The Florida Senate

Interim Project Report 2002-101 *October 2001*

Committee on Agriculture and Consumer Services Senator Steven A. Geller, Chairman

REVIEW OF THE RELATIONSHIP BETWEEN MOTOR FUEL REFINERS AND "MOM AND POP" MOTOR FUEL RETAIL ESTABLISHMENTS & REVIEW OF THE MOTOR FUEL MARKETING PRACTICES ACT

SUMMARY

Crude oil production, refining and transportation activities have historically been conducted by a few large companies, while the distribution of refined motor fuel products at the wholesale and retail levels has involved a mix of smaller independent businesses and distribution outlets. A variety of economic, technological and regulatory developments have resulted in a trend toward fewer, but larger (volume) stations, not only in Florida, but throughout the United States.

The clear tendency toward fewer independent gasoline retailers has raised concerns about the potential concentration of market power in the hands of the vertically integrated firms. The fundamental concern is that a concentration of economic power will eventually permit these firms to raise prices with impunity. Florida has a Motor Fuel Marketing Practices Act, which prohibits the sale of gasoline at a price below cost except in very limited circumstances and for very brief periods.

For the last two sessions of the Legislature, bills have been filed to amend the Act. Proponents of repealing the law have argued that the existing law prevents large retailers such as Walmart, Kmart, Winn Dixie and Publix from offering below-cost gasoline to customers as an inducement to shop at their stores. Opponents have argued that sustained, below-cost discounting could be used to discipline or ruin smaller retail gasoline outlets and thereby permit a predatory retailer to raise prices above market levels at a later date without fear of effective competition from smaller firms.

The principal economic testimony in support of repeal of the sale-below-cost rule was prepared by Dr. Hank Fishkind. The principal economic testimony in opposition to repeal was prepared by Dr. David Kamerschen. Both economists cite the published works of other analysts in addition to offering their own quantitative and theoretical arguments.

The arguments on both sides of the issue have more theoretical validity than empirical support. Dr. Fishkind's argument that the repeal of the law will produce at least short term benefits for the consumer is demonstrable theoretically, with less empirical evidence (essentially, one juried article not produced for purposes of advocacy). Dr. Kamerschen's argument that short-term price reductions will be paid for through long-term price increases is also supported by theory, but lacking in empirical support. In the final analysis, both arguments rest on theoretical models of competition that are better behaved in the classroom than in the market place.

There are four possible options with respect to this issue:

- Retain the Law
- Modify the Law
- Repeal the Law
- Replace the Law

Upon review it cannot be reported with certainty what the ultimate effect of the act has been or what result would occur in the marketplace over time without the law. It is recommended that the legislature monitor this issue, receive relevant information through the committee process and determine if a change is warranted as to the public policy of the issue.

BACKGROUND

Crude oil production, refining and transportation activities have historically been conducted by a few large companies, while the distribution of refined motor fuel products at the wholesale and retail levels has involved a mix of smaller independent businesses and distribution outlets directly owned by the vertically integrated producing and refining companies (i.e., those that extract and refine petroleum as well as distribute and sell it to final consumers). Since the 1970s, the number of gasoline stations—both independent and company owned—declined sharply in almost all markets across the country. In 1972 there were 226,459 retail gasoline stations in operation in the United States. By 2000 that figure had fallen to 175,956. A variety of economic, technological and regulatory developments have resulted in a trend toward fewer, but larger (volume) stations, not only in Florida but throughout the United States.

The vertically integrated oil companies have been accused of exacerbating this trend through the use of a variety of predatory practices that favored company owned or affiliated outlets over independent retailers. In 1978 Congress enacted the Petroleum Marketing Practices Act (PMPA) to address this issue.

The clear tendency toward fewer independent gasoline retailers has raised concerns about the potential concentration of market power in the hands of the vertically integrated firms. The fundamental concern is that a concentration of economic power will eventually permit these firms to raise prices with impunity.

Six states have addressed this concern through divorcement statutes which effectively prohibit the producer-refiner firms from more than token participation in the retail distribution business. Florida formerly had a divorcement law but replaced it in 1985 with the Motor Fuel Marketing Practices Act, an act that prohibits the sale of gasoline at a price below cost, except in very limited circumstances and for very brief periods. Ten other states have enacted variations of sale-below-cost laws.

