



Consumer Federation of America

**TESTIMONY OF DR. MARK N. COOPER
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CONSUMER FEDERATION OF AMERICA
ON
FEDERAL TRADE COMMISSION REAUTHORIZATION
BEFORE
THE INTERSTATE COMMERCE, TRADE, AND TOURISM SUBCOMMITTEE
OF
THE SENATE COMMITTEE ON COMMERCE, SCIENCE, AND
TRANSPORTATION**

September 12, 2007

Mr. Chairman and Members of the Committee,

Thank you for the opportunity to testify. My name is Mark Cooper and I am Director of Research at the Consumer Federation of America (CFA).¹

In my comments today I address two areas where the antitrust authorities, the Federal Trade Commission (FTC) in particular, have dropped the ball, failing to protect consumers from the abuse of market power. While the two sectors I address – the oil industry² and high-speed, broadband Internet access³ – would appear to be dramatically different, the underlying problem that afflicts consumers in each of these markets is the same – inadequate competition and the failure of antitrust authorities to act to promote competition or prevent anti-consumer, anti-competitive behavior by the industry.

Federal authorities have allowed a tight oligopoly in oil and a cozy duopoly in broadband to engage in strategic under-investment in facilities, creating artificial shortages that allow them to overcharge consumers.

There are other areas where we think the FTC is doing a good job, including certain aspects of consumer protection, merger review in other industries, and anti-competitive, anti-consumer practices in the drug industry. But the oil industry and the broadband industry are extremely important and they are real weak spots.

¹ The Consumer Federation of America (CFA) is a non-profit association of 300 consumer groups, with a combined membership of more than 50 million people. CFA was founded in 1968 to advance the consumer's interest through advocacy, research, and education.

² "The Failure of Federal Authorities to Protect American Energy Consumers from Market Power and Other Abusive Practices," Loyola Consumer Law Review, 19:4 (2007); The Role of Supply, Demand, Industry Behavior and Financial Markets in the Gasoline Price Spiral (Prepared for Wisconsin Attorney General Peggy A. Lautenslager, May 2006); Record Prices, Record Oil Company Profits: The Failure Of Antitrust Enforcement To Protect American Energy Consumers (Consumer Federation of America, Consumers Union, September 2004).

³ This testimony draws on Mark Cooper, "The Importance of Open Networks in Sustaining the Digital Revolution," in Thomas M. Lenard and Randolph J. May (Eds.) Net Neutrality or Net Neutering (New York, Springer, 2006); Open Architecture as Communications Policy (Stanford Law School, Center for Internet and Society: 2004); "Open Communications Platforms: Cornerstone of Innovation and Democratic Discourse In the Internet Age," Journal on Telecommunications, Technology and Intellectual Property, 2:1, 2003, first presented at The Regulation of Information Platforms, University of Colorado School of Law, January 27, 2002.

The FTC has allowed refining markets and wholesale gasoline markets to become highly concentrated through lax merger review. The result is a tight oligopoly and severe pain in the pocketbook – hundred of billions of dollars in overcharges and excess profits. The FTC’s analysis of recent price spikes ignores fundamental structural problems of its own making in oil markets.

The FCC has allowed a cozy duopoly of telephone and cable companies to dominate the broadband access market, without any obligation to provide nondiscriminatory access. The FTC⁴ and the DOJ⁵ have cheered this decision claiming that market forces in a duopoly will protect consumers, but theory and empirical evidence contradict that claim. As a result, the cozy duopoly dribbles out bandwidth at prices that are 10 to 20 times as high as in other nations around the world. The reliance on this cozy duopoly has been disastrous for the United States. In a short half decade, we have fallen from third in the world in broadband penetration and now are behind at least a dozen nations (15th) and, by some counts almost two dozen. Consumers pay too much for too little and the economy suffers as other nations with consumer and competition-friendly policies become the focal point of innovation.

OIL PRICES

If the subject of the recent FTC oil price gouging investigation had been the first price spike in the petroleum industry in recent years, then the report on the 2006 price spike might be plausible, but as every gasoline consumer knows, it was not the first price spike by any stretch of the imagination. In fact, the 2006 spike was the sixth in a string of seven that have occurred in the last eight years.

⁴ Federal Trade Commission, *Report on Spring/Summer 2006 Nationwide Gasoline Price Increases*.

⁵ “U.S. Department of Justice Ex Parte Filing,” *IN the Matter of Broadband Industry Practices*, WC Docket No. 07-52,

Given the ever lengthening list of unnatural events – fire, flood, hurricane, lightning, rust, demand surges – that Federal agencies use to explain recent price spikes, the only way you can characterize the FTC conclusion is that the price spikes are not the result of a conspiracy – they are the result of stupidity. The industry is simply unable to cope with any event that is out of the ordinary and even deal with routine spring cleaning without driving prices through the roof. When there are surprises and unexpected events for which the industry is unprepared, prices go up and oil companies just happen to make a lot more money. Its all quite innocent; dumb, but innocent – stupid like a fox.

What are these surprises and unexpected events that the FTC identified in the 2006 price spike? “Seasonal effects of the summer driving season... and increased consumer demand for gasoline beyond the seasonal effects.”

Surprise, surprise – consumers drive more in the summer and more as the population and economy grow. Those two facts have been in evidence since Mr. Ford first mass produced the model T, but they still seem to have snuck up on the oil industry. As Exhibits 1 and 2 show, the long term growth trend and seasonal driving patterns predict the gasoline demand in 2006 almost perfectly.

Even if there were a bit of a surprise, why is there no spare capacity or stockpiles to deal with it? In competitive industries, when there is a seasonal pattern, producers build systems to respond without having to raise prices dramatically, for fear that they will lose their customers. Prices fluctuate, but competition drives seasonal sectors to shave the peaks. In the oil industry they don't work that way, they just put the prices up. Over the past couple of decades the oil industry has systematically under-invested in storage (see Exhibit 3), reducing the amount of gasoline on hand, thereby creating a tight

market with little capacity to respond not only to genuinely unexpected shifts in demand, but even to routine seasonal patterns.

What are these surprises and unexpected events? “Refinery outages resulting from hurricane damage, other unexpected problems or external events, and required maintenance.”

Surprise, surprise – refineries need to be maintained and they break. How could the industry have been so stupid as not to notice? Never mind that in a competitive industry each individual producer would carry more spare capacity for fear that he might get caught short if he had an outage or have to raise prices, which would cost him his customers (see Exhibit 4). In the oil industry they don’t work that way, they just put the prices up. Worse still, the stupidity of the oil industry makes matters worse. When you don’t build enough refineries and you run them at high levels of capacity, they break more often. Over the past couple of decades the oil industry has systematically under-invested in refining capacity – closing dozens of refineries and refusing to build new ones – thereby creating a system that not only cannot respond to accidents, but that cannot even provide routine maintenance without causing price spikes. There is now a shortfall of over 3 million barrels a day of refining capacity (see Exhibits 5 and 6).

What are these surprises and unexpected events? “Increased price of ethanol... capacity reductions stemming from refiners’ transition from methyl tertiary-butyl ether (MTBE) to ethanol.”

That summer fuels require oxygenates has been known for well over a decade. That everyone in the industry switched to ethanol at the same time creating a temporary shortage was dumb. They did not have to switch, they chose to, en mass, even though they had not arranged for adequate supplies. They switched without making sure that

alternatives would be available. The result is a most remarkable pattern of behavior. When ethanol is cheap they don't use it, when it is expensive they all want it.

Thus, five of the six excuses that the FTC gave for the price spikes of 2006 are the result of strategic under-investment in capacity and management mistakes that have created a tight market and exploit that tightness. If the cost of inputs, like crude and ethanol, and the need to bring expensive imports to market were the cause of increases in prices at the pump, then one would not expect the domestic spread and refinery margins and oil industry profits to be increasing, but they are (see Exhibits 7 and 8).

The simple fact of the matter is that this pattern of behavior was made possible by the merger wave of the past decade (see Exhibit 9). It has created a situation in which the industry does not have to collude to increase prices and profits. It just waits for the inevitable driving season to arrive, leavened by inadequate capacity and excuses, to put prices up.

