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Prepared Statement of the Federal Trade Commission

**Market Forces, Competitive Dynamics, and Gasoline Prices:
FTC Initiatives to Protect Competitive Markets**

**Presented by
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**Before the
Committee on Commerce, Science and Transportation
United States Senate**

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I. Introduction

Mr. Chairman and members of the Committee, I am John Seesel, the Federal Trade Commission's Associate General Counsel for Energy. I am pleased to appear before you to present the Commission's testimony on FTC initiatives to protect competitive markets in the production, distribution, and sale of gasoline, and to discuss an important recent Commission study on the factors that affect gasoline prices.¹

The petroleum industry plays a crucial role in our economy. Not only do changes in gasoline prices affect consumers directly, but the price and availability of gasoline also influence many other economic sectors. No other industry's performance is more deeply felt, and no other industry is so carefully scrutinized by the FTC.

Prior to Hurricane Katrina, increasing crude oil prices had resulted in rising gasoline prices during much of this year. Despite these rising prices, the demand for gasoline during this past summer was strong and exceeded summer demand in 2004. In the recent weeks since Hurricane Katrina, gasoline prices rose sharply to \$3.00 per gallon or more in most markets. In part because of the soaring prices associated with Katrina, gasoline demand has decreased somewhat. National gasoline inventories remain at the lower end of the average range.

On top of an already tight market, Katrina has temporarily disrupted an important source of crude oil and gasoline supply. At one point, over 95 percent of Gulf Coast crude oil production was shut in, and numerous refineries and pipelines were either damaged or without

¹This written statement represents the views of the Federal Trade Commission. My oral presentation and responses to questions are my own and do not necessarily represent the views of the Commission or any Commissioner.

that they purchase, but also indirectly in raising prices of inputs into other goods and services. In addition, Katrina damaged many other industries and businesses on the Gulf Coast, and some of those impacts – such as the damage to port facilities – may significantly impede the flow of raw materials or finished goods to producers and distributors in many industries.

The Commission is very conscious of the swift and severe price spikes that occurred immediately before and after Katrina made landfall. There have been numerous calls for investigations of “price gouging,” particularly at the retail gasoline level. Legislation that would require the Commission to study this issue recently passed the Senate.⁵ In addition, Section 1809 of the recently enacted Energy Policy Act⁶ mandates an FTC investigation “to determine if the price of gasoline is being artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price gouging practices.” The Commission staff already has launched an investigation to scrutinize whether unlawful conduct affecting refinery capacity or other forms of illegal behavior have provided a foundation for price manipulation. A determination that unlawful conduct has occurred will result in aggressive law enforcement activity by the FTC.

The FTC has initiated this inquiry with a keen understanding of its importance to the American consumer and intends faithfully to fulfill its obligation to search for and stop illegal conduct. We recognize, of course, that our investigation will not be a simple one. As many have

⁵On September 15, 2005, the Senate passed the Fiscal Year 2006 Commerce-Justice-Science Appropriations bill, which included funding for the FTC. An amendment to this bill introduced by Senator Mark Pryor requires the FTC to conduct an investigation into gasoline prices in the aftermath of Hurricane Katrina.

⁶Energy Policy Act of 2005, Pub. L. No. 109-58 § 1809, __ Stat. __ (2005).

already pointed out, “price gouging” is not prohibited by federal law. Consumers justifiably are upset when they face dramatic price increases within very short periods of time, especially during a disaster. Some price increases, however, benefit consumers in the long run. In our economy, prices play a critical role: they signal producers to increase or decrease supply, and they also signal consumers to increase or decrease demand. In a period of shortage – particularly with a fungible product, like gasoline, that can be sold anywhere in the world – higher prices create incentives for suppliers to send more product into the market, while also creating incentives for consumers to use less of the product. Higher prices ultimately help make the shortage shorter-lived than it otherwise would have been. There may be situations where sellers go beyond the necessary market-induced price increase, taking advantage of a crisis to “gouge” consumers. However, it can be very difficult to determine the extent to which any price increases are greater than necessary. Furthermore, even these “gouging” types of price increases do not fit well under longstanding principles of antitrust injury. (400 Principles of) Tj TD TDne th(antitri)Tj58.

⁷FEDERAL TRADE COMMISSION, GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (2005) [hereinafter GASOLINE PRICE CHANGES], *available at* <http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf>.

