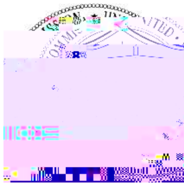

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Prepared Statement of the Federal Trade Commission

Petroleum Industry Consolidation

Presented by
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I. Introduction

Mr. Chairman and members of the Committee, I am William Kovacic, a Commissioner of the Federal Trade Commission. I am pleased to appear before you to present the

capacity was not operating. In the periods immediately following Katrina and Rita, gasoline prices rose sharply to $3.00 per gallon or more in many markets.

Substantially in response to the price effects of this massive supply disruption, demand for gasoline fell somewhat in the weeks after Hurricane Katrina. This reduced demand – together with increased gasoline output from refineries not affected by the hurricanes, the resumption of a sizeable fraction of production in the hurricane-damaged region, and increased gasoline imports – brought both wholesale and retail gasoline prices back down to pre-hurricane levels by the end of last November.[3]

Although we analyze each petroleum merger according to numerous market facts surrounding the transaction, an overall analysis of merger policy in the petroleum industry necessarily takes a longer and broader view. Over the past 20 years, the Commission's merger policy has been consistent across administrations. Applying sound principles of law and of economics, it has been designed and focused to prevent the accumulation and use of market power to the detriment of consumers.

Over the past two decades, the petroleum industry has undergone a structural upheaval, punctuated by a burst of large mergers in the late 1990s. A number of other industries also saw a large number of mergers in that time frame. However, certain forces unique to producing and distributing petroleum products have spurred the transformation of that industry. Technological,

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[3] Several refineries in the Gulf Coast area are still running at reduced capacity or remain inoperable. Yet, despite this reduced capacity, it appears that the rebound in gasoline prices that the country has experienced since early December has largely been attributable to rising crude oil prices, which have been affected by recent world events, especially in Iran and Nigeria. The Commission will examine this further in the course of the two investigations the agency is conducting pursuant to Congressional directives, described *infra* pp. 14-15.

economic, and regulatory factors have led toward reliance on a smaller number of larger, more sophisticated refineries that can process different kinds of crude oil more efficiently. The development of crude oil spot and futures markets has reduced the risks of acquiring crude oil through market transactions – as opposed to owning crude oil extraction and production assets – thus contributing to a decline in vertical integration between crude oil extraction and production and refining among the major oil companies. A number of major integrated firms have restructured to concentrate on one or more segments of the industry, and a number of unintegrated refiners or retion hasfmalln(, and)Tj0.005 Tc -0.005 Tw 29.496 -2.36 Tdfmorigr

competition, or tend to create a monopoly."[5] Under Section 5 of the FTC Act and Section 7 of the Clayton Act, the agency has carefully examined proposed mergers and has blocked or required revisions[6] of any that have threatened to harm consumers by reducing competition.[7] Indeed, in 2004, the Commission released data on all horizontal merger investigations and enforcement actions from 1996 to 2003.[8] These data show that the Commission has brought more merger cases at lower levels of concentration in the petroleum industry than in any other industry. Unlike in other industries, the Commission has obtained merger relief in moderately concentrated petroleum markets.

In 2004, the FTC staff also published a study reviewing the petroleum industry's mergers

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[5] Section 7 of the Clayton Act, 15 U.S.C. § 18.

[6] FTC enforcement action has played an important role in the restructuring of the petroleum industry over the past 20 years. The Commission has allowed mergers to proceed when the overall transaction was efficient and procompetitive but has required divestitures to remedy the anticompetitive effects that might have arisen in particular relevant markets. These FTC orders permitted the merging firms to achieve the economic benefits of the transaction while curing the potential anticompetitive effects through divestiture to a third party

and structural changes as well as the antitrust enforcement actions that the agency has taken in the industry over the past 20 years.[9] This was the Commission's third such report since 1982.[10] Like its predecessors, the 2004 Report had two basic goals: to inform public policy concerning competition in the petroleum industry, and to make more transparent how the Commission analyzes mergers and other competitive phenomena in this sector.