The FTC adopts a very consumer unfriendly definition of price gouging. The domestic spread on gasoline was 49 cents per gallon higher in 2006 than the average for 1990-1999 (see Exhibit 9). However, the FTC assumes that the inflated prices of 2001-2005 as the base, so it concludes that the "extraordinary" increase in 2006 was only 16-21 cents. Because the market is too tight, it estimates that prices could have risen by as much as \$1.35 to \$2.21, so consumers should take solace in the fact that the industry left a lot on the table. When it looks at price gouging for individual companies, it assumes that if all the companies raise prices at the same time, then none is gouging, even though profits are going through the roof.

BROADBAND INTERNET

The FTC and the Department of Justice have made precisely the same mistakes in analyzing the broadband market place that have afflicted the FTC's analysis of the oil industry. They see vigorous competition,⁶ where there is little; they see little harm,⁷ where there is a great deal of damage.

The decision to abandon the principle of open communications networks after the Telecommunications Act of 1996 (the 1996 Act) resulted in a cozy duopoly of the telephone and cable companies that has failed to accomplish the most fundamental goals of the Telecommunications Act of 1996. In comparison to at least a dozen other nations, the closed proprietary networks of the cozy duopoly have:

- Failed "to make available to all people of the United States... adequate facilities at reasonable charges,"
- Failed to "encourage the deployment on a reasonable and timely basis" of a two-way communications network, with advanced telecommunications capabilities, with "high-speed, switched, broadband telecommunications capability that enables users to originate and receive high-quality voice, graphics, and video telecommunication," and
- Threatened the vibrant and competitive Internet that Congress sought to preserve in the 1996 Act.

The failure of the closed, proprietary, and cozy duopoly is evident in a multidimensional context. This model has

- Failed to deliver *any* broadband services to substantial numbers of American households (around 9%, according to the GAO);
- Failed to deliver bandwidth with data transfer rates comparable to the broadband networks which are deployed in other industrialized nations.

⁶ FTC Staff Report, *Broadband and Connectivity Competition Policy*, June 2007, p. 10; DOJ, Ex Parte Filing, p. 1.

⁷ FTC Staff Report, p. 11; DOJ, Ex Parte Filing, p. 24.

- Failed across the board to deliver facilities that afford two-way communications at full broadband functionality and at reasonable prices.

In addition,

- Where last-mile broadband networks are available, the prices charged for broadband are excessive when compared with the price per megabit available in other industrialized nations;
- The target recipients of advanced broadband facilities, which are capable of providing bandwidth on par with the higher speeds available in other industrialized nations, are households with high incomes, reflecting pricing practices which demand extremely high charges for access.

When congress passed the Telecommunication Act of 1996, virtually all Internet traffic originated by or delivered to the public traveled on telecommunications networks that were obligated to provide nondiscriminatory interconnection and carriage under Title II of the Communications Act. The U.S. was the global Internet leader by far. But the FCC abandoned the principles of nondiscrimination, first for broadband provided by cable companies, then for telephone companies.

Half a decade latter we have fallen far behind many other nations (see Exhibits 10, 11 and 12). When it comes to truly broadband communications that Congress envisioned in the 1996 Act, compared to many other nations, most of which strengthened their commitment to open communications networks,

- Americans pay over ten times more for far less service than the leading broadband nations (see Exhibit 13) and
- The communications networks being deployed in America relegate the public to the role of passive listeners and restrict their opportunity as producers of content and speakers to fully utilize the immense functionality of broadband technologies in civic discourse (see Exhibit 14).

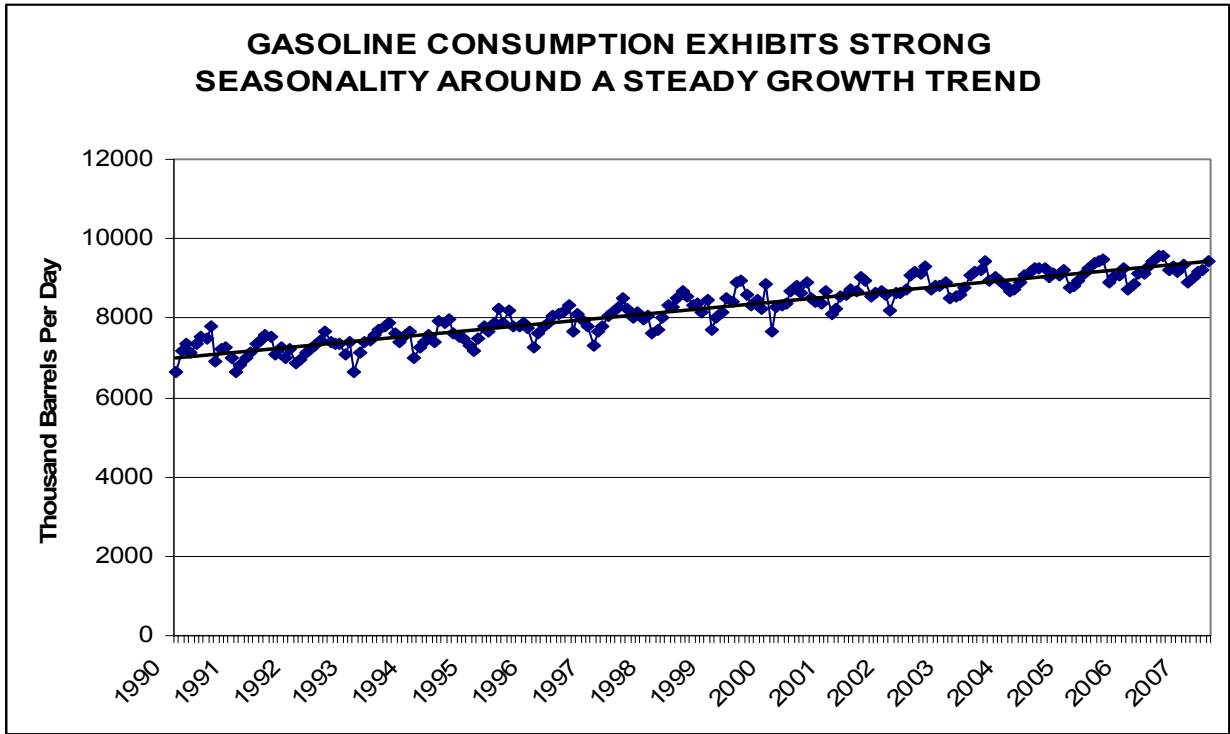
The root cause of this failure is the abandonment of the commitment to open communications networks and the reliance on feeble competition between, at best, two

closed proprietary networks that possess and abuse market power. With inadequate competition and little public obligation, the cozy duopoly dribbles out capacity at high prices and restricts the uses of the network, chilling innovation in applications and services and causing a much lower rate of penetration of broadband in the U.S. than abroad.

Efforts to explain away the declining status of the U.S. by population density, market concentration, household size, income levels, income inequality, education, age, among other factors do not negate the finding the U.S. is well behind a dozen or more developed nations (see Exhibits 15 and 16).

