Federal Trade Commission slammed markup law over the years

Minimum markup laws discourage competition, harm consumers and are unnecessary, according to findings repeatedly issued by the Federal Trade Commission over the years but either never made public or given little attention in the mainstream media.

Leaders of the commission charged with protecting consumers and maintaining competition have weighed in on such laws at least three different times. Twice, they were specifically responding to requests from state Democratic lawmakers trying unsuccessfully to amend or repeal Wisconsin's minimum markup law.

In 2005, the FTC chairman herself, Deborah Platt Majoras, remarked on such laws during testimony at a joint hearing of the Senate Committee on Commerce, Science and Transportation and the Senate Committee on Energy and Natural Resources.

Majoras prefaced her comments on gas prices at the time by saying that the FTC had developed expertise in the gasoline industry "through years of investigation and research" that closely scrutinized prices and examined any activity that could decrease competition and harm consumers. Obstacles to competition, she added, can arise from either private behavior — things such as price gouging in the wake of Hurricane Katrina, for example — or public policies such as high taxes or government-mandated markups.

Gas taxes were — and are — relatively high in Wisconsin. In 2005, Majoras said, the average state gas tax was 22 cents per gallon across the country. (Wisconsinites at the time were paying a tax of 29.9 cents per gallon and are now paying a tax of 32.9 cents per gallon.)

In addition, she testified, 11 states at the time had laws banning sales below certain levels.

> 9.18% gas markup appears 'completely arbitrary,' FTC letter said

Majoras

"These laws," she told the U.S. senators, "harm consumers by depriving them of the lower prices that more efficient (e.g., high-volume) stations can charge."

One of the biggest changes in the retail sale of gasoline in the prior three decades, she added, had been the rise of convenience stores and high-volume operations — places with multiple fuel islands, sometimes called "pumpers" — that "appear to lower retail gasoline prices."

"Another change to the retail gasoline market that appears to have helped keep gasoline prices lower is the entry of hypermarkets," she testified. "Hypermarkets are large retailers of general merchandise and grocery items, such as Wal-Mart and Safeway, that have begun to sell gasoline. Hypermarket sites typically sell even larger volumes of gasoline than pumper stations — sometimes four to eight times larger. Hypermarkets' substantial economies of scale generally enable them to sell significantly greater volumes of gasoline at lower prices."

Majoras was speaking in general terms when she said bans on below-cost sales harm consumers, but the FTC has twice issued findings specifically regarding the Wisconsin law, most recently in 2003.

The law's evolution

Wisconsin's Unfair Sales Act, adopted in 1939, has evolved over the years. In 1986, legislators passed a version that generally forbid below-cost sales of most goods but affirmed that three items — alcoholic beverages, tobacco products and motor vehicle fuel — had to be marked up 3% over wholesale and 6% over retail.

In 1997, legislators amended the law on gasoline to require either a 6% markup above certain actual costs or a 9.18%

