailer-refiner relationship, which could increase transaction costs and translate into higher retail prices.²⁰ Finally, we also believe that a ban on zone pricing is unnecessary because state and federal antitrust laws already are broad and flexible enough to support enforcement in any circumstances in which zone pricing is likely to harm consumers.

If the Connecticut legislature nevertheless believes that regulation of this practice is necessary, we would urge the legislature not to ban all zone pricing. Instead, we would recommend that any legislation prohibit zone pricing only when it can be demonstrated to be likely to harm consumers. This would be consistent with the antitrust laws that reserve *per se* antitrust condemnation only for those practices that have a “pernicious effect on competition and lack . . . any redeeming virtue.”²¹ Because zone pricing has the potential to benefit consumers, it does not fall into this category.²²

* * *

¹⁹ Refiners who own the land on which their branded stations are located derive two revenue streams from retailers: wholesale prices and rent. A higher lease payment and a lower markup on the wholesale gasoline price induces the gasoline retailer to price more aggressively, because the retailer captures a higher fraction of the profit on each incremental gallon sold. At the same time, because a higher percentage of the refiner’s compensation is independent of the amount of gasoline sold, such an arrangement may reduce the refiner’s incentives to support the station or the brand. A lower lease payment and a higher markup on the wholesale gasoline price creates an incentive for the refiner to support the brand and to ensure that the retailer has adequate supplies, because the refiner earns more the greater are retail sales. This arrangement also mitigates the risk for the retailer of uncertainty over demand: the greater the percentage of the refiner’s compensation that is taken as rent, the more the retailer is at risk of losing money if there is a small reduction in the quantity of gasoline demanded. Because refiners tend to be better-capitalized businesses than gasoline retailers, refiners are better able to bear the risk of shifts in gasoline demand. By moving some of the risk of demand shifts from retailers to refiners, retailers are willing to take a smaller markup than otherwise, thus reducing retail prices. *See id.*

²⁰ *See id.*

²¹ *Northern Pac. Ry. v. United States*, 356 U.S. 1, 5 (1958). *See also Business Elecs. Corp. v. Sharp Elecs. Corp.*, 485 U.S. 717, 723 (1988) (*per se* condemnation reserved for practices that “would always or almost always tend to restrict competition and decrease output”). Currently, antitrust laws condemn under the *per se* rule only naked horizontal agreements among competitors, such as price fixing, and explicit minimum resale price maintenance agreements. The Supreme Court currently is considering whether the continued *per se* treatment of minimum resale price maintenance is warranted. *See Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 763 (Dec. 7, 2006) (*cert. granted*).

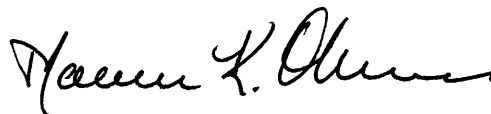
²² Although a *conspiracy among refiners* to set wholesale prices using zone pricing systems would be judged under the *per se* rule, the unilateral adoption of a zone pricing system would not.

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FTC staff believes that SB 1136's proposed regulation of retail prices could potentially harm consumers by raising retail prices and hindering the market's ability to respond to supply disruptions. SB 1136's regulation of wholesale prices may also harm Connecticut consumers by reducing refiners' incentives to locate new stations in less competitive areas. Finally, federal and state antitrust laws already address any circumstance in which zone pricing is likely adversely to affect competition among refiners or retailers.

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