⁸BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT (2004) [hereinafter PETROLEUM MERGER REPORT], *available at* <http://www.ftc.gov/os/2004/08/040813mergersinpetrolbezte7mo.0.00040813mergersinpet/1.00000.0.00000.0o8>

the transactions altogether after agency antitrust challenges; one case resulted in a remedy requiring the acquiring firm to provide the Commission with advance notice of its intent to acquire or merge with another entity; and the sixth case was resolved recently.⁹

In addition to litigation and industry studies, the Commission has taken aggressive measures to protect consumers through other initiatives. For example, in a program unique to the petroleum industry, the Commission actively and continuously monitors retail and wholesale prices of gasoline and diesel fuel.¹⁰ Three years ago, the FTC launched this initiative to monitor gasoline and diesel prices to identify “unusual” price movements¹¹ and then examine whether any such movements might result from anticompetitive conduct that violates Section 5 of the FTC Act. FTC economists developed a statistical model for identifying such movements. The agency’s economists scrutinize regularly price movements in 20 wholesale regions and approximately 360 retail areas across the country. Again, in no other industry does the Commission so closely monitor prices.

The staff reviews daily data from the Oil Price Information Service, a private data collection agency, and receives information weekly from the public gasoline price hotline maintained by the U.S. Department of Energy (“DOE”). The staff monitoring team uses an econometric model to determine whether current retail and wholesale prices are anomalous in comparison to the historical price relationships among cities. When there are unusual changes in

⁹See *infra* at 11 (discussing *Aloha Petroleum, Ltd.*, FTC File No. 051 0131).

¹⁰See FTC, *Oil and Gas Industry Initiatives*, at <http://www.ftc.gov/ftc/oilgas/index.html>.

¹¹An “unusual” price movement in a given area is a price that is significantly out of line with the historical relationship between the price of gasoline in that area and the gasoline prices prevailing in other areas.

gasoline or diesel prices, the project alerts the staff to those anomalies so that we can make further inquiries into the situation.

This gasoline and diesel monitoring and investigation initiative, which focuses on the timely identification of unusual movements in prices (compared to historical trends), is one of the tools that the FTC uses to determine whether a law enforcement investigation is warranted. If the FTC staff detects unusual price movements in an area, it researches the possible causes, including, where appropriate, through consultation with the state attorneys general, state energy agencies, and DOE's Energy Information Administration. In addition to monitoring DOE's gasoline price hotline complaints, this project includes scrutiny of gasoline price complaints received by the Commission's Consumer Response Center and of similar information provided to the FTC by state and local officials. If the staff concludes that an unusual price movement likely results from a business-related cause (*i.e.*, a cause unrelated to anticompetitive conduct), it continues to monitor but – absent indications of potentially anticompetitive conduct – it does not investigate further.¹² The Commission's experience from its past investigations and from the current monitoring initiative indicates that unusual movements in gasoline prices typically have a business-related cause. FTC staff further investigates unusual price movements that do not appear to be explained by business-related causes to determine whether anticompetitive conduct may underlie the pricing anomaly. Cooperation with state law enforcement officials is an important element of such investigations.

The Commission's testimony today addresses the Committee's inquiries in two parts. It

¹²Business-related causes include movements in crude oil prices, supply outages (*e.g.*, from refinery fires or pipeline disruptions), or changes in and/or transitions to new fuel requirements imposed by air quality standards.

first reviews the basic tools that the Commission uses to promote competition in the petroleum industry: challenging potentially anticompetitive mergers, prosecuting nonmerger antitrust violations, monitoring industry behavior to detect possible anticompetitive conduct, and researching petroleum sector developments. This review of the Commission's petroleum industry agenda highlights the FTC's contributions to promoting and maintaining competition in the industry. The Commission places a premium on careful research, industry monitoring, and investigations to understand current petroleum industry developments and to identify accurately obstacles to competition, whether arising from private behavior or from public policies. The petroleum industry's performance is shaped by the interaction of extraordinarily complex, fast-changing commercial arrangements and an elaborate set of public regulatory commands. A well-informed understanding of these factors is essential if FTC actions are to benefit consumers.

The second part of this testimony reviews the learning the Commission has derived from its conferences and research and its review of recent gasoline price changes. Among other findings, this discussion highlights the paramount role that crude oil prices play in determining both the levels and the volatility of gasoline prices in the United States. Over the period 1984 to 2003, changes in crude oil prices accounted for approximately 85 percent of the variability of gasoline prices.¹³ When crude oil prices rise, so do gasoline prices. Crude oil prices are determined by supply and demand conditions worldwide. The supply of crude is strongly influenced by production levels set by members of the Organization of Petroleum Exporting

¹³See GASOLINE PRICE CHANGES, *supra* note 7, at 13.