Several themes emerged from the Commission's study of changes in the petroleum industry over the past two decades:

- Mergers of private oil companies have not significantly affected worldwide concentration in crude oil. This fact is important, because crude oil prices are the chief determinant of gasoline prices.
- Despite some increases over time, concentration for most levels of the United States petroleum industry has remained low to moderate.
- Intensive, thorough FTC merger investigations and enforcement have helped prevent further increases in petroleum industry concentration and avoid potentially anticompetitive problems and higher prices for consumers.
- Economies of scale have become increasingly significant in shaping the petroleum industry. The United States has fewer refineries than it had 20 years ago, but the average size and efficiency of refineries have increased, along with the total output of refined products.
- Industry developments have lessened the incentive to vertically integrate throughout all or most levels of production, distribution, and marketing. Several significant refiners have no crude oil production, and integrated petroleum

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[9] BUREAU OF ECONOMICS, FEDERAL TRADE COMMISSION, THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT (2004), *available at* http://www.ftc.gov/os/2004/08/040813mergersinpetrolberpt.pdf.

[10]

companies today tend to depend less on their own crude oil production. In addition, a number of independent retailers purchase refined products on the open market.

- Some significant independent refiners have built market share by acquiring refineries that were divested from integrated majors pursuant to FTC enforcement orders.[11]

III. 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.[12] For more than 20 years, the FTC has been the federal antitrust agency primarily responsible for reviewing conduct in the petroleum industry to assess whether it is likely to reduce competition and harm consumer welfare. In this role, the FTC has devoted substantial resources to investigating and studying the industry. For example, during the period of large oil industry mergers in the late 1990s, the Bureau of Competition spent almost one-fourth of its enforcement budget on investigations in energy industries.

The Commission investigates every substantial petroleum industry merger. Many transactions, particularly smaller ones, raised no competitive concerns and required no

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[11] Last year the Commission issued a report on the various factors that influence the price of gasoline and other refined petroleum products. *See* Federal Trade Commission, *Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition* (2005), *available at* http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf. Lessons of this report included the findings that worldwide supply, demand, and competition for crude oil are the most important factors in the national average price of gasoline in the United States. Other important factors impacting retail gasoline prices include retail station density, new retail formats, environmental factors, state and local tax rates, and state and local regulations.

[12] Section 7 of the Clayton Act prohibits acquisitions whose effect "may be substantially to lessen competition, or to tend to create a monopoly" "in any line of commerce or in any activity affecting commerce in any section of the country." 15 U.S.C. § 18.

although merger analysis begins with concentration data, emphasis is placed on qualitative factors that indicate whether a merger will increase the ability of the merging parties to exercise market power in one or more properly defined relevant markets[15] by curbing output unilaterally or by coordinating their behavior with rival suppliers.

Despite increases in concentration at some production levels over the last two decades, particularly since the mid-1990s, most sectors of the petroleum industry generally remain unconcentrated or moderately concentrated. In addition, the growth of independent marketers and hypermarkets has increased competition at the wholesale and retail levels in many areas.

Some mergers have led to increased concentration. An increase in concentration from a merger, however, is not by itself a sufficient basis for finding that a merger is anticompetitive. Where concentration changes raise concerns about potential competitive harm, the FTC conducts a more detailed investigation. When it has concluded that a merger is likely to reduce competition, the FTC has required divestitures or sought preliminary injunctions. Many of the mergers the FTC challenged would have lessened competition significantly if they had proceeded

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years of experience, FTC Chairman Majoras has announced that the FTC, along with DOJ, will develop a Commentary on the Merger Guidelines to bring greater transparency to the agencies' application of the Guidelines to merger analysis. The Commentary will clarify how the agencies apply the Guidelines and will enhance the dialogue between the agencies, businesses, legal advisors, and the public.

