UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
Washington, DC 20580

OFFICE OF POLICY PLANNING
BUREAU OF ECONOMICS
BUREAU OF COMPETITION

June 8, 2007

Councilmember Mary M. Cheh
Chairperson, Committee on Public Services and Consumer Affairs
1350 Pennsylvania Avenue NW, Suite 108
Washington, D.C. 20004

Dear Councilmember Cheh:

We[1] are pleased to respond to your request for our comments on the competitive effects of the Retail Service Station Act's ("the Act") divorcement provision, which prohibits the operation of a retail gasoline service station in the District of Columbia by a "jobber, producer, refiner, or manufacturer of motor fuels."[2] Suppliers sell their gasoline through retail service stations that they own and operate and through service stations that are operated by unaffiliated

[1] 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.

[2] DC St. § 36-302.02(a). The Act defines a "jobber" as "a wholesale supplier or distributor of motor fuel." *Id*. at § 36-301.01(6A). The Act defines a "refiner, producer, or manufacturer" as:

> any person who is engaged in the business of manufacturing, producing, refining, distilling, blending, or compounding motor fuels, petroleum products, or precursors of motor fuels or petroleum products, which are ultimately sold, supplied or distributed to retail service stations in the District of Columbia by such person or any other person, whether or not such manufacturing, producing, refining, distilling blending, or compounding is performed by such person within the District of Columbia, or who is engaged in the business of importing motor fuels or petroleum products.

Id. at § 36-301.01(12). For the remainder of this letter we collectively refer to jobbers, producers, refiners, and manufacturers of motor fuels as "suppliers."

dealers. Empirical studies suggest that suppliers choose whether directly to operate a service station or to sell gasoline through an unaffiliated dealer based on cost considerations. Further, studies have found that when laws prohibit suppliers from operating retail service stations, consumers pay higher prices for gasoline. Based on drporrvice stations,

on its investigation of price manipulation and price increases in the wake of Hurricane Katrina.[6] In 2005, it released a report examining the factors that affect gasoline prices in the United States,[7] and in 2004 the Commission released a report on mergers and structural changes in the

Hawaii and New York on the likely competitive effects of divorcement laws similar to the Retail Service Station Act.[13]

Background on Gasoline Distribution

Suppliers sell gasoline to consumers through retail service stations that they own and operate and to service stations that are operated by unaffiliated dealers. If a supplier chooses to own and operate a service station (*i.e.*, vertically integrate), the manager of the service station is an employee of the supplier, receiving a salary and possibly some performance incentives. An unaffiliated dealer may operate a service station that is leased from a supplier. This type of dealer (a “lessee-dealer”) purchases gasoline from the supplier, pays it rent to use the station, and retains the station’s profits. The lease terms typically require the lessee-dealer to maintain certain quality standards and to purchase a specified minimum amount of gasoline from the supplier per period. Rather than leasing a service station from a supplier, an “open dealer” owns the retail service station he or she operates. An open dealer may contract to sell a particular supplier’s branded product (*e.g.*, Shell or Exxon gasoline) or may operate as an “independent,” selling an unbranded product.[14] [13]

There are two basic means by which gasoline is distributed to retail services stations: direct supply and jobber supply. A supplier that is a branded refiner typically will directly

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As discussed above, a supplier can vertically integrate or delegate operations to an unaffiliated dealer (either a lessee-dealer or an open dealer). Both direct operation and delegation to unaffiliated retail dealers have advantages and disadvantages. Direct operation allows a supplier to control – through an employee – pricing and quality decisions. Employees' incentives, however, are not necessarily aligned with those of the supplier, so a supplier must expend resources to monitor the station manager to ensure that he or she is taking the correct actions. When suppliers and retail dealers are separate firms, they have different incentives to set prices and provide quality. For example, when both suppliers and station operators have the ability to price above cost, each will add a mark-up to the final price. This "double mark-up problem" reduces supplier profits because retail prices are higher than they would be if the supplier set them, causing business to be lost to lower-priced retailers. Further, because an unaffiliated dealer does not capture the full financial benefit from providing additional quality (*e.g.*, cleaner facilities, friendlier and more knowledgeable staff, more reliable repair work), it

We appreciate this opportunity to provide our views and welcome any additional questions you may have.

Respectfully submitted,

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