

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 or carefully scrutinized.

Gasoline prices are among the most visible prices in our complex economy. Consumers closely follow gasoline prices, and in recent months these prices have experienced dramatic increases. In recent weeks, prices of gasoline have exceeded \$3.00 a gallon in some markets. Despite higher prices, demand for gasoline continues to grow, increasing at a 1.6 percent rate over the most recent four-week period for which data are available (August 19), over that same period for last year. Gasoline inventories remain at the lower end of the average range. These rising prices command our attention.

On top of this tight market, Hurricane Katrina has temporarily disrupted an important source of crude oil and gasoline supply. At one point, over 95 percent of Gulf Coast crude oil

¹ This 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.

² See Minerals Mgmt. Serv., U.S. Dep't of the Interior, Release No. 3328, *Hurricane Katrina Evacuation and Production Shut-in Statistics Report as of Tuesday, August 30, 2005* (2005), at <http://www.mms.gov/ooc/press/2005/press0830.htm>.

³ FEDERAL 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>.

complaints against 19 large petroleum mergers. In 13 of these cases, the FTC obtained significant divestitures. Of the six other matters, the parties in four cases abandoned the transactions altogether after our respective 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 is ongoing.

In addition to litigation and industry studies, the Commission also protects consumers through other initiatives. The Commission actively monitors wholesale and retail prices of gasoline.⁵ Three years ago, the FTC launched an initiative to monitor gasoline prices to identify “unusual” movements in prices⁶ 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 daily scrutinize price movements in 20 wholesale and approximately 360 retail markets across the country. In no other industry does the Commission so closely monitor prices.

This gasoline monitoring and investigation initiative focuses on the timely identification of unusual movements in gasoline prices (compared to historical trends) to determine if a law enforcement investigation is warranted. If the FTC staff detects unusual price movements in an area, it researches the possible causes, including consultation, if appropriate, with the state Attorneys General, state energy agencies, and the Department of Energy’s (“DOE”) Energy

⁵ See FTC, *Oil and Gas Industry Initiatives*, at <http://www.ftc.gov/ftc/oilgas/index.html>.

⁶ An “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.

Information Administration. The FTC staff also monitors DOE's gasoline 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), absent other evidence of potential anticompetitive conduct, it does not investigate further (although it continues to monitor).⁷ The Commission's experience from its past investigations and the current monitoring initiative indicate 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.

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

⁷ Natural 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.

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. Changes in crude oil prices account for approximately 85 percent of the variability of gasoline prices.⁸ 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 Countries (“OPEC”). 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, it is not surprising that we 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.⁹ In 2004, the Commission released data on

⁸ See GASOLINE PRICE CHANGES, *supra* note 3, at 13.

⁹ Section 7 of the Clayton Act prohibits acquisitions where the anticompetitive effects may occur “in any line of commerce or in any activity affecting commerce in any section of the country.” 15 U.S.C. § 18.

all horizontal merger investigations and enforcement actions from 1996 to 2003.¹⁰ 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.

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 the Union Oil Company of California ("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.¹¹ 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

¹⁰ Federal 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>.

¹¹ *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>.

¹⁶ *Chevron Corp.*, FTC Docket No. C-4023 (Jan. 2, 2002) (consent order), at <http://www.ftc.gov/os/2002/01/chevronorder.pdf>.

¹⁷ *Id.*

¹⁸ Shell and Texaco jointly controlled the Equilon venture, whose major assets

²⁰ *Valero Energy Corp.*, FTC Docket No. C-4031 (Feb. 19, 2002) (consent order), at <http://www.ftc.gov/os/2002/02/valerodo.pdf>.