[15] The correct definition of a market in pre-merger review is a detailed, fact-intensive inquiry that involves both product and geographic components. We must ascertain for which product (or products) the transaction may harm competition, and we must also determine the geographic area over which any anticompetitive effects will be felt. In our analysis of petroleum mergers, national, state, or PADD-wide "markets" rarely correspond to properly defined geographic markets. ("PADD" stands for "Petroleum Administration for Defense District." PADD I consists of the East Coast. PADD II consists of the Midwest. PADD III includes the Gulf Coast. PADD IV consists of the Rocky Mountain region. PADD V is made up of the West Coast plus Alaska and Hawaii.)

as originally planned. Our antitrust remedies prevented those increases: through carefully crafted divestitures, the Commission has mandated the elimination of competitively problematic overlaps between the merging parties while allowing the competitively unobjectionable – or even efficiency-enhancing – portion of a transaction to proceed.[16]

Collectively, mergers have raised competitive concerns at all of the various levels of the petroleum industry, but the majority of FTC actions have targeted downstream activities, *i.e.*, refining, refined products pipelines, terminals, and marketing. The competitive concern generally has been that the merger would enable the merged firm to raise prices in a market for products that it sells to the next level of the industry (*e.g.*, refined products sold to wholesalers, or wholesale products sold to retailers) through either unilateral or coordinated behavior. A key element in assessing the potential for adverse competitive effects is to determine the alternatives available to customers, including whether more distant suppliers are viable options. Some enforcement actions have been based on a potential competition theory; some on competitive problems involving market power held by a buyer or a group of buyers; and some on vertical concerns relating to the ability of a single firm or a coordinating group of firms to raise the costs of other firms in the industry, to the injury of consumers.

Several recent investigations illustrate the FTC's approach to merger analysis in the petroleum industry.[17] An important recently completed case challenged Chevron's acquisition of Unocal. When the merger investigation began, the Commission was in the middle of a

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[16] *See also supra* note 6.

[17] The attached appendix shows every Commission merger enforcement action in the petroleum industry since 1981.

monopolization case against Unocal in which the FTC's administrative complaint alleged that Unocal had deceived the California Air Resources Board ("CARB") in connection with regulatory proceedings to develop the reformulated gasoline ("RFG") standards that CARB adopted. The complaint further charged that Unocal had 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 the additional concern that, by unconditionally inheriting Unocal's patents through the acquisition, Chevron 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 settled both the merger and the monopolization matters with separate consent orders that compelled Chevron to forgo enforcement of the Unocal patents, thus pred(to forgzopa1 0 Td(ts, thus pr)Tziw96

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. The complaint alleged that the acquisition had the potential to increase prices in bulk gasoline and diesel markets.[19] The FTC's divestiture 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.[20]

Most recently, the Commission filed a complaint on July 27, 2005, in federal district court in Hawaii, alleging that Aloha Petroleum's then-proposed acquisition of Trustreet Properties' half interest in an import-capable terminal and retail gasoline assets on the island of Oahu would have reduced the number of gasoline marketers and could have led to higher gasoline prices for Hawaii consumers.[21] To resolve this complaint, the parties executed a 20-year throughput agreement with a third party 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

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

[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 .

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

cases. One of these challenged the merger of Chevron and Texaco,[23] which combined assets located throughout the United States. Following an investigation in which 12 states participated, 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.

Another petroleum industry transaction that the Commission challenged successfully was the $6 billion merger between Valero Energy Corp. ("Valero") and Ultramar Diamond Shamrock Corp. ("Ultramar").[24] Both Valero and Ultramar were leading refiners and marketers of gasoline that met the specifications of the California Air Resources Board, and they were the only significant suppliers to independent stations in California. The Commission's complaint alleged competitive concerns in both the refining and the bulk supply of CARB gasoline in two separate geographic markets – Northern California and the entire state of 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.[25] To remedy the

and (3) 70 Ultramar retail stations in Northern California.[26]

An additional example is the Commission's 2002 challenge to the merger of Phillips Petroleum Company and Conoco Inc., alleging that the transaction would harm competition in the Midwest and Rocky Mountain regions of the United States. To resolve that challenge, the Commission required the divestiture of (1) the Phillips refinery in Woods Cross, Utah, and all of the Phillips-related marketing assets served by that refinery; (2) Conoco's refinery in Commerce City, Colorado (near Denver), and all of the Phillips marketing assets in Eastern Colorado; and (3) the Phillips light petroleum products terminal in Spokane, Washington.[27] The Commission's order ensured that competition would not be lost and that gasoline prices would not increase as a result of the merger.