Countries (“OPEC”).¹⁴ Demand has increased substantially over the past few years, both in the United States and in the developing economies of China and India. When worldwide supply and demand conditions result in crude oil prices in the range of \$70 per barrel – a level from which we are all doubtless glad to have seen the price recede somewhat in recent days – it is not surprising to see higher gasoline prices nationwide.

II. FTC Activities to Maintain and Promote Competition in the Petroleum Industry

A. Merger Enforcement in the Petroleum Industry

The Commission has gained much of its antitrust enforcement experience in the petroleum industry by analyzing proposed mergers and challenging transactions that likely would reduce competition, thus resulting in higher prices.¹⁵ In 2004, the Commission released data on all horizontal merger investigations and enforcement actions from 1996 to 2003.¹⁶ These data show that the Commission has brought more merger cases at lower levels of concentration in the petroleum industry than in other industries. Unlike in other industries, the Commission has obtained merger relief in moderately concentrated petroleum markets.

¹⁴FTC investigations of mergers and potentially anticompetitive conduct in the petroleum industry have generally focused on issues arising at the midstream and downstream stages of the industry – transportation, refining, terminaling, wholesaling, and retailing. In view of the minuscule shares of crude oil reserves and production held by individual private firms, as well as OPEC’s key role in establishing global crude oil supply and price levels, antitrust enforcement opportunities have been far less likely to arise at the crude exploration and production stage. For a further discussion of crude oil, *see* Section III.A. of this testimony, *infra*.

¹⁵Section 7 of the Clayton Act prohibits acquisitions that may have anticompetitive effects “in any line of commerce or in any activity affecting commerce in any section of the country.” 15 U.S.C. § 18.

¹⁶Federal Trade Commission Horizontal Merger Investigation Data, Fiscal Years 1996-2003 (Feb. 2, 2004), Table 3.1, et seq.; FTC Horizontal Merger Investigations Post-Merger HHI and Change in HHI for Oil Markets, FY 1996 through FY 2003 (May 27, 2004), *available at* <http://www.ftc.gov/opa/2004/05/040527petrolactionsHHIdeltachart.pdf>.

Several recent merger investigations illustrate the FTC's approach to merger analysis in the petroleum industry. The most recently completed case involved Chevron's acquisition of Unocal. When the merger investigation began, the Commission was in the middle of an ongoing monopolization case against Unocal that would have been affected by the merger. Thus, the Commission settled both the merger and the monopolization matters with separate consent orders that preserved competition in all relevant merger markets and obtained complete relief on the monopolization claim.¹⁷ The nonmerger case is discussed below.

Another recent merger case that resulted in a divestiture order resolved a complaint concerning the acquisition of Kaneb Services and Kaneb Pipe Line Partners, companies that engaged in petroleum transportation and terminaling in a number of markets, by Valero L.P., the largest petroleum terminal operator and second largest operator of liquid petroleum pipelines in the United States.¹⁸ The complaint alleged that the acquisition had the potential to increase prices in bulk gasoline and diesel markets.¹⁹

The FTC's consent order requires the parties to divest assets sufficient to maintain premerger competition, including certain Kaneb Philadelphia-area terminals, Kaneb's West pipeline system in Colorado's Front Range, and Kaneb's Martinez and Richmond terminals in

¹⁷*Chevron Corp.*, FTC Docket No. C-4144 (July 27, 2005) (consent order), at <http://www.ftc.gov/os/caselist/0510125/050802do0510125.pdf>; *Union Oil Co. of California*, FTC Docket No. 9305 (July 27, 2005) (consent order), at <http://www.ftc.gov/os/adjpro/d9305/050802do.pdf>.

¹⁸*Valero L.P.*, FTC Docket No. C-4141 (June 14, 2005) (complaint), at <http://www.ftc.gov/os/caselist/0510022/050615comp0510022.pdf>.

¹⁹*Id.*

Northern California.²⁰ In addition, the order forbids Valero L.P. from discriminating in favor of or otherwise preferring its Valero Energy affiliate in bulk ethanol terminaling services, and requires Valero to maintain customer confidentiality at the Selby and Stockton terminals in Northern California. The order succeeds in maintaining import possibilities for wholesale customers in Northern California, Denver, and greater Philadelphia and precludes the merging parties from undertaking an anticompetitive price increase.