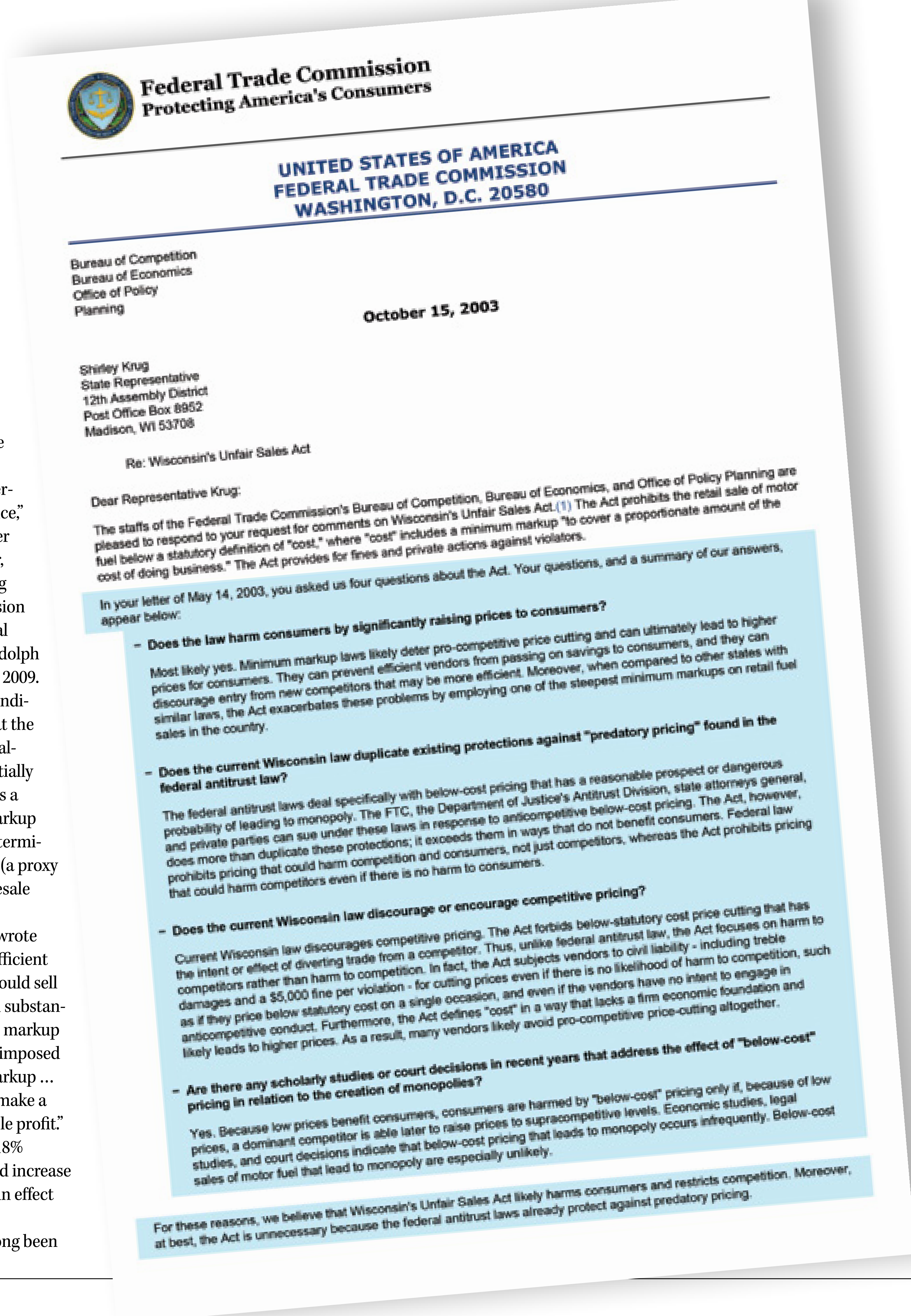
markup above the "average posted terminal price," whichever is greater, according to a decision by Federal Judge Rudolph Randa in 2009.

Randa indicated that the law, in reality, essentially mandates a 9.18% markup over the terminal price (a proxy for wholesale costs).

Randa wrote that an efficient retailer could sell gas "with substantially less markup than the imposed 9.18% markup … and still make a reasonable profit."

That 9.18% mandated increase remains in effect today.

It has long been



Federal Trade Commission
Protecting America's Consumers

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Bureau of Competition
Bureau of Economics
Office of Policy
Planning

October 15, 2003

Shirley Krug
State Representative
12th Assembly District
Post Office Box 8952
Madison, WI 53708

Re: Wisconsin's Unfair Sales Act

Dear Representative Krug:

The staffs of the Federal Trade Commission's Bureau of Competition, Bureau of Economics, and Office of Policy Planning are pleased to respond to your request for comments on Wisconsin's Unfair Sales Act.(1) The Act prohibits the retail sale of motor fuel below a statutory definition of "cost," where "cost" includes a minimum markup "to cover a proportionate amount of the cost of doing business." The Act provides for fines and private actions against violators.

In your letter of May 14, 2003, you asked us four questions about the Act. Your questions, and a summary of our answers, appear below:

- **Does the law harm consumers by significantly raising prices to consumers?**

  Most likely yes. Minimum markup laws likely deter pro-competitive price cutting and can ultimately lead to higher prices for consumers. They can prevent efficient vendors from passing on savings to consumers, and they can discourage entry from new competitors that may be more efficient. Moreover, when compared to other states with similar laws, the Act exacerbates these problems by employing one of the steepest minimum markups on retail fuel sales in the country.

