UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Bureau of Competition
Office of Policy Planning

August 8, 2002

Governor George E. Pataki
The State of New York
New York State Capitol
Albany, NY 12224

Re: Bill No.S04522 (New York Motor Fuel Marketing Practices Act); Bill No. A06942 (An Act to Amend the General Business Law, in Relation to the Operation of Retail Service Stations)

Dear Governor Pataki:

The staff of the Office of Policy Planning and of the Bureau of Competition of the Federal Trade Commission welcome the opportunity to submit this letter in response to your request for comments on the "New York Motor Fuel Marketing Practices Act" (the MFMPA"), Bill No. S04522, and the amendment to Section 199-a of the General Business Law (the "Amendment"), Bill No. A06942.[1] The MFMPA would prohibit, *inter alia*, refiners and nonrefiners of motor fuel from selling motor fuels below refiner or nonrefiner cost respectively, where the effect is to injure competition. The Amendment would prohibit a crude oil producer or refiner from directly competing with its own franchised dealers within certain geographic areas.

We believe if both pieces of legislation are signed into law, they have a significant potential to harm consumers. Gasoline is a significant consumer expenditure; given constant demand, even a one cent increase in the retail price of gasoline would cost New York consumers approximately $57 million

[1] This letter expresses the views of the Bureau of Competition and of the Office of Policy Planning of the Federal Trade Commission. The letter does not necessarily represent the views of the Commission or of any individual Commissioner. The Commission has, however, voted to authorize us to submit these comments.

[2] *See* U.S. Energy Information Administration data available at http://www.eia.doe.gov/emeu/states/oilsales_trans/oilsales_trans_ny.html (showing New York daily

[3] Federal Trade Commission Act, 15 U.S.C. § 45.

[4] In recent years, the Commission has investigated, among others, the mergers of Chevron and Texaco, Exxon and Mobil, and BP and Amoco – the three largest oil mergers in history – and the combination of the refining and marketing businesses of Shell, Texaco and Star Enterprises to create what was, at the time, the largest refining and marketing company in the United States. Last fall, the Commission investigated the proposed merger of petroleum refiners Valero Energy and Ultramar Diamond Shamrock. *See Valero Energy Corp.*, C-4031 (Dec. 18, 2001) (proposed consent order), *Chevron Corp.*, C-4023 (Dec. 18, 2001) (consent order); *Exxon Corp.,* C-3907 (Jan. 30, 2001) (consent order); *British Petroleum Company p.l.c.,* C-3868 (Apr. 19, 1999) (consent order); *Shell Ol mCo.,*

proposed state laws covering a variety of areas, including laws that would ban sales of motor fuels below cost or prevent "unfair" competition between refiner-owned and independent gas stations.[5] Section II below presents our views on the MFMPA. Section III presents our views on the Amendment.

## II. Analysis of the MFMPA

### A. Anticompetitive below-cost pricing is already illegal under federal antitrust laws.

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Commission, using the competition analysis principles in the Merger Guidelines, completed an investigation of a spike in reformulated gasoline (RFG) prices in several Midwest states in the spring and summer of 2000. Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001). Also in 2001, the Commission concluded its investigation of gasoline price increases in West Coast markets. *FTC Closes Western States Gasoline Investigation,* FTC Press Release (May 7, 2001). In addition, in August 2001, the Commission held an initial public conference to examine factors that affect prices of refined petroleum products in the United States. *FTC to Hold Public Conference/Opportunity for Comment on U.S. Gasoline Industry,* FTC Press Release (July 12, 2001). A second public conference was held in May 2002. *FTC to Hold Second Public Conference on the U.S. Oil and Gasoline Industry in May 2002*, FTC Press Release (Dec. 21, 2001). Commission staff also recently filed public comments with the Environmental Protection Agency concerning "boutique fuel" regulations. Comments of the Staff of the General Counsel, Bureaus of Competition and Economics, and the Midwest Region of the Federal Trade Commission, *Study of Unique Gasoline Fuel Blends ("Boutique Fuels"), Effects on Fuel Supply and Distribution and Potential Improvements,* EPA 420-P-01-004, Public Docket No. A-2001-20 (Jan. 30, 2002).

[5] *See, e.g.*, Letter from Joseph J. Simons, Director, FTC Bureau of Competition, and R. Ted Cruz, Director, FTC Office of Policy Planning to Hon. Robert F. McDonnell, Commonwealth of Virginia House of Delegates (Feb. 15, 2002) at http://www.ftc.gov/be/V020011.htm; 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, Ways and Means Committee, Other Taxes and Revenues Subcommittee, South Carolina House of Representatives (May 12, 1989).