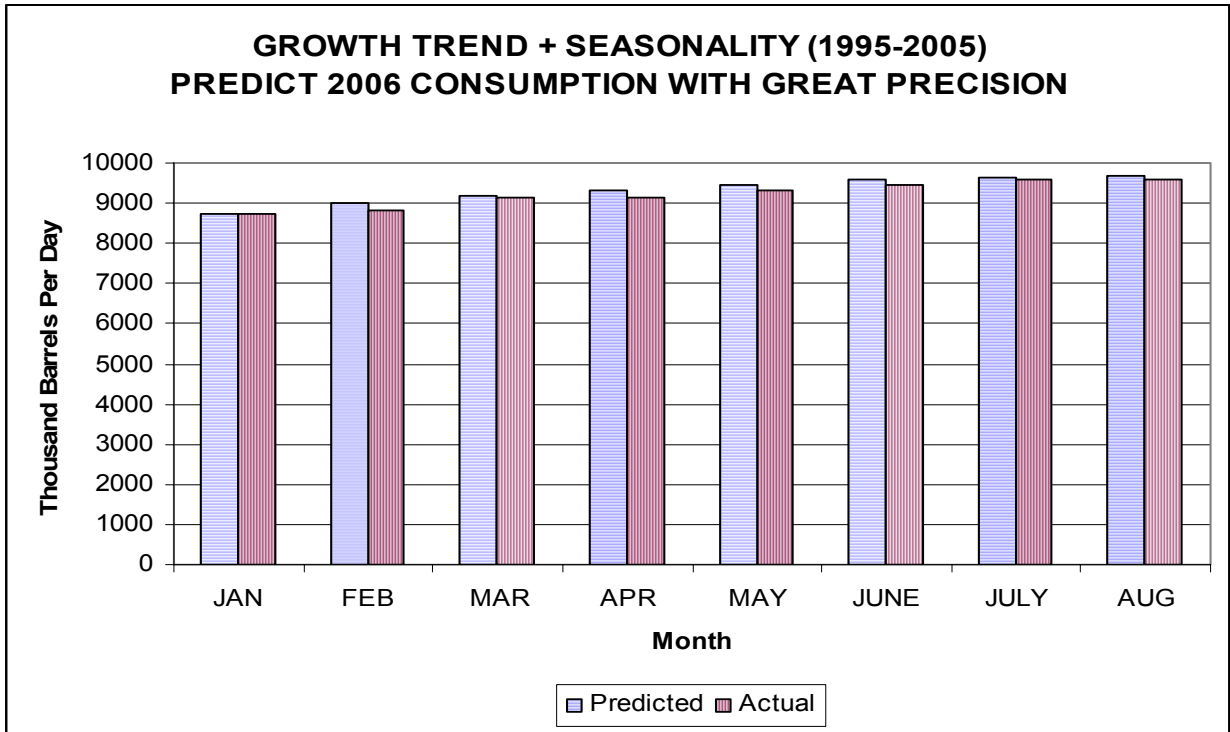
The demonstrated failure of the cozy duopoly model to achieve the goals of the 1996 Act, the flawed theory of the benefits of discrimination, the clear initial signs of anti-competitive and anti-consumer practices, as well as the extremely dim prospects for vigorous competition in facilities, combine to create a very dismal future for broadband consumers in America. The Federal antitrust agencies have turned a blind eye to the problem. The only way to break out of this quagmire is to return to the successful policies of open communications that made the Internet possible and allowed the U.S. to be the world leader in the first generation of the digital age. The success of the Internet was built on communications networks that were operated in an open and non-discriminatory manner so that the vigorous competition between applications and service providers was free to provide innovations and consumer-friendly service that drove demand.

Exhibit 1:



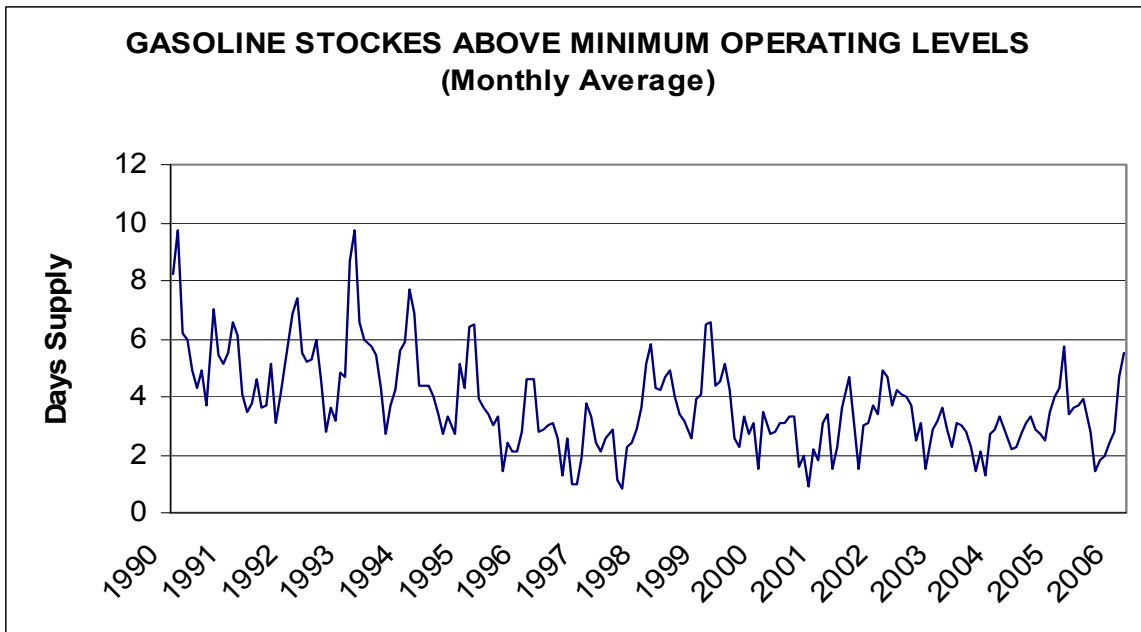
Source: Energy Information Administration, Database, Petroleum Consumption.

Exhibit 2:



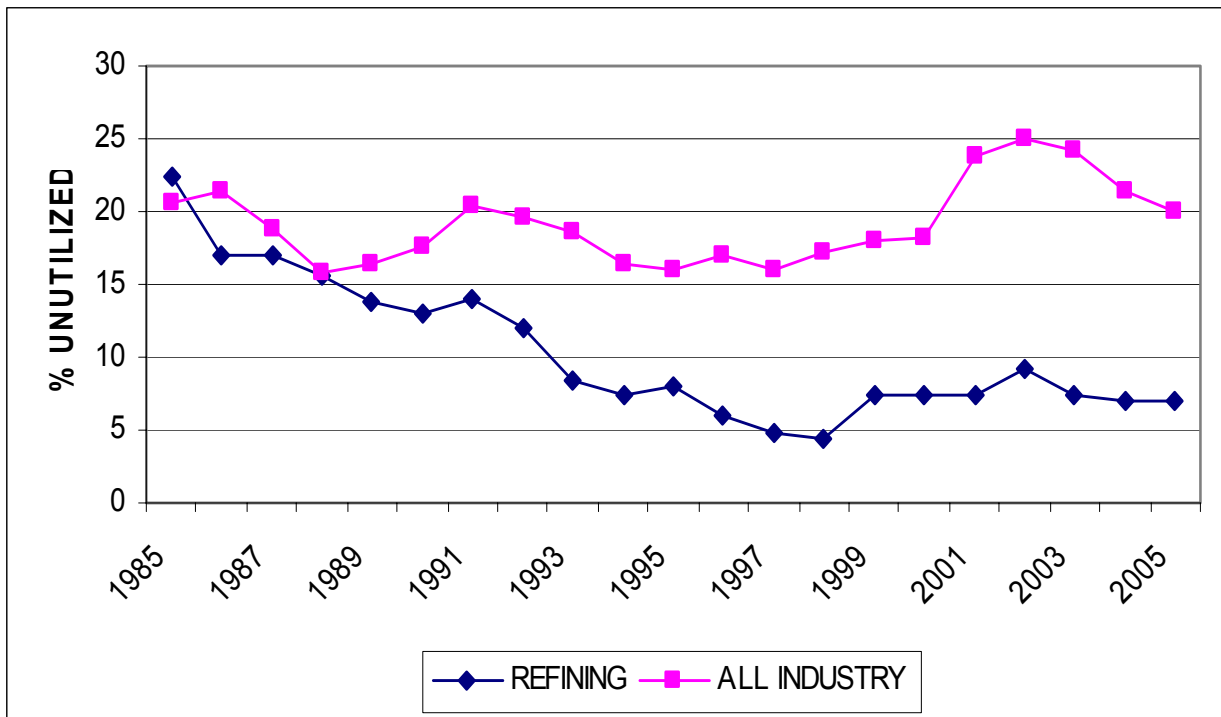
Source: Energy Information Administration, Database, Petroleum Consumption.

