LEGISLATURE TAKES AIM AT CALIFORNIA’S HIGHER GAS PRICES: MISGUIDED MEASURES TO INCREASE COMPETITION IN THE CALIFORNIA RETAIL GASOLINE MARKET

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INTRODUCTION

While gasoline prices have skyrocketed throughout the country, California motorists have earned the dubious distinction of paying even higher prices at the pump. California gasoline has been consistently more expensive than that of almost every state in the union.¹

In 1999, for example, regular grade gasoline averaged 16¢ per gallon higher in California than in the rest of the United States, after adjustment for tax differences.² In fact, gasoline prices in California were higher during 1999 than in any other state except Hawaii and Nevada.³ Moreover, California has suffered severe price spikes that were not experienced in the rest of the country. The state suffered a price spike in the spring and summer of 1996 with the introduction of cleaner burning gasoline and several refinery outages that led to a whopping 30¢ per gallon

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3. Id.
differential from the national average. The higher prices have resulted in California consumers paying $1.3 billion more than the rest of the United States for gasoline through August 1999.

In addition to the higher prices relative to other states, there are significant price disparities among regions within California. Gasoline prices in San Francisco and San Diego are consistently higher than in Los Angeles. In 1999, San Francisco drivers paid in excess of 20¢ per gallon more than Los Angeles commuters. In recent years, San Diego’s gasoline prices have averaged about 12¢ per gallon more than in Los Angeles. The fact that Northern California has the highest prices is particularly interesting considering that San Francisco refiners typically produce more gasoline than necessary for Northern California consumption and export the surplus to Southern California.

The public and media throughout California have become increasingly resentful of the large price differential with other states and among regions within the state. The public outcry has caught the attention of policymakers at all levels of government. For example, antitrust investigations have begun at both the federal and state levels. The Federal Trade Commission is investigating potential anticompetitive behavior by California refineries to determine whether antitrust laws were violated. State and federal antitrust officials are carefully scrutinizing proposed mergers by oil companies to determine the competitive impact on refining and gasoline production. Even local governments have joined in the fray;

4. Id.
5. Id.
6. Id. at 4.
7. Leffler & Pulliam, supra note 1, at 4, 12.
8. Id. at 13.
San Diego and San Francisco counties have recently considered local ordinances to increase competition.\textsuperscript{12}

The most significant policy changes, however, could come from state legislation. Legislators have been busy holding informational hearings and introducing bills to combat the higher California prices.\textsuperscript{13} The California Attorney General commissioned a task force to recommend legislative and regulatory proposals in 1999. The Attorney General’s Task Force issued its final report in May 2000, and the Attorney General has adopted several of its recommendations.\textsuperscript{14}

Before evaluating specific proposals to lower gasoline prices, it is important to distinguish between two different approaches, each of which focuses on a different segment of the industry. First, gasoline prices can be lowered by increasing the supply. This can be accomplished by increasing in-state refining capacity, importing gasoline from other states, or eliminating the stricter state environmental mandates on gasoline. A second potential means to lower gasoline prices is to increase competition in the retail or marketing segment of the industry. Of course, this latter approach implies that the retail market structure is not competitive and government intervention is necessary to achieve competition.

These approaches were evaluated by the Task Force, and the Attorney General is sponsoring legislation to increase both supply and retail competition.\textsuperscript{15} The measures that attempt to increase supply include creating a state-owned gasoline reserve, importing gasoline from other states, expanding pipeline connections to California, and increasing in-state refining capacity.\textsuperscript{16} A detailed evaluation of proposals to increase gasoline supply is not the focus of this Note.

This Note focuses on those proposals that purport to increase competition in the retail segment. Specifically, it analyzes two proposals, which were presented by the Task Force and that are being recommended by the Attorney General: divorcement and open supply.\textsuperscript{17} Neither of these proposals is new. Both have been introduced in the Legislature in prior

\begin{thebibliography}{9}
\bibitem{14} Leffler & Pulliam, supra note 1; Lockyer, supra note 2.
\bibitem{15} See Lockyer, supra note 2, at 39–62.
\bibitem{16} Id. at 48.
\bibitem{17} See id. at 59–63.
\end{thebibliography}
sessions, though neither has been enacted. Now that the Attorney General is publicly endorsing these measures, they will undoubtedly resurface in future sessions.

Both of these measures are misguided and deserve to be defeated. Supporters of open supply and divorcement, including the Attorney General, base their analysis upon a faulty premise: that the retail gasoline market is broken and needs to be fixed. This Note will demonstrate that the market structure in the retail sector is not anticompetitive and that the purported solutions will make matters worse. These so-called solutions fundamentally misunderstand the nature of the problem in that they would prohibit pro-competitive arrangements that alleviate market failures. These proposals would, ironically, raise prices, not lower them.

Indeed, the entire focus on increasing competition in the retail segment is misguided. As explained in Part I, the real cause of California’s higher gasoline prices stems from supply problems in the upstream refinery market. More specifically, the supply problems are predominantly caused by state mandated cleaner burning gasoline. An unintended consequence of cleaner gasoline is that the state has become a virtual island, enhancing the market power of California refiners. This phenomenon of separating the state supply from the rest of the nation is known as “decoupling” of the California market. Policymakers must acknowledge that the government mandate is predominantly responsible for limiting the supply of gasoline in California and increasing prices. This result does not suggest that cleaner burning gasoline is not a worthwhile policy. It does mean, however, that we should not mislead ourselves by blaming the market for consequences of governmental mandates.

Parts II and III discuss the specific measures that are being considered to increase competition in the retail segment. Part II analyzes the divorcement proposal, concluding that it should be rejected. Divorcement refers to the prohibition against oil company ownership of retail gasoline stations. Proponents claim that divorcement is necessary to prevent oil companies from opportunistically driving franchisees out of business.

18. Unless otherwise indicated, the terms “oil company,” “refiner,” “gasoline supplier,” and “supplier” are used interchangeably throughout this Note to refer to upstream suppliers of gasoline. The terms “franchisee,” “service station,” “gasoline dealer,” and “gasoline station” are used interchangeably, unless otherwise indicated, to refer to downstream gasoline retailers. Although there are multiple levels of production in the petroleum industry (such as exploration and refining), this simplified classification merely distinguishes the upstream production market from the downstream retail market.
They argue that vertical integration—through the practice of dual distribution—allows oil companies to exercise control over the retail market to the detriment of franchisees and consumers.

This argument is flawed. If oil companies are truly motivated to act opportunistically toward their dealers, a more effective tool to accomplish this is the use of maximum resale prices—which would remain legal under divorcement. Moreover, contrary to the assertions of divorcement proponents, the vertical restrictions and integration in the gasoline industry are generally pro-competitive responses to market failures. While there is potential for oil companies to use vertical arrangements anticompetitively, divorcement does nothing to curb such behavior. Rather, divorcement merely eliminates the pro-competitive effects of vertical integration without eliminating the anticompetitive potential. Finally, existing laws offer sufficient remedies for gasoline dealers who suffer oil company abuse, and franchisees who are “squeezed” by their suppliers have sufficient remedies under the contractual covenant of good faith and fair dealing. Therefore, divorcement is both unnecessary and harmful.

Part III analyzes the “open supply” legislation, rejecting it as well. Open supply legislation is intended to curb the practice of zone pricing, the oil company practice of dividing the state into various geographic wholesale pricing zones. Zone pricing is blamed for contributing to the difference in price between different parts of the state because it prevents gasoline dealers from purchasing gasoline from a less expensive distributor in a different price zone. Open supply legislation would prohibit these exclusive purchasing contracts and allow dealers to shop around for the cheapest branded gasoline.

While seemingly pro-competitive, the rationales offered in support of open supply do not hold. First, proponents claim that zone pricing is anticompetitive because it helps oil companies isolate low-priced, independent stations. This assertion is meritless because lowering prices in response to competition is a pro-competitive phenomenon and should be encouraged. Second, contrary to assertions by proponents, zone pricing is not the underlying cause of the price differential among California regions; rather, these price differentials are caused by the varying levels and intensity of retail competition. Finally, zone pricing does not create entry barriers in the retail market because each oil company retains an incentive to open new retail outlets and earn higher profits.

Moreover, not only are the rationales in support of open supply flawed, but open supply causes actual harm to the retail gasoline market.
Open supply would likely cause wholesale prices to homogenize throughout the state. In turn, the uniform wholesale prices would make it difficult for branded franchisees to compete effectively if they are located near aggressively-priced independent stations.

Therefore, this Note concludes that proposals to increase competition in the retail sector are flawed and counter-productive. If policymakers truly wish to lower California prices, they must address the consequences of governmental mandates for cleaner-burning fuel.

I. SUPPLY PROBLEMS: “DECOUPLING” OF CALIFORNIA’S GASOLINE PRODUCTION MARKET

The most significant cause of California’s higher gasoline prices is the decoupling of the state gasoline production market from the rest of the world. In 1996, California began requiring cleaner burning gasoline, known as CARB gasoline, in order to comply with federal Clean Air Act standards. The cleaner burning gasoline is produced by only a handful of in-state refiners; the government mandates have transformed the state gasoline production market into a virtual island. In fact, only six refiners control more than ninety percent of the gasoline production capacity in California.

The California response to the federal mandate produces higher gasoline prices for two reasons. First, the mandate of cleaner burning gasoline results in higher prices because it isolates the California market, making the state extremely sensitive to disruptions in supply. For example, when a California refiner suffers a temporary shutdown, additional supply from outside the state is no longer automatically imported. Moreover, in-state refiners have little spare capacity to increase production of CARB gasoline. These factors have increased the sensitivity of retail prices to relatively small supply disruptions.

19. *High Gasoline Prices in San Diego*, supra note 13, at vii; *Leffler & Pulliam*, supra note 1, at 2. CARB is the acronym for the California Air Resources Board, which is the agency that promulgated the regulations. *Id.* at 2 n.4.

20. *Leffler & Pulliam*, supra note 1, at 7–8. Out-of-state refiners “have some limited ability to manufacture CARB gasoline. However, since refiners outside California do not manufacture CARB on a day-to-day basis, and because shipping costs from refining centers outside the state can run as much as 8¢–12¢ per gallon, the price of gasoline in California can rise far above prices elsewhere before attracting additional supplies.” *Id.* at 2.

21. *Id.* at 2.

22. *Id.* at 4.
Second, the fact that only six refiners produce ninety percent of CARB gasoline has increased the market power of California refiners. The extra market power allows oil companies to increase wholesale prices and earn super-competitive profits. This unintended consequence of cleaner burning gasoline is often neglected by policymakers, but its implications cannot be underestimated.

