



# **“Price Gouging,” the Antitrust Laws, and Vertical Integration in the Petroleum Industry: How They Are Related**

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May 28, 2008

Congressional Research Service

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[www.crs.gov](http://www.crs.gov)

RS22262

## Summary

The antitrust laws and statutes to prohibit “price gouging” each aim to serve the same end—realization of lower or reasonable prices for consumers, but they do so from different perspectives. Antitrust law operates on the premise that vigorous and unfettered marketplace competition will yield the most advantageous result for consumers. Statutes concerning “price gouging,” by contrast, are direct consumer-protection measures, generally making no reference to competition. Statutes to limit the extent of vertical integration in the petroleum industry (common ownership of different stages of production, marketing, or retailing) have been proposed at the federal level, and exist at the state level, but contrary to the expectations of proponents, the price of gasoline in those states that prohibit refiners from operating retail gasoline stations is generally higher than in states without similar prohibitions. Although the potential for anticompetitive actions by vertically integrated entities has been noted by, among others, the Federal Trade Commission (FTC), it also states in a 2005 report, that “the vast majority of the FTC’s investigations [into the petroleum industry] have revealed market factors to be the primary drivers of both price increases and price spikes.” The Energy Policy Act of 2005 required an FTC investigation “to determine if the price of gasoline is being artificially manipulated by reducing refinery capacity or by any other form of market manipulation or price-gouging practices”; the 110<sup>th</sup> Congress enacted the Energy Independence and Security Act of 2007 with a provision authorizing the FTC to promulgate a rule concerning market manipulation. Also in the 110<sup>th</sup> Congress, the House has passed H.R. 1252, which would define “price gouging” as “excessively unconscionable” or “unreasonably” increased prices during Presidentially declared “energy emergencies,” incorporates the FTC Act, directs FTC enforcement, and provides for civil and criminal penalties (several, similar measures are pending in the Senate Commerce Committee); and H.R. 6074 to make “oil-producing and exporting cartels illegal” under U.S. antitrust laws. This report, which may be updated to further reflect congressional action, attempts to provide the antitrust context for the prohibited practices, notes prior congressional action concerning vertical divestiture in the petroleum industry, and provides information on the state “divorcement” statutes.

The primary purpose of the antitrust laws is to foster free and unfettered competition on the assumption that such competition will produce the best result for consumers—the lowest and most reasonable prices. To that end, section 1 of the Sherman Act (15 U.S.C. § 1) prohibits contracts or conspiracies in restraint of trade.<sup>1</sup> That is, section 1 forbids two or more persons or entities from, for example, agreeing to limit output or set prices. Section 2 of the Sherman Act (15 U.S.C. § 2) prohibits monopolization or attempted monopolization, either of which can be violated by individual persons or entities, although the provision also prohibits agreements to monopolize; section 2 is frequently used in conjunction with a charge pursuant to the so-called anti-merger provision of the Clayton Act (section 7 of the Clayton Act, 15 U.S.C. § 18). That having been said, it is important to emphasize that the prohibition against monopolization is not violated by the mere possession of monopoly power or some predetermined share of the market. U.S. antitrust law does not include a “no-fault” monopoly statute, and there is no “bright line” that, once crossed, exposes an otherwise lawful monopolist to antitrust sanctions.<sup>2</sup>

In addition, the courts have acknowledged the right of an individual businessman to do business, or not to do business, with whomever he likes, and on whatever conditions he deems acceptable:

*In the absence of any purpose to create or maintain a monopoly, the [Sherman] act does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal; and, of course, he may announce in advance the circumstances under which he will refuse to sell.*<sup>3</sup>

Finally, the role of vertical integration—common ownership of different stages of production, marketing, or retailing—is ambiguous; vertical integration, without more, does not, at least at the federal level, automatically lead to a conclusion of antitrust law violation, although, to be sure, there may be some anticompetitive effects. Just as there may be lawful monopoly power that, if misused by the monopolist to extend or maintain his monopoly, becomes unlawful as a violation of the antitrust law prohibition against monopolization in restraint of trade, there is no general prohibition in U.S. law on the ownership of all stages of production by a single firm,<sup>4</sup> but lawful vertical integration may give rise to anticompetitive practices that would be challengeable as violations of antitrust prohibitions.<sup>5</sup> In the petroleum industry, for example, any single entity may

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<sup>1</sup> Section 3 of the Sherman Act (15 U.S.C. § 3) is virtually identical to section 1 except that it specifically makes the prohibitions contained in section 1 applicable to the District of Columbia.