Exhibit 3: Gasoline Stocks above Minimum Operational Levels



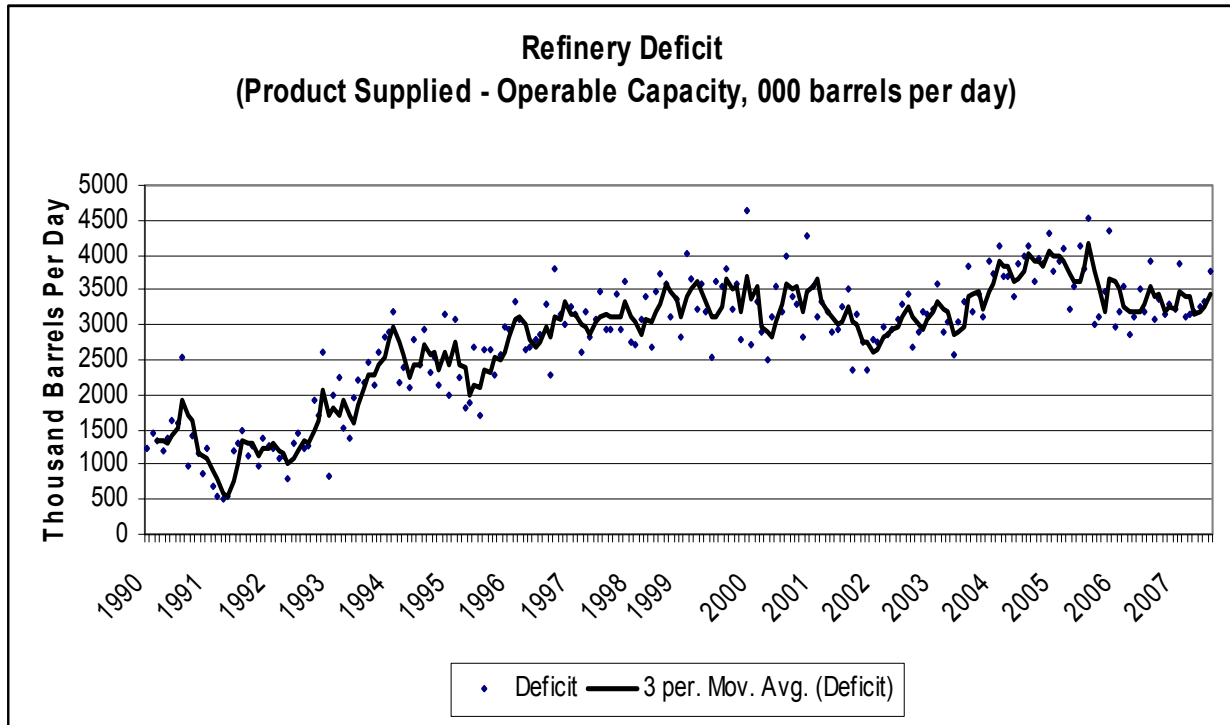
Source: Energy Information Administration, Petroleum Database.

Exhibit 4: Spare Capacity in Refining V. All Industry



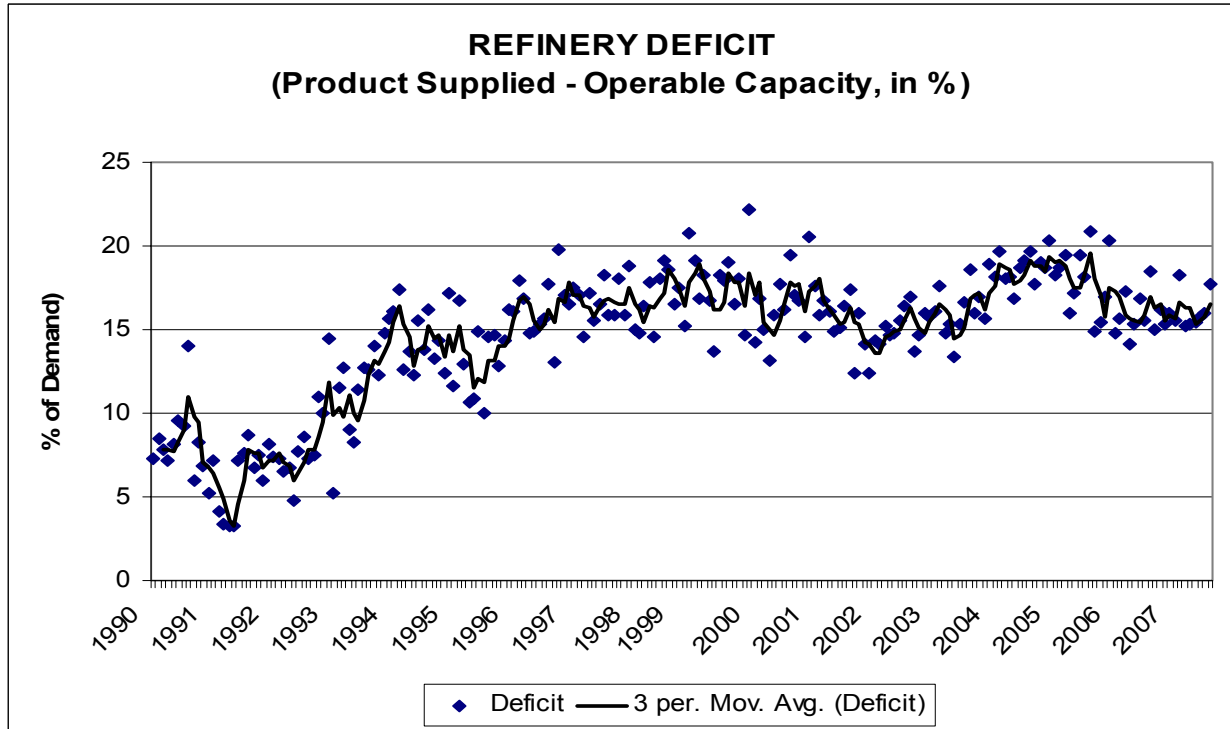
Source: Calculated from Board of Governors of the Federal Reserve System, *Federal Reserve Statistical Release, Industrial Production and Capacity Utilization*; Energy Information Administration, U.S. Department of Energy, *U.S. Percent Utilization of Refinery Operable Capacity*.

Exhibit 5:



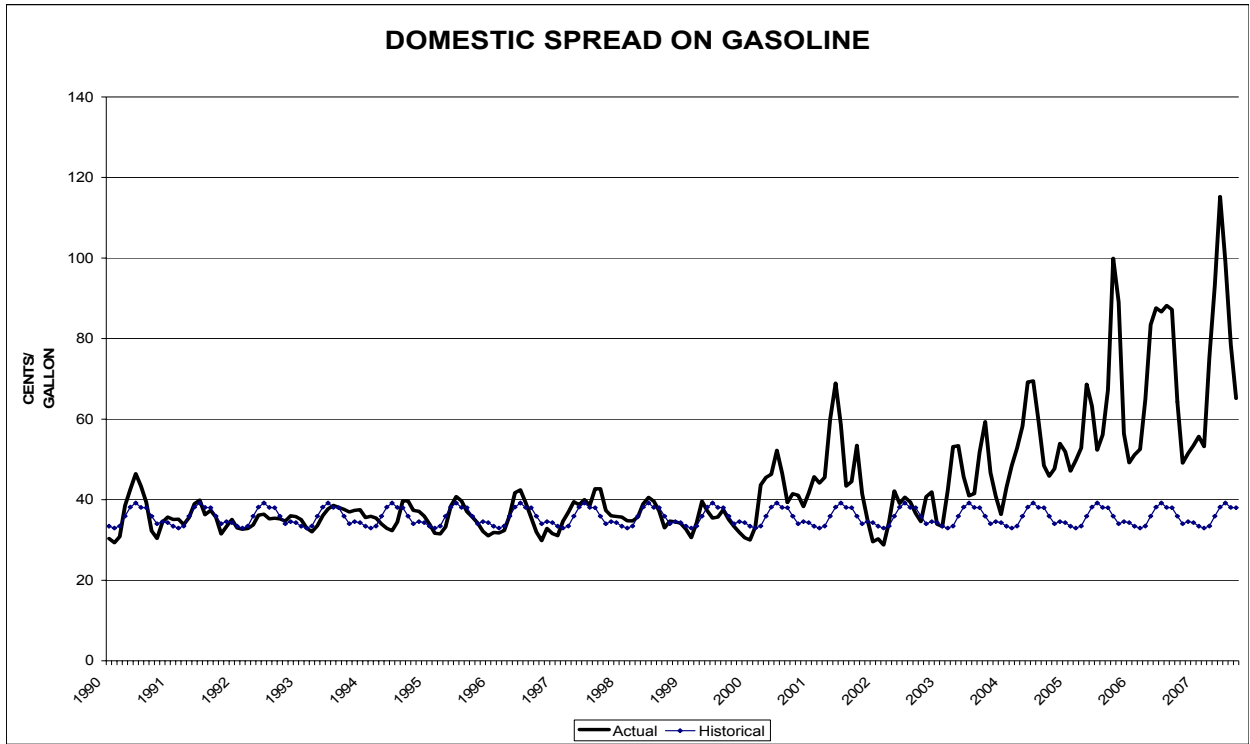
Source: Energy Information Administration, Database, Petroleum Consumption, Refining.