²³ *Conoco Inc. and Phillips Petroleum Corp.*, FTC Docket No. C-4058 (Aug. 30, 2002) (Analysis of Proposed Consent Order to Aid Public Comment), *at*

The Commission resolved both the Chevron/Unocal merger investigation and the monopolization case against Unocal with consent orders. The key element in these settlements is Chevron's agreement not to enforce the Unocal patents.²⁵ The FTC's settlement of these two matters is thus a double victory for California consumers. The Commission's monopolization case against Unocal was complex and, with possible appeals, could have taken years to resolve, with substantial royalties to Unocal – and higher consumer prices – in the interim. The settlement provides the full relief sought in the monopolization case and also resolves the only competitive issue raised by the proposed 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.

The FTC undertook another major nonmerger investigation during 1998-2001, examining the major oil refiners' marketing and distribution practices in Arizona, California, Nevada, Oregon, and Washington (the "Western States" investigation).²⁶ The agency initiated the Western States investigation out of concern that differences in gasoline prices in Los Angeles,

²⁵ *Union Oil Co. of California*, *supra* note 11.

²⁶ FTC 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>.

San Francisco, a

²⁷ Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001), *available at*

how low they fall. Limited substitutes for gasoline restrict the options available to consumers to respond to price increases in the short run. Because gasoline consumers typically do not reduce their purchases substantially in response to price increases, they are vulnerable to substantial price increases.

Third, producers' responses to price changes will affect how high prices rise, and how low they fall. In general, when there is not enough gasoline to meet consumers' demands at current prices, higher prices will signal a potential profit opportunity and may bring additional 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.³⁰ United States refiners compete with refiners all around the

³⁰ 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

world to obtain crude, and the United States now imports more than 60 percent of its crude from foreign sources.

If world crude prices rise, then U.S. refiners must pay higher prices for the crude they buy. Facing higher input costs from crude, refiners charge more for the gasoline they sell at wholesale. This requires retail stations to pay more for their gasoline. In turn, retail stations, facing higher input costs, charge consumers more at the pump. In short, when crude oil prices rise, gasoline prices rise because gasoline becomes more costly to produce.

Crude oil prices are not wholly market-determined. Since 1973, decisions by OPEC have been a significant factor in the prices that refiners pay for crude oil. Over time, OPEC has met with varying degrees of success in raising crude oil prices. (For example, OPEC members can be tempted to “cheat” and sometimes sell more crude oil than specified by OPEC limits.) Higher world crude prices due to OPEC’s actions, however, increased the incentives to search for oil in other areas, and crude supplies from non-OPEC members such as Canada, the United Kingdom, and Norway have increased significantly. Nonetheless, OPEC still produces a large enough share of world crude oil to exert market power and strongly influence the price of crude oil when its

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.

members adhere to their assigned production quotas. Especially when demand surges unexpectedly, as in 2004, OPEC decisions on whether to increase supply to meet demand can have a significant impact on world crude oil prices.

Crude oil consumption has fallen during some periods over the past 30 years, partially in reaction to higher prices and partially in response to federal laws, such as requirements to increase the fuel efficiency of cars. Gasoline

³¹ GASOLINE PRICE CHANGES, *supra* note 3, at 43-45.

³² *Id.* at 19.

³³ This 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.

³⁴ *Id.* at 48.

annual retail gasoline prices and average annual retail gasoline consumption in the United States from 1978 through 2004 shows that, in general, gasoline prices remained relatively stable despite significantly increased demand.³⁸ Indeed, over the very long run in the 84-year 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.³⁹

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 2005.⁴⁰ In the last two months, the prices have moved even higher. 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.

³⁸ “Real” prices are adjusted for inflation and therefore reflect the different values of a dollar at different times; they provide more accurate comparisons of prices in different time periods. “Nominal” prices are the literal prices shown at the time of purchase.

³⁹ See *GASOLINE PRICE CHANGES*, *supra* note 3, at 43-47.

⁴⁰ The 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 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.