[6] Predatory pricing claims are brought under Section 2 of the Sherman Act, 15 U.S.C. § 2. Plaintiffs can also claim anticompetitive predation under the Robinson-Patman Act, 15 U.S.C. § 13(a) (as amended).

[7] Notable examples include *American Airlines* and *Microsoft*. *See*, e.g., *United States v. AMR Corp.*, 2001-1 Trade Cas. (CCH) ¶ 73,251 (D. Kan. 2001); *United States v. Microsoft Corp.*

taken great pains to ensure that antitrust law is not used to prevent procompetitive price-cutting. It is axiomatic that the antitrust laws are intended for "the protection of competition, not competitors."[9] That is, the federal antitrust laws are intended to promote and maintain legitimate, vigorous price competition, irrespective of how individual competitors may fare in the face of such competition. Vigorous price competition forces producers to minimize costs and prices and to increase quality. Through this dynamic, consumer welfare is maximized because consumers reap the benefits of lower prices, greater variety, and higher quality goods and services. Indeed, the Court, in several important antitrust decisions, has been absolutely clear that consumer

welfare is the linchpin of the antitrust laws, and that low prices, as a general matter, are "a boon to consumers."[10]

**ii. Only below-cost prices can be predatory**

Indeed, the Supreme Court has spoken directly and definitively to the lawfulness of low pricing strategies. In *Brooke Group*, the seminal case in this area, the Court left no doubt that a decrease in a plaintiff's profits from a reduction in the defendant's prices, by itself, is not unlawful under the antitrust laws. "Low prices benefit consumers regardless of how those prices are set."[11] Rather, to be unlawful, the low prices, at a minimum, must be predatory. "[S]o long as they are above predatory levels, [low prices] do not threaten competition. . . . We have adhered to this principle regardless of the type of antitrust claim involved."[12]

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[9] *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 488 (1977) (quoting *Brown Shoe Co. v. United States,* 370 U.S. 294, 320 (1962)).

[10] *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp*., 509 U.S. 209, 224 (1993); *Atlantic Richfield Co. v. USA Petroleum Co.*, 495 U.S. 328 (1990); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

[11] *Brooke Group*, 509 U.S. at 224.

[12] *Id.* (quoting *Atlantic Richfield Co.*, 495 U.S. at 340).

[13] *Id.* (citing *Atlantic Richfield Co.,* 495 U.S. at 340).

competition in the long run."[14] Although the Court has not stated what the appropriate measure of cost should be, prominent antitrust scholars and several federal circuit courts have concluded that the price-cutter's marginal costs, or a close proxy such as average variable costs, should be the yardstick.[15]

It is important to note that, whatever cost measure is chosen, the pertinent comparison is to the *price-cutter's* cost, not the costs of its rivals. If the price-cutter has lower costs, and thus is more efficient, than its rivals, no predatory pricing occurs when it prices above its own costs, irrespective of whether those prices are below its rivals' costs. "To hold that the antitrust laws protect competitors from the loss of profits due to such price competition would, in effect, render illegal any decision by a firm to cut prices in order to increase market share."[16]

**iii. Not all below-cost pricing harms consumers**

Below-cost pricing by itself, however, is insufficient under the antitrust laws to constitute a violation. Under federal law, consumers must also be injured, and consumers are not harmed by below-cost pricing

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[14] *Cargill, Inc. v. Monfort of Colorado, Inc.*, 479 U.S. 104, 117 (1986).

[15] *See Kelco Disposal, Inc. v. Browning-Ferris Indus.*, 845 F.2d 404, 407 (2d Cir. 1988), *aff'd on other grounds,* 492 U.S. 257 (1989) (finding that "[p]rices that are below reasonably anticipated marginal cost, and its surrogate, reasonably anticipated average variable cost, are presumed predatory"); *MCI Communications Corp. v. AT&T*, 708 F.2d 1081, 1122-23 (7th Cir.), *cert. denied,* 464 U.S. 891 (1983) (holding that no predatory intent can be presumed from prices at or above long run incremental cost); *International Air Indus. v. American Excelsior Co.*, 517 F.2d 714, 724 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976) (holding that plaintiff must show that "either (1) a competitor is charging a price below its average variable cost . . . or (2) the competitor is charging a price below its short-run, profit maximizing price and barriers to entry are great enough to enable the discriminator to reap the benefits of predation before new entry is possible"); P. Areeda and H. Hovenkamp, *Antitrust Law*, ¶ 724; P. Areeda and D. Turner, "Predatory Pricing and Related Practices under Section 2 of the Sherman Act," 88 *Harv. L. Rev*. 697 (1975). In *Brooke Group*, the parties both agreed that average variable cost should be the appropriate measure.

[16] *Brooke Group*, 509 U.S. at 223 (quoting *Cargill*, 479 U.S. at 116).