- **Does the current Wisconsin law duplicate existing protections against "predatory pricing" found in the federal antitrust law?**

  The federal antitrust laws deal specifically with below-cost pricing that has a reasonable prospect or dangerous probability of leading to monopoly. The FTC, the Department of Justice's Antitrust Division, state attorneys general, and private parties can sue under these laws in response to anticompetitive below-cost pricing. The Act, however, does more than duplicate these protections; it exceeds them in ways that do not benefit consumers. Federal law prohibits pricing that could harm competition and consumers, not just competitors, whereas the Act prohibits pricing that could harm competitors even if there is no harm to consumers.

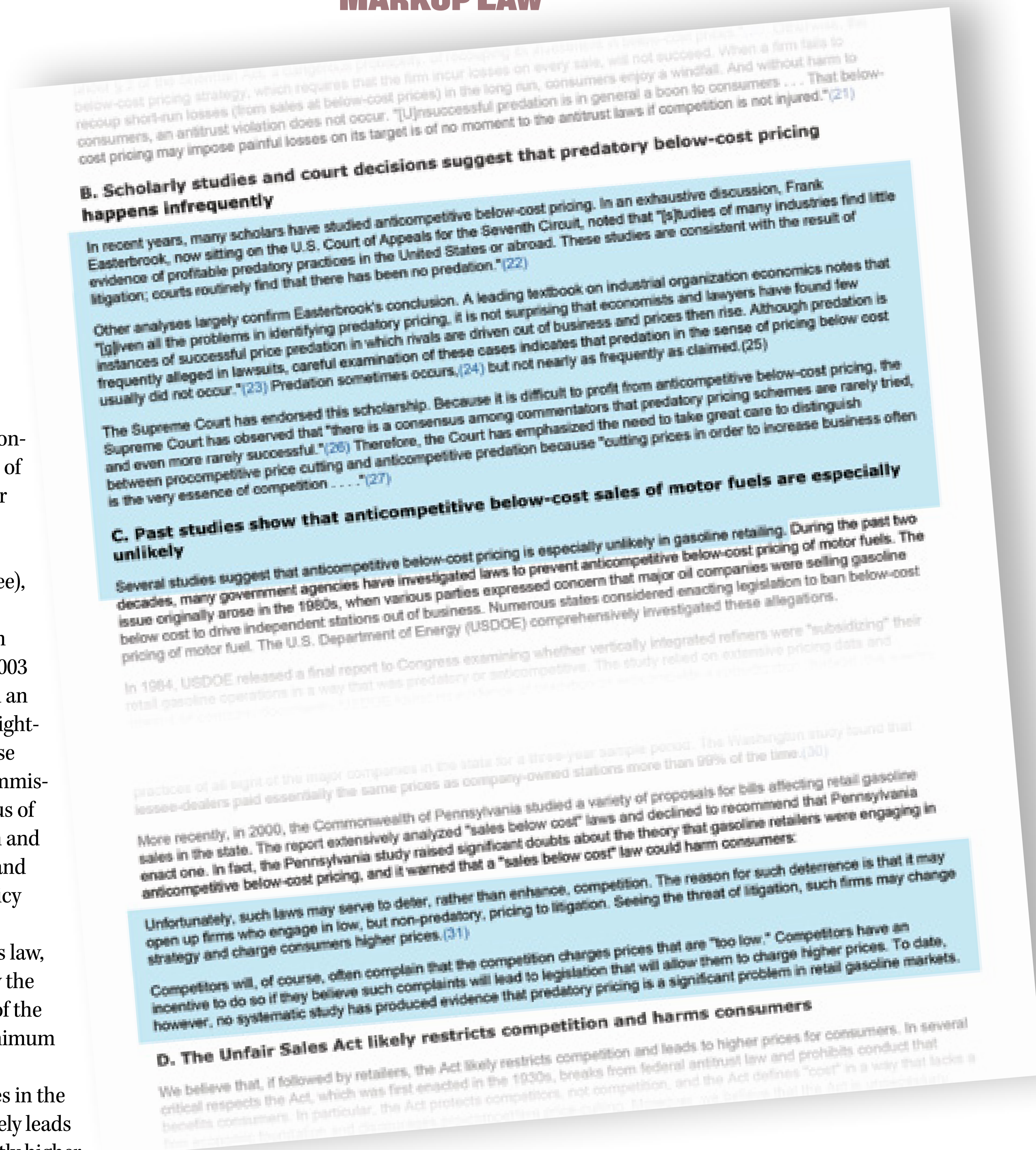
- **Does the current Wisconsin law discourage or encourage competitive pricing?**