Environmental Protection Agency – under the Clean Air Act⁴² – requires various gasoline blends for particular geographic areas that have not met certain air quality standards. While available information shows that the air quality in the United States has improved due to the Clean Air Act,⁴³ as with any regulatory program, costs come with the benefits. Environmental laws and regulations have required substantial and expensive refinery upgrades, particularly over the past 15 years. It costs more to produce cleaner gasoline than to produce conventional gasoline. Estimates of the increased costs of environmentally mandated gasoline range from \$0.03 to \$0.11 per gallon.⁴⁴

Our studies indicate that higher retail prices are not caused by excess oil company profits. Although recent oil company profits may be high in absolute terms, industry profits have varied widely over time, as well as over industry segments and among firms.

EIA's Financial Reporting System ("FRS") tracks the financial performance of the 28

⁴² Beginning 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..

⁴³ Robert 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 Products 79-80 (May 8, 2002).

⁴⁴ See EIA, *1995 Reformulated Gasoline Market Affected Refiners Differently*, in DOE/EIA-0380(1996/01), PETROLEUM MARKETING MONTHLY (1996), and studies cited therein. Environmental mandates are not the same in all areas of the country. The EPA requires particular gasoline blends for certain geographic areas, but it sometimes allows variations on those blends. Differing fuel specifications in different areas can limit the ability of gasoline wholesalers to find adequate substitutes in the event of a supply shortage. Thus, boutique fuels may exacerbate price variability in areas, such as California, that are not interconnected with large refining centers in other areas.

minimum amount above its wholesale gasoline price.⁵¹ 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 of sales, depending on how many competitors were close by.⁵² Those with a large number of nearby competitors (27 or more within 2 miles) lost 4.4 percent of sales in response to a 1 percent price increase; those with a smaller number of nearby competitors (fewer than 19 within 2 miles) lost only 1.5 percent of sales.⁵³ With all else equal, stations that face greater lost sales from raising prices will likely have lower retail prices than stations that lose fewer sales from raising prices.

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⁵¹ See GASOLINE PRICE CHANGES, *supra* note 3, at 113.

⁵² JOHN M. BARRON ET AL., CONSUMER AND COMPETITOR REACTIONS: EVIDENCE FROM A RETAIL-GASOLINE FIELD EXPERIMENT (Mar. 2004), at <http://ssrn.com/abstract=616761>.

⁵³ *Id.* at 13, 15, 30-31.

areas with high land prices and strict zoning regulations.⁵⁴

One of the biggest changes in retail sales of gasoline in the past three decades has been the development of such new formats as convenience stores and high-volume operations. These new formats appear to lower retail gasoline prices. The number of traditional gasoline-pump-and-repair-bay outlets has dwindled for a number of years, as brand-name gasoline retailers have moved toward a convenience store format. Independent gasoline/convenience stores – such as RaceTrac, Sheetz, QuikTrip, and Wawa – typically feature large convenience stores with 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 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.⁵⁵

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 4 to 8 times larger.⁵⁶ Hypermarkets’ substantial economies of scale generally enable them to sell significantly greater volumes of gasoline at lower prices.

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

⁵⁴ See *id.* at 30-31; GOV’T ACCOUNTABILITY OFFICE (GAO), GAO/RCED-00-121, MOTORFUELS: CALIFORNIA GASOLINE PRICE BEHAVIOR 20 (2000), available at <http://www.gao.gov/new/items/rc00121.pdf>.

⁵⁵ PETROLEUM MERGER REPORT, *supra* note 4, at 246 tbl.9-5.

⁵⁶ *Id.* at 239.

shows that prices are set by a complex array of market and regulatory forces working throughout the economy. In the long run, these forces have combined to produce remarkably stable prices in the face of consistently growing demand. Short-run variations, while sometimes painful to consumers, are unavoidable in an industry that depends on the demand and supply decisions of literally billions of people.

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 study this industry in detail, to monitor wholesale and retail gasoline prices, and to search for instances of illegal mergers or anticompetitive conduct.

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.