Exhibit 6:



Source: Energy Information Administration, Database, Petroleum Consumption, Refining.

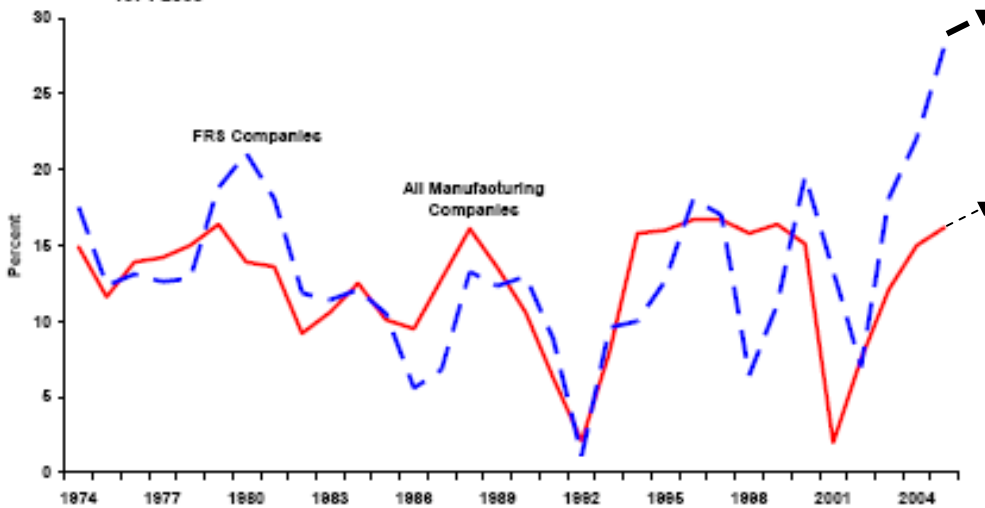
Exhibit 7:



Source: Energy Information Administration, Database, Petroleum Consumption, Retail Gasoline (excluding taxes) minus refiner acquisition cost of crude.

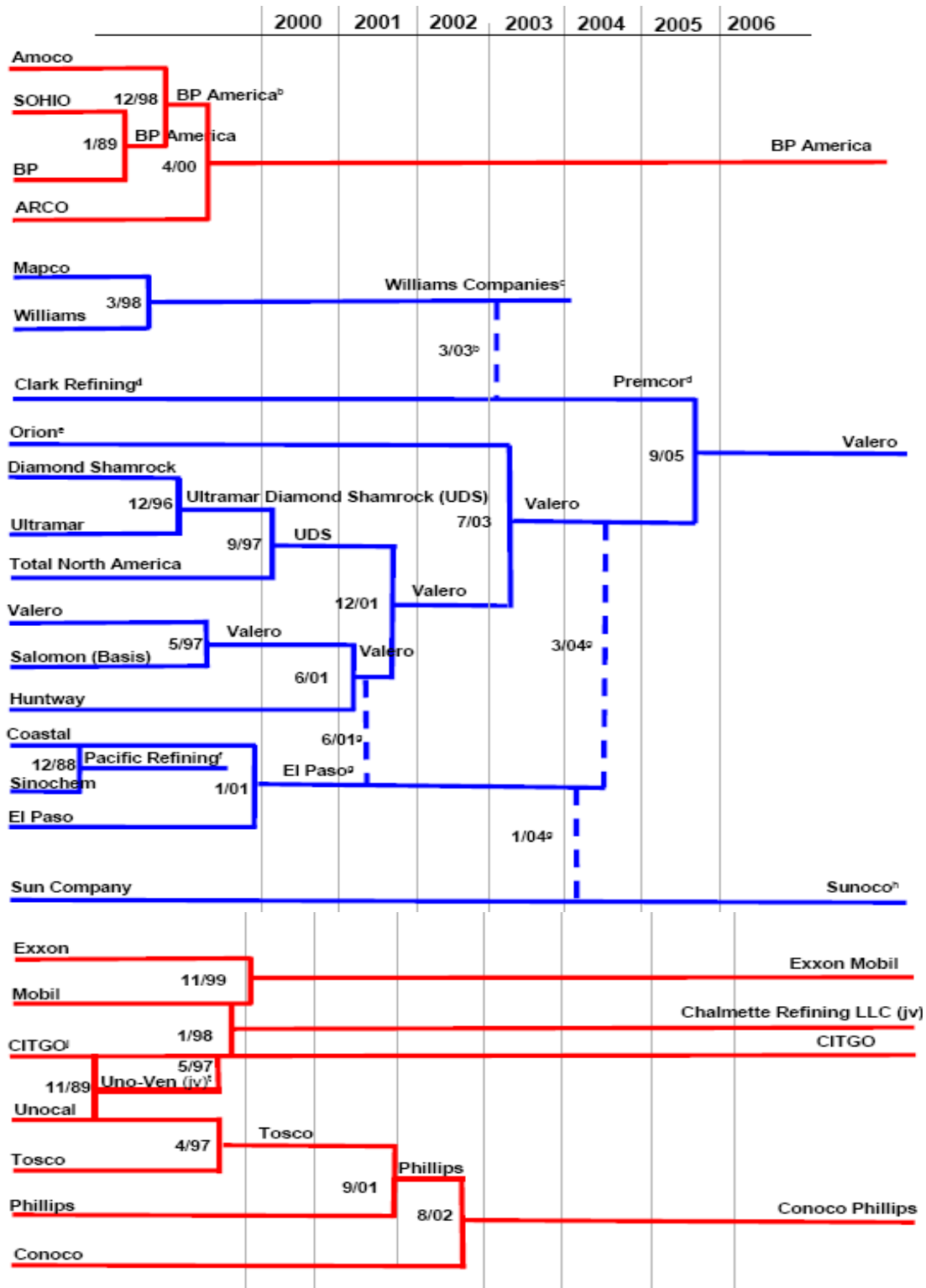
Exhibit 8: Major Oil Company Return on Equity is Far Above Historic Levels

Figure 2. Return on Stockholders' Equity for FRS Companies and All Manufacturing Companies, 1974-2005



Sources: FRS Companies: Energy Information Administration, Form EIA-28 (Financial Reporting System). All Manufacturing Companies: U.S. Census Bureau Quarterly Financial Report, All Manufacturing Companies.

Exhibit 9: Mergers have severely reduced the number of refiners



Source: <http://tonto.eia.doe.gov/FTP/ROOT/financial/mergers/dwnstream.pdf>

Exhibit 10: The U.S. Is Falling Behind On Broadband: 3 OECD Nations Were Ahead Of The U.S. In 2001, 14 Nations Are Now Ahead of the U.S.