<sup>2</sup> In *U.S. v. Grinnell*, 384 U.S. 563 (1966), the Court noted that “[t]he offense of monopoly under s[ection] 2 of the Sherman Act has two elements: (1) the possession of monopoly power in the relevant market *and* (2) the willful acquisition or maintenance of that power as distinguished from growth or development as a consequence of a superior product, business acumen, or historic accident.” At 570-71 (emphasis added). *See also*, CRS Report RS20241, *Monopoly and Monopolization—Fundamental But Separate Concepts in U.S. Antitrust Law*; and CRS Report RL33708, *The Distinction Between Monopoly and Monopolization in Antitrust Law*, both by (name redacted).

<sup>3</sup> *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919) (emphasis added).

<sup>4</sup> “... combinations, such as mergers, joint ventures, and various *vertical agreements*, hold the promise of increasing a firm’s efficiency and enabling it to compete more effectively. Accordingly, such combinations are judged under a rule of reason, an inquiry into market power and market structure designed to assess the combination’s actual effect.” *Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752, 768 (1984) (emphasis added).

<sup>5</sup> The FTC report, *Gasoline Price Changes: The Dynamic of Supply, Demand, and Competition* (2005), lists, among other potential anticompetitive effects of vertical integration in the petroleum industry, the ability of an integrated entity to minimize the effectiveness of a competitor by, e.g., structuring its dealings so as to raise the competitor’s input costs, or by making it more difficult for a competitor to enter its markets. At 121-124. (The full report is available at <http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf>).

engage in any or all of the stages: exploration or production of crude oil, transportation of crude oil to refineries, operation of crude oil refiner[ies], transportation or storage of refined product, distribution and marketing at the local wholesale or retail level, or retail sales. Vertical integration does not, without more, therefore, violate the prohibition against monopolization. Nor does a price increase attributable to vertical integration constitute a violation of the antitrust laws, unless it is shown that the increase is the result of collusion between the vertically integrated firm and another firm or portion thereof.<sup>6</sup>

There were unsuccessful attempts in the mid-1970s, precipitated by the oil embargo of 1973, and the operation of OPEC, to mandate divestiture in the petroleum industry. S. 2387 (94<sup>th</sup> Congress), for example, asserted that in order to facilitate "the creation and maintenance of competition in the petroleum industry," S. 2387 would "require the most expeditious and equitable separation and divestment of assets and interests of vertically integrated major petroleum companies."<sup>7</sup> The legislation would have prohibited major producers from owning or controlling any interest in any refinery asset, major refiners or major marketers from being involved in production or transportation, and petroleum transporters from being involved in any other segment of the industry.<sup>8</sup> Refiners would have been able to continue to own retail marketing facilities, but to operate only those which they operated prior to January 1, 1976.<sup>9</sup> The accuracy of the bill's premise was viewed differently by its supporters and opponents. It was argued both that S. 2387 would increase competition at each level of the industry, increase refining capacity by reducing barriers to entry into that sector, and "place restraints on the pricing power of the OPEC cartel";<sup>10</sup> and that vertical integration was not the cause of "the spiraling cost of petroleum products to the American consumers,"<sup>11</sup> would lead to reduced efficiencies in the petroleum industry, would have no effect on the pricing policies of OPEC, and would lead to "higher-priced petroleum products."<sup>12</sup> The bill was reported favorably by the Senate Antitrust Subcommittee and the full Judiciary Committee, but not voted on by the Senate.

Divorcement statutes, however, do exist at the state level. There are several states that currently prohibit oil refiners from operating retail service stations; they mandate operation of such stations only by independent operators, that is, persons neither employed by nor under contract to the

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<sup>6</sup> "An increase in prices alone does not necessarily constitute 'price gouging.'" CRS Report RS22236, *Gasoline Price Increases: Federal and State Authority to Limit 'Price Gouging'*, by (name redacted). Further, the Supreme Court has ruled that the divisions of a single firm are not legally capable of the kind of conspiracy prohibited by the antitrust laws:

Nothing in the literal meaning of those terms ["unilateral," "concerted"] excludes coordinated conduct among officers or employees of the same company. But it is perfectly plain that an internal "agreement" to implement a single, unitary firm's policies does not raise the antitrust dangers that § 1 was designed to police. The officers of a single firm are not separate economic actors pursuing separate economic interests, so agreements among them do not suddenly bring together economic power that was previously pursuing divergent goals. Coordination within a firm is as likely to result from an effort to compete as from an effort to stifle competition. In the marketplace, such coordination may be necessary if a business enterprise is to compete effectively. *Copperweld*, *supra*, note 4, at 769.