Most recently, the Commission filed a complaint on July 27, 2005, in federal district court in Hawaii, alleging that Aloha Petroleum's proposed acquisition of Truststreet Properties' half interest in an import-capable terminal and retail gasoline assets on the island of Oahu would reduce the number of gasoline marketers and could lead to higher gasoline prices for Hawaii consumers.²¹ The recently announced resolution of this case involved the execution by the parties of a 20-year throughput agreement that will preserve competition allegedly threatened by the acquisition.²²

In the past few years, the Commission has brought a number of other important merger cases. One of these involved the merger of Chevron and Texaco,²³ which combined assets located throughout the United States. Following an investigation in which 12 states participated,

²⁰*Valero L. P.*, FTC Docket No. C-4141 (July 22, 2005) (consent order), at <http://www.ftc.gov/os/caselist/0510022/050726do0510022.pdf>.

²¹*Aloha Petroleum Ltd.*, FTC File No. 051 0131 (July 27, 2005) (complaint), at <http://www.ftc.gov/os/caselist/1510131/050728comp1510131.pdf> .

²²FTC Press Release, *FTC Resolves Aloha Petroleum Litigation* (Sept. 6, 2005), available at <http://www.ftc.gov/opa/2005/09/alohapetrol.htm>.

²³*Chevron Corp.*, FTC Docket No. C-4023 (Jan. 2, 2002) (consent order), at <http://www.ftc.gov/os/2002/01/chevronorder.pdf>.

the Commission issued a consent order against the merging parties requiring numerous divestitures to maintain competition in particular relevant markets, primarily in the western and southern United States.²⁴ Among other requirements, the consent order compelled Texaco to (a) divest to Shell and/or Saudi Refining, Inc., all of its interests in two joint ventures – Equilon²⁵ and Motiva²⁶ – through which Texaco had been competing with Chevron in gasoline marketing in the western and southern United States; (b) divest all assets relating to the refining, bulk supply, and marketing of gasoline satisfying California’s environmental quality standards; (c) divest assets relating to the refining and bulk supply of gasoline and jet fuel in the Pacific Northwest; and (d) divest various pipelines^{728o433.8000 0.0000 194cd.s.TjET2s}.

²⁴*Id.*

²⁵Shell and Texaco jointly controlled the Equilon venture, whose major assets included full or partial ownership in four refineries, about 65 terminals, and various pipelines. Equilon marketed gasoline through approximately 9,700 branded gas stations nationwide.

²⁶Motiva, jointly controlled by Texaco, Shell, and Saudi Refining, consisted of their eastern and Gulf Coast refining and marketing businesses. Its major assets included full or partial ownership in four refineries and about 50 terminals, with the companies’ products marketed through about 14,000 branded gas stations nationwide.

²⁷*Valero Energy Corp.*, FTC Docket No. C-4031 (Feb. 19, 2002) (consent order), at <http://www.ftc.gov/os/2002/02/valerodo.pdf>.

²⁸*Valero Energy Corp.*, FTC Docket No. C-4031 (Dec. 18, 2001) (complaint), at <http://www.ftc.gov/os/2001/12/valerocmp.pdf>.

²⁹*Valero Energy Corp.*, *supra* note 27.

³⁰*Conoco Inc. and Phillips Petroleum Corp.*, FTC Docket No. C-4058 (Aug. 30, 2002) (Analysis of Proposed Consent Order to Aid Public Comment), at <http://www.ftc.gov/os/2002/08/conocophillipsan.htm>. Not all oil industry merger activity raises competitive concerns. For example, in 2003, the Commission closed its investigation of Sunoco's acquisition of the Coastal Eagle Point refinery in the Philadelphia area without requiring relief. The Commission noted that the acquisition would have no anticompetitive effects and seemed likely to yield substantial efficiencies that would benefit consumers. *Sunoco Inc./Coastal Eagle Point Oil Co.*, FTC File No. 031 0139 (Dec. 29, 2003) (Statement of the Commission), at

order ensured that competition would not be lost and that gasoline prices would not increase as a result of the merger.