  Current Wisconsin law discourages competitive pricing. The Act forbids below-statutory cost price cutting that has the intent or effect of diverting trade from a competitor. Thus, unlike federal antitrust law, the Act focuses on harm to competitors rather than harm to competition. In fact, the Act subjects vendors to civil liability - including treble damages and a $5,000 fine per violation - for cutting prices even if there is no likelihood of harm to competition, such as if they price below statutory cost on a single occasion, and even if the vendors have no intent to engage in anticompetitive conduct. Furthermore, the Act defines "cost" in a way that lacks a firm economic foundation and likely leads to higher prices. As a result, many vendors likely avoid pro-competitive price-cutting altogether.

- **Are there any scholarly studies or court decisions in recent years that address the effect of "below-cost" pricing in relation to the creation of monopolies?**

  Yes. Because low prices benefit consumers, consumers are harmed by "below-cost" pricing only if, because of low prices, a dominant competitor is able later to raise prices to supracompetitive levels. Economic studies, legal studies, and court decisions indicate that below-cost pricing that leads to monopoly occurs infrequently. Below-cost sales of motor fuel that lead to monopoly are especially unlikely.

For these reasons, we believe that Wisconsin's Unfair Sales Act likely harms consumers and restricts competition. Moreover, at best, the Act is unnecessary because the federal antitrust laws already protect against predatory pricing.



below-cost pricing strategy, which requires that the firm incur losses on every sale, will not succeed. When a firm fails to recoup short-run losses (from sales at below-cost prices) in the long run, consumers enjoy a windfall. And without harm to consumers, an antitrust violation does not occur. "[U]nsuccessful predation is in general a boon to consumers . . . . That below-cost pricing may impose painful losses on its target is of no moment to the antitrust laws if competition is not injured."(21)

B. Scholarly studies and court decisions suggest that predatory below-cost pricing happens infrequently

In recent years, many scholars have studied anticompetitive below-cost pricing. In an exhaustive discussion, Frank Easterbrook, now sitting on the U.S. Court of Appeals for the Seventh Circuit, noted that "[s]tudies of many industries find little evidence of profitable predatory practices in the United States or abroad. These studies are consistent with the result of litigation; courts routinely find that there has been no predation."(22)

Other analyses largely confirm Easterbrook's conclusion. A leading textbook on industrial organization economics notes that "[g]iven all the problems in identifying predatory pricing, it is not surprising that economists and lawyers have found few instances of successful price predation in which rivals are driven out of business and prices then rise. Although predation is frequently alleged in lawsuits, careful examination of these cases indicates that predation in the sense of pricing below cost usually did not occur."(23) Predation sometimes occurs,(24) but not nearly as frequently as claimed.(25)

The Supreme Court has endorsed this scholarship. Because it is difficult to profit from anticompetitive below-cost pricing, the Supreme Court has observed that "there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful."(26) Therefore, the Court has emphasized the need to take great care to distinguish between procompetitive price cutting and anticompetitive predation because "cutting prices in order to increase business often is the very essence of competition . . . ."(27)

C. Past studies show that anticompetitive below-cost sales of motor fuels are especially unlikely

Several studies suggest that anticompetitive below-cost pricing is especially unlikely in gasoline retailing. During the past two decades, many government agencies have investigated laws to prevent anticompetitive below-cost pricing of motor fuels. The issue originally arose in the 1980s, when various parties expressed concern that major oil companies were selling gasoline below cost to drive independent stations out of business. Numerous states considered enacting legislation to ban below-cost pricing of motor fuel. The U.S. Department of Energy (USDOE) comprehensively investigated these allegations.

More recently, in 2000, the Commonwealth of Pennsylvania studied a variety of proposals for bills affecting retail gasoline sales in the state. The report extensively analyzed "sales below cost" laws and declined to recommend that Pennsylvania enact one. In fact, the Pennsylvania study raised significant doubts about the theory that gasoline retailers were engaging in anticompetitive below-cost pricing, and it warned that a "sales below cost" law could harm consumers:

Unfortunately, such laws may serve to deter, rather than enhance, competition. The reason for such deterrence is that it may open up firms who engage in low, but non-predatory, pricing to litigation. Seeing the threat of litigation, such firms may change strategy and charge consumers higher prices.(31)

Competitors will, of course, often complain that the competition charges prices that are "too low." Competitors have an incentive to do so if they believe such complaints will lead to legislation that will allow them to charge higher prices. To date, however, no systematic study has produced evidence that predatory pricing is a significant problem in retail gasoline markets.