Although it is easy to criticize oil companies for raising wholesale prices under these circumstances, they neither created nor maintain this market power by monopolistic or predatory means. The state effectively granted them monopoly power by mandating special fuel. The only way to prevent oil companies from raising prices in this situation would be to convert the refinery market into a regulated industry whereby a state agency would determine prices.

As this is neither a feasible nor sensible option, there are two main approaches to address the supply problem. One approach is a long-term strategy of increasing supply by investing in new forms of energy, building pipelines to other states, and increasing state refining capacity. Such long-term strategies are beyond the scope of this Note but are critically important.

Rather than increasing long-term supply, a second approach merely mitigates the short-term problem by alleviating major price spikes associated with refinery outages. One way to accomplish this goal is to partially “recouple” or reintegrate the California market with the rest of the nation by selling non-CARB gasoline if the price differential reaches a specified amount. Specifically, Professor Severin Borenstein has proposed allowing non-CARB gasoline to be imported into the state, taxed by a pollution surcharge of 15¢ per gallon. This would place an upper limit on how much the price of CARB gasoline could exceed the price of gasoline in other states. If California’s gasoline prices exceeded other markets by more than 15¢, non-CARB gasoline would be imported to California and the price would stabilize. However, it is important to emphasize that any

24. See id. at 11–13; High Gasoline Prices in San Diego, supra note 13, at 45–57 (testimony of Severin Borenstein). The downside with importing “dirty gasoline” in California is the potential environmental effects. Proponents of this proposal argue that any environmental effects would be negligible. See Lockyer, supra note 2, at 12. However, additional analysis is necessary to determine the actual net emissions from use of non-CARB gasoline.
25. See Lockyer, supra note 2, at 11–12. The Task Force also evaluated two other approaches to mitigate price hikes: creation of a state-owned gasoline reserve and mandatory inventory requirements, analyses of which are beyond the scope of this Note. See id. at 8–11.
such proposal to mitigate price spikes would not significantly and permanently lower the price of gasoline.

Whether or not such a proposal to decrease price spikes should be adopted is beyond the scope of this Note. Nonetheless, it is clear that, if policymakers are serious about reducing California gasoline prices, more attention must be placed on supply issues. Decoupling California’s gasoline production market is the most significant cause behind our higher prices. Proposals to reintegrate the market and increase refining capacity involve serious tradeoffs between cleaner air and higher gasoline prices that policymakers must address.

Instead of focusing on these supply issues, however, state legislators and the Attorney General have directed much attention to the downstream retail market. Their legislative proposals have been pushed by associations representing franchisees who, of course, have their own self-interest in mind. These groups have pressed hard for two pieces of legislation: “divorcement” and “open supply.”

II. DIVORCEMENT LEGISLATION

A. DESCRIPTION AND GOALS OF DIVORCEMENT LEGISLATION

1. What Is Divorcement?

Divorcement refers to the statutory prohibition against oil company ownership of retail service stations. It prohibits oil companies from vertically integrating into the retail market. Statutes can vary from complete divorcement to less extreme forms. Statutes can require oil companies to sell off their existing retail stations, which is known as “divestiture,” or they can prospectively prohibit oil companies from acquiring new retail stations. For example, Maryland is a state with complete divorcement; oil companies there are prohibited from owning and operating any retail stations. Another divorcement state, Nevada, statutorily specifies the number of retail stations that refiners may own and

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26. Id. at 34.
27. Id.
28. MD. CODE ANN., BUS. REG. § 10-311 (1998) (“each retail service station in the State (1) shall be operated by a retail service station dealer; and (2) may not be operated by a producer or refiner of motor fuel”). Maryland’s divorcement statute has been in effect since 1974.
operate. Divorcement statutes were declared constitutional in *Exxon Corp. v. Maryland*, where the Supreme Court upheld Maryland’s statute against claims of due process and Commerce Clause infringements.

Divorcement proposals have been considered by the California Legislature in recent years. One measure would have placed a ceiling on the relative amount of gasoline that oil companies could sell through company-owned retail stations. Senate Bill 52 merely would have placed a moratorium on company-owned sales and would not have mandated divestiture of company-operated stations. In addition to proposed state legislation, at least one California county has seriously considered local regulation. The San Diego County Board of Supervisors passed a divorcement bill but quickly repealed it after threats of litigation by oil companies. Moreover, the Attorney General endorsed divorcement legislation during the 1999-2000 legislative session.

Although divorcement proposals thus far have been defeated in California, they undoubtedly will continue to resurface in the future. The Attorney General has recently stated that he believes “divorcement or divestiture proposals would instill greater competition in the gasoline market and lower California gasoline prices.” It is therefore imperative to examine divorcement’s merits and to understand the benefits and costs of vertical integration in the oil industry. The next section will examine the goals of divorcement proposals. It also explores vertical arrangements within the petroleum industry to explain the effects and shortcomings of divorcement.

2. What Are Divorcement’s Goals?

Purportedly, the main objective of divorcement legislation is to lower gasoline prices by preventing oil companies from exercising control over the retail market. Proponents claim that vertical integration allows oil...
companies to take advantage of consumers by charging inflated prices. They point to statistics that show a correlation between higher prices and the increasing level of integration. However, this claim is contrary to basic economic principles. Vertical integration does not enhance a firm’s ability to raise prices. A manufacturer with monopoly power in the upstream level can already charge the highest possible price that the market can bear; it cannot raise prices any further by vertically integrating downstream.

Proponents make a second argument in favor of divorcement. They claim that oil companies are engaged in a systematic attempt to drive franchisees and independent stations out of business and transform service stations into company-operated facilities. Divorcement would break refiner control of the retail segment, which would result in increased price competition by independent retailers. According to this view, divorcement is necessary to prevent oil companies from driving franchisees out of business and stifling retail competition. They claim that oil companies are accomplishing this by “squeezing” their franchisees, or, in other words, forcing them to operate at an economic loss.

This claim, however, is also meritless. Oil companies have no incentive to squeeze their dealers, and divorcement will neither increase

36. Leffler & Pulliam, supra note 1, at 9.
37. See, e.g., PHILLIP AREEDA & DONALD F. TURNER, ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATIONS ¶¶ 725(a), 725(b), at 197–99 (1978); ROBERT H. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 228–29 (1978); HERBERT HOVENKAMP, ECONOMICS AND FEDERAL ANTITRUST LAW 199 (1985); HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE 337 (1994); RICHARD A. POSNER & FRANK H. EASTERBROOK, ANTITRUST CASES, ECONOMIC NOTES AND OTHER MATERIALS 870–71 (2d ed. 1981); Charles R. Andres, Refusals to Deal by Vertically Integrating Newspaper Monopolists: Paschall V. Kansas City Star Co., 11 WM. MITCHELL L. REV. 527, 538 n.70, 542 n.111, 550 & n.172; Robert H. Bork, Vertical Integration and the Sherman Act: the Legal History of an Economic Misconception, 22 U. CHI. L. REV. 157, 195–98 (1954). See also Paschall v. Kansas City Star Co., 727 F.2d 692, 700–03 (8th Cir. 1984) (en banc). If the upstream monopolist were to raise its downstream retail prices after integrating, its total profits would actually decrease because of the successive monopoly problem. See supra notes 58–65 and accompanying text. Vertical integration, however, can result in higher prices if it facilitates collusion among oligopolistic upstream firms. In such a circumstance, ownership of downstream firms may help detect cheating and enforce a collusion agreement so that the upstream firms can charge the monopoly price. But this explanation does not seem to apply here; even proponents of divorcement legislation concede that there is no evidence of collusion among California refineries. See, e.g., High Gasoline Prices in San Diego, supra note 13, at v. (noting “[t]he [Energy] Committee has seen no evidence of any collusion by any oil companies”).
38. See High Gasoline Prices in San Diego, supra note 13, at vi.
39. Lockyer, supra note 2, at 35.
40. High Gasoline Prices in San Diego, supra note 13, at vi.
competition nor lower prices. This form of opportunistic behavior is against the oil companies’ long-term interests. Even if suppliers are motivated by short-term considerations and abuse their franchisees, divestiture legislation is, nevertheless, unwise, because it is ineffective in eliminating such behavior.

Finally, an unstated objective of divestiture is to mollify franchisees who claim that the vertical arrangements have reduced dealer margins.\(^{41}\) This objective runs completely counter to the first objective of lowering prices. Regrettably, many policymakers fail to acknowledge this fact; they seem to automatically equate the franchisees’ interests with those of consumers and assume that legislation opposed by oil companies would necessarily benefit consumers.\(^ {42}\) This Note will demonstrate that vertical integration and vertical restraints can benefit both consumers and oil companies. If the goal of policymakers is to lower gasoline prices, divestiture measures should not be enacted.

B. VERTICAL RESTRAINTS & INTEGRATION IN THE RETAIL GAS INDUSTRY

In order to understand the effects and shortcomings of divestiture it is necessary to analyze first the types of vertical arrangements in the gasoline industry. In particular, this section will explore the vertical restraint of maximum resale prices and the vertical integration achieved through dual distribution.

1. The Vertical Restraint of Maximum Resale Prices

a. Description and legality:

Maximum resale price mechanism is a contractual limitation imposed by the manufacturer that sets a ceiling on the prices charged by its distributors or retailer.\(^ {43}\) Its legality under antitrust laws has undergone an almost complete about-face. In a much maligned decision, the Supreme Court held that maximum resale prices were per se illegal in *Albrecht v. Herald Co.*\(^ {44}\) under section 1 of the Sherman Act.

\(^{41}\) See id. at 24–25 (statement of Jan Speelman).


