IN THE COUNCIL OF THE DISTRICT OF COLUMBIA

BEFORE THE COMMITTEE ON GOVERNMENT OPERATIONS AND THE ENVIRONMENT

Mary M. Cheh, Chairperson

Public Hearing on B19-299 – the Retail Service Station Amendment Act of 2011

Remarks Prepared By:

David A. Balto
Law Offices of David A. Balto
David.balto@dcantitrustlaw.com

June 17, 2011

TESTIMONY OF DAVID A. BALTO
BEFORE THE DC CITY COUNCIL
IN SUPPORT OF PROPOSED LEGISLATION B19-299
JUNE 17, 2011

INTRODUCTION

Madam Chair and other distinguished members of the council, I want to thank you for giving me the opportunity today to speak about B19-299. The proposed legislation to amend the Retail Service Station Act of 1976 to prohibit gasoline distributors from owning and operating retail service stations in the District of Columbia. As I will detail in my testimony, the retail gasoline market in the District of Columbia is not competitively healthy. Two gasoline distributors (jobbers) control approximately 70% of the retail market. Since the council passed legislation to permit jobbers to own service stations four years ago, there have been numerous service station acquisitions which have led to a significant increase in gasoline prices. This tremendous vertical integration between jobbers and retailers raises serious competitive concerns and has led to significantly higher prices for hundreds of thousands of DC consumers.

My testimony today is based on over 25 years of experience as an antitrust practitioner, the majority of which I spent as a trial attorney in the Department of Justice and in several senior management positions including Policy Director of the Federal Trade Commission. As a trial attorney in the Justice Department, I helped to bring several criminal enforcement actions against gasoline jobbers for price fixing. As the Policy Director of the Federal Trade Commission, I investigated numerous gasoline mergers including Exxon/Mobil and BP/Arco—both of which led to major divestitures. Finally, on multiple occasions I have contributed to studies on retail gasoline competition.

I am here before the committee today with a simple message: the repeal of the DC divorcement law harms consumers. By diminishing competition, the law results in higher prices at the pump. The DC gasoline market is a tight duopoly controlled by two gasoline jobbers with a combined market share of approximately 70% -- a market share higher than jobbers in any other US metropolitan market. The price gap between DC and its suburban neighbors has increased by more than 7 cents since 2009, according to the Washington Post. The elimination of divorcement law has caused consumers in DC to pay far more for gasoline.

But the council can correct this mistake by enacting B19-299. Enactment of this proposed divorcement legislation, along with sound antitrust enforcement actions by the DC Attorney General, would appropriately address this broken market.

I will begin my testimony with a discussion of the issues with vertical integration in the gasoline industry and will then, make three major points.

1. Elimination of the divorcement legislation has harmed consumers through higher retail gasoline prices, greater concentration and a less than competitive gasoline market.

2. Enactment of B19-299 will restore competitive balance to this market and should in turn, lead to lower gasoline prices.

3. The 2007 FTC letter to the DC Council and other FTC studies which claim the ban on divorcement to be procompetitive are inapt.

CONCERNS OVER VERTICAL INTEGRATION

Since the proposed legislation importantly prohibits the vertical integration of jobbers and retailers, let me first raise a few concerns about vertical integration in this market. In many markets, vertical integration among complimentary levels can be beneficial. By coordinating the production and distribution of products, vertical integration can promote efficiency and eliminate the need for firms on different levels of the market to secure profits. With one firm controlling both production and distribution, there is only a single margin to be secured.

But vertical integration is not innocuous. As the early history of Standard Oil has demonstrated, vertical integration can also be a very effective tool for stifling competition. There are three tendencies of vertical integration that may explain how the elimination of divorcement legislation has harmed competition in the DC gasoline market.

For one, vertical integration can raise entry barriers or foreclose nonintegrated firms from a market. In the case of the DC gasoline, for example, having two dominant jobbers that control approximately 70% of the retail market makes it is much more difficult for new jobbers to enter. In preparation for this testimony, I spoke with jobbers from outside the Washington area. They explained that because of the vertical integration between the two dominant jobbers and their service stations, it was particularly difficult to enter into the Washington wholesale gasoline market. Because of the lack of nonintegrated independent gasoline retailers, it is exceedingly difficult for a nonintegrated jobber to effectively enter into this market.

Second, vertical integration may enable integrated firms to raise its competitors' costs in an anticompetitive manner and reduce the incentive for nonintegrated firms to compete. For example, a dominant jobber may diminish the ability of independent firms to compete by limiting its supply or by raising prices strategically. Positioned at two levels of the market, a vertically integrated jobber/retailer relates to service stations as both a horizontal competitor, and as a supplier. In its position as supplier, the jobber/retailer has access to competitively sensitive information about its retail competitors. Access to such sensitive information enables a firm to diminish the ability of its rivals to compete. Also thanks to their dual market position, jobber/retailers can manipulate the price it charges to retail competitors, thus further hindering their rivals' ability to compete. Put simply, permitting jobbers to own retailers is essentially to put the fox in charge of guarding the henhouse.

