Testimony of

Mr. Tom Greene

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Thomas Greene, Chief Assistant Attorney General,
California Department of Justice,
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Concerning "Consolidation in the Oil and Gas Industry: Raising Prices?"

Good morning, Mr. Chairman and members. My name is Tom Greene and I am the Chief Assistant Attorney General for the Division of Public Rights for the California Department of Justice. I appear today on behalf of Attorney General Bill Lockyer who could not attend because of other duties in California.

By way of introduction, I am the past chief of our Antitrust Law Section and the former chair of the Multistate Antitrust Task Force of the National Association of Attorneys General. I also had the opportunity to chair Attorney General Lockyer's Gasoline Pricing Task Force, which examined the causes and consequences of spiking gasoline prices in California.

My purpose today is to share our experiences with the treatment of petroleum companies by state and federal law, particularly federal antitrust law. Let me begin with our experience with California's price-gouging statute and then turn to federal antitrust issues.

1. An Effective Price-Gouging Statute Must Encompass Refiners as Well as Retailers.

California's price-gouging prohibition is found in Cal. Penal Code section 396, and applies to "essential consumer goods and services". The law is triggered if prices increase more than 10% after the declaration of an emergency. However, "a greater price is not unlawful if that person can prove that the increase in price is directly attributable to additional costs imposed on it by the supplies or the goods..." Just after Hurricane Katrina, our office received an avalanche of complaints about dramatically higher gasoline prices. This raised major concerns, not the least of which was the fact that Gulf refineries do not supply California stations except in very rare circumstances. We investigated dozens of the most egregious complaints and learned that the prices were spiking not because of the retailers that are covered by the law but by the refiners that supplied them. In considering new legislation, it is imperative to include refiners within its purview if it is to be effective.

2. Section 1 of the Sherman Act Is Increasingly Irrelevant in Concentrated Industries, and Needs Reform to be Useful in the 21st Century.

The Sherman Act was written at a time when de jure price-fixing cartels, often with elaborate management and oversight structures, were strangling the American economy. At that time, the fact that prosecutors and plaintiffs were required to demonstrate the existence of a "conspiracy" or "combination" was rarely dispositive. Today, however, our most important industries, including petroleum, are dominated by a small number of firms. Such oligopolies are interdependent, and carefully monitor each other's activities. In this environment, proof of a "combination" has become far harder, to the point that many federal courts have been unwilling to allow even substantial cases to go to federal juries so these powerful economic structures are largely outside the purview of the antitrust laws.

In terms of economic effects on consumers, there is "no vital difference between formal cartels and tacit collusive arrangements" often found in oligopolized industries. Starting with Cournot in 1838 and continuing to the present,

economists have found that concentrated industries lend themselves to prices and output levels that are less than optimum. Chamberlin in 1960 concluded that "since the result of a [price] cut by any one is inevitably to decrease his own profits, no one will cut, and, although the sellers are entirely independent, the equilibrium result is the same as though there were a monopolistic agreement between them."

Judge Posner of the 7th Circuit, and the author of the seminal book Antitrust Law, makes the point that the ability of firms, even in a relatively concentrated industry, to find their way to the equivalent of a shared monopoly price depends on a variety of factors, and that these factors are often conjoined with signals that can form the basis for a finding of a "combination" within the meaning of the Sherman Act. He notes, however, that the more concentrated the industry, the less explicit the communications that are required to organize prices and limit production. This produces "the paradox that the more conducive the market's structure to collusion without express communications, the weaker the plaintiff's case" is likely to be.

Many courts have not fully appreciated the fact that the most dangerous agreements may be in industries in which the tell-tale signs of a combination in restraint of trade are the most subtle. Confounding this necessarily delicate search for truth are two major summary judgment decisions of the U.S. Supreme Court. In Monsanto Co. v. Spray-Rite Service Corp., the Court noted in a vertical case that, on the question of the existence of a combination, "there must be evidence to exclude the possibility of independent action..." In Matsushita Electrical Industrial Co. v. Zenith Radio Corp. , the Court addressed what was regarded as a highly improbable price-cutting scheme that was intended to eventually allow Japanese manufacturers to take over the U.S. market. Under these circumstances, the Court substantially reigned in possible inferences to be drawn from circumstantial evidence of agreement.