\(^{44}\) 390 U.S. 145 (1968). In this case, a newspaper publisher had awarded exclusive territories to its carriers. The carriers purchased the newspapers at wholesale prices from the publisher and delivered them to subscribers’ homes. The newspaper publisher had required its carriers, under threat of
The *Albrecht* Court failed to acknowledge the crucial differences between *maximum* resale prices and *minimum* resale prices, which were already forbidden by the Sherman Act. The decision was based on three justifications that have since been repudiated. First, the Court expressed a fear that maximum price fixing by suppliers would interfere with dealer freedom. 46 Second, the Court expressed concern that maximum prices may be set too low for dealers to offer desired services. 47 Third, the opinion reflected the Court’s fear that maximum resale price could be used to disguise minimum price fixing. 48

After years of stinging academic criticism, 49 a unanimous Supreme Court recognized its error, overruling *Albrecht* in *State Oil Co. v. Khan*. 50 *Khan* did not conclude that maximum resale prices are legal per se, but rather, they are to be judged under the rule of reason. 51 Under this standard, the plaintiff would prevail only by proving that the anticompetitive effects of the defendant’s practice outweigh its pro-competitive effects. 52

In reaching its decision, the *Khan* Court explained that “[l]ow prices . . . benefit consumers regardless of how those prices are set, and so long as they are above predatory levels, they do not threaten competition.” 53 Moreover, “condemnation of practices resulting in lower prices to consumers is especially costly because cutting prices in order to increase business often is the very essence of competition.” 54 The Court systematically refuted the justifications used to support *Albrecht*. First, *Albrecht*’s concern for dealer freedom was unjustified because franchisors

46. *Albrecht*, 390 U.S. at 152.
47. *Id.* at 152–53.
48. *Id.* at 153.
50. 522 U.S. 3, 7 (1997). Interestingly, *Khan* involved a gasoline franchisee who was evicted after falling behind in lease payments. The franchisee filed suit, claiming that the franchise agreement ran afoul of the *Albrecht* prohibition on maximum resale price maintenance.
51. *Id.* at 14–15.
52. See *id.* at 10 (citing *Board of Trade of Chicago v. United States*, 246 U.S. 231, 238 (1918), which established the rule of reason approach).
54. *Id.* (citations omitted).
were free to vertically integrate into retailing and avoid its reach.\(^{55}\) Second, *Khan* rejected the notion that artificially-low prices may foreclose dealer services because this would equally harm the franchisor; thus, the franchisor would not set such a low price as a matter of business judgment.\(^{56}\) Third, *Khan* expressed confidence that the courts could distinguish maximum resale prices with minimum price fixing.\(^{57}\)

b. Pro-competitive justifications:

(i) The successive monopoly problem: Commentators have hypothesized that maximum resale price maintenance is a pro-competitive mechanism used by producers to alleviate the “successive monopoly problem.”\(^{58}\) In fact, the Supreme Court seemed to adopt this rationale in *Khan*.\(^{59}\)

The successive monopoly problem is an economic phenomenon that may occur when two or more levels of production are independently monopolized.\(^{60}\) In other words, it potentially arises when both the producer (upstream firm) and the reseller (downstream firm) possess market power that is independently derived. The source of market power for the upstream firm might be derived from such sources as having a natural monopoly, patents, or intellectual property on its products or generated by brand differentiation.\(^{61}\) By contrast, the downstream market power stems primarily from the exclusive territories granted to resellers by the producer.\(^{62}\)

The existence of successive monopolies is a “problem” because it results in higher prices to consumers and *less* total profits than having a single, integrated monopoly in both levels of production.\(^{63}\) The counter-intuitive nature of this phenomenon is that eliminating the successive monopoly problem would result in higher total profits and *lower* consumer

55. *Id.*
56. *Id.* at 16–17.
57. *Id.* at 17.
59. See *Khan*, 522 U.S. at 15.
60. Blair & Lafontaine, supra note 58, at 28. For simplification, this Note will assume only two levels of production: upstream and downstream. The successive monopoly problem can arise, however, if any two or more successive levels are monopolized.
62. *See id.*
63. *See id.*
prices. From the perspective of the producer, there are two ways to eliminate this problem. First, the producer can vertically integrate—i.e. distribute its products through company-owned outlets. Integration would ensure that there are no incentive incompatibilities in that the retailers would set a price to maximize total profits.

The alternative method to alleviate the successive monopoly problem is for the producer to impose maximum resale price restraint upon on its retailers. Maximum resale price restraint contractually prevents the retailer from exercising its market power and charging super-competitive prices. Thus, it is a contractual alternative to achieving the efficiency benefits of integration. Since the upstream firms know what price will maximize total profits (i.e., the competitive retail price), it will agree to distribute its products through the independent retailer or franchisee only on the condition that the retailer will not charge a price in excess of this competitive price. This allows the upstream firm to appropriate all of the economic profits, leaving the retailer with only a competitive return. In addition to increasing total profits, maximum resale prices benefit consumers by forcing the retailer to set a price below the price it would have charged otherwise. Therefore, by eliminating the successive monopoly problem, maximum resale prices increase the producer’s profits, while decreasing the price charged to consumers.

The Supreme Court seemed to adopt this explanation in Khan when it upheld the use of maximum resale price mechanism in the oil industry. The Court correctly assumed that the upstream firms in the oil industry (i.e., the refiners or oil companies) possess market power. The source of market power for upstream firms comes from brand name differentiation and the high degree of market concentration. Khan’s analysis is problematic, however, because it is less evident whether the second condition for a successive monopoly problem exists in the oil industry. Namely, do downstream retail stations possess market power? The Court, quoting the lower court opinion by Chief Judge Posner, seemed to assume that they do:

64. See id.
65. By contrast, an independently owned retailer would set a price to maximize its own profits, which would result in higher consumer prices and lower overall profits.
66. See id.
67. See id.
68. Khan, 522 U.S. at 15.
69. See supra text accompanying notes 60–61.
A supplier might . . . fix a maximum resale price in order to prevent his dealers from exploiting a monopoly position . . . . [S]uppose that State Oil, perhaps to encourage . . . dealer services . . . has spaced its dealers sufficiently far apart to limit competition among them (or even given each of them an exclusive territory); and suppose further that Union 76 is a sufficiently distinctive and popular brand to give the dealers in it at least a modicum of monopoly power. Then State Oil might want to place a ceiling on the dealers’ resale prices in order to prevent them from exploiting that monopoly power.\(^70\)

The Court then backtracked: “We do not intend to suggest that dealers generally possess sufficient market power to exploit a monopoly situation. Such retail market power may in fact be uncommon.”\(^71\)

The schizophrenic nature of the opinion reflects the fact that the Court recognized the tenousness of gasoline dealer market power but did not have an alternative economic theory to support its holding. While gasoline dealers may face demand curves that are somewhat negatively sloped, this does not necessarily imply that they have sufficient market power to justify maximum resale prices. One respected commentator has written that if gasoline dealers’ small amount of market power were sufficient, then maximum resale price maintenance would be used in almost every industry. Indeed, “[n]early every retailer in the economy faces demand at least as inelastic as that faced by gasoline dealers,”\(^72\) as “every firm in the economy except perhaps the wheat farmers of the perfectly competitive economics textbook model has a ‘modicum of monopoly power’ in this sense.”\(^73\)

Professor Klein correctly argues that the Court and Posner have confused monopoly power (or market power) with an individual firm’s pricing discretion.\(^74\) The latter merely means that a firm has some ability to change its own prices without losing all of its sales; market power, by contrast, means that a firm’s pricing decisions can influence market prices. Although individual gasoline stations may have some discretion to set their own prices, they do not have the ability to influence market prices.\(^75\) Therefore, since there is no downstream market power in the petroleum

\(^70\) Khan, 522 U.S. at 16 (quoting 93 F.2d 1358, 1362 (7th Cir. 1996)).
\(^71\) Id. at 18.
\(^72\) Klein, supra note 58, at 4 (1999).
\(^73\) Id. at 47.
\(^74\) See id.
\(^75\) See id.
industry, the successive monopoly problem is not an adequate explanation for the use of maximum retail prices.\(^{76}\)

(ii) Different elasticities of multiple grades of gasoline: Professor Klein has recently advanced two alternative explanations for the use of maximum resale prices in *Khan* and in the petroleum industry generally. Both of these explanations are based on the fact that gasoline is sold in multiple grades and each grade has a different elasticity of demand.\(^{77}\) Klein’s first explanation is that premium-grade gasoline in particular has a successive monopoly-like problem.\(^{78}\) His second explanation is that maximum resale price maintenance helps solve a “variable proportions” problem.\(^{79}\) Each will be examined in turn.

With respect to the first explanation, he notes that regular-grade gasoline is purchased by customers with more elastic demand curves, while customers who purchase premium gasoline have more inelastic demand.\(^{80}\) There are three reasons for the difference in elasticity. First, premium gasoline customers are generally higher-income individuals who drive cars that require the higher grade.\(^{81}\) Second, higher-income individuals usually have higher shopping or search costs so that they are less likely to compare stations based on price.\(^{82}\) Third, these customers have higher demand for perceived quality and are thus less price sensitive.\(^{83}\)

A relatively inelastic demand curve for premium gasoline creates an incentive for gas stations to increase the price and margin on premium gasoline.\(^{84}\) That is, the negatively sloped demand curve on premium

\(^{76}\) See id. It is important to note, however, that the successive monopoly problem may in fact be the underlying cause of maximum resale prices in situations where the downstream retailer possesses market power, especially as a result of an exclusive territory. This appears to have been the case in *Albrecht*, where the downstream distributor possessed an exclusive territory for newspaper delivery. Since consumers had no alternatives in selecting their newspaper carrier, Albrecht exercised his market power by raising prices above the publisher’s advertised price. See *Albrecht*, 390 U.S. at 147–48. Moreover, the successive monopoly problem may exist in the gasoline industry if there is only one gasoline dealer in an entire geographic market. In this limited situation, the sole retailer would comprise the entire market and could therefore influence market prices. To control this specific instance of successive monopoly problem, the oil company may wish to vertically integrate and run this particular station as a company-operated facility, or in the alternative, impose maximum resale prices.

\(^{77}\) Klein, *supra* note 58, at 52–55.

\(^{78}\) Id.

\(^{79}\) Id. at 55–56.

\(^{80}\) Id. at 53.

\(^{81}\) Id.

\(^{82}\) Id.

\(^{83}\) Id.

\(^{84}\) Id.
gasoline provides dealers with increased pricing power with respect to that grade of gasoline. While dealers would wish to take advantage of the inelastic demand by setting a higher price for premium gasoline (equal to the intersection of marginal cost and marginal revenue), this would be incompatible with the oil companies’ objective. The latter would not want the dealers to earn a higher margin on premium gasoline because this would create a successive monopoly type of problem on premium gasoline sales. In other words, if retailers charged a super-competitive price on premium gasoline and earned positive economic profits, the sum of profits earned by the oil company and the retailers would not be maximized. As discussed in the successive monopoly analysis above, the upstream firm would wish to restrain the lower firm’s ability to raise prices above a competitive level so that the upstream firm would earn all of the economic profits. This would maximize joint profits, while reducing the final price charged to consumers. Therefore, Klein argues that maximum resale prices are used to prevent a gasoline dealer from raising its price on premium gasoline.