[17] *Matsushita Elec.*, 475 U.S. at 589.

[18] *Brooke Group,* 509 U.S. at 224, 226.

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[20] Frank H. Easterbrook, "Predatory Strategies and Counter-Strategies," 48 *U. of Chicago L. Rev.*

[26] USDOE, *Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers* (March 1984); USDOE, *Final Report: The State of Competition in Gasoline Marketing*

stations. Information was gathered on the practices of all eight of the major companies in Washington for a three-year sample period. The Washington study found that lessee-dealers paid essentially the same prices as company-owned stations more than 99 percent of the time.[28]

More recently, the Commonwealth of Pennsylvania conducted a study examining a variety of proposals for legislation affecting retail gasoline sales in the state. The report extensively analyzed "sales below cost" laws and declined to recommend that Pennsylvania enact one. In fact, the Pennsylvania study raised significant doubts about the theory that gasoline retailers were engaging in anticompetitive below-cost pricing, and it warned that a "sales below cost" law might harm consumers more than it would help them:

> Unfortunately, such laws may serve to deter, rather than enhance, competition. The reason for such deterrence is that it may open up firms who engage in low, but non-predatory, pricing to litigation. Seeing the threat of litigation, such firms may change strategy and charge consumers higher prices.[29]

Competitors will, of course, sometimes complain that the competition charges prices that are too low. Competitors have an incentive to do so if they believe such complaints will lead to legislation that will allow them to charge higher prices. Thus far, no systematic study has produced evidence that predatory pricing is likely to be a significant problem in retail gasoline markets.

### D. If enforced vigorously, the legislation could harm consumers by increasing the price of motor fuels.

As noted above, anticompetitive price-cutting is already illegal under federal antitrust laws. We believe that this legislation could outlaw more types of pricing behavior than federal antitrust laws do, and therefore it runs the risk of penalizing procompetitive price-cutting that benefits consumers.

During the past two decades, a growing body of empirical economic research has assessed the impact of state "sales below cost" laws on retail gasoline prices. Most studies find these laws raise gasoline prices or leave them unchanged. Some suggest that the laws raise retail gasoline prices by one

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

[29] Commonwealth of Pennsylvania, Legislative Budget and Finance Committee, *Factors Affecting Motor Fuel Prices and the Competitiveness of PA's Motor Fuels Market* 35 (Oct. 2000).

competiton are complex, because such actions can simultaneously stimulate interbrand competition.[34] For this reason, the Court held that in deciding the lawfulness of supplier policies affecting intrabrand

[34] *Id.* at 51.

[35] *Id.* at 59.

[36] *Id.* at 52 n.19.

[37] *Id.* at 56.

[38] *Id.* at 55 n.23.

refiners from owning any retail outlets; others, like the Amendment to Section 119-a, are "partial" in the sense that they prohibit refiners from establishing new retail outlets within a certain distance of existing branded dealers.  Economic research consistently shows that both0 -* -0. ceoonomiitOtengs by se0ilishing newed h Tc

[39] A.A. Blass and D.W. Carlton, "The Choice of Organization Form in Gasoline Retailing and the Costs of Laws Limiting that Choice," NBER Working Paper #7435 (1999).

[40] J.M. Barron and J.R. Umbeck, "The Effect of Differenct Contractual Arrangements: the Case of Retail Gasoline Market," 37 *Journal of Law and Economics 313 (1984)*.

[41] See Vita, *supra* note 32.

[42] Vita concluded that legislation prohibiting or limiting refiners from owning retail gas stations increased gasoline prices by 2.6 cents per gallon and reduced consumer welfare by approximately $112 million annually in the six states that have such legislation.

## IV. Summary and Conclusions

For the reasons stated above, we believe that the MFMPA would be more likely to harm than to promote competition. The legislation addresses a problem that is unlikely to occur. To the extent that anticompetitive below-cost pricing is a danger in the retail gasoline market, federal antitrust laws are sufficient to deal with the problem. Moreover, the additional layer of state law could significantly deter procompetitive price-cutting at the gas pump.

We similarly believe that the Amendment to Section 199-a of the General Business Law would restrain, rather than enhance, retail competition in motor fuels, because it places limits on the ability of individual crude oil producers and motor fuel refiners to develop the most efficient level of intrabrand competition for their products. In so limiting, the Amendment would likely raise costs, restrain interbrand competition, and ultimately raise retail gasoline prices in New York.

In short, in the judgment of the Office of Policy Planning and Bureau of Competition of the Federal Trade Commission, Bill No. S04522 and Bill No. A06942, if signed into law, are likely to raise prices significantly at the gas pump, to the detriment of New York consumers.

Respectfully submitted,

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