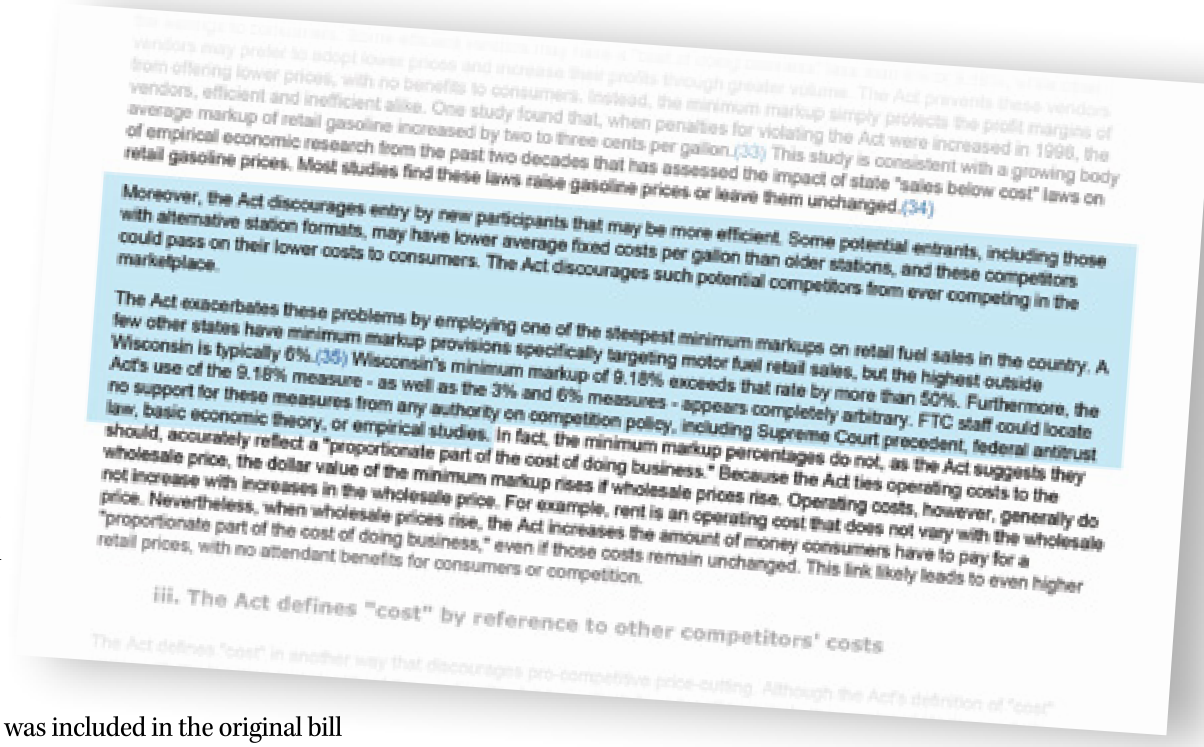
D. The Unfair Sales Act likely restricts competition and harms consumers

We believe that, if followed by retailers, the Act likely restricts competition and leads to higher prices for consumers. In several critical respects the Act, which was first enacted in the 1930s, breaks from federal antitrust law and prohibits conduct that

unpopular with some legislators who lament the cost to consumers. One of them, former state Rep. Shirley Krug (D-Milwaukee), asked for an opinion from the FTC in 2003 and received an exhaustive eight-page response from the commission's Bureaus of Competition and Economics and Office of Policy Planning.

Wisconsin's law, described by the FTC as one of the steepest minimum markups on retail sales in the country, "likely leads to significantly higher prices for consumers" discourages pro-competitive price cutting and — given federal antitrust laws — is simply not necessary, according to the commission's findings.