Klein’s second explanation for the use of maximum resale prices in the gasoline industry is a solution to what he calls the “variable proportions” problem. This problem is caused by oil companies and retailers wishing to maximize sales of different grades of gasoline. The oil company wants to maximize sales of premium grade gasoline because it provides a higher profit margin. However, the dealer has the opposite incentive in that the dealer wishes to maximize regular gasoline sales. Regular gasoline is a better input for drawing consumers into the dealer’s convenience store, which is a greater source of profits than gasoline sales. In fact, the data from the Khan litigation showed that every additional regular gallon sold led to an additional 14.55¢ of convenience store sales, while other gasoline grades had no statistically significant relationship with convenience store sales. Therefore, the retailer would wish to increase premium grade prices and decrease regular grade prices in order to shift sales to the regular grade and

85. Id.
86. The term “joint profits” is a bit of a misnomer because joint profits are maximized when the upstream firm earns all of the economic profits and the retailer earns zero economic profits.
87. See Klein, supra note 58, at 55.
88. Id.
89. Id.
90. Id.
91. Id.
92. Id.
draw customers into its convenience stores. However, “the dealer’s shift in gasoline demand towards regular and away from premium hurts the gasoline supplier by producing a mix of premium and regular gasoline sales that is not jointly profit-maximizing. Maximum resale price maintenance then is used to prevent this substitution of dealer demand between gasoline grades.”

In sum, the cause of maximum resale price mechanism in the petroleum industry is based on the existence of multiple grades of gasoline with different elasticities of demand. The fact that premium gasoline has a more inelastic demand creates a successive monopoly type of problem so that the dealer would want to exercise its market power and raise its premium gasoline prices to the detriment of total profits and consumers. Moreover, the fact that regular gasoline sales encourages more-profitable convenience store sales further incentivizes the dealer to raise premium-grade gasoline prices and lower regular-grade gasoline prices in order to shift demand towards regular-grade gasoline. Although Khan mentioned neither of these reasons, they are both pro-competitive justifications in that they result in lower prices and increased profits.

2. (Partial) Vertical Integration Through Dual Distribution

   a. Description and legality:

   In addition to the vertical restraint of maximum resale prices, the petroleum industry is also partially vertically integrated through the practice of dual distribution. Dual distribution means that the oil companies own and operate some, but not all, of the retail stations which distribute its products. These company-operated stations are in intrabrand competition with the oil company’s franchised stations. By contrast, full integration means that the producer sells directly to final customers without any independent distributor. On the other extreme, a producer may distribute its products entirely through independent distributors or franchisees.

93. Id.
94. See High Gasoline Prices in San Diego, supra note 13, at vi.
95. Blair & Esquibel, supra note 43, at 171–72. Intrabrand competition is competition between two distributors of the same brand (i.e., two Shell stations competing against each other), while interbrand competition refers to competitors of different brands (i.e., competition between an ARCO and a Shell station).
While full integration generally poses no antitrust problems,\(^\text{96}\) earlier cases were much more skeptical to dual distribution arrangements.\(^\text{97}\) These earlier cases framed the dispositive issue as how to characterize the restraints that usually accompany dual distribution systems. If the court characterized the restraints as vertical (because they are imposed by the manufacturer), the rule of reason would be applied. In contrast, if the restraint was deemed horizontal (because the manufacturer is also a competitor), the distribution system would be declared per se illegal.\(^\text{98}\) This methodology was unprincipled and arbitrary because dual distribution arrangements always involve both vertical and horizontal restraints.

This characterization approach was abandoned after the Supreme Court's decision in Continental T.V., Inc. v. GTE Sylvania\(^\text{99}\) in which the Court overruled the per se rule for non-price vertical restraints. The characterization approach of the earlier cases was inconsistent with Sylvania's admonition against formalistic line-drawing.\(^\text{100}\) Moreover, the Court stated that the rule of reason is the "prevailing standard of analysis" under section 1 of the Sherman Act and that the per se rule should only be used where the conduct is "manifestly anticompetitive."\(^\text{101}\) Finally, Sylvania re-emphasized that the focus of antitrust laws is interbrand competition. Thus, vertical restrictions should be upheld as long as the effect on interbrand competition exceeds the loss in intrabrand competition.\(^\text{102}\)

Following Sylvania, lower courts have emphasized dual distribution's positive effects on interbrand competition and have upheld such arrangements under the rule of reason.\(^\text{103}\) The Ninth Circuit explicitly

\(^{96}\) See Robert Zwirb, Dual Distribution and Antitrust Law, 21 Loy. L.A. L. Rev. 1273, 1273 & n.3 (1988) (providing a list of cases). As Judge Posner observed, "[V]ertical integration is not an unlawful or even a suspect category under the antitrust laws . . . . Vertical integration is a universal feature of economic life and it would be absurd to make it a suspect category under the antitrust laws just because it may hurt suppliers of the service that has been brought within the firm." Jack Walters & Sons Corp. v. Morton Bldg., Inc., 737 F.2d 698, 710 (7th Cir. 1983).


\(^{98}\) See Zwirb, supra note 96, at 1277–78.


\(^{100}\) Id. at 59 (White, J., concurring in judgment).

\(^{101}\) Id. at 49.

\(^{102}\) Id. at 50.

\(^{103}\) Id. at 54–56.

adopted this view in *Krehl v. Baskin-Robbins Ice Cream Co.*\(^{105}\) Relying on the familiar Supreme Court test for determining whether the per se rule should be applied,\(^{106}\) the court found that application of a per se illegality rule “would be both inapposite and anticompetitive.”\(^{107}\) Using a rule of reason analysis, *Krehl* upheld the dual distribution system as it found no significant adverse impact upon either interbrand or intrabrand competition. Indeed, the court noted that such a distribution system fosters interbrand competition in promoting wider availability of its products and new market penetrations.\(^{108}\)

Thus, post-*Sylvania* analysis indicates that dual distribution arrangements probably will be upheld under a rule of reason analysis. The reasons that oil companies in particular employ this form of partial vertical integration will be examined next.

b. Pro-competitive justifications:

As indicated above, dual distribution is a form of partial vertical integration, which itself should be properly understood as “just one point on a continuum of methods of *transaction governance*.\(^{109}\) In other words, vertical integration is a form of long-term contract in which the rights and obligations of the parties are fully specified.\(^{10}\) The decision of whether to vertically integrate is similar to the decision-making process of other transactions and contracts; namely, a firm will integrate when the total benefits exceed total costs.\(^{111}\)

(i). Controlling retailer’s incentive to raise prices: The interbrand competition that results from dual distribution helps counter the retailers'
incentive to increase prices. In this sense, dual distribution may be another solution to the successive monopoly problem associated with premium grade gasoline.\footnote{112. See supra text accompanying notes 77–93.}

Dual distribution complements use of maximum resale price maintenance in preventing the retailer from increasing premium gasoline prices. The company-owned stations have no incentive to charge prices that are different than the joint profit-maximizing price; indeed, their incentives are exactly the same as the supplier. Thus, the company-owned stations will charge a price that approximates the marginal cost of retailing. Through intrabrand competition, the supplier hopes to pressure the franchisees to lower their prices to this level.\footnote{113. Indeed, a lobbyist representing franchisees conceded that company-owned stations often have the cheapest prices: “The retail market is very often set by the company-operated stations that are in that locale.” \textit{High Gasoline Prices in San Diego}, supra note 13, at 24 (statement of Jan Speelman of the Automotive Trade Organizations).} Unlike maximum resale price maintenance, then, dual distribution is an indirect means to accomplish this goal.

But given that oil companies may freely use maximum resale price maintenance after the \textit{Khan} decision, why use dual distribution at all? Put differently, if maximum resale prices are a more direct means to control retail market power, why would oil companies simultaneously use a less direct means?\footnote{114. See Blair & Esquibel, supra note 43, at 172 (stating that “dual distribution . . . provides only an approximate resolution of the successive monopoly problem”).} I offer several explanations for the use of dual distribution in light of the legality of maximum resale price maintenance. First, \textit{Khan} is a relatively new decision and firms’ distribution systems cannot be changed immediately. Thus, even if there were no other advantages to this form of intrabrand competition, it would take some time for suppliers to divest themselves completely of gasoline retailing.

Second, while the \textit{Khan} decision legalized resale price maintenance with respect to federal antitrust laws, there is some uncertainty with respect to state antitrust laws. For example, the California Supreme Court has not revisited this issue after \textit{Khan} was decided. In a pre-\textit{Khan} decision, the state high court held that California antitrust law prohibits maximum resale prices as per se illegal.\footnote{115. See Mailand v. Burckle, 572 P.2d 1142 (Cal. 1978) (construing California Cartwright Act, \textsc{Cal. Bus. Prof. Code} § 16700 et seq.). See also Warren S. Grimes, \textit{Making Sense of State Oil Co. v. Khan: Vertical Maximum Price Fixing Under A Rule of Reason}, 66 \textsc{Antitrust L.J.} 567, 610 (1998) (noting that California antitrust law “may continue to treat vertical maximum price fixing as per se unlawful”).}

Interpretation of federal antitrust laws by federal
courts is persuasive authority for states in interpreting state laws. Thus, the California Supreme Court will probably overrule its pre-Khan decision and adopt the rule of reason analysis if confronted with the issue. Some uncertainty about the California disposition exists, however, because the California Cartwright Act is sometimes interpreted more broadly than federal law. Therefore, maintaining a dual distribution system may be a safety net should the maximum resale price maintenance be held illegal under state law.

Third, there are high transaction costs in enforcing maximum resale price agreements. The supplier must bear significant policing costs in visiting its franchisees and determining whether their prices exceed the agreed-upon maximum prices. Moreover, if the supplier finds that a franchisee has violated the maximum resale price agreement, its remedy is a costly termination action. Dual distribution, by contrast, uses market forces to accomplish the same goal. While only an indirect mechanism, it is less costly to enforce than the contract mechanism.

(ii) Ensuring Adequate Promotional Services: In addition to controlling retailer’s incentive to raise prices, dual distribution may be used to ensure that retailers provide adequate promotional services. Franchisees may have an incentive to shirk on providing consumer services that the manufacturer desires. This is particularly true in remote regions because there are high externalities associated with providing such services.

For example, take the case of a franchised Shell station that is located along an isolated stretch of highway. Most of this station’s customers will not be repeat customers but rather those on long drives. Shell Oil Company will want this dealer to provide certain services, such as clean bathrooms and paper towels for washing windows. The benefits of providing such services at this location would accrue to all Shell stations, because it would improve the name brand of Shell. This particular dealer, however, would bear all the costs of providing its services. Therefore, it would not be in the dealer’s interest to provide many of the services that

117. See, e.g., Cianci v. Superior Court, 710 P.2d 375, 384 (Cal. 1985). “[T]he Cartwright Act is broader in range and deeper in reach than the Sherman Act.” Id.
118. See Klein, supra note 58, at 5–15, 23–25 (analyzing the free rider problems with respect to promotional services).
119. See id. at 23–24 (discussing dealer’s incentive to free ride on manufacturer’s brand name by reducing quality).
would maximize joint profits. The supplier could require the dealer to provide these services as a condition of the franchise and could terminate the franchise upon non-performance. In situations where the externality is particularly large (i.e., remote stations that have little or no repeat customers), the threat of termination might be ineffective to ensure that these services will be provided. Shell may therefore wish to operate this station as a company-owned outlet to ensure that these services are provided.120

These pro-competitive justifications behind dual distribution and maximum resale price agreements should be balanced against the potential for anticompetitive conduct in order to reach a considered decision on the wisdom of divorcement legislation.

