PUTTING THE CONSUMER FIRST:
PRESERVING FREE-MARKET COMPETITION IN GASOLINE RETAILING

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Thank you for the opportunity to share our views on proposed regulatory legislation of the American gasoline retailing market.

In the USA, motorists who want to buy name brand gasoline can choose from thousands of retail service stations. These stations are owned by the major oil companies and fall into two categories. They're either leased to dealers or operated by the oil companies' own employees.

The proposed legislation would restrict the operations of the company-run stations, or eliminate them altogether. We believe that either option would have a negative financial impact on motorists.

The dealers who support this legislation insist that it's necessary to protect them from what they call unfair competition by the oil companies. They claim that company-operated stations sell gasoline at predatory prices—prices calculated to drive them out of business.

According to the dealers, once they're gone, the major oil companies will have a monopoly on gasoline retailing. At that point, the companies will raise prices and gouge the consumer.

Like many conspiracy theories about the oil industry, the dealers' charges are based on a fundamental misconception about what constitutes free market competition. What the dealers call unfair behavior by the oil companies is actually aggressive marketing. It's a logical response to radical changes in consumer demand for gasoline.

The results of government regulation are likely to follow a different law—the Law of Unintended Consequences. That is, they'll produce the opposite of their intended results. With competition from company-operated service stations limited or eliminated, it's the dealers themselves who will raise gasoline prices.

In the end, consumer interests will be sacrificed to protect a single segment of the retail gasoline market from having to compete. Motorists will pay higher prices at the pump. In effect, they'll be rewarding the dealers for their inefficiency and unwillingness to change.

(Brief pause)

To understand why this legislation is not in the public interest, let's look at the dramatic changes in the gasoline retailing industry in recent decades.

Imagine we're back in the 1950s or 60s. You're behind the wheel of your family car. Your gas gauge is almost on empty, so you drive into your neighborhood service station. It's a family-owned, four-pump operation. It's open from dawn to dusk and closed on Sundays and holidays.

As you drive up, the dealer greets you by name. You're a regular customer. While filling your tank, he cleans your windshield and checks your oil and water. When he's done, he hands you a premium—maybe a drinking glass or some trading stamps—to show his appreciation of your business.

If your car needs any repair work, you just pull into a service bay and the station's mechanic handles it. It's one-stop shopping for all your automotive needs.

(Brief pause)

Now let's fast forward and look at today's typical service station. Imagine you're back behind the wheel. But this time, the station you drive into is much larger. In fact, it has a dozen pumps, maybe even two or three dozen. Most of them are self-service. This station handles many times the gasoline volume of the old familiar neighborhood dealer, and it's open 24/7.

If you want someone to pump your gas, you'll have to pay several cents extra per gallon. But if you're like most motorists, you'll choose to save money by pumping it yourself and checking your own oil and water. When you're done, you'll pay an attendant in a booth. Before driving away, you might buy some fast food or a magazine in the station's convenience store.

Need any repairs? You won't get them at this station. It has no service bays. For repair work, you'll take your car to a specialist, like Midas Muffler or Jiffy Lube.

(Brief pause)

So what led to these striking changes in gasoline retailing?

It all started with the 1973 OPEC oil embargo and the resulting Energy Crisis. If you're old enough, you'll remember what it was like.

Gasoline prices skyrocketed. The amount of gas you could buy on a single trip was limited. Stations cut back their hours. Waiting lines stretched down the block. Sales of locking gas caps, designed to prevent siphoning, rose sharply.

To cope with all this, you filled up your tank whenever and wherever gas was available. You discovered that your car ran pretty well on brands other than your usual one. From then on, you made your buying decisions mainly on price and availability. For you, gasoline became a commodity.

The major oil companies realized they were going to have to compete on the basis of price or fall by the wayside. Full service, once built into the price of gas, became an option, offered for a higher per-gallon price. Discounts were offered for payment by cash instead of credit card. Motorists voted with their wallets by taking advantage of these features. "No-frills" gasoline marketing was born.

(Brief pause)

In the decades since the Energy Crisis, fuel economy, air quality, and safety standards have become more stringent. And today's vehicles are more sophisticated and technically complex than ever.

The result: Today's motorist relies mostly on specialized retail outlets for goods and services like tires, tune-ups, oil changes, transmission work, batteries and mufflers. The neighborhood auto mechanic has become an endangered species, like the family doctor who once made house calls. The number of service stations offering repair service has dropped sharply.

With motorists no longer turning to service stations for auto repair, station operators have had to find other ways to make gasoline retailing profitable. But with consumer brand loyalty eroding and price competition becoming more intense, profit margins have shrunk.

To make up for this, many stations have adopted lower-cost operating modes. These include higher gasoline volume, self-service to reduce labor costs, and discounts for cash purchases, to lower credit card transaction fees. On the revenue side, they've opened convenience stores that sell items like foods, beverages, newspapers and magazines.

It's no surprise that dealers who persist in running traditional high-profit-margin, low-volume stations, and rely on auto service to cover some of their overhead, have found themselves at a competitive disadvantage. In fact, thousands of those stations have closed. They've been replaced by larger and more efficient operations.