Courts have split on the scope of Monsanto and Matsushita in cases involving concentrated industries and allegations of horizontal price-fixing. Some courts, notably the Eighth and Eleventh Circuits have read these cases broadly, and essentially foreclosed the finding of a "combination" within the meaning of the Sherman Act in concentrated industries. Most troubling is the Eighth Circuit's Blomkest Fertilizer decision in which the court dismissed plaintiff's proofs item by item as "fundamentally unreliable" because they individually could be explained innocently. The court ignored the implications of concentration in this market and the evidence taken as a whole, points strenuously argued in a thoughtful dissent.

This same approach was taken by the California Supreme Court in Aguilar v. Atlantic Richfield Co. Taking a broad view of Monsanto and Matsushita, the court concluded that a plaintiff must at least show evidence that "tends to exclude" the possibility that alleged conspirators acted "independently", and then sustained a grant of summary judgment for the defense notwithstanding significant evidence of oligopolistic coordination and communications.

On the other hand, some courts have confined Monsanto and Matsushita to their facts. For example, the Ninth Circuit in In re Petroleum Products limited these cases to their specific facts. Specifically the court concluded that:

Nor do we think that Matsushita and Monsanto can be read as authorizing a court to award summary judgment to antitrust defendants whenever the evidence is plausibly consistent with both inference of conspiracy and inferences of innocent conduct... Such an interpretation of Matsushita would seem to be tantamount to requiring direct evidence of conspiracy. This cannot be what the Court meant in Matsushita. Since direct evidence will rarely be available, such a reading would seriously undercut the effectiveness of the antitrust laws.

Judge Posner has likewise been critical of a broad reading of Monsanto, concluding that "[m]ost courts mistakenly regard tacitly collusive behavior as independent and therefore infer from the dictum in Monsanto that the plaintiff must negate the possibility that supracompetitive pricing was achieved without explicit agreement."

Judge Posner himself used this approach in In re High Fructose Syrup. In reversing a grant of summary judgment, he warned of three "traps" that must be avoided in such cases: (1) weighing "conflicting evidence", a jury function; (2) failing to take into account "the evidence as a whole" and (3) failing to "distinguish between the existence of a conspiracy and its efficacy." He went on to assess the evidence, noting that "the structure of the...market, far from inimical to secret price fixing, is favorable to it." A similarly thoughtful decision was enunciated by the Third Circuit in In re Flat Glass. There the court concluded that a plaintiff that can establish a conspiratorial motivation and acts against self-interest has simultaneously allayed the concerns of Matsushita.

So what is the problem? Notwithstanding the careful scholarship of Judge Posner and others, '[l]ower federal courts have decided simply to grant summary judgment to defendants when the evidence of conspiracy is evenly balanced, or is ambiguous."

This is particularly likely and problematic in cases involving concentrated industries, like petroleum. As a consequence, it is time to consider action, including legislative action, to provide a calculus that would use the Posner scholarship and the work of the more thoughtful federal courts to make possible the use of section 1 of the Sherman Act in concentrated industries. The committee could consider drafting legislation to establish this decision-making calculus or ask the federal competition agencies to provide a report and recommendation, presumably with significant input from the National Association of Attorneys General. But whichever strategy is chosen, absent broad change, a key element of the Sherman Act will become a sham without action very soon.

3. Merger Analysis Must Take into Account Local Conditions and Not Reflexively Assume a Worldwide Market for Petroleum.

The California Attorney General's office has been involved in every one of the recent petroleum mergers. Indeed, in partnership with our sister states of Oregon and Washington and our federal partner, the Federal Trade Commission, we have secured spin-offs of refineries and other assets in every one of these transactions, starting with the spin-off of the Exxon's Benicia refinery, a major source of clean fuels for western markets. In every one of these cases, the defense has argued that petroleum markets are international so that their mergers are minor developments in this worldwide market. In framing new legislation in this area, particular sensitivity will be required to address the broad market definition claims typically made in these cases.

Conclusion

In conclusion, on behalf of Attorney General Bill Lockyer, let me thank you for allowing us to share our experiences in this important area. The committee should be applauded for its leadership in holding this hearing, and addressing the important issues being discussed today. Our office stands ready to assist you in any way we can. I would be pleased to answer any questions the committee may have.