Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

Oil Divorcement: Refining the Issues

TO THE EDITOR:

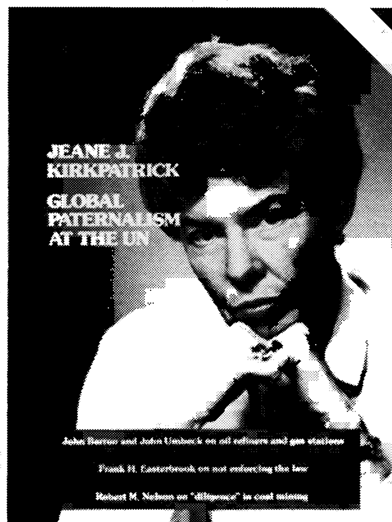
The oil divorcement legislation now pending in Congress would prohibit major oil refiners from operating gasoline stations. John Barron and John Umbeck's report on their study of this issue ("A Dubious Bill of Divorcement: The Case of Oil Refiners and Gas Stations," *Regulation*, January/February 1983), which was funded by the Atlantic Richfield Company, contributes little to enlightened debate on the subject. As chief sponsor of the proposal in the House of Representatives, I would like to point out some of the article's errors and omissions.

Testifying before the Pennsylvania state legislature in March, Umbeck acknowledged that gasoline prices in Maryland remain among the lowest in the nation—even today, four years after the state's comprehensive divorcement law was implemented. In fact, anyone who travels through the mid-Atlantic region can see that gasoline prices in Maryland are highly competitive with those in neighboring states.

Although Barron and Umbeck say they designed their comparison of Maryland prices before and after divorcement so as to avoid the pitfalls of previous studies, they fell into the most obvious trap of all. The Maryland divorcement law went into effect in 1979, which was also the last year that gasoline was subject to federal price controls and supply allocations. During the period of federal regulation, refiners had repeatedly petitioned for permission to raise prices in their company-operated outlets. Meanwhile, independent dealers had been forced to operate under arbitrary limits on their profit margins. After decontrol, marketers of all classes raised prices in search of compensation for half a decade of price and supply regulations.

I cannot conceive how these two scholars could study Maryland gas prices for so long without taking into account the effects of federal regulations. They have made the same mistake as the authors of the 1979 Department of Energy study that projected future gasoline prices based on the assumption that government-mandated price differentials would remain in place forever.

Barron and Umbeck make some misleading statements that further mar their argument. First, they



note that the number of company-run service stations remained relatively stable between 1973 and 1979 (the only period for which we have good data). That might seem to indicate that the company-operated stations were not expanding in a predatory way. What they fail to mention is that the volume of these stations did not remain stable. The number of gallons sold in company-run outlets more than doubled during those years. Data provided by the American Petroleum Institute show that the refiner-run stations increased their market share by roughly 10 percent.

Second, it is a cheap shot for the authors to suggest that divorcement would ban "superpumper" stations. Nothing in my divorcement proposal would prevent the operation of high-volume, self-service stations offering the lowest gasoline prices. Indeed, there are in Maryland today a number of such stations operated by independent, branded dealers. Several nonrefiners operate large chains of these stations across the United States.

The authors make much of predatory pricing but do not even mention the abundant evidence of predatory *costing*, which is the primary issue. Through lease terms and supply franchise agreements, refiners can unilaterally control rents, the prices and supplies of products, credit policies, hours of operation, and many other elements crucial to a gasoline dealer's business. Why should a refiner sell gasoline at a loss when it can force dealers' prices up beyond competitive levels?

I am hard-pressed to think of any other industry where one business can exercise such complete control over another. Perhaps Barron and Umbeck should do another study to find out how much of the price increase they observed after decontrol was due to new terms in leases or supply contracts forced on independent gasoline dealers by their suppliers/landlords, the oil companies. I doubt that Atlantic Richfield would be as willing to fund that study as they were the first.

Berkley Bedell,
U.S. House of Representatives

TO THE EDITOR:

As Barron and Umbeck note, there is little doubt that divorcement legislation is anticompetitive and costly. While agreeing with their overall conclusion, however, I have a few differences.

Barron and Umbeck ascribe the decline in the number of franchised stations to the drop in the demand for gasoline and for the services offered by the full-line service stations. Gasoline consumption has indeed fallen from its 1978 peak (down 12 percent by 1982), but it

has leveled off in the past three years. The principal reason why there are fewer franchised dealers is that the economics of marketing has changed. Before the price increases of the 1970s, the refiners' marketing strategies called on them to sell at many low-volume locations. Now, to maintain a reasonable overall rate of return, station costs must be spread over more gallons, which means selling more gas at each of fewer stations. Traditionally, franchised dealers have operated low-volume stations, while company-run operations have been built on the principle of high volume, no-frills service.

