

Testimony of

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Market Forces, Anticompetitive Activity and Gasoline Prices-
FTC Initiatives to Protect Competitive Markets

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I. Introduction

Mr. Chairman and members of the Subcommittee, I am Bill Kovacic, General Counsel of the Federal Trade Commission. I am pleased to appear before you today at this hearing on the important topic of competitive prices for gasoline, and to present the testimony of the Federal Trade Commission. The title of this hearing is particularly appropriate. As Figure One illustrates, changes in gasoline prices have historically tracked changes in the price of crude oil. With crude oil prices at approximately \$37, it is not surprising that we are seeing higher prices, nationwide, at the pump.

The FTC is a law enforcement agency with two related missions: to preserve competition in the marketplace for the benefit of consumers, and to protect consumers from deceptive or unfair practices that may injure them. The Commission's statutory authority covers a broad spectrum of sectors in the American economy, including the energy industry and its various components.

The significance of antitrust law enforcement is particularly clear in the petroleum industry; fuel price increases can strain the budgets of consumers and can have a direct and substantial impact on businesses of all sizes throughout the U.S. economy. Antitrust enforcement helps ensure that the petroleum industry is, and remains, competitive.

During the period of large oil industry mergers, the Bureau of Competition has spent almost one-fourth of its enforcement budget on investigations in energy industries.

The Commission also performs functions beyond law enforcement. Congress established the agency to provide expert analysis of major trends affecting the American economy. Because of the importance of the petroleum industry to the American economy, and increased public concern about the level and volatility of gasoline prices in recent

years, the Commission studies, on an on-going basis, the central factors that may affect the level and volatility of refined petroleum products prices in the United States. The Commission held public conferences on this topic in 2001 and 2002. The Commission also is updating its 1982 and 1989 "Petroleum Merger Reports" to focus on mergers and structural change in the oil industry since 1985. In March, Commission staff economists released a retrospective study of the effects of the Marathon Ashland joint venture in Kentucky.

In addition to the agency's conferences and research reports, the Commission actively monitors wholesale and retail prices of gasoline. About two years ago, the FTC launched an initiative to monitor gasoline prices to identify "unusual" movements in prices and then examine whether any such movements might result from anticompetitive conduct that violated Section 5 of the Federal Trade Commission Act. FTC economists developed a statistical model for identifying such movements. They look at price movements in 20 wholesale and over 350 retail markets across the country. A map of these markets is attached (Figure Two).

Our gasoline monitoring and investigation initiative focuses on the timely identification of unusual movements (compared to historical trends) in gasoline prices to determine if a law enforcement investigation is warranted. If the FTC's staff detects unusual price movements in an area, it researches the possible causes, including, if appropriate, consulting with the state Attorneys General, state energy agencies, and of the Department of Energy's ("DOE") Energy Information Administration ("EIA"). The FTC's staff also monitors DOE's gas price "hotline" complaints. If the staff concludes that the unusual price movement likely results from a "natural" cause (i.e., a cause unrelated to anticompetitive conduct), it does not investigate further. The Commission's experience from past investigations and the current monitoring initiative indicates that unusual movements in gasoline prices typically have a natural cause. FTC staff further investigates unusual price movements that do not appear to be explained by "natural" causes to determine whether anticompetitive conduct may be a cause. Cooperation with state law enforcement officials is an important element of such investigations.

This testimony summarizes the Commission's recent enforcement activity, reviews its ongoing work to increase understanding of the factors that may affect the level and volatility of refined petroleum product prices, and discusses some of the factors that, based on the agency's experience, the Commission believes affect gasoline prices.

II. Merger Enforcement in the Oil and Gasoline Industries

The Commission has obtained much of its antitrust enforcement experience in the petroleum industry by analyzing proposed mergers. Merger enforcement protects a competitive marketplace, because it helps preserve rivalry that brings lower prices and better services to consumers. The Commission has extensive experience with merger investigations in the petroleum industry, and the FTC has challenged proposed mergers that likely would reduce competition, result in higher prices, and injure the economy of the nation or any of its regions. Since 1981, the Commission has taken enforcement action against 15 major petroleum mergers. Four of the mergers were either abandoned or blocked as a result of Commission or court action. In the other 11 cases, the Commission required the merging companies to divest substantial assets in the markets where competitive harm was likely to occur. The agency's basic approach in those cases was to maintain the pre-merger levels of concentration in the relevant markets. The Commission recently released data on all horizontal merger investigations and enforcement actions from 1996 to 2003. Unlike in other industries, in mergers involving petroleum products, the Commission has obtained relief in moderately concentrated industries.

