

The FTC's Report on Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases: Some Comments

Elizabeth M. Bailey

As gasoline prices at the pump in the United States have risen to over \$3.00 for a gallon of regular unleaded in the summer of 2006 from a low of about \$1.00 in 1998, the Federal Trade Commission has been under pressure from consumers and from Congress to investigate the reasons for the increase. Of particular interest has been whether transactions in the petroleum industry that government agencies had reviewed contributed to the higher prices. Some of the recent transactions that have taken place in the petroleum industry include Shell-Texaco (1998), Exxon-Mobil (1999), BP-Amoco (1998), BP-ARCO (2000), Chevron-Texaco (2001), Phillips-Tosco (2001), Valero-UDS (2001) and Conoco-Phillips (2002). The FTC is the antitrust agency that reviewed most, but not all, of the petroleum industry transactions reported under the Hart Scott Rodino Act in the past decade; the U.S. Department of Justice reviewed the remainder.

The FTC has released a lengthy list of reports over the past few years addressing the results of its investigations into the causes of gasoline price increases.¹ On May 22, 2006, the FTC released its most recent report, *Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases*.² The report provides the FTC's findings on an investigation that responds to two mandates from Congress, one general on the behavior of refiners and distributors of gasoline in the United States and the other specific to the events in the wake of Hurricane Katrina.

The report is divided into three parts. Part I of the report addresses the mandate in the 2005 Energy Policy Act, which required the FTC to investigate whether the price of gasoline is being "artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price gouging."³ The report defines price manipulation as including "(1) all transactions and practices that are prohibited by the antitrust laws . . . and (2) all other transactions and practices, irrespective of their legality under the antitrust laws, that tend to increase prices relative to costs and to reduce output."⁴ Part II of the report addresses the mandate in the FTC's 2006 appropriation legislation, which required the FTC to investigate "nationwide gasoline prices and possible price gouging in the aftermath of Hurricane Katrina."⁵ Part III of the report provides, in part, a policy discussion of the merits of federal price gouging legislation.

Elizabeth M. Bailey is a Clinical Assistant Professor in the Department of Economics, Arizona State University, and Special Consultant, NERA Economic Consulting.

¹ Those reports include: THE MIDWEST GASOLINE PRICE INVESTIGATION (Mar. 2001); THE PETROLEUM INDUSTRY: MERGERS, STRUCTURAL CHANGE, AND ANTITRUST ENFORCEMENT: A REPORT OF THE STAFF OF THE FEDERAL TRADE COMMISSION BUREAU OF ECONOMICS (Aug. 2004); and GASOLINE PRICE CHANGES: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION (June 2005). All of these reports can be found at http://www.ftc.gov/ftc/oilgas/competn_reports.htm.

² Available at <http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf>.

³ *Id.* at i.

⁴ *Id.* at ii.

⁵ *Id.* at i.

This article summarizes the report's findings and offers some comments on what the report's findings tell us—and don't tell us—about market power in the petroleum industry.

Market Manipulation in the Supply and Distribution of Gasoline

The FTC report addresses two questions related to whether there is any evidence of market manipulation in the supply and distribution of gasoline in the United States. First, is there any evidence that refiners and distributors of gasoline in the United States attempted historically to manipulate gasoline prices? Second, is there any evidence that refiners and distributors of gasoline in the United States attempted to manipulate gasoline prices in the wake of Hurricanes Katrina?

To answer these questions, the FTC analyzed voluntary interviews conducted with firms in the petroleum industry, sworn investigational hearings, data and documentary responses to Civil Investigatory Demands, and data on wholesale and retail gasoline prices obtained from Oil Price Information Service, a third party which sells data on prices in various segments of the petroleum industry.⁶