C. ANTICOMPETITIVE POTENTIAL OF RESTRAINTS AND INTEGRATION

Proponents of divorcement legislation claim that the restraints and integration in the oil industry are used to further anticompetitive goals of the oil companies. Specifically, they allege that oil companies utilize these mechanisms in order to “squeeze” the franchisees and independent stations.121 Proponents claim that this anticompetitive behavior stifles competition in the retail market by reducing the number of stations, and thus, driving up prices.122

Squeezing refers to forcing retailers to operate below a competitive rate of return by either: (1) supplying gasoline to dealers at high wholesale prices or (2) preventing dealers from charging a competitive retail price. Squeezing can be accomplished by both maximum resale price maintenance and dual distribution. For example, oil companies can set the maximum resale price so low that dealers are contractually forced to operate at a loss. Dual distribution can also result in squeezing if franchisees are forced to lower their prices in response to competition by

120. Klein provides an alternative means to ensure that services are provided besides operating the station as a company-owned outlet. He argues that franchisors use distribution restrictions to ensure that the “distributor earns a sufficient profit when it performs as desired so that it has something to lose when it fails to perform as desired.” Id. at 26. My analysis is consistent with Klein’s proposition. In some cases, sufficient dealer rents may be generated by the distribution arrangement in order to ensure that promotional services are provided. But in other situations, it is possible that these dealer rents would simply be inefficient to prevent the dealer from shirking on quality or services (i.e., when the benefits of shirking are particularly high due to the fact that none of its customers are repeat customers, resulting in a large externality problem). In this situation, the franchisor might forego trying to create larger dealer rents and simply integrate and run it as a company-owned station.

121. High Gasoline Prices in San Diego, supra note 13, at vi.

122. See Lockyer, supra note 2, at 35.
company-owned stations that are charging prices that foreclose a competitive return. This opportunistic behavior is socially harmful because it artificially reduces competition at the retail level. If squeezing is in fact occurring, some form of legal remedy is justified.

Whether suppliers do in fact act anticompetitively with respect to their own distributors is a matter of contention among economists. Chicago School economists argue that a “franchisor has no long-run incentive to actually squeeze its franchisees” because “this ultimately would destroy the market for the upstream firm’s product.”¹²³ In other words, a “reputation effect” would guard against opportunistic behavior because no potential franchisee would agree to distribute the products of a supplier with a reputation for squeezing.¹²⁴ Judge Posner recognized this in his Khan opinion when he said that a low resale price ceiling “would just drive . . . dealers into the arms of a competing supplier.”¹²⁵

On the other hand, other commentators argue that suppliers do have an opportunistic incentive with respect to their distributors. Professor Grimes, for example, argues that a supplier may have market power over distributors who have incurred substantial “sunk costs” in order to carry the supplier’s products.¹²⁶ Sunk costs are capital investments that cannot be recovered if the dealer sells or abandons his business.¹²⁷ In the gasoline industry, sunk costs might include up-front franchise fees paid to the franchisor and the cost of terminals, equipment, and inventory that cannot be fully recovered upon sale of the business.

A retailer that has incurred substantial sunk costs to carry the products of a particular supplier might become effectively “locked in” to its relationship with that supplier.¹²⁸ In other words, unrecoverable capital investments may result in switching costs so high that it might become too costly for the dealer to change suppliers, thus providing the supplier with a source of monopoly power over its dealers.¹²⁹

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¹²⁷. See id. at 125.
¹²⁸. See Grimes, supra note 115, at 586.
¹²⁹. See id.
Grimes recognizes that franchisors have no long-term incentive to abuse their dealers, but he nonetheless argues that franchisors may act opportunistically if they “disregard long-term interests or . . . misperceive what those long-term interests are.” Franchisors might be incentivized by shareholders and performance-based compensation to increase short-term performance at the expense of franchisee loyalty and long-run stability of the franchise system. In response to those that argue that reputation effect is sufficient to guard against opportunistic behavior, Grimes retorts:

[T]here is a disquieting arrogance about any contention that market forces prevent franchisors from pursuing short run gain at the expense of business reputation, allocative efficiency, and franchisee welfare. If this logic were sound, insurance companies would never commit fraud on their policyholders, used car dealers would never cheat their customers, securities firms would never churn customer accounts, and the wolf would never have eaten Little Red Riding Hood. The business pages are full of stories of firms of all sizes in diverse businesses that have chosen the wrong marketing strategy, even to the point of defrauding customers. A decision by a corporate franchisor to pursue short-term profits may be a mistake, but it is a mistake that can produce short term rewards in higher stock values and increased compensation for the franchisor’s key executives. And the immediate costs of that mistake may fall not on the franchisor but on franchisees with heavily committed investments in their outlets.

Perhaps empirical evidence can one day conclusively determine whether franchisors act opportunistically to maximize short-run profits or whether they remain committed to maximizing long-run franchisee loyalty. Until then, policymakers need concrete advice on statutory proposals that aim to increase protections for dealers. Therefore, it seems prudent to assume that some franchisors may act on their short-run interests and abuse their dealers. The next section will thus analyze the merits of divorcement legislation assuming that some oil companies might use their vertical arrangements in an anticompetitive manner.

D. EFFECTS OF DIVORCEMENT LEGISLATION

Divorcement would eliminate the practice of dual distribution by prohibiting oil company ownership of retail gasoline stations. Consequently, all of the pro-competitive effects of dual distribution would
be lost. Suppliers would no longer be able to use market pressures to prevent franchised stations from taking advantage of their market power to raise prices or to shift demand among grades of gasoline.\textsuperscript{133} Moreover, the level and quality of promotional services (such as clean bathrooms) may suffer, as gasoline suppliers no longer have the option of running certain dealerships as company-owned facilities.\textsuperscript{134} By eliminating these pro-competitive features, divorcement would greatly benefit franchisees who would be empowered to raise consumer prices, shirk on services, and earn super-competitive profits.

More significantly, divorcement would have no impact on the alleged anticompetitive behavior of oil companies towards their franchisees. Even if oil companies act opportunistically toward their franchisees by forcing them to operate at an economic loss, they could still accomplish this by use of maximum resale price restraints, which would remain legal. As explained above, dealers could be squeezed, or forced to operate at a loss, in either of two ways: by being forced to sell gasoline at prices that are too low or by being forced to purchase gasoline at wholesale prices that are too high.\textsuperscript{135} By eliminating dual distribution, divorcement merely prohibits oil companies from utilizing the former means. But divorcement does nothing to prevent oil companies from using maximum resale price restraints to force retailers to purchase gasoline at excessively high wholesale prices. Moreover, maximum resale price arrangements provide a more direct means to squeeze dealers than a system of dual distribution, which relies on market pressures. In sum, even if the franchisees’ claim of supplier abuse is valid, divorcement is an ineffective remedy. Existing laws provide sufficient remedies to curb this behavior.

E. EXISTING LAWS PROVIDE SUFFICIENT REMEDIES

Assuming there is a problem of opportunistic behavior, the foregoing analysis suggests that proposed solutions must address the more direct means of squeezing: setting maximum resale prices too low or setting wholesale prices too high. As explained next, existing laws provide sufficient remedies to gasoline franchisees who are squeezed by their supplier.

\begin{itemize}
\item \textsuperscript{133} \textit{See supra} text accompanying notes 112–117.
\item \textsuperscript{134} \textit{See supra} text accompanying notes 118–120.
\item \textsuperscript{135} \textit{See supra} text accompanying notes 112–123. By “too high” and “too low,” I simply mean that the prices do not allow for a competitive rate of return.
\end{itemize}
1. Antitrust Remedies

It is important to emphasize that Khan still allows franchisees to use antitrust laws in challenging maximum resale price restraints. Khan did not hold that maximum resale prices are legal per se; merely that the rule of reason analysis applies.136 Plaintiffs now bear the burden of proving that the effect of the maximum resale price mechanism is, on balance, anticompetitive.137 This is a difficult hurdle as the “Court [has] provided a great deal of ammunition for a defendant”138 but very little guidance on how a plaintiff could win such a case.

The defendant will undoubtedly rely on economic theory that states that such a vertical arrangement is pro-competitive because it alleviates the successive monopoly problem. The plaintiff must present evidence that counters the general economic theory and show that the restraint decreases intra brand competition without a proportional increase in inter brand competition. For example, the plaintiff might show that maximum resale prices have squeezed certain franchisees out of business and have not increased the oil company’s market share in that area. Admittedly, this is a difficult burden because the plaintiff is essentially arguing that the oil company acted against its own long-term interest. However, this burden is appropriate because maximum resale prices are generally pro-competitive.

Even though Khan allows plaintiffs to use antitrust laws in challenging dealers’ opportunistic behavior, courts should be reluctant in awarding antitrust remedies in this context. Antitrust remedies should be reserved for cases that involve genuine harm to the competitive landscape, since the successful plaintiff can recover treble damages. In the words of the Supreme Court, antitrust laws were passed for the “protection of competition, not competitors . . . .”139

Cases dealing with franchisor squeezing or opportunism should not implicate antitrust laws; rather, they are merely situations of contract “hold up.” A contracting party holds up when he opportunistically takes advantage of the other’s sunk costs and demands concessions in order to perform.140 Hold up must be distinguished from market power for antitrust purposes. As Klein and Saft explain, a postcontract hold up potential should not be confused with market power in the precontract stage:

136. Khan, 522 U.S. at 322.
137. See supra text accompanying note 51.
140. Klein & Saft, supra note 124, at 356.
The important economic distinction that must be made is between pre- and postcontract economic power. Precontract, competition among franchisors . . . to sign up franchisees prevents [a single franchisor] from exercising any economic power in setting contract terms with potential franchisees . . . .

Postcontract, on the other hand, a franchisor can use the threat of termination to “hold up” a franchisee that has made a specific investment in the marketing arrangement. However, this potential economic power has nothing to do with market power, ultimate consumers’ welfare, or antitrust.142

For example, take the case of an oil company that sets a maximum resale price that is too low for the franchisee to earn a competitive return. While the franchisee is harmed, consumers are clearly benefited from this restraint in the form of lower prices.142 Dealers should not be able to recover treble damages for a contractual relationship that lowers consumer prices.