B. Nonmerger Investigations into Gasoline Pricing

In addition to scrutinizing mergers, the Commission aggressively polices anticompetitive conduct. When it appears that higher prices might result from collusive activity or from anticompetitive unilateral activity by a firm with market power, the agency investigates to determine whether unfair methods of competition have been used. If the facts warrant, the Commission challenges the anticompetitive behavior, usually by issuing an administrative complaint.

Several recent petroleum investigations are illustrative. On March 4, 2003, the Commission issued the administrative complaint against Unocal discussed earlier, stating that it had reason to believe that Unocal had violated Section 5 of the FTC Act.³¹

Commission), at <http://www.ftc.gov/os/2001/09/phillipstoscostmt.htm>.

As noted above (*supra* note 14), acquisitions of firms operating mainly in oil or natural gas exploration and production are unlikely to raise antitrust concerns, because that segment of the industry is generally unconcentrated. Acquisitions involving firms with de minimis market shares, or with production capacity or operations that do not overlap geographically, are also unlikely to raise antitrust concerns.

³¹*Union Oil Co. of California*, FTC Docket No. 9305 (Mar. 4, 2003) (complaint), at <http://www.ftc.gov/os/2003/03/unocalcmp.htm>.

substantial royalties if CARB mandated the use of Unocal's technology in the refining of CARB-compliant summertime RFG. The Commission alleged that, as a result of these activities, Unocal illegally acquired monopoly power in the technology market for producing the new CARB-compliant summertime RFG, thus undermining competition and harming consumers in the downstream product market for CARB-compliant summertime RFG in California. The Commission estimated that Unocal's enforcement of its patents could potentially result in over \$500 million of additional consumer costs each year.

The proposed merger between Chevron and Unocal raised additional concerns. Although Unocal had no horizontal refining or retailing overlaps with Chevron, it had claimed the right to collect patent royalties from companies that had refining and retailing assets (including Chevron). If Chevron had unconditionally inherited these patents by acquisition, it would have been in a position to obtain sensitive information and to claim royalties from its own horizontal downstream competitors. Chevron, the Commission alleged, could have used this information and this power to facilitate coordinated interaction and detect any deviations.

The Commission resolved both the Chevron/Unocal merger investigation and the monopolization case against Unocal with consent orders. The key element in these orders is Chevron's agreement not to enforce the Unocal patents.³² The FTC's settlement of these two matters is a substantial victory for California consumers. The Commission's monopolization case against Unocal was complex and, with possible appeals, could have taken years to resolve,

³²*Chevron Corp.*, *supra* note 17.

competitive issue raised by the merger. With the settlement, consumers will benefit immediately from the elimination of royalty payments on the Unocal patents, and potential merger efficiencies could result in additional savings at the pump.

³³FTC Press Release, *FTC Closes Western States Gasoline Investigation* (May 7, 2001), available at <http://www.ftc.gov/opa/2001/05/westerngas.htm>. In part, this investigation focused on “zone pricing” and “redlining.” See *Statement of Commissioners Sheila F. Anthony, Orson Swindle and Thomas B. Leary*, available at <http://www.ftc.gov/os/2001/05/wsgpiswindle.htm>, and *Statement of Commissioner Mozelle W. Thompson*, available at <http://www.ftc.gov/os/2001/05/wsgpithompson.htm>, for a more detailed discussion of these practices and the Commission’s findings. See also Cary A. Deck & Bart J. Wilson, *Experimental Gasoline Markets*, Federal Trade Commission, Bureau of Economics Working Paper (Aug. 2003), available at <http://www.ftc.gov/be/workpapers/wp263.pdf>, and David W. Meyer & Jeffrey H. Fischer, *The Economics of Price Zones and Territorial Restrictions in Gasoline Marketing*, Federal Trade Commission, Bureau of Economics Working Paper (Mar. 2004), available at <http://www.ftc.gov/be/workpapers/wp271.pdf>.

In conducting these and other inquiries, the Commission makes the important distinction between short-term and long-term effects. While a refinery outage on the West Coast could significantly affect short-term 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 at full (or nearly 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 profitably increase prices as demand for its products increases – generally only for a short time, until the outage is fixed or alternative supply becomes available. This transient power over price – which occurs infrequently and lasts only as long as the shortage – should not be confused with the durable power over price that is the hallmark of market power in antitrust law.