Based on an analysis of that information, the first part of the report concludes that refiners and distributors in the United States petroleum industry have “behaved competitively.”⁷ With the exception of upstream exploration, development, and production of crude oil, the first part of the report provides a detailed discussion of the stages of the petroleum industry that relate to gasoline supply. These include refining, pipeline supply, marine shipments, and terminal services. The FTC bases its conclusion that refiners have behaved competitively on a lack of evidence that refiners in the United States underinvested in new refining capacity. Likewise, the report states that no evidence was found that refiners’ planned (or unplanned) refinery outages were strategically timed or that refiners’ adjusted the mix of refinery output in order to attempt to manipulate gasoline price. In addition, the FTC found no evidence that firms exported gasoline to less profitable markets nor evidence that the distribution infrastructure—such as marine transportation services, pipeline services, and terminalling services—manipulated gasoline prices via rate structures and/or forgone expansions. Finally, the FTC found no evidence that the firms in the petroleum industry reduced inventory holdings in order to manipulate gasoline prices. The report concludes that one of the largest contributors to the increase in gasoline prices at the pump were increases in crude oil costs.⁸

The second part of the report concludes that the responses by firms in the petroleum industry to the negative shock to the supply of gasoline caused by Hurricane Katrina were “consistent with competition.”⁹ The FTC based these conclusions on an absence of evidence that firms adjusted their refinery output mix, diverted gasoline supplies, or withheld inventories in order to manipulate gasoline prices in reaction to the supply shortage created by Hurricane Katrina.

The second part of the report also concludes that the increases in gasoline prices after Hurricanes Katrina and Rita “were consistent with the standard supply and demand competitive paradigm.”¹⁰ This conclusion, however, says little about whether the firms have market power

⁶ *Id.* at iv–v.

⁷ *Id.* at vi.

⁸ *Id.*

⁹ *Id.* at ix.

¹⁰ *Id.*

The elephant in the room in this report is whether the investments in capacity and infrastructure made by firms in the petroleum industry would have been any different absent the consolidation that has taken place over the past decade.

because it is a true statement for firms with no market power and for firms that possess market power. For example, one would expect to see supply being diverted from lower-priced areas to higher-priced areas in an industry in which firms possess market power. Similarly, one would expect to see firms with market power drawing down inventory in the face of a negative supply shock. As well, one would expect to see refineries that possess market power and that were not affected by the hurricanes to increase output. The difference between the response in an industry characterized by no market power compared to the response in an industry characterized by participants with market power is in the magnitude of the response (e.g., how much supply is diverted, how much inventory is depleted, how big an increase in refinery output). Based on the information contained in the report, it is not possible to conclude whether the firms' responses to the gasoline supply disruption caused by Hurricane Katrina were closer to the magnitude expected in an industry characterized by no market power or closer to that expected in an industry characterized by market power.

The elephant in the room in this report is whether the investments in capacity and infrastructure made by firms in the petroleum industry would have been any different absent the consolidation that has taken place over the past decade. Similarly, absent the consolidation in this industry, would the magnitude of the responses to the negative supply shock from Hurricane Katrina been any different? If so, would those different investments and strategies have resulted in a slower rise in gasoline prices over the past several years and/or smaller price increases post-Hurricane Katrina?

Of course, it is also possible that the consolidation that has taken place over the past decade has generated cost savings, improvements in best practices, or other efficiencies. If so, these improvements may have in fact allowed firms in the petroleum industry to make investments and implement strategies that have resulted in a slower rise in gasoline prices over the past several years, including potentially smaller price increases post-Hurricane Katrina, none of which would have been possible absent consolidation.

Understanding what price levels, investments, and strategic decisions would have been observed had consolidation in the petroleum industry not taken place over the last decade is a difficult analysis and one that was not explicitly included in the mandates that Congress imposed on the FTC. One of the primary reasons the analysis is difficult is that in order to evaluate what investments and strategic decisions would have taken place if, counterfactually, there had been no consolidation, one would have to define a "but for" state of the world that incorporates decisions and actions that were never observed and never took place. Moreover, the exact structure of what that unobserved state would have looked like would be the subject of much debate. For example, is that unobserved state of the world one in which a particular merger was blocked? Is it one in which additional divestitures were required? Or is it one in which no additional divestitures were required, but that the required divestitures were different than those that actually took place?