Fortunately, courts have generally refused to award antitrust damages in franchisor hold up cases. For example, the Ninth Circuit has held that postcontract hold-up potential does not provide market power for tying purposes. In Mozart Co. v. Mercedes-Benz of North America,143 the court correctly distinguished between sunk costs that allow the franchisor to extract concessions with market power that is derived from possible uniqueness of the product.144 The analysis for vertical restraints and tying claims, the court said, must be made at the precontract stage and not after a franchise agreement has been signed.145

141. Id. (emphasis added).
142. Of course, it is possible that consumers are harmed in the long-run if the low prices force dealers out of business and company-owned stations will then increase prices. It is not, however, in the long-run interest for oil companies to do this. Even Grimes admits that dealer squeezing is not a long-term incentive, but merely a short-term opportunistic phenomena. See supra text accompanying notes 130–132. Thus, it is difficult to imagine why an oil company would continue to squeeze dealers in the long-run, given that dealers may quit the business if they do so.
143. 833 F.2d 1342 (9th Cir. 1987).
144. Id. at 1346–47.
145. Id. Accord Queen City Pizza, Inc. v. Domino’s Pizza, Inc., 922 F. Supp. 1055 (E.D. Penn. 1996) (citing Klein & Saft, the court said that the plaintiff mistakenly “engages in ‘post-contract’ analysis concerning defendant’s power over already existing franchises by virtue of their ‘sunk costs.’ . . . [A]llegations of wrongdoing in the post-contractual setting implicate principles of contract, and are not the concern of the antitrust laws.”). Id. at 1061–62.
The rationale of Mozart was recently applied in the retail gasoline context in Exxon Corp. v. Superior Court. There, the franchisee filed suit against Exxon for supplying gasoline at higher prices than sold to other stations in its distribution network. In essence, this was a simple price squeezing case. The court denied the franchisees’ antitrust claims against Exxon and noted that “[p]laintiff’s real complaint is that they are being oppressed within a contractual relationship with the manufacturer. There are legal remedies for oppressive conduct regarding a contractual relationship, but they are not antitrust remedies.” Further, the court emphasized that the hold-up problem resulted from a business relationship freely chosen by the franchisee.

Thus, these cases have appropriately held that gasoline dealers who have been squeezed or abused by franchisor opportunism should seek contract, not antitrust, remedies.

2. Covenant of good faith and fair dealing

Gasoline franchisees who have been squeezed by their suppliers may have contractual remedies under the covenant of good faith and fair dealing, which is implied by law in every contract. This covenant imposes an obligation on each contracting party to refrain from actions, which would prevent the other from realizing the fruits of performance or frustrate the other party’s receipt of bargained-for benefits. When a party possesses discretion under a contract (i.e., setting the wholesale price of gasoline), the duty of good faith requires the party to exercise that discretion for purposes contemplated by the parties.

This principle was applied in Bills, Inc. v. Tzucanow, where a gasoline dealer challenged its supplier’s high wholesale prices. The franchisee claimed that the oil company was charging it more for gasoline than the price offered to the public at company-owned stations. The franchisee subsequently purchased gasoline from alternative sources, and as a result, the oil company terminated the franchise and brought an unlawful detainer action. In response, the franchisee claimed an

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146. 60 Cal. Rptr. 2d 195, 204 (Ct. App. 1997).
147. Id. at 204.
148. See id.
149. See, e.g., CAL. COM. CODE § 1203 (West 2001) (California’s codification of the Uniform Commercial Code); Roberts v. Sentry Life Ins., 90 Cal. Rptr. 2d 408, 415 (Ct. App. 1999); Harm v. Frasher, 5 Cal. Rptr. 367, 374–75 (Ct. App. 1960).
150. See CAL. COM. CODE § 2305 (West 2001); Pride v. Exxon Corp., 911 F.2d 251, 256 (9th Cir. 1990); Lazar v. Hertz Corp., 191 Cal. Rptr. 849, 857 (1983).
151. 700 P.2d 1280 (Cal. 1985).
affirmative defense that the plaintiff-franchisor did not have good cause for termination, because the excessively high prices contravened the good faith provisions of the Uniform Commercial Code. The California Supreme Court agreed with the franchisee and held that the trial court had improperly excluded evidence that the franchisor’s prices were too high to allow the franchisee to earn a competitive return.

Although the case concerned an affirmative defense to an unlawful detainer claim, Bills’ holding should apply with equal force to a suit by the franchisee against the oil company for breach of the implied covenant. In other words, it should not matter whether the franchisee waits until his franchise is terminated before raising this claim or whether he initiates the action himself. Moreover, although Bills involved a situation where the wholesale prices were set too high, the covenant should also apply where a retailer alleges that maximum resale prices were set too low. The economic effect resulting from excessively low maximum resale prices and excessively high wholesale prices is the same; indeed, they are merely two sides of the same coin. If maximum resale prices are too low, then wholesale prices are, by definition, relatively too high.

In sum, the foregoing discussion has shown that divorcement would not be successful in eliminating franchisor opportunistic behavior. This behavior is blamed incorrectly for decreasing competition in the retail sector and for increasing prices. This section has demonstrated that there is no long-term incentive for oil companies to engage in this behavior. Even if squeezing does occur, the problem is a contractual dispute between franchisees and oil companies. Divorcement would not remedy this problem because alternative means to accomplish squeezing would remain legal. Not only does divorcement fail to achieve its objective, it does more harm than good by eliminating a pro-competitive mechanism to correct market failures.

The next Section analyzes the other hotly-debated measure facing the California Legislature: open supply legislation which is intended to curb the practice of zone pricing.
III. OPEN SUPPLY LEGISLATION: ENDING ZONE PRICING

A. THE PRACTICE OF ZONE PRICING

Zone pricing refers to the oil company practice of dividing the state into various geographic wholesale pricing zones.\(^{152}\) This practice is not unique to California; it is used throughout the country.\(^{153}\) Under zone pricing, all retail stations of the same brand, in a given price zone, pay an identical wholesale price known as the Dealer Tank Wagon price (DTW).\(^{154}\) Retailers in different price zones, however, pay different wholesale prices.\(^{155}\) Under this system, dealers are not permitted to shop around for the cheapest source of branded gasoline, as their supply contract requires them to purchase gasoline on a “delivered basis.”\(^{156}\) For instance, a San Diego Shell franchisee cannot purchase gasoline from a less expensive Shell distributor in Los Angeles. Instead, Shell Oil Company will deliver gasoline to the dealer’s station and charge the DTW price that is in effect for that zone.

Zone pricing allows oil companies to monitor local competition and selectively change pricing without impacting prices in other areas. Thus, companies can drop prices in certain zones to meet a competitive threat from lower-priced independent dealers.\(^{157}\) Zone pricing is blamed for price differences between different parts of the state.\(^{158}\) For example, prices in San Francisco were 21.6¢ per gallon higher than prices in Los Angeles during the first nine months of 1999, and San Diego prices were 12¢–15¢ per gallon higher than those in Los Angeles in prior years.\(^{159}\) The


\(^{153}\) See Cain v. Chevron U.S.A., Inc., 757 F. Supp. 1120, 1123–25 (D. Or. 1991) (recognizing that zone pricing has been used by oil companies for many years throughout the nation).

\(^{154}\) See High Gasoline Prices in San Diego, supra note 13, at 37; Leffler & Pulliam, supra note 1, at 13. The street price of gasoline is comprised of the DTW price, excise taxes, state sales tax, and the dealer’s profit margin. By contrast to the DTW price, another wholesale price is called the “rack price.” The rack price is the price sold to independent distributors (or “jobbers”) who, in turn, sell gasoline to retail stations. Thus, some retailers are supplied by the oil company at the DTW price, while others are supplied by jobbers who had purchased the gasoline at the rack price.

\(^{155}\) Id.

\(^{156}\) High Gasoline Prices in San Diego, supra note 13, at 37.

\(^{157}\) id.

\(^{158}\) See Leffler & Pulliam, supra note 1, at 3.

\(^{159}\) See Senate Rules Committee, Bill Analysis on S.B. 52, 1996–1997 Leg. Sess. (Cal. 1997), available at Westlaw, CCA-OLD database (claiming a 15¢ differential); High Gasoline Prices in San Diego, supra note 13, at 12 (discussing that media sponsored surveys have shown differences as large as 20¢ per gallon between San Diego and Los Angeles); Leffler & Pulliam, supra note 1, at 4, 12 (showing a 12¢ differential). The spread in San Diego and Los Angeles prices is not merely caused by
spread between San Francisco and Los Angeles prices is particularly interesting in light of the fact that San Francisco refiners typically produce more gasoline than necessary for Northern California consumption and export the surplus to Southern California.\footnote{160}

B. LEGALITY OF ZONE PRICING UNDER THE ROBINSON-PATMAN ACT

Though the Supreme Court has never squarely addressed the legality of zone pricing,\footnote{161} franchisees have alleged that it violates the Robinson-Patman Act\footnote{162}—the principal federal antitrust statute against price discrimination.

In order to establish a prima facie case of price discrimination, a plaintiff must demonstrate that (1) the defendant consummated two or more sales within interstate commerce, (2) involving commodities of like grade and quality, (3) in which different prices were charged by the same seller to two or more purchasers, and (4) that that this price difference substantially injured competition or had a reasonable probability to do so.\footnote{163}

The first element of interstate commerce is easily satisfied in states that have no refining operations because they must import gasoline from other states.\footnote{164} In states with their own refining capacity, such as California, this element may be lacking. Plaintiffs, however, can simply file state antitrust claims which have similar price discrimination statutes, absent the requirement of interstate commerce.\footnote{165} The second element of like grade and quality is easily met because each grade of gasoline sold by

\footnote{160. \textit{Leffler & Pulliam, supra} note 1, at 12 n.28; \textit{High Gasoline Prices in San Diego, supra} note 13, at 12 (estimating that it costs 1.5¢ per gallon to transport gasoline to San Diego via the Santa Fe Pipeline and 3¢ per gallon to transport it by truck).

161. \textit{Leffler & Pulliam, supra} note 1, at 13.

162. \textit{The Court did consider the issue of zone pricing in FTC v. National Lead Co., 352 U.S. 419 (1957). There, the FTC had issued a cease and desist order prohibiting lead pigment sellers from adopting a zone pricing system which resulted in identical prices among competitors. The Court was asked to determine whether the FTC had the power to issue such an order and found that it did. \textit{See id. at 430. However, the Court declined to address the legality of zone pricing in general. \textit{See id. at 425 n.4. \textit{163}}\textit{See Texaco Inc. v. Hasbrouck, 496 U.S. 543, 556 (1990); FTC v. Morton Salt Co., 334 U.S. 37 (1948) (construing the Robinson-Patman Act, 15 U.S.C. § 13(a)).