Let me briefly describe two recent FTC merger investigations in this area. One involved Chevron and Texaco. This transaction combined assets located throughout the United States. Twelve states participated in the FTC's investigation. The Commission entered a consent order with Chevron and Texaco requiring numerous divestitures to maintain competition in particular relevant markets, primarily in the western and southern United States. Among other requirements, the consent order required Texaco to: (a) divest to Shell and/or Saudi Refining, Inc. ("SRI") all of its interests in two joint ventures - Equilon and Motiva - through which Texaco had been competing with Chevron in gasoline marketing in the western and southern United States; (b) divest the refining, bulk supply and marketing of gasoline satisfying California's environmental quality standards; (c) divest the refining and bulk supply of gasoline and jet fuel in the Pacific Northwest; and (d) divest the pipeline transportation of crude oil from the San Joaquin Valley. Another important oil merger that the Commission challenged recently was the \$6 billion merger between Valero Energy Corp. ("Valero") and Ultramar Diamond Shamrock Corp. ("Ultramar"). Both Valero and Ultramar are leading refiners and marketers of CARB gasoline in California (i.e. gasoline that meets the specifications of the California Air Resources Board ("CARB")), and are the only significant suppliers to independent stations in California. CARB 2 gasoline meets the current Phase 2 specifications in effect between 1996 and 2003, and was the only gasoline that could be sold to consumers in California. CARB 3 gasoline meets the proposed Phase 3 specifications effective since January 1, 2003, and is the only gasoline that can currently be sold to consumers in California. The Commission's complaint alleged competitive concerns in the refining and bulk supply of both CARB 2 and CARB 3 gasoline in

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. To remedy the Commission's competitive concerns, the consent order settling the case required Valero to divest an Ultramar refinery in Avon, California; all bulk gasoline supply contracts associated with that refinery; and 70 Ultramar retail service stations in Northern California.

III. Nonmerger Investigations Into Gasoline Pricing

The second important part of the Commission's enforcement function is to detect and stop anticompetitive nonmerger conduct. The Commission has been aggressive in investigating, and prosecuting when appropriate, instances of potentially anticompetitive nonmerger activity. When it appears that higher prices might result from collusive activity, or anticompetitive unilateral activity by a firm with market power, the agency investigates to determine if unfair methods of competition have occurred. If the facts warrant, the Commission challenges the anticompetitive behavior, usually by issuing an administrative complaint.

Several recent petroleum investigations deserve discussion. On March 4, 2003, the Commission issued an administrative complaint, stating that it had reason to believe that the Union Oil Company of California ("Unocal") had violated Section 5 of the FTC Act. 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 Unocal's technology in the refining of CARB-compliant summer RFG. As a result of Unocal's activities, the Commission alleged, Unocal illegally acquired monopoly power in the technology market for producing the new CARB-compliant summer RFG. In addition, the Commission alleged that Unocal undermined competition and harmed consumers in the downstream product market for CARB-compliant summer RFG in California.

The Commission's complaint further charged that these activities, unless enjoined, could cost California's consumers hundreds of millions of dollars per year. The complaint cited testimony of Unocal's expert, who estimated that 90 percent of any royalty paid to Unocal for its technology would be passed on to drivers in the form of higher gasoline prices. This case was dismissed by an Administrative Law Judge, and is currently on appeal before the Commission. Another major nonmerger investigation occurred during 2000-2001, when the Commission conducted a substantial investigation of the major oil refiners' marketing and distribution practices in Arizona, California, Nevada, Oregon, and Washington (the "Western States" investigation). The agency initiated the Western States investigation out of concern that differences in gasoline prices in Los Angeles, San Francisco, and San Diego might be due in part 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 performing these and other inquiries, the Commission distinguishes between short-term and long-term effects. While a refinery outage on the West Coast could significantly affect prices, the FTC did not find that it would be profitable in the long run for a refiner to restrict its output to raise the level of prices in the market. For example, absent planned maintenance or unplanned outages, refineries on the West Coast (and in the rest of the country) generally run close to, or at, full capacity. If gasoline is in short supply in a locality due to refinery or pipeline outages, and there are no immediate alternatives, a market participant may find that it can increase prices - - generally for a short time only until the outage is fixed or alternative supply becomes available. However, this transient power over price - which occurs infrequently and lasts only as long as the shortage - should not be confused with the sustained power over price that is the hallmark of market power in antitrust law.

