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The FTC's Primer on Price Gouging

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With the high price of gasoline today, Members of Congress are scrambling for policies that could lower prices and demonstrate that they are doing everything they can to address the issue. However, most of the legislation introduced so far would be counterproductive, raising gasoline prices further or bringing back the horrible gasoline shortages of the 1970s. In that vein, some Members of Congress want the Federal Trade Commission (FTC) to police oil companies for price gouging on gasoline. But the FTC doesn't think that this is a good idea.

Over the past year, Congress has introduced dozens of bills targeting high gasoline prices. A few are good, such as proposals to open up more domestic oil production in Alaska and offshore as well as efforts to streamline convoluted regulations that raise refining costs.

Most, however, are awful, such as bills imposing the kind of price controls that led to shortages and gas lines in the 1970s and early 1980s. Back then, Americans learned the hard way that Washington can't simply force down the price at the pump.

The market price of gasoline is the price at which supply and demand are balanced. Currently, that price is uncomfortably high, due to very strong global demand for oil and refined products and supply that is barely adequate to meet that demand.

But high prices eventually lead to solutions – they give producers extra inventive to increase supplies and consumers extra incentive to cut back on unnecessary driving. Over the long term, they can even create opportunities for alternative fuels. This is why oil and gas prices fluctuate over time, and no increase has ever been permanent.

Of course, some are losing patience with this process and want to use price controls to wrench the price below market levels. But that only means that demand will outstrip supply at the mandated price. That is why past attempts to do so inevitably led to shortages and gas lines, rationing, and many stations' pumps running dry.

At first blush, consumers paying $2.90 per gallon for gas may like the idea of the government stepping in and setting a limit on the price – until they realize how hard it will be to actually find gas at the below-market price.

Fortunately, efforts to bring back price controls

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have stalled in Congress. However, one proposal that is nearly as bad passed the House and now awaits debate in the Senate. The Federal Energy Price Protection Act of 2006 (H.R. 5253), would outlaw “price gouging.” This approach could cause the same problems as price controls.

This bill feeds off consumer anger over high gas prices and suspicion that oil industry misconduct is somehow to blame. Existing antitrust laws already forbid any company from engaging in monopolistic practices or colluding with competitors to suppress supplies and raise prices. The new measure proposes to add “price gouging” to the list of illegal activities.

But “price gouging” is a term often used but never clearly defined. It implies an “unreasonable” price that is higher than that justified by market forces, but how can that be determined? For example, many accused the oil companies, refiners, and retailers of price gouging after Hurricane Katrina, but the storm did knock out many offshore oil wells, refineries, and pipelines. Given the supply disruptions, a post-Katrina price jump was all but inevitable. How could the government distinguish a fair price increase from price gouging?

The bill itself does not answer this question. It would require FTC to come up with its own definition of the term and then enforce it. The bill also proposes penalties exceeding $3 million per day per violation.

Because the success or failure of this approach would fall on FTC, it is worthwhile to find out what FTC has to say on the subject. The agency recently released a comprehensive report, “Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases.” The report is the result of the latest congressionally-mandated FTC investigation of the oil industry and looked specifically at the reasons for high gasoline prices in 2005, both before and after Katrina and Rita. As with previous FTC reports on the same topic, this one found no evidence of antitrust violations, concluding that “the evidence collected in this investigation indicated that firms behaved competitively.”

With regard to the hurricanes, the FTC believes that the price increases are due to supply disruptions, not market manipulation. “In light of the amount of crude oil production and refining capacity knocked out by Katrina and Rita, the sizes of the post-hurricane price increases were approximately what would be predicted by the standard supply and demand paradigm that presumes a market is performing competitively,” it concluded.

Beyond exonerating the oil industry of wrongdoing under existing laws, the report also takes a critical look at the possibility of expanding current prohibitions to include price gouging. “Our examination of the federal gasoline price gouging legislation that has been introduced … indicates that the offense of price gouging is difficult to define.” FTC adds that “the lack of consensus on which conduct should be prohibited could yield a federal statute that would leave businesses with little guidance on how to comply and would run counter to consumers’ best interest.”

FTC concludes that a price gouging law that doesn’t account for market forces would be counterproductive. “Holding prices too low for too long in the face of temporary supply problems risks distorting the price signal that ultimately will ameliorate the problem.” In other words, price gouging restrictions could act as *de facto* price controls and cause the same problems. For example, if suppliers to the post-Katrina gasoline market feared being targeted for price gouging and so kept prices artificially low, the shortages could have been prolonged and caused even more hardship for consumers.

It is rare for a government agency to be anything less than thrilled at the prospect of a congressionally-granted expansion of its authority. That's why FTC's reluctance to become price-gouging cops is particularly noteworthy. Congress should heed FTC's advice.

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