In addition to the *Unocal* and Western States pricing investigations, the Commission conducted a nine-month investigation into the causes of gasoline price spikes in local markets in the Midwest in the spring and early summer of 2000.³⁴ As explained in a 2001 report, the Commission found that a variety of factors 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

³⁴Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001), available at <http://www.ftc.gov/os/2001/03/mwgasrpt.htm>; see also Remarks of Jeremy Bulow, Director, Bureau of Economics, Federal Trade Commission, *The Midwest Gasoline Investigation*, available at <http://www.ftc.gov/speeches/other/midwestgas.htm>.

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 *ad valorem* taxes in certain states. 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. By mid-July 2000, prices had receded to pre-spike or even lower levels.

The Commission's merger investigations also are relevant to the detection of nonmerger antitrust violations. FTC oil and gas merger investigations during the past decade uniformly have been major undertakings that have reviewed all pertinent facets of the relevant markets. These investigations have involved the review of thousands of boxes of documents in discovery, examination of witnesses under oath, and exhaustive questioning of outside experts. The FTC staff, therefore, has learned information that also could assist in detecting and investigating potentially anticompetitive conduct.

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³⁵FTC Press Release, *FTC to Hold Second Public Conference on the U.S. Oil and Gasoline Industry in May 2002* (Dec. 21, 2001), available at <http://www.ftc.gov/opa/2001/12/gasconf.htm>.

³⁶GASOLINE PRICE C

supply into the market. Additional supply will be available to the extent that an increase in price exceeds the producers' cost of expanding output.

The vast majority of the Commission's investigations and studies have revealed market factors as the primary drivers of both price increases and price spikes. There is a complex landscape of market forces that affect gasoline prices in the United States.

A. Worldwide Supply, Demand, and Competition for Crude Oil Are the Most Important Factors in the National Average Price of Gasoline in the United States

Crude oil is a commodity that is traded on world markets, and the world price of crude oil is the most important factor in the price of gasoline in the United States and all other markets. Over the past 20 years, changes in crude oil prices have explained approximately 85 percent of the changes in the price of gasoline.³⁷ United States refiners compete with refiners all around the world to obtain crude, and the United States now imports more than 60 percent of its crude from

³⁷ A simple regression of the monthly average national price of gasoline on the monthly average price of West Texas Intermediate crude oil shows that the variation in the price of crude oil – based on data for the period January 1984 to October 2003 – explains approximately 85 percent of the variation in the price of gasoline. This is similar to the range of effects given in United States Department of Energy/Energy Information Administration, *Price Changes in the Gasoline Market: Are Midwestern Gasoline Prices Downward Sticky?*, DOE/EIA-0626 (Feb. 1999). More complex regression analysis and more disaggregated data may give somewhat different estimates, but the latter estimates are likely to be of the same general magnitude.

This percentage may vary across states or regions. See Prepared Statement of Justine Hastings before the Committee on the Judiciary, Subcommittee on Antitrust, Competition Policy and Consumer Rights, United States Senate, *Crude Oil: The Source of Higher Gas Prices* (Apr. 7, 2004). Dr. Hastings found a range from approximately 70 percent for California to 91 percent for South Carolina. South Carolina uses only conventional gasoline and is supplied largely by major product pipelines that pass through the state on their way north from the large refinery centers on the Gulf Coast. California, with its unique fuel specifications and its relative isolation from refinery centers in other parts of the United States, historically has been more susceptible to supply disruptions that can cause major gasoline price changes, independent of crude oil price changes.

of 1978.³⁸ Overall, however, the long-run trend is toward significantly increased demand for crude oil. Over the last 20 years, United States consumption of all refined petroleum products increased on average by 1.4 percent per year, leading to a total increase of nearly 30 percent.³⁹

Although they have receded from the record levels they reached immediately after Hurricane Katrina, crude oil prices have been increasing rapidly in recent months. Demand has remained high in the United States, and large demand increases from rapidly industrializing nations, particularly China and India, have made supplies much tighter than expected.⁴⁰

B. Gasoline Supply, Demand, and Competition Produced Relatively Low and Stable Prices From 1984 Until 2004, Despite Substantial Increases in United States Gasoline Consumption

Consumer demand for gasoline in the United States has risen substantially, especially since 1990.⁴¹ In 1978, U.S. gasoline consumption was about 7.4 million barrels per day. By 1981, in the face of sharply escalating crude oil and gasoline prices and a recession, U.S. gasoline consumption had fallen to approximately 6.5 million barrels per day.⁴² As gasoline prices began to fall in the 1980s, U.S. consumption of gasoline began to rise once again. By 1993, consumption rose above 1978 levels, and it has continued to increase at a fairly steady rate since then. In 2004, U.S. gasoline consumption averaged about 9 million barrels per day, and

³⁸GASOLINE PRICE CHANGES, *supra* note 7, at 43-45.

