Working Party No. 2 on Competition and Regulation

ROUNDTABLE ON COMPETITION POLICY FOR VERTICAL RELATIONS IN GASOLINE RETAILING

-- Canada --

20 October 2008

The attached document is submitted to Working Party No. 2 of the Competition Committee FOR DISCUSSION under item III of the agenda at its forthcoming meeting on 20 October 2008.

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1. **Introduction**

1. The Competition Bureau of Canada (the “Bureau”) submits this paper in response to the OECD's request for submission on issues of vertical integration and separation within the gasoline markets.

2. The Bureau in particular and the federal government in Canada in general do not regulate the gasoline industry. However, given the nature of this industry, the Bureau has investigated the petroleum industry over the years by conducting and commissioning several studies on the gasoline industry.\(^1\)

3. Neither the federal government nor provincial or territorial governments have legislation or regulations that require vertical separation between refiners and retail gasoline stations, although this issue has been examined over the past 20 years by the aforementioned investigations and studies conducted by the Bureau. It is important to note that the *Competition Act* (the “Act”) applies to the gasoline industry as it does to other sectors of the economy. For example, this past June 2008, an enforcement case lead to charges and guilty pleas under the conspiracy provision of the Act against gasoline retailers in four Quebec municipalities.

4. While the federal government does not regulate the gasoline industry, five Canadian provinces have decided to regulate retail gasoline prices. Newfoundland, New Brunswick and Prince Edward Island have implemented maximum retail prices in order to protect consumers. While Quebec uses a minimum price law in order to protect retail margins. Nova Scotia imposes both a minimum and maximum retail price to the benefit of consumers and independent gasoline stations.

2. **Overview of Retail Gasoline Markets**

5. According to the *National Retail Petroleum Site Census 2006, 27 June 2007*, from MJ Ervin & Associates Inc. \(^2\) (the “MJ Ervin Census”), as of the 31\(^{st}\) of December 2006, there were 13,772 retail gasoline stations operating in Canada – approximately 4.2 outlets for every 10,000 people. The number of gasoline stations has declined by 36% since 1990, dropping from an estimated 22,000 retail gasoline stations.

6. The rationalization of the networks started in the 1980s, responding to the over-capacity in the retail segment of the industry. According to the *Study of the Economics of the Nova Scotia Gasoline Market for Service Nova Scotia & Municipal Relations* by Gardner Pinfold Consulting Economists Ltd. and MJ Ervin & Associates Inc. in September 2005, this rationalization has produced a substantial benefit in terms of improved average sales volumes, resulting also in reduced margin requirements at the surviving outlets.\(^3\)

7. Gasoline retailing has shifted from a service offered in conjunction with automobile repair services to a gasoline station selling food. The provision of goods and food instead of automobile repair services are of vital importance to the competitiveness and viability of retail gasoline outlets. One of the main reasons explaining this shift is that the gross margin on the sale of a litre of gasoline is generally not sufficient to provide for the operating costs and reasonable return on the operation of these facilities. A

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study shows other reasons why automobile repairs integrated into a gasoline station are becoming rare: cars are travelling longer distances between fuel stops, requiring less maintenance, carry longer warranties, are much more fuel efficient and they are strongly tied to car dealerships. Also, the emergence of specialist automotive shops (mufflers and shocks), and the emergence of hypermarkets that use cross-merchandising as a means of consolidating demand has contributed to this trend.  

3. Structure of the Canadian Petroleum Markets

8. Canada’s gasoline supply is largely produced from the 16 refineries, operated by a total of ten refining organizations. The MJ Ervin Census describes the following players in the marketplace:

- **Integrated Refiner-Marketers**: marketers whose corporate structure also encompasses one or more domestic refineries. There are ten refiner-marketers operating a total of 16 refineries in Canada.

- **Non-refiner Marketers**: marketers who obtain supply from a refiner “at arms’ length”.

