

Competition in the Petroleum Industry: The Situation in 2001¹

A Summary

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Competition in the petroleum industry is normally assessed using the traditional tools of antitrust analysis. The expectation is that markets will remain competitive, prices will stay relatively stable, and the exercise of market power will be blocked if proposed mergers are approved only when it can be shown that the merged firms will not gain excessive control. Divestitures are sometimes required to meet these conditions.

Thus, in evaluating the mergers of BP with Amoco, Exxon with Mobil, BP Amoco (now BP) with Arco, and Chevron and Texaco, as well as the formation of joint refining and marketing ventures created by Shell and Texaco (Motiva and Equilon) and Marathon Ashland, the Federal Trade Commission (FTC) has examined indices of competition in a number of activities. Ownership of critical facilities such as pipelines and terminals has been studied closely, and the competitive conditions in refining have been examined. In addition, the Commission has focused on the ownership of retail establishments by the merging parties, as well as their contracts with independent marketers. In some cases, the FTC has also examined the control merging firms may have over exploration and production of crude oil or natural gas.

In the five years since the merger wave in the oil industry began, the FTC's examinations have resulted in demands for altering specific transactions through divestitures. Asset sales have been required for the purported purpose of maintaining competition and preventing the merging parties from exercising market power to raise prices to consumers.

Some may assert that the Commission has failed because the merger wave has coincided with an increase in prices and price volatility. Certainly, Democratic senators Barbara Boxer, Diane Feinstein, Carl Levin, and Ron Wyden believe the mergers have contributed to price volatility.

¹ This paper was prepared at the request of the staff of the Federal Trade Commission for presentation to a public conference, "Factors that Affect Prices of Refined Petroleum Products," on August 2, 2001.

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Senator Wyden has gone so far as to accuse the oil industry of conspiring to limit production to raise prices.² Republicans have complained as well, including Speaker of the House Dennis Hastert and the chairman of the Judiciary Committee, Henry Hyde. Both represent the state of Illinois, which has experienced substantial price volatility.

With the benefit of hindsight, one could conclude that the Commission's effort has failed. The volatility of retail gasoline, heating oil, jet fuel, and natural gas prices has increased noticeably since the first merger was announced. Furthermore, the increased volatility has been most noticeable in those regions where mergers occurred.

It will be suggested here that these criticisms of the FTC and of the oil industry are incorrect. In particular, accusations of conspiracy within the petroleum industry have been rejected at both the federal and state levels. The FTC itself found no evidence of a conspiracy on the part of any individuals in the industry to raise prices in its recent investigation of marketing practices in the Midwest during the spring of 2000.³ The Commission also found no evidence of anticompetitive actions in its investigation of the California gasoline market.⁴ Furthermore, the California Supreme Court dismissed a separate class action lawsuit alleging a conspiracy on the part of the oil industry to raise prices in 1996.⁵ Lastly, investigations of the petroleum market's performance conducted by the FTC following the 1996 increase in prices revealed no violation of the law.⁶

However, findings of no antitrust violations do not absolve competition authorities of all responsibility for the upsurge in price volatility. To the contrary, actions taken by both the FTC and the Department of Justice (DOJ) have contributed to the increased price instability. Their acts — combined with those taken or not taken by the Department of Energy, the Department of State, the Environmental Protection Agency, competition authorities in the European Union, the International Energy Agency, and legislative bodies in the United States and Europe — are the primary cause of the rise in price volatility.

This examination suggests that the FTC's application of a "one size fits all" theory of competition has been a principal source of the increase in prices and price volatility. Specifically, it proposes that the Commission has focused too much attention on retail marketing and too little on the costs of entry into and continued operation of refining. Rather than mandating divestitures of refining assets, the FTC should require merging firms to operate and expand existing refining capacity as a condition for the merger. Rather than mandating the sale of terminal facilities, the FTC should require merging firms to expand existing terminal facilities, as well as open them to third parties.

² Senator Ron Wyden, "The Oil Industry, Gas Supply and Refinery Capacity: More than Meets the Eye," Investigative Report, June 14, 2001. [<http://wyden.senate.gov/oilinvest.doc>]

³ See "Midwest Gasoline Price Investigation," Final Report of the Federal Trade Commission, March 29, 2001. [<http://www.ftc.gov/os/2001/03/mwgasrpt.htm>]

⁴ See "Western States Gasoline Pricing Investigation," Statement of Commissioners Sheila F. Anthony, Orson Swindle, and Thomas B. Leary, File No. 981-0187, May 7, 2001. [<http://www.ftc.gov/os/2001/05/wsgpiswindle.htm>]

⁵ See *Theresa Aguilar et al. v. Atlantic Richfield Company et al.*, California Supreme Court Opinion S086738, June 14, 2001. [<http://www.courtinfo.ca.gov/opinions/documents/S086738.PDF>]

⁶ No report was issued following this investigation.

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Neither of these two proposals is among the remedies normally put forth by US or European competition authorities. However, implementing such steps would better serve the economic interests of consumers in the short and longer run. In the short run, instituting the steps would increase the supply of petroleum products and lower prices. In the longer run, it would increase the likelihood of the refining industry having the capacity to adapt to the demands imposed by consumers and environmental regulators.

This analysis also argues that the leading anticompetitive force in energy markets is the Organization of Petroleum Exporting Countries. Competition authorities on both sides of the Atlantic should address the conspiracy among OPEC members, along with the governments of Norway and Mexico, to raise prices artificially. If action is not taken to address this conspiracy, there seems to be no reason for government agencies to use their limited resources to investigate actions by refiners or others in the industry.

The fundamental focus here, however, is on the role of commodity markets. Such markets represent a backwater of economic research. Few papers are published on the subject and much of the research is more than thirty years old. Academic institutions such as Stanford have closed research institutes that once focused on the subject and terminated professors despite their having tenure. Yet the techniques developed for assessing commodity markets explain the recent fluctuations observed in petroleum markets. Indeed, the rise in crude oil prices from March 1999 to the fall of 2000, the increase in heating oil prices in January and February 2000, the boost in gasoline prices in the spring of 1996, 1999, 2000, and 2001, the increase in natural gas prices during the fall and spring of 2000/2001, and perhaps even the recent surge in electricity prices can all be explained by one relatively old and simple theory.

Given the strength of the commodity market model, an improved understanding of the relationships it is based on would clearly help the Commission assess the effects of proposed mergers and predict the consequences. Furthermore, an improved understanding of the behavior of commodity markets would enable the FTC to advise other agencies — particularly the Environmental Protection Agency, the Department of Treasury, the Department of Energy, and the Department of State — regarding proposed policies and regulations.

Author's Note

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