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[26] *Valero Energy Corp.*, *supra* note 24.

[27] *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* http://www.ftc.gov/os/caselist/0310139/031229stmt0310139.pdf. The FTC also considered the likely competitive effects of Phillips Petroleum's proposed acquisition of Tosco. After careful scrutiny, the Commission declined to challenge the acquisition. A statement issued in connection with the closing of the investigation set forth the FTC's reasoning in detail. *Phillips Petroleum Corp.*, FTC File No. 011 0095 (Sept. 17, 2001) (Statement of the Commission), *at* http://www.ftc.gov/os/2001/09/phillipstoscostmt.htm.

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.

To sum up structural changes and merger enforcement policy in the last two decades, mergers have contributed to the restructuring of the petroleum industry but have had only a limited impact on industry concentration. The FTC has investigated all major petroleum mergers

a substantial number of companies in this investigation, and our lawyers and economists have been analyzing the data that we have collected, including information received from staff's contacts with the Department of Energy, the DOE's Energy Information Administration, and other government agencies. Although I cannot provide more complete details about this ongoing investigation, the Commission anticipates reporting to Congress on the findings of this investigation this spring. Any identification of unlawful conduct will result in aggressive FTC law enforcement activity.

V. Conclusion

The Federal Trade Commission has an aggressive program to enforce the antitrust laws in the petroleum industry. The agency 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 analyze and bring cases against any merger that is potentially anticompetitive, and to study this industry in detail.

Thank you for this opportunity to present the FTC's views on this important topic. I look forward to answering your questions.

Magellan/ Shell[5] (2004)	Terminaling of light products in the Oklahoma City area.	Coordinated	Post-merger > 4300 Change > 1200	Divestiture of Shell's Oklahoma City terminal assets
Shell/Pennzoil Quaker State[6] (2002)	Refining and marketing of paraffinic base oil in U.S. and Canada	Unilateral / Coordinated	Post-merger >2300 Change >700	Divestiture of Pennzoil interest in lube oil joint venture; Pennzoil sourcing of lube oil from third party lube oil refiner frozen at current level
Phillips/ Conoco[7] (2002)	1. Bulk supply (via refining or pipeline) of light petroleum products in eastern Colorado 2. Bulk supply of light petroleum products in northern Utah 3. Terminaling services in the Spokan			

3. Refining and bulk supply of CARB gasoline for California	Unilateral / Coordinated	Post-merger 2000 Change 500	As above
4. Refining and bulk supply of gasoline and jet fuel in the Pacific Northwest	Coordinated	Post-merger > 2000 Change > 600	As above
5. Refining and bulk supply of RFG II gasoline for the St. Louis metropolitan area	Coordinat		

2. Gasoline marketing in

	12. Refining and marketing of jet turbine oil worldwide	Unilateral[26]	Pre-merger >5625	Divestiture of Exxon jet turbine oil manufacturing facility at Bayway, NJ, with related patent licenses and intellectual property
BP/ Amoco[27] (1998)	1. Terminaling of gasoline and other light products in nine separate metropolitan areas, mostly in the Southeast U.S.			

7. Terminaling and marketing of gasoline and

	4. Transport of crude oil from West Texas/New Mexico	Unilateral / Coordinated[37]	Not publicly available	Divestiture of Gulf interests in specified crude oil pipelines, including 51% of Gulf's interest in the West Texas Gulf Pipeline Company
Texaco/Getty[38] (1984)	1. Refining of light products			

	3. Pipeline transportation of refined products into the Mid Atlantic and Northeast	Unilateral[44]	Not publicly available	As above
Mobil/ Marathon[45] (1981)	Wholesale marketing of gasoline and middle distillates in various markets in the Great Lakes area	Unilateral /m02 398.8881 710..83602 Tm(s m/THT/T6ETBT/TT0 1 Tf8.80 0 10.02 150.		