In addition to the Unocal and the West Coast pricing investigations, the Commission in 2001 issued a report on its nine-month investigation into the causes of gasoline price spikes in local markets in the Midwest in the spring and early summer of 2000. The Commission found a variety of factors that contributed in different degrees to the price spikes. Primary factors included refinery production problems (e.g., refinery breakdowns and unexpected difficulties in producing the new summer-grade RFG gasoline required for use in Chicago and Milwaukee), pipeline disruptions, and low inventories. Secondary factors included high crude oil prices that contributed to low inventory levels, the unavailability of substitutes for certain environmentally required gasoline formulations, increased demand for gasoline in the Midwest, and, in certain states, ad valorem taxes. Importantly, 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. In fact, from the firms' perspective, an "excessive" amount of product was delivered; by mid-July 2000, prices had receded to pre-spike or even lower levels.

The discussion above covers but a few of the gasoline pricing investigations to which the Commission has devoted

substantial time and resources. To date, we have identified no instances of collusion between petroleum companies. That does not mean that collusion cannot occur, which is why the agency continues to be vigilant in pursuing its enforcement mission.

IV. Recent Commission Research on Factors That May Affect Prices of Refined Petroleum Products

Prices in any commodity may fluctuate dramatically for reasons unrelated to antitrust violations. A sudden surge in demand, or an unexpected problem in the supply chain, can cause prices to spike quickly. A change in the price of a necessary input can have a dramatic effect on the price of the final good.

Such price changes are disruptive to both consumers and businesses, but they are not, by themselves, evidence of anticompetitive activity. They can occur in some regional gasoline markets because of a unique combination of short-run supply and demand conditions. The amount of gasoline that can be supplied to a particular region can be inflexible in the short run because of various limitations of refining and transportation capabilities or product requirements unique to that region. The demand for gasoline, however, is inelastic. Thus, in the short run, changes in price do not heavily influence the amount of gasoline purchased by consumers. Under these conditions, when a sudden supply shortage jolts the market, perhaps due to a refinery fire or pipeline rupture, the normal consequence of even a relatively small shortage of supply is a sharp increase in price until the amount of product desired at that price is equal to the volume available.

A. Gasoline Monitoring and Investigation Initiative

Regional price spikes for gasoline have occurred in various parts of the country, and, as you know, we have been experiencing rapid price increases for gasoline this spring as well. As noted above, the FTC is monitoring wholesale and retail gasoline prices in cities throughout the country, and will continue to analyze this data to seek explanations for pricing anomalies. A look at some recent price spikes illustrates the kinds of factors, other than crude oil prices, that affect retail price levels.

ARIZONA

At the end of last summer, gasoline prices increased sharply in Arizona. The average price of a gallon of regular gasoline in Phoenix rose from \$1.52 during the first week in August to a peak of \$2.11 in late August. Several sources accounted for these price movements. The majority of gasoline sold in Phoenix comes from West Coast refineries. A pipeline from Texas also brings gasoline into the Phoenix area but is usually at capacity, so the marginal supply comes from the West Coast.

Product supplies on the West Coast were already becoming tight in early August following a number of unplanned refinery interruptions in California and an unplanned shutdown at a refinery in Washington. This placed upward pressure on prices on the West Coast and in Arizona. On July 30, 2003, Kinder Morgan's El Paso to Phoenix pipeline ruptured between Tucson and Phoenix. With this disruption, most of Arizona immediately became much more dependent on California for its gasoline supplies. The outage immediately reduced the volume of gasoline delivered to Phoenix by 30 percent. With supplies reduced by 30 percent, a price increase is likely, and necessary to both attract additional volume and to reduce demand. Without a price increase, stations would likely run out of gasoline. On August 24, Kinder Morgan opened a temporary by-pass of the pipeline section affected by the rupture, and prices quickly fell. The average price of regular gasoline began to drop immediately. (See Figure Three.)

Marked price increases in the wake of a sudden, severe drop in supply are a normal market reaction. Because gasoline is so important to consumers, a large price increase may be required to reduce immediate demand to equal the level of available supply following a large reduction in supply. Price increases in turn attract additional supplies, which should then cause prices to decline. This response occurred in the Kinder Morgan rupture. Retail prices in Phoenix increased during the week immediately following the August 8 pipeline rupture (the week ending August 16) to levels higher than predicted by historical relationships. As California refineries increased supply shipments to Arizona (displacing refining capacity that could otherwise serve California markets), retail prices in Los Angeles increased above the predicted level during the following week (the week ending August 23). By the end of August, gasoline prices in the Phoenix area were declining; they continued to drop throughout September and October. In examining this pricing anomaly, the FTC staff consulted with the Attorneys General's offices in Arizona and California.