Finally, since a vertically integrated jobber has both the incentive and ability to raise retail prices, integration can facilitate collusion. In the Justice Department cases against jobbers for retail price fixing, jobbers owning retail stations were frequently members to the conspiracy.

In owning retail stations, jobber/retailers have more price information, and are more able to coordinate price increases. Their position as supplier furthermore enables them to discipline rivals should they choose not to follow through with price increases.

IMPACT OF THE REPEAL OF THE DIVORCEMENT LEGISLATION

When the divorcement legislation was repealed in 2007, the Council received testimony that its elimination had the potential to increase competition and reduce gasoline prices. The facts, however, do not reveal this to be the truth. Since 2007, gasoline prices have increased significantly and based on my review, their increases have largely not been the result of any other factor, including increases in wholesale costs or increases in taxes. Gasoline prices have increased at a more rapid rate in the District of Columbia than in any adjoining jurisdictions and there are simply no exogenous facts to explain this disproportionate increase.

So, why didn't the 2007 acquisition work the way it was intended? First, despite the testimony that there are few barriers to entry in the jobber market, the very limited entry to the market over the past several years seems to suggest otherwise. Second, the fragile nature of gasoline competition, due to the significant entry barriers at the retail level, was insufficiently recognized. These factors combined made this a fertile environment for retail acquisitions to lead to increased prices.

In the past four years, there have been significant increases in concentration at both the jobber and the retail level. Two jobbers control approximately 70% of the market, a level of concentration much higher than any other metropolitan gasoline market in the United States. The two major jobbers have acquired approximately 30 stations in the past four years.

Sometimes, these types of acquisitions create efficiencies, especially where an acquisition allows a firm to improve service or lower costs resulting in lower prices for consumers. In this case, however, the acquisitions have not benefited consumers. The retailers I have spoken with continually complained that these dominant jobbers do not support the same level of quality as previous owners and that competition based on the level of service has diminished enormously.

ENACTMENT OF THE PROPOSED LEGISLATION SHOULD RESTORE COMPETITIVE BALANCE AND LEAD TO INCREASED COMPETITION

The current market structure, where two jobbers have such a substantial share of both the wholesale and retail market, leads to significant anticompetitive problems. Enactment of the proposed legislation will eliminate the vertical control that these two dominant jobbers possess. By breaking the ownership bind, independent retailers would have greater freedom to price competitively. For, with a broader selection of jobbers to choose from, independent retailers should be better able to seek the lowest wholesale costs, thus spurring competition at both retail and wholesale levels.

Elimination of the ownership bind over retail should also spur greater entry at the wholesale level. With more nonintegrated service stations, there will be an increased ability for jobbers to enter the DC market.

FTC STUDIES ON DIVORCEMENT ARE INAPT

In 2007, the FTC wrote to the Council suggesting that the elimination of the divorcement law would be procompetitive. They suggested that past FTC studies have demonstrated divorcement legislation to lead to higher prices and other anticompetitive effects.

There are several reasons to discount this FTC study. First, though economic theory is surely of important value, here the evidence clearly demonstrates that the elimination of divorcement legislation has ***led to higher and not lower prices***. Regardless of the theoretical rationale of these FTC studies, the fact is that in reality, the elimination of divorcement legislation has harmed consumers.

Second, the 2007 FTC letter never considered the market structure at issue. FTC studies typically assume that both the wholesale and retail markets are competitive. Yet in this case, with two firms having a 70 percent wholesale market share, the wholesale market is obviously not structurally competitive.

Third, FTC studies, including those referenced in the letter, are frequently based on dated evidence. Most of the studies referenced by the FTC are from the 1990s with one even dating all the way back to 1984.

Finally, one reason the FTC gives for opposing divorcement legislation is that the vertical integration in this case enables refiners to effectively control the level of service provided at gasoline stations so as to protect the value and reputation of their brand. While this may indeed be a legitimate concern in other contexts, this simply is not a concern relevant for jobber ownership. Jobbers are not a brand. They are the middlemen between refiners and retailers. No one goes to a particular service station because it is owned by a particular jobber.

On a final note, I would like to briefly touch upon the impact of these gas price increases on DC tax revenue. While typically, higher prices translate to higher taxes, the close proximity of DC's adjoining jurisdictions negates this norm. In this case, high gas prices caused by the ban on divorcement may actually lead to lower tax revenue as more consumers are incentivized to fill up out of the district. Divorcement legislation, therefore, should maximize DC revenue as well as keep more DC based services in business.

I hope this testimony has been valuable in illuminating the need for proposed legislation and I look forward to your questions.