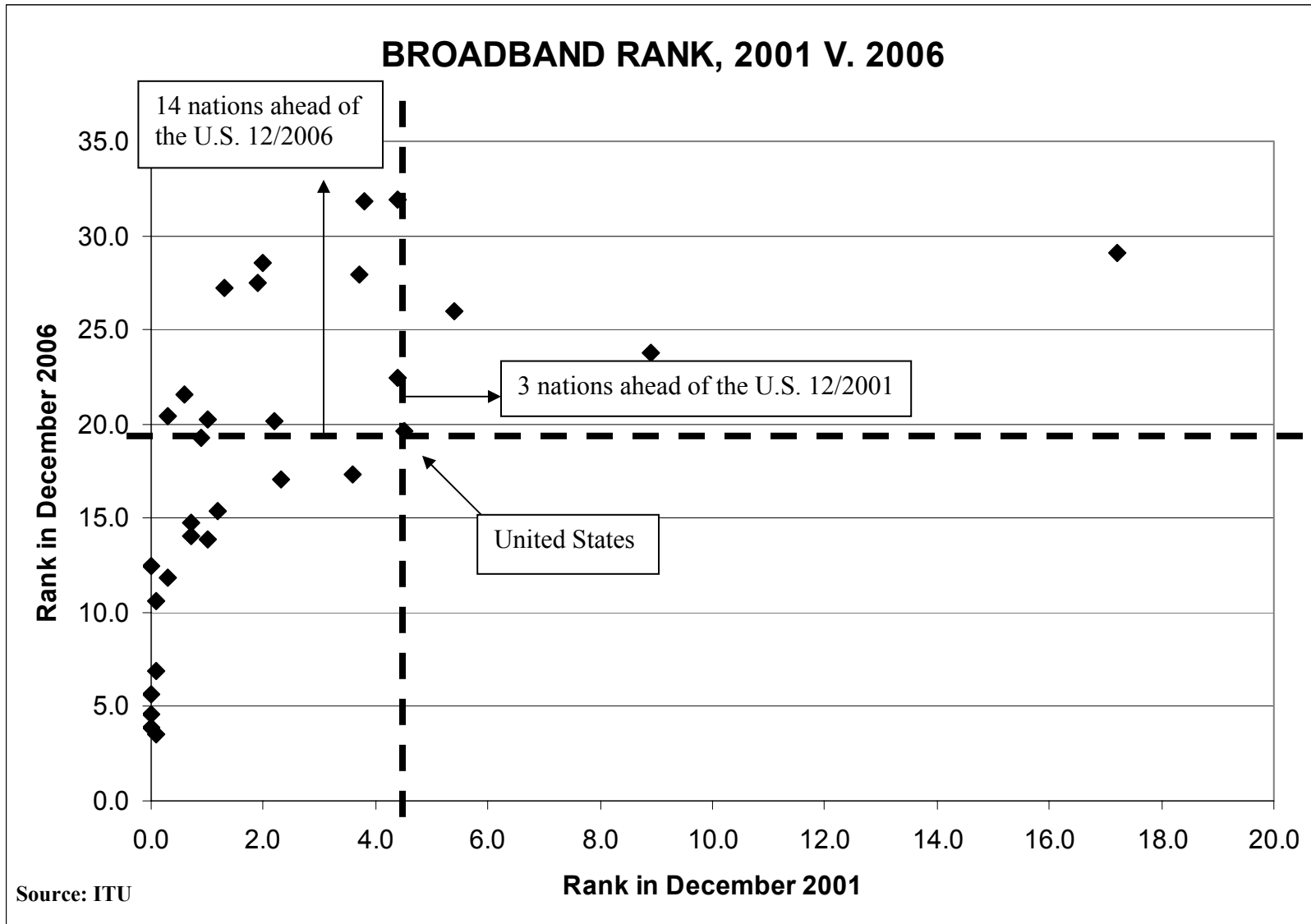


Exhibit 11: The U.S. Ranks 15th on Broadband Penetration by Households and Per Capita

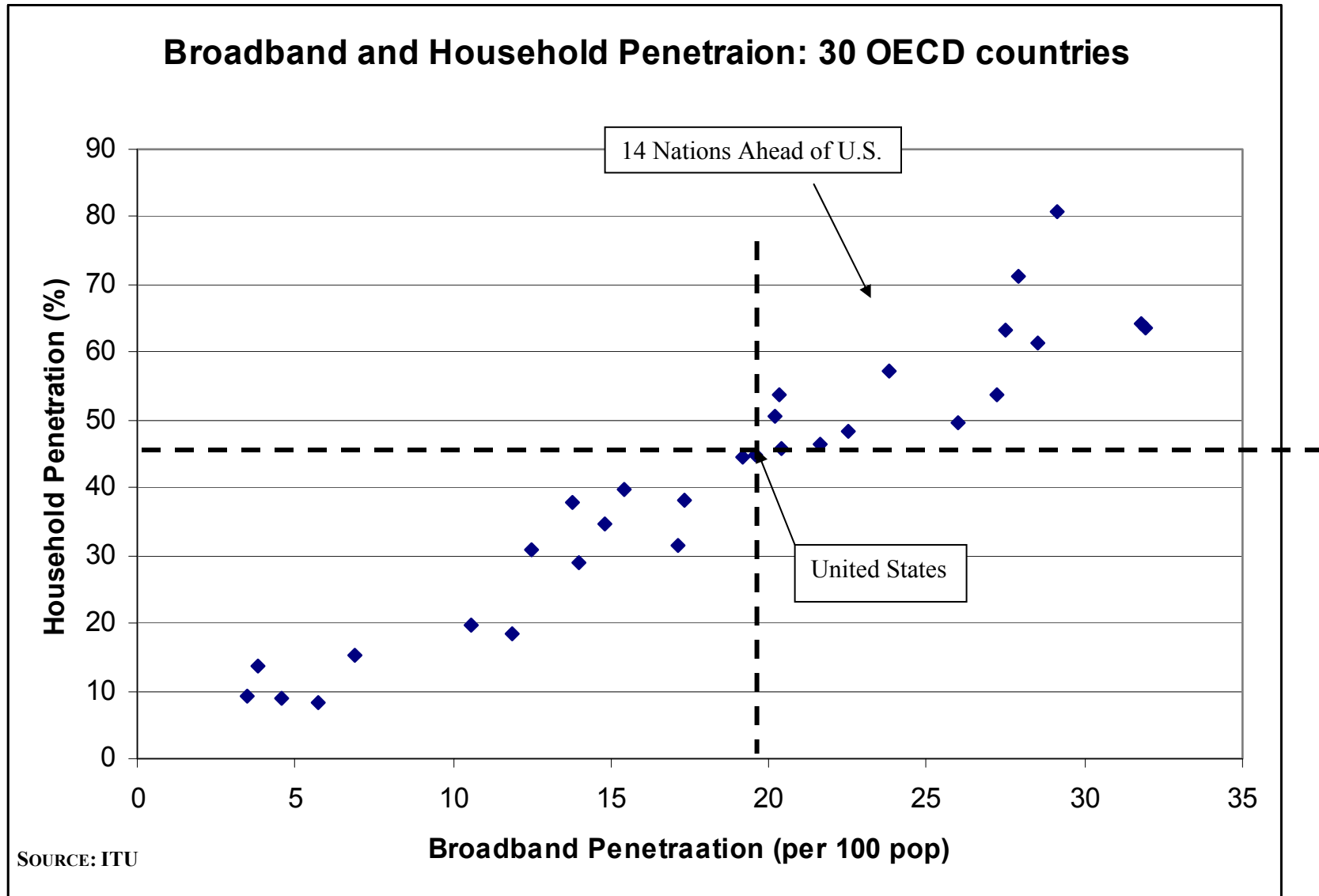
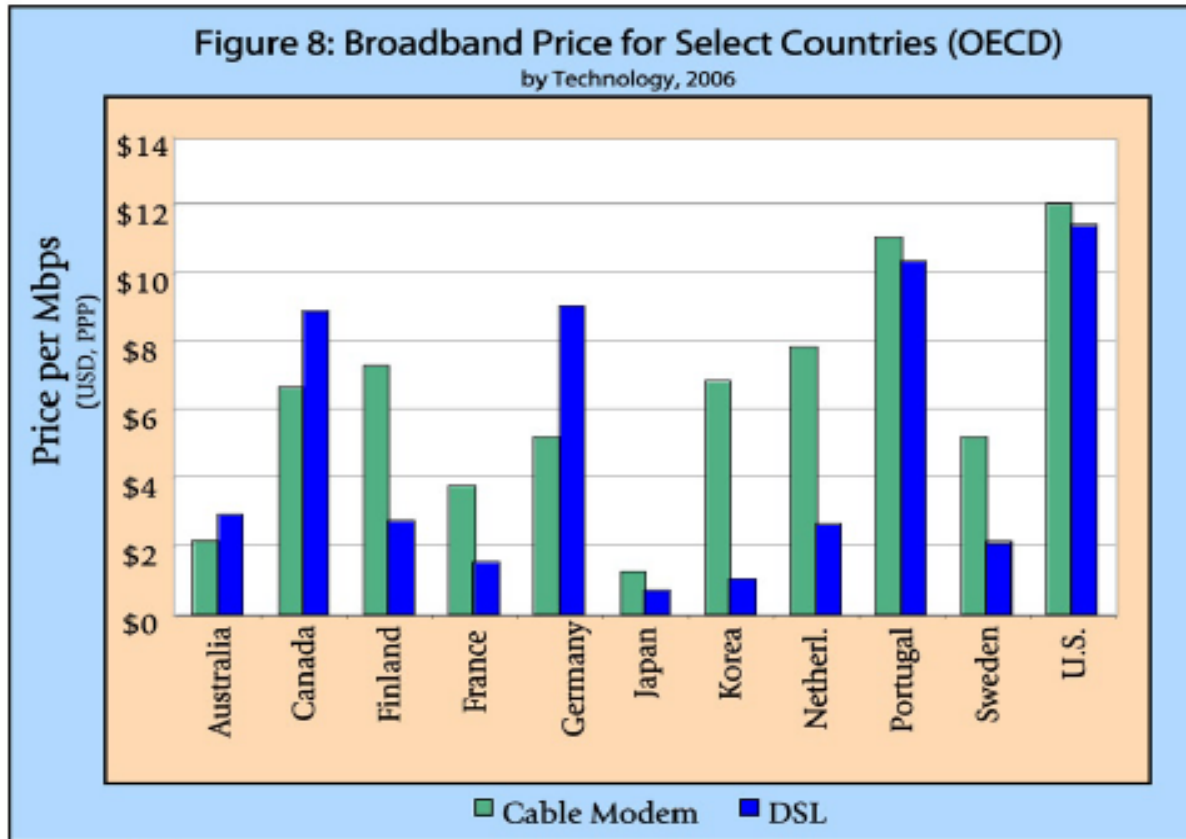