³⁹*Id.* at 19.

⁴⁰This phenomenon was not limited to crude oil: other commodities that form the basis for expanded growth in developing economies, such as steel and lumber, also saw unexpectedly rapid growth in demand, along with higher prices. *Id.* at 27.

⁴¹*Id.* at 48.

⁴²*Id.*

⁴³*See id.* at 49; EIA, DOE/EIA-0202, SHORT-TERM ENERGY OUTLOOK, Apr. 2005

period between 1919 and 2003, real annual average retail gasoline prices in the United States did not increase at all. The data show that, from 1986 through 2003, real national average retail prices for gasoline, including taxes, generally were below \$2.00 per gallon (in 2004 dollars). By contrast, between 1919 and 1985, real national average retail gasoline prices were above \$2.00 per gallon (in 2004 dollars) more often than not.⁴⁶

Average U.S. retail prices have been increasing since 2003, however, from an average of \$1.56 in 2003 to an average of \$2.04 in the first five months of 2005.⁴⁷ In the last several months, the prices have moved even higher. Setting aside whatever short-term effects may be associated with Hurricane Katrina, it is difficult to predict whether these increases represent the beginning of a longer-term trend or are merely normal market fluctuations caused by unexpectedly strong short-term worldwide demand for crude oil, as well as reflecting the effects of instability in such producing areas as the Middle East and Venezuela.

One reason why long-term real prices have been relatively contained is that U

periods. “Nominal” prices are the literal prices shown at the time of purchase.

⁴⁶See GASOLINE PRICE CHANGES, *supra* note 7, at 43-47.

⁴⁷The higher prices in 2005 appear to be the result of market factors that have uniformly affected the entire country. At least for the part of this year that preceded Hurricane Katrina, the FTC’s Gasoline Price Monitoring Project has detected no evidence of significant unusual local or regional gasoline pricing anywhere in the United States during this summer driving season. This contrasts with the past two summers, during which various regional supply shocks, such as the Arizona pipeline shutdown and the Northeast blackouts of August 2003, and the several unanticipated regional refinery outages and late summer hurricanes during the summer of 2004, significantly increased prices in some areas above levels that might be expected based on historical price patterns.

refine crude oil into various refined petroleum products by 8.9 percent, moving from 15.7 million barrels per day in 1985 to 17.133 million barrels per day as of August 2005.⁴⁸ This increase – approximately 1.4 million barrels per day – is roughly equivalent to adding approximately 10 to 12 average-sized refineries to industry supply. Yet U.S. refiners did not build any new refineries during this time. Rather, they added this capacity through the expansion of existing refineries. They also have adopted methods that broaden the range of crude oils that they can process and allow them to produce more refined product for each barrel of crude processed. In addition, they have decreased their inventory costs by lowering their inventory holdings (although lower inventory holdings may also make an area more susceptible to short-term price spikes when there is a disruption in supply).

Offsetting some of the observed efficiency gains, increased environmental requirements since 1992 have likely raised the retail price of gasoline by a few cents per gallon in some areas. Because gasoline use is a major factor in air pollution in the United States, the U.S. Environmental Protection Agency – under the Clean Air Act⁴⁹

⁴⁸PETROLEUM MERGER REPORT, *supra* note 8, at 196, tbl.7-1; EIA, DOE/EIA-0340(04)/1, 1 PETROLEUM SUPPLY ANNUAL 2004, at 78, tbl.36 (2005), *at* http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/petroleum_supply_annual/psa_volume1/current/pdf/volume1_all.pdf. EIA, DOE/EIA-0208(2005-33), WEEKLY PETROLEUM STATUS REPORT, August 24, 2005, *at* http://www.eia.doe.gov/pub/oil_gas/petroleum/data_publications/weekly_petroleum_status_report/historical/2005/2005_08_24/pdf/wpsrall.pdf.

⁴⁹Beginning with the Clean Air Act Amendments of 1970 (Pub. L. No. 91-604, 84 Stat. 1698) and continuing with further amendments in 1990 (Pub. L. No. 101-549, 104 Stat. 2468) and the Energy Policy Act of 1992 (Pub. L. No. 102-486, 106 Stat. 2776), Congress has mandated substantial changes in the quality of gasoline, as well as diesel, that can be sold in the United States.