On the question of whether consolidation has had any effect on the potential for price manipulation, the report only states that the FTC staff reviewed "all of the company documents obtained in this investigation" including specific requests for "any formal internal report or study analyzing the effects of any past merger or joint venture" and found that there was "no evidence that past mergers contributed significantly to the potential for price manipulation."¹¹ To the extent these firms were aware of the possible scrutiny their actions would receive and thus did not document

¹¹ *Id.* at 58.

these types of thoughts on paper, it is unlikely the FTC staff would have found any evidence. In most industries, particularly one as operationally complex as the petroleum industry, the number of dimensions along which a firm could attempt to exercise market power seem only to be limited by the boundless ingenuity of a clever human mind.

Proposals on Possible Price Gouging Legislation

In addition to the qualitative and quantitative discussion of the investment and inventory decisions made by participants in the petroleum industry and how these firms responded to the negative supply shock caused by Hurricane Katrina, Congress directed the FTC to recommend possible anti-price-gouging legislation to Congress.¹² Part III of the report provides a policy discussion of the FTC's views on the merits of federal price-gouging legislation.

Any test to determine whether a firm is engaged in price-gouging behavior must be predicated on the firm having market power, however persistent or transitory that market power may be.

The report demurs from providing its own affirmative definition of price gouging due to the difficulty of doing so and the lack of consensus on how to do so.¹³ Rather, the report adopts the definition provided to it by Congress. The congressionally mandated definition characterizes price gouging according to a two-step approach.¹⁴ First, a firm's monthly average sales price for gasoline in a particular area must be higher than that in a previous month. Second, the higher price must not be explainable by higher costs or market trends. While the report notes that several refiners and retailers would be categorized as price gouging post-Hurricane Katrina according to the first step of the test, the investigation finds very few of these firms would be categorized as price gouging once the second step of the test is implemented.

The FTC's concerns about defining an empirical test for price gouging is reminiscent of the debate during the 1970s and 1980s over whether and how to structure a legal test to identify predatory pricing. The large amount of academic literature generated on the topic of predatory pricing indicates that, like the debate over price-gouging legislation today, there was no consensus among economists and lawyers as to what behavior constituted predatory pricing. Ultimately, several tests for predatory pricing emerged, each with its own strengths and weaknesses.¹⁵

Another obvious parallel between an empirical test for predatory pricing and an empirical test for price gouging is the cost-based nature of the empirical test. As with the issues that arose with several predatory pricing tests, any empirical test for price gouging that is cost-based is likely to be subject to great debate about which costs are relevant to the analysis and how to accurately measure those costs.

A key component of any test for price gouging is the ability of the firm alleged to be price gouging to have power over price, albeit temporarily. Without the ability to exercise market power, however temporary, any attempt by the firm to price gouge would result in customers quickly and easily substituting to other sources of supply, thus defeating any attempt to profit from the pricing strategy. Any test to determine whether a firm is engaged in price-gouging behavior must be predicated on the firm having market power, however persistent or transitory that market power may be.

¹² *Id.* at 183.

¹³ *Id.* at 137 n.2, 190–91, 196.

¹⁴ *Id.* at 137–38.

¹⁵ Several well-known versions of these tests include the Areeda-Turner test, the Joskow-Klevorick test, and the Ordover-Willig test. See Phillip Areeda & Donald F. Turner, *Predatory Pricing and Related Practices Under Section 2 of the Sherman Act*, 88 HARV. L. REV. 697 (1975); Paul L. Joskow & Alvin K. Klevorick, *A Framework for Analyzing Predatory Pricing Policy*, 89 YALE L.J. 213 (1979); Janusz A. Ordover & Robert D. Willig, *An Economic Definition of Predation: Pricing and Product Innovation*, 91 YALE L.J. 8 (1981).

A Resource

The latest FTC report on gasoline prices, while leaving some questions unanswered, is nevertheless likely to serve as a useful resource for many years to come to students of the petroleum industry. Collectively, the tables and charts gather together a comprehensive collection of numerous sources of data and anecdotes available on the petroleum industry. The report also provides a well thought-out discussion of the economic issues that arise in an attempt to pin down the behavior that constitutes price gouging. The report will also provide a jumping off point for future studies assessing the investment and strategic decision that have been made in this industry. ●