<sup>7</sup> S. 2387 (94<sup>th</sup> Cong.), Sec. 2(b).

<sup>8</sup> "Major producers," "major refiners," and "major marketers" were defined in section 101.

<sup>9</sup> Section 103.

<sup>10</sup> *Petroleum Industry Competition Act of 1976*, S.Rept. 94-1005, Part 1 at 67-70.

<sup>11</sup> *Id.* at 179 (additional view of Senator Robert C. Byrd).

<sup>12</sup> S.Rept. 94-1005, Part 2 at 195-206; speech by Assistant Secretary of the Treasury for International Affairs Gerald Parsky to the National Economists Club, reported in 757 ANTITRUST & TRADE REGULATION REPORT A-23 (3-30-1976).

refiner.<sup>13</sup> According to the FTC report cited at note 5, the rationale for the state statutes was the concern

that an integrated refiner/retailer might set wholesale prices to independent jobbers and gasoline stations at a rate higher than its own internal transfer price, thus enabling the refiner/retailer to sell gasoline to consumers at prices lower than those charged by its competitors. Some argue[d] that this might persuade consumers to abandon independent gas stations and, in the long run, reduce overall retail competition, as independent gas stations [were driven] out of business.<sup>14</sup>

Statutes in “divorcement” states are more correctly characterized as consumer-protection measures than antitrust statutes, as they (1) may be placed in a state’s unfair trade practices provisions or similar location,<sup>15</sup> (2) do not recognize any justification for exceptions,<sup>16</sup> and (3) unlike the federal antitrust monopolization prohibition, are “no fault” provisions that require no competitive injury as a prerequisite to violation.

The FTC report (*supra*, note 5) sets out both the potential competitive advantages and the possible misuses of vertical integration, but also notes that at least nine studies have concluded that “retail [gasoline] prices tend to be lower if one company owns both refining and retailing operations than if they are owned separately.”<sup>17</sup> At the same time, the report acknowledges studies that have come to a different conclusion. One study found, on the basis of its examination of the long-term lease of several independent stations by a branded refiner-wholesaler (with an accompanying name change on the stations from the independent to the brand name), that retail gasoline prices in the area where the leasing/name change occurred did rise slightly.<sup>18</sup> Another found increased wholesale prices following the merger between a refiner and a refiner-marketer;<sup>19</sup>

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<sup>13</sup> States which, according to our research, mandate varying sorts of “divorcement” between petroleum refining and retail gasoline sales, include Connecticut (Conn. Gen. Stat. §§ 14-344a, 344b); Delaware (6 Del. C. § 2905); District of Columbia (D.C. Code § 36-302.02); Hawaii (H.R.S. § 486H-10.4); Maryland (Md. (Business Regulation) Code Ann. § 10-311); Nevada (N.R.S. § 597.440); Virginia (Va. Code Ann. § 59.1-21.16:2); and Puerto Rico (23 L.P.R.A. § 1102). In addition, “[s]ince 1974, divorcement bills have come before forty-one state legislatures” (Michael C. Vita, Deputy Assistant Director, Bureau of Economics, FTC, *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies* (July 21, 1999), at 1).

<sup>14</sup> At 121.

<sup>15</sup> See CRS Report RS22236, *supra*, note 6.

<sup>16</sup> The statutes do, however, generally recognize existing refiner-run stations and “grandfather” them if they existed prior to a specific date. The simplest of the state “divorcement” statutes appears to be Delaware’s, which states: “No manufacturer of petroleum products shall open a major brand, secondary brand or unbranded retail gasoline outlet or service station in the State, that would be operated by company personnel, a subsidiary company, or a commissioned agent.” That statute also recognizes the possibility that it may be necessary or desirable for manufacturers to operate retail service stations “in times of emergency or similar special circumstances.” 6 Del. C. §§ 2905(a),(b). Virginia and Puerto Rico also make provision for temporary refiner operation of retail service stations previously operated by independent dealers, although with no specific reference to “emergency” situations. Va. Code Ann. § 59.1-21.16:2D; 23 L.P.R.A. § 1102(c).