9. Non-refiner marketers generally include:

- **Regional Distributors**: An independent marketer who operates a number of retail outlets, which carry a well-known brand (usually a refiner’s brand), under a supply and licensing arrangement.

- **Big Box Marketers**: A marketer whose primary offering is non-petroleum in nature, usually dealing in “high volume” retail sites.

- **Traditional non-refiner marketers**: A marketer whose primary offering is petroleum in nature, operating a chain of traditional gas stations under their own brand.

- **Wholesale Brokers**: A marketer who buys from a refiner and sells to independent dealers who are typically not affiliated with any sort of recognized brand.

10. The control of prices at the retail level are determined by various contractual and ownership arrangements. The refiners control prices in two types of retail outlets: refiner-owned station and refiner-owned with a lease to an individual operator. Twenty-nine percent of all gas stations come under the price control of one of the ten integrated refiner-marketers in Canada. The remaining 71 percent of gasoline stations control their own prices and fall into the category of non-refiner marketers, which include both traditional (firms with a primary focus on petroleum products) and non-traditional (firms with a primary focus on products other than petroleum products) marketers.

11. Independent gasoline stations that are having the most significant impact on the market are "Big-Box" marketers. There are approximately 1,433 gasoline outlets in Canada associated with a "Big-Box" (less than 10% of the market by number). A "Big-Box" is a non-traditional marketer whose primary source of gross sales revenue is typically merchandise, such as groceries, rather than gasoline. The MJ Ervin Census stated that these “Big-Box” marketers are generally able to charge lower pump prices due to

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4 *Idem*, supranote 3  
5 *Idem*, supranote 1.  
6 Petro-Canada, Imperial Oil or Shell Canada Ltd.  
7 *Idem*, supranote 1.
the high volume of gasoline sold and thus low operating costs per litre, as well as the ability to cross-merchandise with their non-petroleum products.

4. **Vertical Integration and Separation**

12. The Bureau in the context of studies it has published or commissioned has discussed vertical integration and separation issues at times. These issues include the potential for a small number of refiners to control the retail price of gasoline and the ability of refiners to exclude independent operators from competing by squeezing retail margins.


13. The issue of vertical integration was discussed in the 1986 Restrictive Trade Practices Commission Report titled *Competition in the Canadian Petroleum Industry* (the “RTPC report”. The Restrictive Trade Practices Commission (the “Commission”) existed prior to the coming into force of the Act in 1986. It acted as an independent review body or tribunal. Included in its mandate was to conduct inquiries under section 47 of the *Combines Act* (the predecessor to the *Competition Act*), which is essentially an examination of the workings of the markets or markets involved. In 1981, the Commission was asked by the Director of Investigation and Research (the predecessor to the Commissioner of Competition) to examine the state of the petroleum industry in Canada. This followed an eight-year investigation by the Director dating back to 1973 into allegations of price-fixing by oil companies as well as to determine whether or not vertical integration had contributed to higher prices for gasoline and fuel oil.

14. The result was an extensive report that looked into the petroleum industry from 1958 – 1985. The report looked at various trends affecting the Canadian gasoline market, including the effect on competition of “swap agreements” and vertical integration.

15. With respect to the issue of Inter-Refiner Supply Agreements, or “swap agreements”, the Commission found that the agreement between refiners were not anti-competitive but efficiency enhancing given the geography of Canada. There were a number of agreements that the Commission studied, including exchange, processing and terminalling agreements. All of the individual refiners had agreements with other refiners forming a network, which ensured supply in the event of a supply shock. As well, it allowed for more efficient refinery utilization rates and reduced transportation costs. The Commission agreed that the swap agreements helped refiners to be more efficient, and cited the difficulties and costs of integrated firms to establish new refineries in distant locations, when existing capacity was not being used. This allows refiners without a local refinery to compete with local firms at the retail level.

16. At the time, the predecessor to the Competition Bureau raised issues with the ability of a small number of refiners to have direct control of retail prices. The Commission rejected this argument, as the data did no prove that competition had been reduced.