⁵⁰Robert Larson, Acting Director of the Transportation and Regional Programs,
Environmental Protection Agency, Remarks at the FTC Conference on Factors that Affect Prices
of Refined Petroleum

that oil companies may at times earn less (as a percentage of capital or equity) than other industrial firms. This simply reflects the large amount of capital necessary to find, refine, and distribute petroleum products.

The rates of return on equity for FRS companies have varied widely over the years, ranging from as low as 1.1 percent to as high as 21.1 percent during the period from 1974 to 2003.⁵³ Returns on equity vary across firms as well. Crude oil exploration and production operations typically generate much higher and more volatile returns than refining and marketing. In essence, companies with exploration and production operations now find themselves in a position analogous to that of a homeowner who bought a home in a boom market.

⁵³*Id.*

⁵⁴*Id.* at 111 (noting that the other four states with the highest average taxes on gasoline in 2004 were Wisconsin (\$0.33 per gallon), Connecticut (\$0.325 per gallon), Rhode Island (\$0.306

taxes.⁵⁵

Local regulations may also have an impact on retail gasoline prices. For example, bans on self-service sales or below-cost sales appear to raise gasoline prices. New Jersey and Oregon ban self-service sales, thus requiring consumers to buy gasoline bundled with services that increase costs – that is, having staff available to pump the gasoline.⁵⁶ Some experts have estimated that self-service bans cost consumers between \$0.02 and \$0.05 per gallon.⁵⁷ In addition, some 11 states have laws banning below-cost sales, so that a gas station is required to charge a minimum amount above its wholesale gasoline price.⁵⁸ These laws harm consumers by depriving them of the lower prices that more efficient (*e.g.*, high-volume) stations can charge.

Not surprisingly, retail gasoline prices are likely to be lower when consumers can choose – and can switch their purchases – among a greater number of retail stations. A small number of empirical studies have examined gasoline station density in relation to prices. One study found that stations in Southern California that imposed a 1 percent price increase lost different amounts

per gallon), and California (\$0.301 per gallon)).

⁵⁵*Id.* For example, all areas in Florida also have a local tax between \$0.099 and \$0.178 per gallon. Similarly, Honolulu has a local tax of \$0.165 per gallon.

⁵⁶*See, e.g.*, OREGON REV. STAT., ch. 480, § 480.315.

⁵⁷*See* Michael G. Vita, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, 18 J. REG. ECON. 217 (2000); *see also* Ronald N. Johnson & Charles J. Romeo, *The Impact of Self-Service Bans in the Retail Gasoline Market*, 82 REV. ECON. & STAT. 625 (2000); Donald Vandegrift & Joseph A. Bisti, *The Economic Effect of New Jersey's Self-Service Operations Ban on Retail Gasoline Markets*, 24 J. CONSUMER POL'Y 63 (2001).

⁵⁸*See* GASOLINE PRICE CHANGES, *supra* note 7, at 113.

multiple fuel islands and multi-product dispensers. They are sometimes called “pumpers” because of their large-volume fuel sales. By 1999, the latest year for which comparable data are available, brand-name and independent convenience store and pumper stations accounted for almost 67 percent of the volume of U.S. retail gasoline sales.⁶²

Another change to the retail gasoline market that appears to have helped keep gasoline prices lower is the entry of hypermarkets. Hypermarkets are large retailers of general merchandise and grocery items, such as Wal-Mart and Safeway, that have begun to sell gasoline. Hypermarket sites typically sell even larger volumes of gasoline than pumper stations – sometimes four to eight times larger.⁶³ Hypermarkets’ substantial economies of scale generally enable them to sell significantly greater volumes of gasoline at lower prices.

This list of factors that have an impact on retail gasoline prices is not exhaustive, but it

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⁶²PETROLEUM MERGER REPORT, *supra* note 8, at 246 tbl.9-5.

⁶³*Id.* at 239.

IV. Conclusion

The Federal Trade Commission has an aggressive program to enforce the antitrust laws in the petroleum industry. The Commission has taken action whenever a merger or nonmerger conduct has violated the law and threatened the welfare of consumers or competition in the industry. The Commission continues to search for appropriate targets of antitrust law enforcement, to monitor retail and wholesale gasoline and diesel prices closely, and to study this industry in detail.

Thank you for this opportunity to present the FTC's views on this important topic. I would be glad to answer any questions that the Committee may have.