The FTC emphasized that the federal government, state attorneys general and private parties all have the ability without minimum markup laws to fight "predatory pricing," something the U.S. Supreme Court defines as "pricing below an appropriate measure of (a defendant's) cost for the purpose of eliminating competitors in the short run and reducing competition in the long run." But the FTC also stated that "predatory below-cost pricing happens infrequently"



vendors may prefer to adopt lower prices and increase their profits through greater volume. The Act prevents these vendors from offering lower prices, with no benefits to consumers. Instead, the minimum markup simply protects the profit margins of vendors, efficient and inefficient alike. One study found that, when penalties for violating the Act were increased in 1998, the average markup of retail gasoline increased by two to three cents per gallon.(33) This study is consistent with a growing body of empirical economic research from the past two decades that has assessed the impact of state "sales below cost" laws on retail gasoline prices. Most studies find these laws raise gasoline prices or leave them unchanged.(34)

Moreover, the Act discourages entry by new participants that may be more efficient. Some potential entrants, including those with alternative station formats, may have lower average fixed costs per gallon than older stations, and these competitors could pass on their lower costs to consumers. The Act discourages such potential competitors from ever competing in the marketplace.

The Act exacerbates these problems by employing one of the steepest minimum markups on retail fuel sales in the country. A few other states have minimum markup provisions specifically targeting motor fuel retail sales, but the highest outside Wisconsin is typically 6%.(35) Wisconsin's minimum markup of 9.18% exceeds that rate by more than 50%. Furthermore, the Act's use of the 9.18% measure - as well as the 3% and 6% measures - appears completely arbitrary. FTC staff could locate no support for these measures from any authority on competition policy, including Supreme Court precedent, federal antitrust law, basic economic theory, or empirical studies. In fact, the minimum markup percentages do not, as the Act suggests they should, accurately reflect a "proportionate part of the cost of doing business." Because the Act ties operating costs to the wholesale price, the dollar value of the minimum markup rises if wholesale prices rise. Operating costs, however, generally do not increase with increases in the wholesale price. For example, rent is an operating cost that does not vary with the wholesale price. Nevertheless, when wholesale prices rise, the Act increases the amount of money consumers have to pay for a "proportionate part of the cost of doing business," even if those costs remain unchanged. This link likely leads to even higher retail prices, with no attendant benefits for consumers or competition.

iii. The Act defines "cost" by reference to other competitors' costs

The Act defines "cost" in another way that discourages pro-competitive price-cutting. Although the Act's definition of "cost"

and that "anticompetitive below-cost sales of motor fuels are especially unlikely."

Finally, the FTC questioned the logic behind the 9.18% markup in particular, writing that it appears "completely arbitrary."

The 6% retail markup was included in the original bill way back in 1939. What was then known as Chapter 56 mandated a retail markup of 6% and a wholesale markup of 2% "added to the invoice cost," according to the Wisconsin Legislative Reference Bureau.

The legislation was based upon a model State Unfair Sales Act prepared by the National Food and Grocery Conference Committee. The committee, in turn, was made up of representatives of associations from various branches — retail, wholesale and manufacturing — of the food and grocery trade, according to 1939 drafting files.

It's unclear why legislators at that time chose the 6% markup or the 2% markup or, for that matter, why the 2% markup eventually was raised to 3%. The state Department of Agriculture, Trade and Consumer Protection, which administers the law today, says it does not have information on why or how those percentages were chosen.

The other FTC-issued comment on Wisconsin's law came in 1987 and was in response to a request from John Norquist, the Democratic state senator who later became Milwaukee mayor.

At the time, according to the FTC, the Wisconsin law required retailers to mark up their price on fuel, alcoholic beverages and tobacco products 6% over their cost in order to account for overhead — an amount that chilled discount pricing and encouraged "fixed profit margins."

Removing the "pricing restraints" would "enable consumers to benefit from lower and more competitive prices," John Peterson, director of the FTC's Chicago Regional Office, wrote to Norquist.

Peterson told Norquist that the FTC staff had substantial experience analyzing the impact on various restraints on competition and concluded that the "requirement that sales be above cost unnecessarily raises consumer prices."

He also quoted the Supreme Court as saying that predatory pricing schemes are "rarely tried and even more rarely successful" and wrote that "even if predatory pricing activity occurred, it could be attacked under the Sherman Act, the Clayton Act or the Federal Trade Commission Act."

"We believe that the Wisconsin Unfair Sales Act is contrary to the public interest because, by prohibiting sales below cost, it unnecessarily restrains competition. The minimum markup provisions further restrain competition and appear to have no countervailing benefits to consumers. Apparently, the Act is intended to protect small retailers and wholesalers, but does so at the expense of consumers."

The FTC staff urged repeal and commented that doing so would continue the state's "tradition of progressive consumer legislation."

— WPRI staff