164. Maryland, for example, satisfies this element because it imports gasoline from other states. \textit{See Maryland Attorney General Opinion, supra} note 152, at *4.

165. \textit{See, e.g., Unfair Practices Act, CAL. BUS & PROF. CODE § 17,040 et seq. (West 1997).}
a particular oil company is identical.\textsuperscript{166} The third element of a price
differential exists by the very nature of zone pricing.

Therefore, the primary issue in cases challenging zone pricing on price
discrimination grounds is whether zone pricing substantially injures
competition.\textsuperscript{167} In order to find an injury to competition, the plaintiff must
first show that he was in actual competition with the retailer who received
the lower prices.\textsuperscript{168} In other words, a gasoline dealer in a higher-priced
zone has a valid price discrimination claim only if it is located in the same
geographic market with the dealer in a lower-priced zone. Retail stations
are in the same geographic market if there is a reasonable possibility that
customers would drive to another station if one dealer raised its prices.\textsuperscript{169}

For example, in \textit{Bargain Car Wash Inc. v. Standard Oil Co.},\textsuperscript{170} there
were twenty-two different price zones within a mile and a half radius of the
plaintiff’s station, containing approximately forty different stations. The
close proximity of the zones led the court to find that the gasoline dealers
were in the same geographic market. Similarly, in \textit{D.L. Ingram v. Phillips
Petroleum Co.},\textsuperscript{171} the court found that two gasoline wholesalers were in
competition with each other despite being in two separate states. Each did
do business in an area comprising a “single homogenous economic unit”
because customers in both states patronized each of the businesses.\textsuperscript{172}
Therefore, a competitive relationship is established if the zones are drawn
so narrowly that retailers within the same geographic market are placed in
different price zones.

Conversely, courts have ruled for gasoline suppliers where the
plaintiffs could not establish that they were in competition with the favored
retailer. For example, the Ninth Circuit affirmed a directed verdict for the
defendant because the plaintiff had “failed to offer any evidence from
which a reasonable person could conclude that plaintiff was in

\begin{itemize}
  \item \textsuperscript{166} Maryland Attorney General Opinion, \textit{supra} note 152, at *4.
  \item \textsuperscript{167} \textit{Id.} at *5.
  \item \textsuperscript{168} See \textit{England v. Chrysler Corp.}, 493 F.2d 269, 271–72 (9th Cir. 1974) (observing that “the
  advantaged and disadvantaged parties must be shown to be competing customers . . . in order for there
to be discrimination”).
  \item \textsuperscript{169} See \textit{Federal Trade Commission, Commission Policy with Respect to Anticompetitive
Practices in the Marketing of Gasoline}, ¶ 10,473 CCH 17,836, 17,838 (1967). According to the FTC,
“zone pricing is illegal under the Robinson-Patman Act only when there is a reasonable possibility that
it will injure competition. When the zone is too narrowly delineated and there is a substantial
difference in the prices charged to competing dealers, injury may occur, i.e., injury to the ability of the
non-favored dealer to compete with the recipient of the discrimination.” \textit{Id.}
  \item \textsuperscript{170} 466 F.2d 1163 (7th Cir. 1972).
  \item \textsuperscript{171} 259 F. Supp. 176 (D.N.M. 1966).
  \item \textsuperscript{172} \textit{Id.} at 182.
\end{itemize}
competition with Shell’s more favored customers.”173 Similarly, in a separate case in the Ninth Circuit, the court granted the defendant’s motion for summary judgment, noting:

[p]laintiff’s argument that he competes with other Chevron dealers is not supported by any evidence in the record. Plaintiff has not shown any shift of customers based on price, nor has plaintiff disclosed the identity or existence of any customers that ever opted to move their business from one Chevron station to another . . . . The record does not reflect any evidence that plaintiff has ever attempted to price competitively with other stations.174

If the plaintiff can establish a competitive relationship, the final step is to prove that the price discrimination substantially injured competition. This final step is, however, relatively easy. The Supreme Court has held that proof of a substantial and sustained price discrimination is sufficient to raise an inference of injury to competition.175 Thus, if the price differences between the zones were sustained and substantial, an injury to competition or a reasonable probability thereof may be inferred.176

Therefore, zone pricing might be illegal if the plaintiff can prove that there was a substantial injury to competition. If the zones were drawn so narrowly that retail stations within the same geographic market were placed in different zones and were forced to purchase gasoline at significantly different prices for a sustained period of time, injury is proven.

C. OPEN SUPPLY LEGISLATION

While gasoline franchisees have sought to end zone pricing through litigation, they have also sponsored legislation to prohibit its use by oil companies. Dealers throughout the country have begun organizing in order to challenge the power of the oil companies, and in particular, the system of zone pricing.177 They argue that elimination of zone pricing would “permit

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173. Hamro v. Shell Oil Co., 674 F.2d 784, 790 (9th Cir. 1982).
176. Cf. American Oil Co. v. FTC, 325 F.2d 101, 104 (7th Cir. 1963) (holding that there was no injury to competition because the price differences were “slight” and “transient”).
them to buy gasoline in markets where prices were low and transport them to markets where prices were high, bringing the areas into balance.\textsuperscript{178}

As a result of lobbying from dealer associations and public outcry in California’s higher-priced areas, state legislators from San Diego and San Francisco have introduced legislation to curb the practice of zone pricing. Former State Senator Quentin L. Kopp (I-San Francisco) introduced Senate Bill 52,\textsuperscript{179} and State Senator Steve Peace (D-El Cajon) introduced Senate Bill 123.\textsuperscript{180} More recently, the Attorney General has been pushing for legislation to ban zone pricing.\textsuperscript{181}

These proposals are commonly known as “open supply” bills, because they effectively prohibit the practice of zone pricing by allowing gasoline retailers to purchase fuel from any branded supplier within the franchisor’s wholesale network.\textsuperscript{182} As an illustration, take the case of a Shell dealer in San Diego. For simplicity, assume that the entire city of San Diego is one price zone with a DTW of $1.20 and that Los Angeles is in a different price zone with a DTW of $1.00. Under an open supply proposal, the San Diego Shell dealer can purchase fuel from a Los Angeles Shell distributor at $1.00 (and presumably pay the 2¢ per gallon trucking cost).\textsuperscript{183}

Peace’s Senate Bill 123 read, in pertinent part, as follows:

(a) A refiner, distributor, manufacturer, or transporter of petroleum products may not prevent a branded gasoline franchisee from purchasing the franchisor’s branded petroleum product from any location or through any vendor in the franchisor’s wholesale petroleum product network.

(b) A refiner, distributor, manufacturer, or transporter of petroleum products may not discriminate in price between different franchisee purchasers of the franchisor’s branded petroleum products if the price discrimination effectively prevents a franchisee from taking advantage of price differences at different locations or between different vendors.\textsuperscript{184}

\textsuperscript{178.} Unintended Consequences of California RFG, 89 NAT’L PETROLEUM NEWS, 20 n.7 (July 1997), available at Westlaw. \textsuperscript{179.} S.B. 52, 1997–1998 Leg. Sess. (Cal. 1996) (as introduced by Senator Kopp). \textsuperscript{180.} S.B. 123, 1999–2000 Leg. Sess. (Cal. 1998) (as introduced by Senator Peace). \textsuperscript{181.} See Lockyer, \textit{supra} note 2, at 61–62. \textsuperscript{182.} SENATE RULES COMMITTEE, BILL ANALYSIS ON S.B. 123, 1999–2000 Leg. Sess. (Cal. 1999), available at Westlaw. \textsuperscript{183.} Note that these proposals are all \textit{branded} open supply proposals, meaning that they will not allow the Shell dealer to purchase non-Shell gasoline. Thus, oil companies cannot raise a quality defense because the legislation would, for example, allow a Shell dealer to buy the same grade and quality of gasoline from another Shell distributor. \textsuperscript{184.} S. Res. 123, 1999–2000 Leg. Sess. (Cal. 1998) (as introduced by Senator Peace).
Similarly, Kopp’s Senate Bill 52 provided that a gasoline franchisee would be able to purchase fuel from another branded supplier if the supplier’s price is at least 5¢ below the current DTW price.185

D. RATIONALES OFFERED IN SUPPORT OF OPEN SUPPLY LEGISLATION

Proponents offer several rationales on behalf of open supply proposals and against zone pricing. Each rationale is explained below.

1. Zone Pricing Allows Oil Companies to Isolate “Low Pricers”

Proponents of open supply legislation claim that zone pricing allows oil companies to isolate and target low-priced independent dealers. Presumably, this is harmful because it “reduce[s] the market value of franchisees and consequently make[s] independent franchises more vulnerable to being bought out and converted into oil company-operated stations.”186

Furthermore, independent dealer associations claim that “a further loss of franchise[d] dealers would enhance the ability of the oil companies to shield the pricing in regional gasoline markets from normal market forces.”187 Similarly, the Utility Consumers’ Action Network (UCAN) asserts that zone pricing allows “oil company executives [to] selectively surround a specific independent with a “ring of fire.” They can actually under-price gasoline at certain stations and subsidize the lower prices by charging a higher rate in areas where there is less competition from independent dealers.”188

These assertions are meritless. Lowering prices to meet competition is a critical feature of competitive markets and has long been recognized as a legitimate practice by antitrust laws.189 Essentially, this argument means that oil companies are acting “too” competitively by lowering prices to match independent dealers in competitive areas. This is exactly the type of behavior society should be encouraging, not outlawing. As the Supreme Court has observed:

187. Id.
cutting prices in order to increase business often is the very essence of competition . . . . To hold that the antitrust laws protect competitors from the loss of profits due to [non-predatory] price competition would, in effect, render illegal any decision by a firm to cut prices in order to increase market share. 190

Zone pricing, however, might be anticompetitive if it is utilized to engage in predatory pricing. Predatory pricing is the practice of lowering prices below one’s marginal or average costs in order to drive out competitors and recoup monopoly profits at a later point. If oil companies were systematically lowering prices below their marginal or average costs to drive out independent dealers, the independents might have a claim of predatory pricing. Since antitrust laws already prohibit this practice, additional legislation is unnecessary. 191

2. Zone Pricing Leads to Higher Prices in Certain Areas

Proponents of open supply legislation argue that zone pricing leads to higher retail prices in certain areas. This view is, however, mistaken; zone pricing is not the cause of the differences in retail prices. Rather, the inter-regional retail price differences are caused by the variation in the amount and intensity of retail competition among the different areas. More specifically, the price differences are a reflection of the number and competitive behavior of retail stations in a given area.