Some dealers have followed the lead of the major oil companies and adapted to the changing marketplace. Others have sought legislative protection.

Crying foul, they accuse the oil companies of predatory pricing, designed to drive them out of business and secure a monopoly position. They advocate legislation prohibiting the sale of gasoline at prices below a producer's wholesale cost.

The dealers' accusations are based on an erroneous and misleading assumption—that low pricing, designed to meet the competition, is the same as unfair or predatory pricing.

But what exactly constitutes predatory pricing?

The Supreme Court has defined it as pricing that's intended not only to eliminate competitors in the short run, but also to reduce competition in the long run.

"Long run" is the key phrase here. Low prices, even if they're below a seller's wholesale cost, aren't considered predatory unless they lead to a long-term monopoly.

To be predatory, the price-cutter must find a way to maintain its monopoly. That way, it can raise prices and increase its profits to make up for the losses it suffered while its retail prices were below its wholesale costs.

But what typically happens in this situation is that the high profits attract new competitors into the market. At that point, the increased competition drives prices back down.

There's a consensus among economists and scholars, backed up by Federal and state court rulings, that predatory pricing rarely occurs in free markets. That's because of the ease of entry of new competitors.

We must be very careful to distinguish between competitive price cutting and predatory pricing, because cutting prices in order to increase a company's market share is what competition is all about.

(Brief pause)

In recent decades, gasoline pricing has been investigated extensively by Federal government agencies
—including the Federal Trade Commission, the US Department of Energy, and the Department of Justice.

These studies have relied not only on extensive retail pricing data, but also on internal oil company documents. They found no evidence of predatory pricing. The studies concluded that the decline in the overall number of retail service stations was the result of a continuing trend toward a more efficient, higher-volume, lower-margin business model.

Several states have conducted their own studies. They include Arizona, Washington and Pennsylvania. These studies reached the same conclusion as the Federal agencies—namely, that shrinking profit margins are evidence of increased competition in the industry. They're not a scheme by the oil companies to drive out dealers. What's causing a significant number of dealers to go out of business is their failure to adapt to a more competitive gasoline retailing marketplace.

Shrinking retail gasoline profit margins are not evidence of some sinister conspiracy by "Big Oil." They're facts of life in a highly competitive market.

(Brief pause)

Not satisfied with price regulation, some have proposed a more radical measure—divorcement. This type of legislation would make it illegal for the major oil companies to operate their own service stations. The companies would be forced to either close them or lease them to dealers.

Let's look at what happened in Maryland after the passage of the nation's first divorcement legislation, in 1974. Instead of promoting competition, the law actually led to fewer stations, shorter business hours and higher prices. The remaining dealers had no incentive to change their antiquated marketing methods, and the motorist was the one who suffered.

A study by the FTC found that Maryland's divorcement law raised self-service gasoline prices by 1.4 to 1.7 cents per gallon. It raised full-service prices by 5 to 7 cents per gallon.

In 1991, Hawaii passed a divorcement law. Hawaii's Law wasn't quite as drastic as Maryland's. It didn't make company-run service stations illegal. But it established a temporary moratorium on the building of any new company-operated stations.

In 1997, Hawaii replaced divorcement with an anti-encroachment law. Anti-encroachment is somewhat milder than divorcement, but still very restrictive. It typically bars oil companies from opening company-operated stations within a specified distance from every dealer-operated station.

In effect, anti-encroachment creates a protected zone where dealers don't have to compete. That's what they're really after—not protection from unfair competition, but from the competitive process itself.

Several studies, including one by the National Bureau of Economic Research, have found that both divorcement and anti-encroachment laws tend to increase retail gasoline prices. An FTC study found that these laws increase retail prices by an average of 2.6 cents per gallon.

Once again, it's the Law of Unintended Consequences in action. Instead of more competition, the states got less. In place of lower gas prices, consumers got higher ones. Is this what the government really wants?

(Brief pause)

According to public opinion polls and surveys, low price is the number-one reason why motorists buy a particular brand of gasoline. Any retailer who wants to stay in business had better deliver what the customer wants.

The major oil companies encourage all retail gasoline dealers to run high-volume, low-margin operations. We strongly advocate cutting costs through efficiency, and generating income from other businesses, such as on-site convenience stores.

Of course, dealers are free to operate their service stations in any way they choose. Yet some of them would like to legislatively deny consumers that same freedom of choice in making their gasoline purchases.

Motorists deserve the chance to decide which type of gasoline retailing they prefer. Their choice should not be pre-empted by regulatory legislation.

(Brief pause)

In any sort of competition, there are always winners and losers. The free market is no different. There will always be some businesses that don't "make the cut."

Relentless and unpredictable change is the only constant in today's global economy, not just in gasoline retailing. Those who adapt stand a good chance of survival and even prosperity. Those who refuse face an uncertain future.

In short, competition is tough. But an economy without it would be even tougher.

Thank you for this opportunity to offer our perspective. I'd be pleased to take your questions now.