For the last two sessions of the Legislature, bills have been filed to amend the Motor Fuel Marketing Practices Act. The authority to bring a civil action for violations of the act was transferred by law to the Department of Agriculture and Consumer Services during the 2000 Session. The Department of Agriculture and Consumer Services is now required to maintain a record of complaints filed under the act. Over the past two years, complaints filed under the act have increased somewhat. For the year 1999, a total of 226 complaints were filed; 167 were resolved, 7 are pending and 52 were referred for enforcement action. The number of complaints filed in 2000 is reported to have been 254, 178 of which were resolved, 43 are pending and 33 were referred for enforcement action. A bill was filed during the 2001 Session to repeal the predatory practices section of the act, which would have allowed retailers to sell motor fuel below cost, however, the bill did not pass. Proponents of the legislation argued that the existing law prevents large retailers such as Walmart, Kmart, Winn Dixie and Publix from offering below-cost gasoline to customers as an inducement to shop at their stores. Gasoline is, in fact, the only consumer product explicitly prohibited by Florida law for use as a “loss leader.” Dairy items, orange juice, paper products, beer and wine, and many other products are routinely used as loss-leaders to stimulate store traffic as can be readily observed in any daily newspaper.

Opponents argued that sustained, below-cost discounting could be used to discipline or ruin smaller retail gasoline outlets and thereby permit a predatory retailer to raise prices above market levels at a later date without fear of effective competition from smaller firms. Proponents countered that the existing law prevents aggressive competition among firms and results in consumers paying higher prices than would be the case were the market allowed to operate freely. Opponents responded that lower prices would only last until the small independent firms were driven from the market. Both sides presented studies and testimony by economists to support their positions.

METHODOLOGY

Interviews were held in person and by telephone with agency staff and with interested parties in the private sector. Documentation presented by proponents and opponents of the law, as well as research prepared for publication in academic journals and other documentary evidence, was also reviewed.

FINDINGS

The principal economic testimony in support of repeal of the sale-below-cost rule was prepared by Dr. Hank Fishkind. The principal economic testimony in opposition to repeal was prepared by Dr. David Kamerschen. Both economists cited the published works of other analysts in addition to offering their own quantitative and theoretical arguments. The strongest (i.e., most valid) aspects of their written testimony are summarized below. In the interest of clear exposition and preservation of space, the disputed and questionable arguments and evidence have been omitted.

Dr. Fishkind's strongest evidence in favor of his claim that Florida's sale-below-cost prohibition has resulted in higher gasoline prices for Floridians comes from an independent analysis that appeared in a juried academic journal suggesting that sale-below-cost prohibitions contribute to retail sales margins and, by implication, to higher prices. Specifically, the 1999 study by Anderson and Johnson found that retail margins were on average 1.61 cents higher in the nine cities in their sample which were located in states with gasoline-specific sale-below-cost prohibitions in place for at least five years, when compared to the cities in their sample which were located in states without such prohibitions (Anderson, R and Johnson, J. 1999."Antitrust and Sales-Below-Cost Laws: The Case of Retail Gasoline." *Regulation* 14:189-204).

Less persuasively, Dr. Fishkind argues that the experience of Georgia, which repealed its sale-below-cost prohibition in 1987 and has lower retail margins than either Florida or Alabama (both of whom have enforced sale-below-cost prohibitions), suggests that prices will decline in Florida if the sale-below-cost prohibition is repealed. Differences in the competitive and regulatory environments of Florida and Georgia confound strict comparability and call into question the predictive power of the Georgia experience.

Dr. Kamerschen's strongest argument is that, to the extent that the vertically integrated oil companies (or anyone else for that matter) manage to gain long-term monopoly power in local gasoline markets, they will use that power to increase their profits by raising prices for consumers. He argues that the sale-below-cost prohibition in Florida law undermines the ability of the vertically integrated oil companies to increase their market power by helping to preserve independent retailers. By implication, the repeal of the sale-below-cost prohibition would, in the long-run, lead to the accumulation of monopoly control in many local markets, other things being equal.

In support of his arguments, Dr. Kamerschen has offered a number of studies, the most persuasive of which is an as yet unpublished, though very well executed, article by Dartmouth College economics professor Justine S. Hastings analyzing the results of an interesting natural experiment in monopoly power in the gasoline industry in southern California. The study analyzes the impact of the 1997 transfer (through long term lease) of 260 independent stations in the Los Angeles-San Diego metropolitan area to ARCO, a vertically integrated oil company, thus bringing about a sudden reduction in competition from independent gasoline retailers. The impact was a statistically significant increase in the price of retail gasoline in the area served by these stations. (Hastings, J. 2001. "Vertical Relationships and Competition in Retail Gasoline Markets." The article is based on Dr. Hastings doctoral dissertation "Essays on Vertical Relationships, Competition and Regulation in the Gasoline Industry" Department of Economics, University of California, Berkeley, June 2001.)