For example, San Diego has only 17.4 gasoline stations per two-square-mile compared to 22.2 stations in Los Angeles. 192 Moreover, there is one gasoline station for every six miles of public highway in San Diego compared to one station per 1.6 miles in Los Angeles. San Diego’s lower station density may simply “reflect[] the less urbanized character of San Diego County.” 193 It might also be a result of San Diego’s permitting

191. See Brooke Group Ltd. v. Brown & Williamson Tobacco Corp., 509 U.S. 209 (1993). The elements of predatory pricing are: (1) pricing below “avoidable” cost (either marginal or average cost, depending on the circuit), (2) dangerous probability that the prey would be driven out, and (3) dangerous probability that the predator can raise prices sufficiently in order to recoup losses and earn monopoly profits. See id. at 222–25.
192. Lockyer, supra note 2, at 59 & n.37.
193. High Gasoline Prices in San Diego, supra note 13, at iv. See also Lockyer, supra note 2, at 8–9 (discussion about this data between Senator Steve Peace and David Rohy of the California Energy Commission).
process and regulatory constraints that makes it more difficult to open new retail stations.¹⁹⁴

San Francisco also has a low station density compared to Los Angeles. There are 18.2 gasoline stations per two-square-mile in San Francisco, compared to 22.2 stations in Los Angeles.¹⁹⁵ Moreover, San Francisco has 1.5 gasoline stations per 10,000 people compared to Los Angeles’ 2.7 stations per 10,000 people.¹⁹⁶ The lower station density in San Francisco is apparently due to higher real estate costs and more stringent regulatory requirements.¹⁹⁷ Moreover, according to Chevron, some Bay Area cities prohibit gasoline stations from operating convenience stores, which are often necessary to make retail stations economically feasible.¹⁹⁸

Therefore, the price differentials among California regions are readily explainable by the varying levels of retail concentration and competition. If zone pricing doesn’t cause the price differentials, then what purpose does it serve? Zone pricing allows the oil companies to appropriate the super-competitive retail profits in areas with less retail competition. In other words, in areas such as San Francisco and San Diego, zone pricing allows refiners to set their DTW price at a higher level and transfer the would-be profits from the retail level to the upstream level.¹⁹⁹ This would equalize the profit margin of retailers throughout the state and ensure that any excess profits flow upstream.

There is nothing inherently anticompetitive or socially harmful from an arrangement that transfers profits from the retail market to the upstream oil companies. From a societal point of view it makes no difference how the profits are distributed along the distribution channel because the retail prices are not affected. As the Ninth Circuit correctly recognized,

¹⁹⁴. See Lockyer, supra note 2, at 34 (testimony of Joe Soraci, from Mobil Oil Co.: “It’s very difficult to get real estate [in San Diego] and go through the permit process and actually build because of the constraints that are placed on us.”). See also id. at 35 (testimony of Mr. Skok from Unocal, complaining about the unwillingness of the San Diego “County Board of Supervisors’ . . . to be a little more open with the permitting process”).

¹⁹⁵. See Lockyer, supra note 2, at 59 & n. 37.


¹⁹⁷. Id.

¹⁹⁸. Id. In fact, according to Chevron, the company recently opened its first new retail station in the Bay Area in ten years. Id.

¹⁹⁹. This arrangement helps ensure that franchisees, on average, earn the same return whether they are in a high-competition or low-competition region. Zone pricing allows the refiners to lower the DTW price for dealers in a competitive area so that they can compete effectively and earn the same gross margin.
“[c]ompetition is promoted when manufacturers are given wide latitude in establishing their method of distribution . . . . Judicial deference to the manufacturer’s business judgment is grounded in large part on the assumption that the manufacturer’s interest in minimum distribution costs will benefit the consumer.”

3. Zone Pricing Creates Entry Barriers in the Downstream Market

Finally, proponents of open supply legislation claim that zone pricing creates barriers for new retail stations to enter the market. Indeed, as stated above, zone pricing equalizes retail profit margins, regardless of the level of retail competition in the area. This phenomena of equalizing dealer margins might mean that there is no profit incentive for new retailers to enter the less competitive areas. Thus, the argument goes, zone pricing erects entry barriers by discouraging new entrants in the less competitive regions.

This view, however, is mistaken. Even if the profit incentive of opening new stations does not exist at the retail level, the oil companies retain this incentive. Each oil company is motivated to open new branded retail stations in order increase its share of industry profits. Indeed, if one oil company charged an excessive wholesale price and discouraged new franchisees, that “would just drive the dealers into the arms of a competing supplier.” Thus, zone pricing could not facilitate entry barriers because any individual supplier would lose market share and profits to its competitors.

E. POTENTIAL HARMs OF OPEN SUPPLY LEGISLATION

The above analysis has demonstrated that the justifications offered on behalf of open supply legislation are meritless. In addition, oil companies have advanced three potential harms that would result from open supply legislation. These harms are examined next.

1. Discourages Support of Franchisees

Opponents of open supply legislation fear that it would discourage oil companies or jobbers from supporting the operations of franchisees.

200. Krehl, 664 F.2d at 1356.
201. See Lockyer, supra note 2, at 29.
Specifically, they claim that oil companies and jobbers frequently provide financing and operational assistance to the franchisees to whom they supply gasoline. This support is provided on the assumption that the parties have entered into a long-term supply contract. Since open supply would allow franchisees to shop for fuel, the incentive to supply such assistance would be allegedly diminished.\footnote{204}{See id.}

This argument is unpersuasive because it is premised on the notion that franchisees will not act in their own self-interest. If a long-term supply contract will provide the franchisee with low-cost financing, then the franchisee is free to enter into such a contract with the oil company or jobber. Indeed, the franchisee is in the best position to weigh the benefits of a long-term supply contract with its costs and enter into such a contract if it is net beneficial. Open supply legislation does not prohibit long-term contracts.

2. Destabilizes the Gasoline Distribution System and Generates Uniform Pricing

Another argument against open supply legislation is that it would “destabilize” the gasoline distribution system.\footnote{205}{Id.} Under open supply, each franchisee can potentially purchase gasoline from any jobber or refiner terminal on a daily basis. This could create chaos and force refiners to substantially increase their terminal reserve capacity to avoid shortages. As one oil company executive said: “it would . . . be a scheduling nightmare. . . . How would one be able to plan where the product throughout the distribution system should be? If a dealer anywhere in California could call and determine what order, it seems to me to border on being a practical nightmare.”\footnote{206}{High Gasoline Prices in San Diego, supra note 13, at 40 (testimony of Harry G. Johnson, ARCO Products Company, Informational Hearing).}

It is difficult to predict whether this doom and gloom scenario will occur, or whether the market will adjust to the “scheduling nightmare.” Regardless of whether the market destabilizes, however, open supply would likely cause wholesale prices to become uniform throughout the state. As dealers shop for the lowest wholesale price, supply and demand would naturally push prices towards uniformity.\footnote{207}{See, e.g., id.} There is nothing inherently wrong with uniform pricing that results from competitive
forces. The problem with uniform wholesale prices in this industry, however, is that it may result in certain franchisees being price squeezed, as discussed next.

3. Squeezes Franchisees in Competitive Regions

Finally, open supply legislation could result in franchisees in competitive areas being price squeezed. Currently, zone pricing enables oil companies to provide a lower wholesale price to franchisees located near lower-priced competitors. For example, assume that Shell’s average DTW in San Diego County is $1.25 per gallon. Let’s say that a franchisee is located near a fiercely competitive independent station whose street price is $1.20. The Shell franchisee may receive a competitive rebate allowance from Shell so that its effective wholesale price is $1.10 and it is able to compete with the independent station.

Under open supply the Shell station, however, would no longer receive a price rebate to remain competitive. While the dealer would be free to shop for the lowest Shell wholesale price, this uniform wholesale price may not be sufficiently low to remain competitive with the independent stations. Absent the competitive rebate allowance that its supplier provides, the franchisee may find him or herself being price squeezed by the lower-priced independent dealer.

The potential harms of open supply legislation are substantial, though not all of the claims by opponents have merit. Moreover, the justifications offered in support of open supply are unfounded. The answer seems clear: open supply proposals should be rejected.

CONCLUSION

Divorcement and open supply are clearly the wrong answers to California’s higher gasoline prices. Though cloaked in a pro-consumer veil, divorcement is not in the interests of consumers, nor does it result in lower prices. Rather, divorcement is sought by franchisees who wish to increase their own pricing power at the expense of consumers. Moreover, this article has shown that divorcement does nothing to curb potential anticompetitive behavior by oil companies because more direct mechanisms to harm retailers would remain legal. If oil companies act

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208. Indeed, prices are homogenous in markets that are perfectly competitive.
209. See Lockyer, supra note 2, at 32.
opportunistically with respect to their franchisees, existing legal doctrines provide sufficient remedies.

Similarly, the rationales offered in support of open supply are unconvincing. Zone pricing simply allows oil companies to transfer monopolistic profits from downstream to upstream markets. Consumers should be indifferent to the allocation of profits along the distribution channel. Moreover, open supply would potentially destabilize the gasoline distribution system and lead to uniform wholesale pricing. This would in turn harm franchisees who could not effectively compete against lower-priced independents without the competitive rebate allowances that are available under zone pricing. Thus, open supply would merely result in higher, but uniformed, pricing throughout the state. The only beneficiaries are those most actively pushing this legislation: the retailers located in less-competitive areas, such as San Francisco, as profits would be reallocated in these areas from the upstream producers to the downstream retailers.

This is not to say that California has no policy or legal recourses. Antitrust officials should continue to investigate whether refiners have colluded to set prices. The Attorney General could bring price discrimination claims against oil companies if they have drawn pricing zones that are too narrow to effect retail competition. State and federal antitrust agencies should rigorously scrutinize mergers between oil companies to prevent anticompetitive consolidations. Moreover, proposals to partially recouple the California gasoline production market with the rest of the world should be seriously considered.

More generally, state policymakers should focus their attention on the real source of the problem: supply shortages caused by environmental mandates. Cleaner burning gasoline has given monopoly power to the few refineries who produce it. Admittedly, it is more politically appealing to blame our higher prices on anticompetitive conduct by oil companies. But this is both counter-productive and deceptive. We should acknowledge that state and federal environmental mandates have created this situation. This does not imply that cleaner burning gasoline is not a worthwhile regulation. Indeed, cleaner air may be worth an additional 20¢ per gallon at the pump—but we should recognize the trade-off between cleaner air and lower prices before placing blame on others or trying to legislate around this dilemma in vain.