ATLANTA

Another recent price anomaly picked up by the monitoring project occurred in Atlanta, Georgia and surrounding counties. This anomaly is not the traditional price spike that attracts the public's attention. Instead, it took the form of a small, sustained increase. Atlanta and its surrounding counties have experienced gasoline formulation changes in the past few years that have differentiated it from the rest of the Southeast. On April 1, 2003, an interim low sulfur standard of 90 parts per million took effect. Additionally, Georgia soon required the 45-county area surrounding Atlanta to introduce a new 30 ppm low sulfur gasoline by September 16. These formulation changes increased the cost of producing gasoline. After the 90 ppm standard was implemented, gasoline prices in Atlanta increased.

After the 90 ppm standard was instituted in April and even more frequently after the 30 ppm standard was instituted in

September, the Commission's monitoring project picked up small anomalies in Atlanta gasoline pricing. Atlanta and the surrounding area have experienced slightly higher prices relative to the historical level because of the greater costs of making low sulfur gasoline. This increase is illustrated at Figure Four.

MID-ATLANTIC AREA

A third pricing anomaly occurred in September and October of last year. Gasoline prices were generally falling nationwide in September-October 2003. However, the price of reformulated gasoline in the New York, New Jersey, Connecticut and Philadelphia area declined more slowly than the price of gasoline in the rest of the country. The FTC monitoring model showed the price of gasoline in this region was unusually high even though prices were decreasing elsewhere. (See Figure Five.)

The FTC staff's examination of this anomaly, which included consultation with the state Attorneys General, showed that the elevated price in this area stemmed from a number of factors. In late August 2003, the Northeast was hit particularly hard by an increase in demand that drew down gasoline stocks in all regions of the United States. The August 14 blackout affected the Northeast, temporarily shutting down seven refineries. While the blackout appeared to have little immediate impact on U.S. retail gasoline prices, the reduction in supply from four refineries in Ontario, Canada, whose operations were hampered by the power outage significantly affected the price of gasoline in Ontario. Typically, the Northeastern states receive significant gasoline exports from Canada. Throughout much of August, however, wholesale prices in Toronto exceeded wholesale prices in Buffalo by approximately 25 cents per gallon, a sign that less product was likely being shipped into the Northeast from Canada. This situation is confirmed by a sizeable drop in exports of gasoline from Canada to the Northeast in August. By the end of September rack prices in Toronto and Buffalo had returned to rough equality.

On top of the low inventories, the switch from summer to winter grade gasoline and the switch in New York and Connecticut from MTBE-blended reformulated gasoline to ethanol RFG both caused a disincentive to build inventories in August and September. While refineries in the Northeast increased production during this period, important additional supply to this area comes by pipeline from the Gulf and imports from abroad. Both of these sources of supply require significant response times, however. Given the shipping lags and the impending switches in formulation, there was limited time to, and a disincentive to, ship additional summer specification RFG to the Northeast.

B. Conferences and Staff Reports Identifying Factors Affecting the Price of Gasoline

Besides our monitoring project, the Commission's public conferences over the past few years have increased our knowledge of the factors that affect the prices of refined petroleum products and enabled us to disseminate that information to the public. The conferences studied in detail the central factors that may affect the level and volatility of refined petroleum product prices. Below we review just a few of those factors.

The single most important factor affecting both the level and movement of gasoline prices in the United States is the price of crude oil. Changes in crude oil prices account for approximately 85 percent of the variability of gasoline prices. When crude oil prices rise, as they have recently, gasoline prices rise. (See Figure One.) Crude oil prices are determined by supply and demand conditions worldwide, most notably by production levels set by OPEC countries. Additionally, other factors that affect the supply of and demand for crude oil, such as the fast growing demand for petroleum in China, influence the price of gasoline in the United States.

Inventories of both crude oil and refined products have an important effect on retail gasoline prices as well. At our conference, EIA reported that "OPEC [production] cuts and high crude prices affect gasoline prices directly through the feedstock cost but also indirectly by reducing gasoline inventories." Participants also commented that average inventories for refined products have declined over time, contributing to price spikes as additional supply is less available quickly to meet demand. Lower inventory costs lower the average cost of producing gasoline, to the benefit of consumers.