Underlying Dr. Kamerschen's argument in favor of retaining the *current* sale-below-cost prohibition is the implicit claim that Florida's absolute prohibition of sales below cost is necessary to preserve the vitality of the independent retailers. The implicit assumption that a less restrictive prohibition will lead to monopoly control and higher consumer prices is not explored in his analysis.

Also implicit in Dr. Kamerschen's argument; is the unstated assumption that the vertically integrated firms would not contest each other's markets, but would, instead, divide the market among themselves; thus, in the long-run, undermining the competitive position of the independent gasoline retailers, leading to the accumulation of market power. While not inconceivable, in light of the historic behavior of the industry, achievement of this objective without violation of the state and federal prohibitions of collusive behavior would probably require a very long period, perhaps more than a decade. And although there is abundant literature with respect to the competitive interaction of vertically integrated and retail-only firms, there has been little opportunity to study the competitive behavior among vertically integrated firms in markets where excess profits exist.

Dr. Hastings study is offered in support of the validity of economic theory in the real world; specifically, that firms with a competitive advantage will maximize profits by raising prices. By studying a unique natural experiment—a very large number of independent stations representing a large share of regional sales were converted to company outlets at virtually the same moment—Dr. Hastings was able to demonstrate the impact on prices of a sudden reduction in retail competition, specifically, an unmistakable increase in gasoline prices. However, some care should be taken in directly applying these results to proposed repeal of Florida's sale-below-cost prohibition. Repeal or amendment of the sale-below-cost prohibition will not produce the sort of sudden and dramatic change in competitive conditions studied by Hastings. Moreover, the Hastings study is a snapshot of the change in prices after only a three month adjustment period. This sort of static analysis, while valuable for illustrating the short term implications of the change, does not reflect the adjustments that will occur in the market as other retailers respond to the opportunities afforded by the increase in price.

Florida's sale-below-cost prohibition attempts to preserve long-term competition in the retail gasoline business through the somewhat counter intuitive strategy of limiting the range of competition; that is, by protecting the retailers not associated with the vertically integrated oil companies from unrestricted competition with those firms. Put differently, it concedes the short-term benefits of competition in the hope of preventing a much worse situation in the indeterminate future.

The arguments on both sides of this issue have more theoretical validity than empirical support. Dr. Fishkind's argument that the repeal of the law will produce at least short term benefits for the consumer is demonstrable in a theoretical sense with less, empirical evidence (essentially, one juried article not produced for purposes of advocacy). Dr. Kamerschen's argument that short-term price reductions will be paid for through long-term price increases is also supported by theory, but lacking in empirical support. In the final analysis, both arguments rest on theoretical models of competition that are better behaved in the classroom than in the market place.

RECOMMENDATIONS

Upon review it cannot be reported with certainty what the ultimate effect of the Florida Motor Fuel Marketing Practices Act has been or what result would occur in the marketplace over time in the absence of the law. As a matter of policy, state statutes presently prohibit the retail sale of gasoline at below cost in most instances and thus prohibit the sale of the product as a "loss leader" item. Four possible options have been identified for consideration which are outlined below. It is recommended that the legislature monitor this issue, receive relevant information through the committee process and thereby determine if a change is warranted as to the public policy of the issue.

There are four possible options with respect to this issue:

- *Retain the Law*

While bills have been filed during the last two legislative sessions relating to this matter, only the bill that transfers the authority to bring civil action for violations to the Department of Agriculture and Consumer Services has become law. The present law allows for the selling of gasoline below retail cost in a few specific cases, such as clearance sales, business liquidation sales, sales under order of a court, grand-opening sales, and sales under certain exceptions, or rebates are allowed, but generally the law prohibits retail sales of gasoline below cost in the state. The effect of this prohibition is the provision of a statutorily imposed "floor price" in the market.

- *Modify the Law*

The law as written poses some challenges to the industry and the department in determining certain costs and the lines of demarcation for market areas. As a result, enforcement of the act by the department can be difficult in some instances. Also, in recent years new marketing activities such as "pay at the pump" features have substantially increased. These features offer consumers new flexibility in their choice of purchase methods and provide a new mechanism for discounts by retailers.

- *Repeal the Law*

Repealing the law would provide a more complete competitive market. The retail sale of below-cost gasoline would be allowed.

- *Replace the Law*

The current law could be replaced. Divorcement statutes are the second most common method of addressing this matter, following motor fuel marketing practices acts. Divorcement laws restrict or eliminate vertically integrated oil companies from operating at the retail level. In 1974, Florida passed such a divorcement law that was contested in the courts and subsequently, that law was replaced with the "Motor Fuel Marketing Practices Act."