17. The Commission also explored the issue of sharing risk when an independent retailer enters into an agency agreement with a refiner. This type of agreement allows for the retailer to sell gasoline as an

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9 According to the RTPC Report, under a terminalling agreement a firm having bulk storage and handling facilities agrees to receive product, store it and redeliver it to the same firm according to an agreed schedule in return for a “throughput” fee.
10 Ibid. p.280
agent for the refiner, earning a commission on each litre of gasoline sold. The refiner may be in a better position to assume the pricing risk inherent in the market. The final major issue that was contemplated by the commission relates to price support given to branded independents.

18. In times of shrinking retail margins, refiners have extended price support to their independent dealers in order to ensure a viable margin. In these cases, the retail outlet will cede control of pricing to the refiner, who will ensure that the retailer makes a certain margin.

19. The Commission’s report recognized that there are potential problems with vertical integration; however, restricting vertical arrangements in gasoline had resulted in higher, not lower, consumer prices in the jurisdiction examined.\(^\text{11}\)

6. The LECG Report

20. The issue of vertical integration was examined again in 2005 following complaints from independent gasoline retailers about margin squeezing and predatory pricing by national-owned and large independent retailers. The Bureau’s examination addressed allegations that the national refinery-owned and large independent retailers dropped gasoline prices below their cost in these areas during certain periods in order to eliminate independent retailers (predatory pricing). It also examined complaints that the national refinery-owned gasoline retailers charged higher wholesale prices to independent retailers who compete with their outlets at retail (margin squeezing). As a result of the alleged behaviour, the independent retailers claimed their profit margins had eroded over time, hurting their ability to compete.

21. The Bureau concluded that there was insufficient evidence to support allegations that the refinery-owned gasoline and large independent retailers engaged in abusive behaviour to eliminate or discipline independent retailers. In the course of the investigation, the Bureau hired LECG, a consulting group, to perform an independent study on the profitability in Canada’s retail gasoline market.\(^\text{12}\)

22. One of the objectives of the LECG Report was to compare the profitability of independent gasoline retailers with vertically integrated retailers. In doing so, the authors compared two independent retailers with three vertically integrater retailers. While the data set was relatively small, and the study was only able to include big box independent retailers, the conclusions remain valid in that wholesale prices charged to independents are nearly identical as to the transfer prices enjoyed by vertically integrated retailers.

23. The key conclusion of the study is that throughput remains a very important driver of profitability. Throughput increases the number of customers that may purchase ancillary services, however, more importantly, the study indicated that the higher throughputs allows the operators to realize lower average costs and has a substantial impact of profitability.

7. Advocacy

24. From time to time the Bureau will provide comments to or will appear before certain bodies when new laws or regulations are being considered. The Bureau advocates for open competition in

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\(^{11}\) Ibid p. 282, the Commission reviewed an academic paper that explored the effects of legislation in Maryland that required vertical separation.

Canadian markets to promote efficient allocation of resources within the economy and provide consumers with the best price, choice, quality and innovation.

25. For example, the Bureau commented to a Nova Scotia legislative committee when the committee studied the issue of vertical separation in 2004. In those hearings, the Bureau indicated that the evidence from four U.S. states that did impose “divorcement” laws resulted in higher prices and shorter operating hours. \(^\text{13}\) The committee decided to propose vertical separation. Ultimately the Government of Nova Scotia decided against the proposal and instead elected to regulate prices. Nova Scotia imposed both a minimum and a maximum price in order to protect retailers and consumers. The Nova Scotia law explicitly regulates retail margins.

8. Conclusion

26. While there have not been recent indepth studies on vertical integration issues in the gasoline sector in Canada, it is important to note that the Bureau believes that generally market forces should prevail over regulation, or in this case, mandating vertical separation. Vertical integration is more often than not pro-competitive and efficiency enhancing. Only in situations where there is evidence of anti-competitive behaviour would the Bureau intervene. Even in such a case, it is unlikely that the Bureau would seek an order requiring vertical separation.