EXHIBIT 12: 60% of U.S. States have lower broadband penetration than Spain, 40% have lower broadband penetration than Portugal

% of HH	Nation/State
80.9	*South Korea
71.1	*Iceland
64.2	*Netherlands
63.6	*Denmark
63.4	*Norway
61.4	*Switzerland
61.1	Hawaii
60.7	New Jersey
59.9	Connecticut
57.3	Massachusetts
57.2	*Canada
56.8	New Hampshire
56.8	California
53.9	*Finland
53.3	Maryland
52.6	Rhode Island
51.8	New York
51.4	Delaware
50.5	*Japan
50.4	Nevada
49.5	*Sweden
48.2	*Belgium
48.2	Florida
47.9	Washington
46.9	Kansas
46.6	*France
46.3	*United Kingdom
46.1	Virginia
45.7	*Luxembourg
45	Australia
45	DC
45	Arizona
44.6	*United States avg.
44.5	*Spain
44.4	Alaska
43.8	Texas
42.9	Nebraska
42.8	Minnesota
41.6	Maine
41.1	Utah
40.8	Pennsylvania
40.2	Ohio
40.2	Vermont
39.7	*Austria
39	Wisconsin
38.9	Missouri
38.3	*Portugal
37.9	*Italy
37.6	Indiana
37	Oklahoma
36.8	Michigan
36.1	Louisiana
35.6	Wyoming
34.6	*Germany
34.5	South Carolina
33.5	Tennessee
33.4	Montana
33.3	North Carolina
32.5	Iowa
31.7	Kentucky
31.6	*Ireland
31.4	Idaho
30.9	New Zealand
30.8	West Virginia
30.1	Arkansas
29.8	New Mexico
29.4	Alabama
28.8	*Czech Republic
21.3	South Dakota
20.4	North Dakota
20.2	Mississippi
19.6	*Czech Republic
18.3	*Hungary
15.3	*Poland
13.6	*Turkey
9.2	*Mexico
8.8	*Greece
8.4	*Slovak Republic

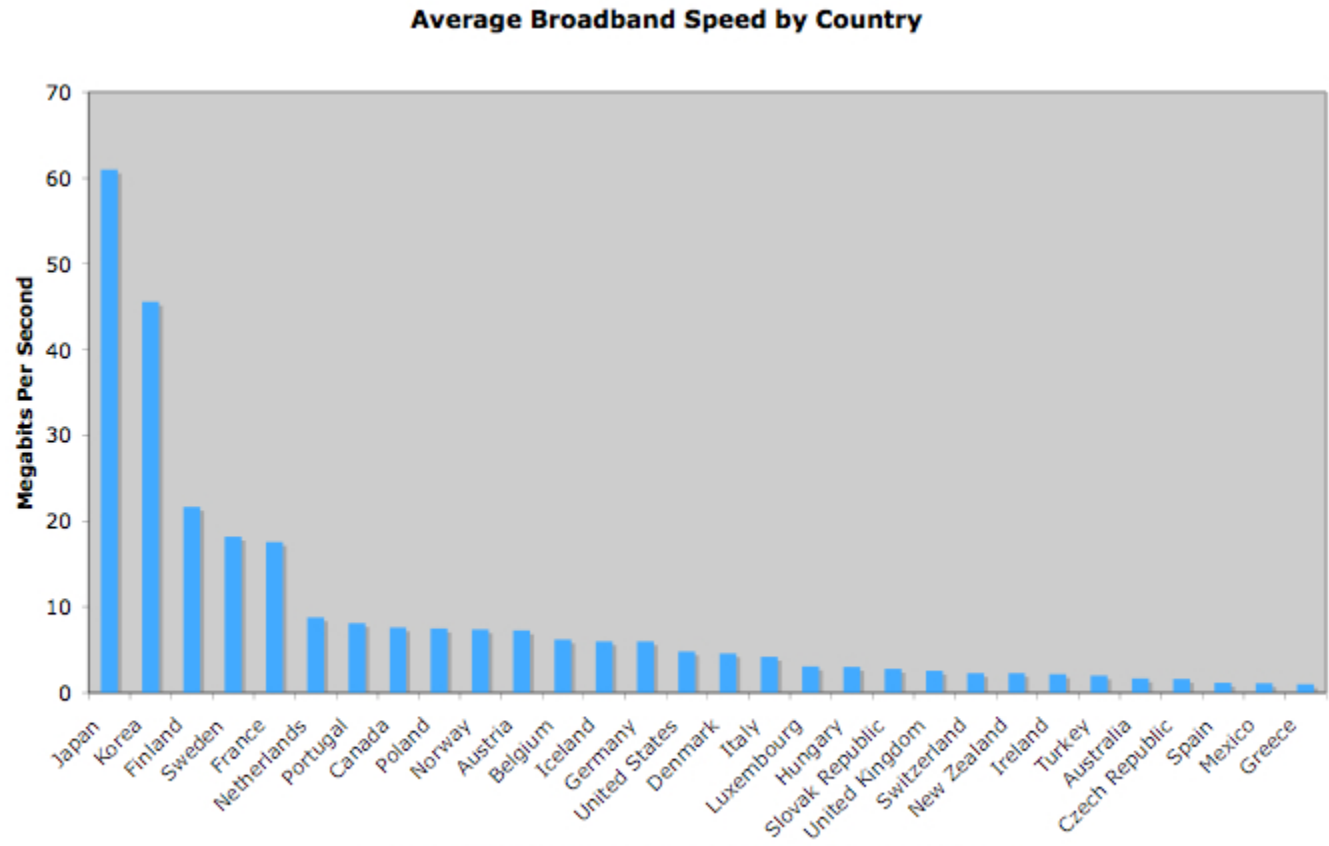
Exhibit 13:



Source: OECD

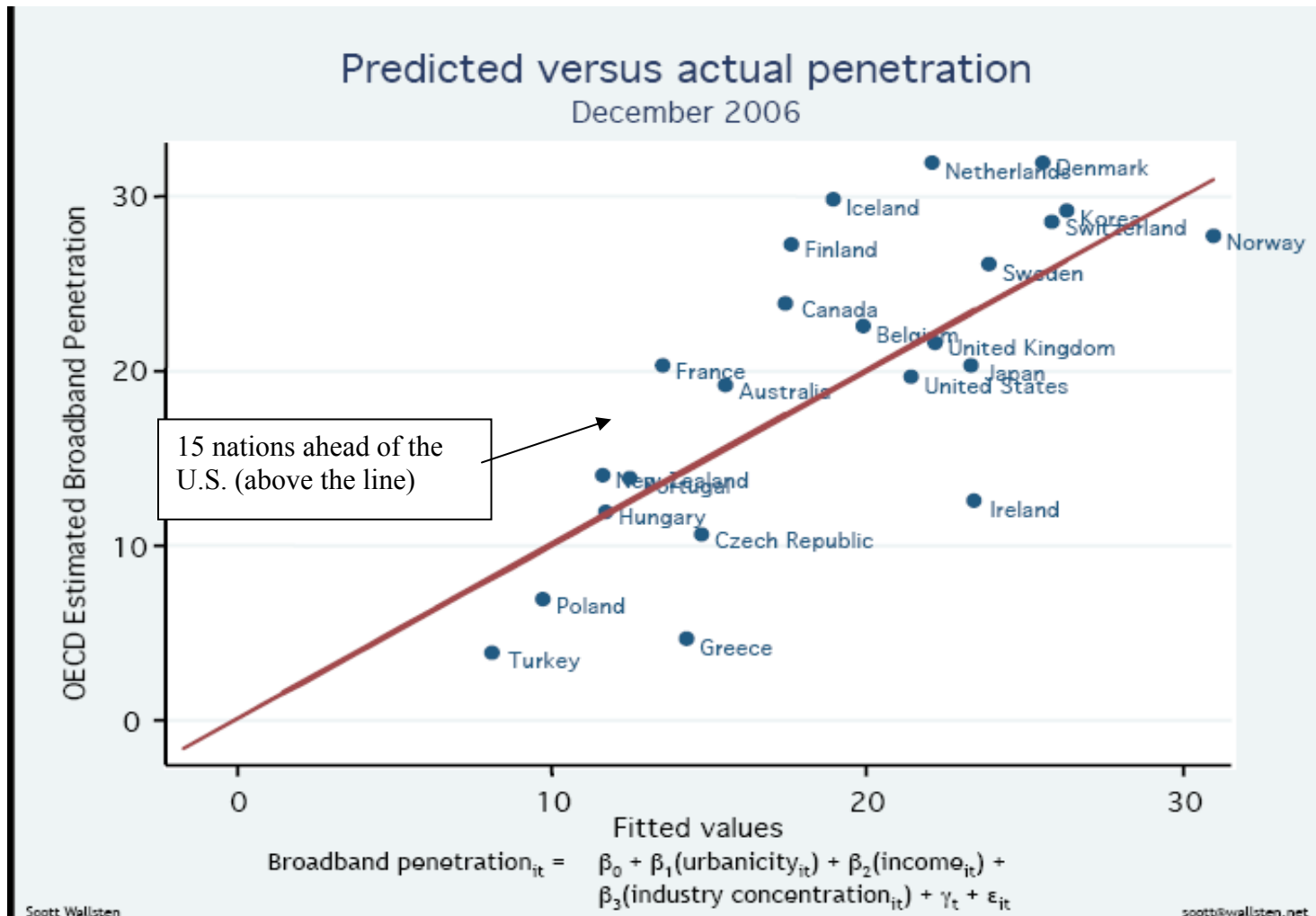
Derek Turner, *Broadband Reality Check II*, Free Press, August 2006.

Exhibit 14: The U.S. Ranks 14th in Average Speed



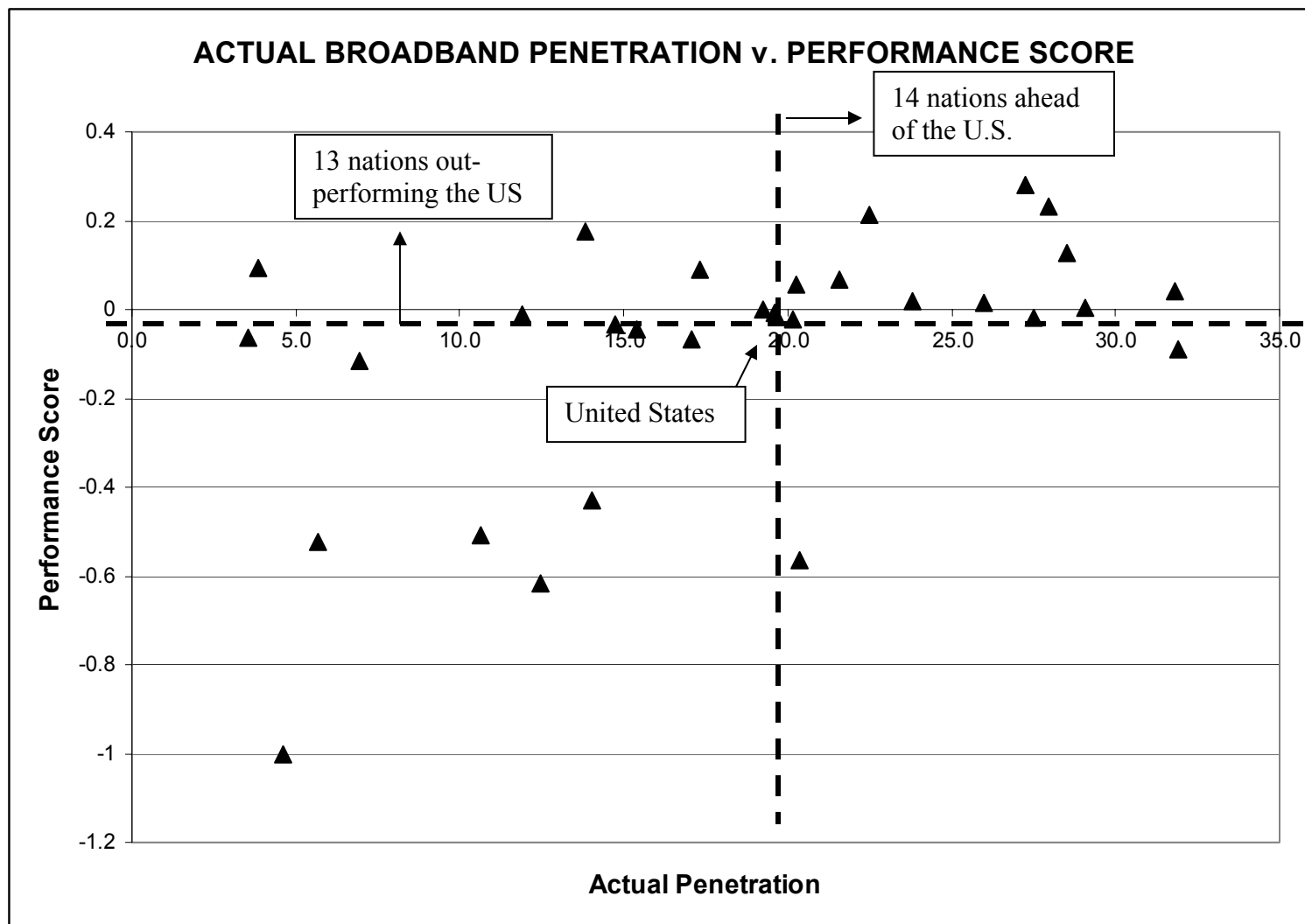
Source: Information Technology and Innovation Foundation

Exhibit 15: Controlling for Urbanicity, Income and Industry Concentration, the U.S. is outperformed by 15 OECD Nations



Source: Scott Wallstein, *Everything You Hear about Broadband in the U.S. is Wrong*, Progress and Freedom Foundation, June 2007

Exhibit 16: Lowering expectations does not improve the picture: The U.S. ranks 14th on performance and 11 of the 14 nations ahead on broadband are also outperforming the U.S.



Source: Phoenix Center, *The Broadband Performance Index*, July 2007; OECD rankings