Divorcement is costly. The Metzenbaum-Thurmond bill (S. 40) would force the sixteen largest refiners to divest their company-operated stations. The latest available DOE data (as of September 1981) show that fifteen of these refiners sold gasoline at their own stations for an average of six cents less than their franchised dealers did. Had a divorcement law been in effect that year driving prices up to the franchised dealers' level, consumers would have paid about $330 million more at the pump.

Barron and Umbeck want to show that franchised dealers would prosper under divorcement, but I am not so sure that they would. For refiners that were running their own stations, a forced switch to franchised dealerships would mean increased marketing costs. Higher retail prices, then, would come from the higher cost of doing business, not from profits. Perhaps some of the higher prices would result in profits for refiners or dealers, but that is highly speculative. In any event, gasoline consumers would lose because they would pay higher prices for a less desirable mix of services. Would anyone win?

Leonard L. Coburn,
Department of Energy

TO THE EDITOR:

Barron and Umbeck make a compelling case that divorcement legislation is anticompetitive. They systematically show how the Maryland law cost consumers several cents per gallon in affected markets, amounting to roughly $15 million per year, while benefiting some franchised dealers. Consumers and the legislators who represent them should ask themselves if they really favor taking small sums from a great many people to provide special benefits for a few.

Studies by Philip Sorensen of Florida State University and Lawrence Lamont and Charles Phillips of Washington and Lee University have confirmed Barron and Umbeck's findings, and also noted other benefits that refiner operation provides for consumers, such as keeping stations open for longer hours. Similarly, a January 1981 Department of Energy study suggested that divorcement of gas stations would cost consumers millions of dollars.

Although divorcement proposals are still being considered in some states, the Maryland law appears to be an anachronism today. First, most states that have considered divorcement legislation have ended by rejecting it. Second, since gasoline was decontrolled in January 1981, service to motorists has greatly improved and some of the franchised dealers' complaints have been rendered moot. The interests of consumers will be best served if the Maryland divorcement law is simply consigned to the textbooks as an example of special interest legislation.

Thomas F. Hogarty,
American Petroleum Institute

JOHN UMBECK responds:

Representative Bedell thinks he finds four serious errors in our article. He claims that Maryland gas prices are among the lowest on the East Coast, that we ignored the effect of federal regulation on retail gas prices, that the major oil companies may have increased the volumes of their own stations in a predatory way, and that the real reason for the price increases we observed was predatory costing. I would argue that it is Bedell's arguments that are misleading on each point.

First, Bedell quotes my testimony before the Pennsylvania legislature acknowledging that Maryland's gas prices were among the lowest in the nation. But he fails to mention that this fact is irrelevant to the divorcement issue. Suppose an Olympic runner can beat any and all competitors by running a mile in three-and-a-half minutes, but falls and breaks his leg. After recovering, he takes longer to run the mile but is still faster than his competition. Bedell would claim that the fall did not hurt him because he is still faster than other runners. A scientist would point out that the fall slowed the runner's speed. Similarly, even if Maryland's gas prices were the lowest in the country, it would prove nothing about the effects of divorcement. The real question would still be whether divorcement had made prices higher than they would have been otherwise.

Furthermore, it turns out that the seemingly low gas prices in Maryland are more illusory than real. Recent evidence submitted to the Pennsylvania Governor's Energy Council shows that the interstate comparison in question was based on retail pump prices that included a wide variety of state taxes. When these taxes are deducted, Maryland's retail prices in fact appear to be among the highest in the eastern region. More relevant for our purposes, the difference has increased since the state's divorcement law was implemented.

Bedell also accuses us of ignoring federal price regulation. We did not ignore it; we simply found that it had no effect on the divorcement issue. During the period we studied, the federal government set ceilings on the markup over wholesale costs that franchisers and company-operated stations could charge. In addition, the regulations discriminated against company-operated stations by allowing them a smaller markup on average than franchised outlets. For most of the period, however, these constraints were not binding. Until the Iranian crisis in spring 1979, retail gas prices were

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well below their legal maximum. Legally both franchisees and refiners could have raised their prices if they had wanted, but competition restrained them. By May 1979, most stations had run up against their legal price limits, where they remained for about a year. When we tested the effects of these regulations on relative prices in Maryland, we dropped from our regression analysis those months in which prices were at their ceiling. Eliminating them did not significantly alter any of our results.