<sup>17</sup> At 120, citing John Gewecke, *Empirical Evidence on the Competitive Effects of Mergers in the Gasoline Industry* (2003). The concurring statement of Commissioner Leibowitz notes that “[t]he Report ... clearly describes to consumers and policymakers the factors that affect gas prices and contribute to price increases ... and it places these price changes into context.” (Complete statement available at the FTC website, <http://www.ftc.gov>). The full Gewecke survey is available at <http://www.ftc.gov/bc/gasconf/comments2/gewecke1.pdf>.

<sup>18</sup> Justine Hastings, *Vertical Relationships and Competition in Gasoline Markets: Empirical Guidance from Contact Changes in Southern California*, 94 AM. ECON. REV. 317 (2004).

<sup>19</sup> Richard Gilbert and Justine Hastings, MARKET POWER, VERTICAL INTEGRATION, AND THE WHOLESALE PRICE OF GASOLINE, Univ. of Cal. Energy Inst., Working Paper No. PWP-084, 2001, rev. 2002, available at (continued...)

that study did not, however, as did a subsequent one, look at the effect on retail gasoline prices to consumers of mergers.<sup>20</sup>

Just as existing state divorcement statutes are generally not found in the states' antimonopoly or antitrust provisions, state "price-gouging" provisions, too, are generally considered to be consumer-protection legislation crafted as either stand-alone measures or as part of a more comprehensive consumer-protection code. We emphasize, therefore, that while they and the antitrust laws were each enacted with the goal of creating and preserving consumer benefits in the form of reasonable prices, the direct "regulation" of prices that characterizes "price-gouging" laws is, in effect, the flip side of the antitrust-law encouragement of marketplace competition to set prices.

The "price gouging" measures currently pending in the 110<sup>th</sup> Congress would treat violations of their prohibitions, however they define "price gouging," as if they were violations of an unfairness rule promulgated under the FTC's rulemaking authority;<sup>21</sup> most would provide for FTC enforcement "as though all applicable terms and conditions of the Federal Trade Commission Act were incorporated into and made a part of this Act."<sup>22</sup>

The so-called "NOPEC" measures<sup>23</sup> would each amend section 1 of the Sherman Antitrust Act to make "oil-producing and exporting cartels illegal" under U.S. antitrust laws, and to authorize suits against such entities by the Attorney General.

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[http://aida.econ.yale.edu/~jh529/RRC\\_Revision0604.pdf](http://aida.econ.yale.edu/~jh529/RRC_Revision0604.pdf).

<sup>20</sup> Christopher T. Taylor and Daniel S. Hosken, *THE ECONOMIC EFFECTS OF THE MARATHON-ASHLAND JOINT VENTURE: THE IMPORTANCE OF INDUSTRY SUPPLY SHOCKS AND VERTICAL MARKET STRUCTURE*, FTC, Bureau of Economic, Working Paper No. 270, 2004, available at <http://www.ftc.gov/be/workpapers/wp270.pdf>. The authors note that although the joint venture they studied did, in fact, increase wholesale gasoline prices, those increases were not passed on by retailers to gasoline consumers.

<sup>21</sup> *E.g.*, section 3(a) of H.R. 1252; section 7(b) of S. 1263. Pursuant to its enforcement authority provided in Subtitle B, Title VIII (sections 811-815) of the Energy Independence and Security Act of 2007 (P.L. 110-140), and particularly that set out in section 811, which prohibits the use of "any manipulative or deceptive device or contrivance" in contravention to a rule or regulation the FTC "may prescribe as necessary or appropriate in the public interest or for the protection of United States citizens," the Commission has announced an Advanced Notice of Proposed Rulemaking (ANPR) to request "comment on the manner in which it should carry out [those] rulemaking responsibilities ...." (73 *FEDERAL REGISTER* 25614-01 (May 7, 2008), 2008 WL 1957726.) Public comments in response to the ANPR are due June 6, 2008. The FTC's rulemaking authority with respect to the FTC Act (15 U.S.C. §§ 41 *et seq.*) is contained in 15 U.S.C. § 57a(a)(1)(B).

<sup>22</sup> *E.g.*, section 3(a) of H.R. 1252; section 5(b) of S. 94; section 205(a) of S. 2991. S. 1520 would directly amend the FTC Act to prohibit fuel price gouging subsequent to a Presidentially declared "major disaster."

<sup>23</sup> *E.g.*, House-passed H.R. 6074, H.R. 2264; Title IV of S. 2991 (pending in the full Senate, together with the House-passed measures), S. 879 (pending in the Senate Judiciary Committee).

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