Participants in the FTC conference also noted that refineries and the pipelines used to transport gasoline to the pump are typically highly utilized. For example, national annual refinery capacity utilization between 1998 and 2002 averaged 92.7 percent. Refinery utilization rates are often higher during peak demand periods, such as during summer months when the demand for gasoline is very strong. Pipeline capacity is also stretched in some regions of the country for at least parts of the year, although various pipeline expansion projects that may relieve some pressure are underway. Although it is efficient to run these capital intensive facilities at high rates of capacity utilization, supply disruptions from unexpected refinery outages or pipeline failures may not be easily or immediately compensated for by other supply sources due to capacity limitations, resulting in substantial market price effects in some cases.

The interaction of environmental quality requirements and gasoline supplies was one area identified as deserving consideration by policymakers. It is clear that environmental regulations have yielded substantial benefits. Since 1970, emissions of the six principal air pollutants - nitrogen dioxide, ozone, sulfur dioxide, particulate matter, carbon monoxide, and lead - have been cut by 25 percent, even as vehicle miles increased by 149 percent. However, these regulations add to the cost of refining crude oil, and to gasoline prices. The Environmental Protection Agency ("EPA")

estimates that the cost of producing a gallon of reformulated gasoline is 4 to 8 cents per gallon more than the cost of producing conventional gasoline. These costs may be higher during times of supply disruption, when significant marginal costs are incurred when firms attempt to quickly adjust previously determined production runs.

Additionally, several participants at the conferences reported that the proliferation of different environmentally mandated gasoline blends has reduced the ability of firms to ship gasoline from one region to another in response to supply disruptions. (Figure Six illustrates the different fuel blends required in the United States.) The FTC staff's analysis of pricing anomalies, discussed *infra*, provides support for these concerns.

As part of its work to improve public understanding of the possible role of environmentally mandated fuels in contributing to price volatility and price spikes, Commission staff provided comments to the EPA in connection with that agency's preparation of the EPA's Staff White Paper, a response to the President's National Energy Report (May 2001). The President's Report directed the EPA Administrator to "study opportunities to maintain or improve the environmental benefits of state and the local 'boutique' fuels programs while exploring ways to increase the flexibility of the fuels distribution infrastructure, improve fungibility, and provide added gasoline market liquidity." The FTC staff commented that the EPA might find it beneficial to use a framework similar to the one the FTC uses to analyze mergers, to determine the competitive effects likely to result from changes in fuel mandates in particular relevant markets. The FTC staff has offered suggestions to the EPA as to how they might perform such an analysis.

Other federal and state laws and regulations were identified as affecting gasoline prices. A federal statute known as the Jones Act increases the cost of transporting petroleum products by requiring that any product transported by vessel between U.S. ports be carried in domestically-built ships staffed by U.S. crews, which is more expensive than carriage by foreign-built, foreign-staffed ships. A recent government estimate of the total welfare cost of the Jones Act for all tanker shipping is \$656 million dollars a year, based on the assumption that a foreign ship has operating costs of only 59 percent of a Jones Act ship. The observed cost of transportation of refined petroleum products from the Gulf to the West Coast, 10-25 cents per gallon, imply the Jones Act imposes an additional cost of about at least 4 cents per gallon during the times of the year when it is necessary to transport gasoline using Jones Act ships.

A number of states have regulatory schemes that substantially influence gasoline prices. Several states have divorcement statutes that require the unbundling of retail sales from upstream refining operations. Careful economic analyses of divorcement statutes conclude that such statutes have the effect of raising consumer prices. Other regulatory statutes that appear to have the effect of increasing gasoline prices include bans on self-service sales, and restrictions on below-cost sales, which appear to simply protect retailers from competition from more efficient competitors. The FTC staff have recently provided comments on sales below cost legislation.

V. Conclusion

The Commission has a long and continuing history with law enforcement investigations in the petroleum industry. The agency has expended substantial effort and resources to maintain and study competition in this industry. We will continue to do so in the future.

The American public needs to know what forces shape the performance of this vital sector of the economy. Higher prices for products that are critical to our citizens' quality of life and for the efficient functioning of the national economy are matters of serious concern. When price increases result from conduct that violates the antitrust laws, the FTC will take enforcement action.

I am pleased to answer your questions.