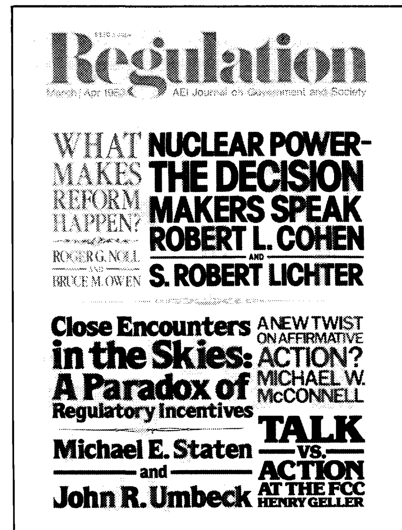
Bedell is correct in pointing out that while the number of company-operated stations has not grown, their share of the retail market has gone up because the total volume per station has risen. But Bedell does not mention the fact that the franchised dealers who stayed in business during this period also enjoyed significant increases in volume. Since 1970, company-operated stations have increased their market share by an average of slightly more than 1 percent a year, and they account for about 18 percent of the total retail gasoline market today. At this rate it will take the refiners eighty-two more years before they succeed in monopolizing the market. Given that the refiners could terminate most of the franchisees in short order simply by not renewing their three-year leases, one must wonder why they are taking the long way around, especially since it will mean eighty-two more years of low prices for consumers. The divorcement bill that Representative Bedell proposes would see to it that these low prices come to an end much sooner—but it would all be for the consumer's own good, of course.

Finally, Bedell suggests that the real problem is not predatory pricing but predatory costing. He says we ignore "abundant evidence" that supports this contention. To date we have seen no such evidence. Some dealers faced with rent increases have accused refiners of predation recently, but the figures they have offered, to the best of our knowledge, have never been tested for bias in sampling or for statistical significance. A recent pilot study revealed no evidence of predatory costing, and indeed suggested that the rent increases observed recently are nothing more than inflation adjustments on leases whose terms had been fixed several years earlier. If Bedell has good statistical evidence of predation he should make it public so that the rest of us can evaluate it.

The Roots of Reform

TO THE EDITOR:

Roger G. Noll and Bruce M. Owen ("What Makes Reform Happen?" *Regulation*, March/April 1983) are rightly optimistic about the prospects for regulatory reform in those policy areas where suppressed market forces are ready to take over from regulators. The generality with which they frame their argument, however, is misleading. It applies mainly to those areas where the problem regulation was intended to solve resulted from supposed market failures or imperfections, which have now presumably been either mitigated by changing technology or reevaluated through the use of more insightful economic analysis.



Many targets of old-style economic regulation, such as transportation and communication, fall into this category. Many targets of the new social or protective regulation, however, do not. In such cases as food safety and hazardous waste management, the pre-regulatory problem can be blamed more on failures or imperfections in the process of litigation than on the market. Unlike the operation of markets, the construction of an efficient and equitable litigation system requires a good deal of human artifice. No naturally "good" system is sequestered underground ready to spring into action if we abolish the food safety laws or—for all its defects—the Superfund arrangement.

Another important reason why loosening the strictures of protective regulation will prove harder than deregulating the economic domain is the higher burden of moral justification that encumbers it. To be sure, removing government restraints on competition can be painful to affected producers, but that is a mild offense indeed compared to the seeming abandonment of the potential victims of corporate negligence and other, more calculated abuses.

The particular prescriptions for regulatory reform that Noll and Owen advance are to "beef up the corps of analysts who keep their sights trained on the impact of regulatory policy" and to "keep the regulatory process accessible at low cost to a variety of interests" who will "raise questions about the subtle ways in which regulatory rules may serve narrow self-interest," and who will subject policy making to the "sunshine of public scrutiny." The first is as applicable to protective regulation as it is to economic regulation, but the second certainly is not.

Just what "variety of interests" do Noll and Owen have in mind? The social groups with the most stake in raising these kinds of questions about self-interest are producers whose compliance costs (actual or expected) are higher than those of their competitors. Although some of these producers might inspire occasional widespread sympathy, as in the case of the small inventor who is kept out of a market by excessive and protectionist safety standards, it is hard to see what interveners would come to the defense of these producers on a regular basis. One can hardly expect the "public interest" groups to do so when these groups' reputations depend in large part on opposing lower health and safety standards and when it is these very groups that helped create the regulatory machinery in the first place. Conceivably the affected producers could ally with each other, but the heterogeneity of both their economic niches and their targets for reform would make it unlikely that they could do much more than join general small business groups.

In the end, we must look to that beefed-up corps of analysts sought by Noll and Owen, and to the political power of the government units to which they are attached. Such units are a poor substitute for weighty and resourceful economic or ideological interests, but they are probably all we have.

Eugene Bardach,
University of California at Berkeley