The Conference Board of Canada

THE FINAL FIFTEEN FEET OF HOSE

How do domestic retail and wholesale gasoline markets work?

How are prices determined at the pumps?

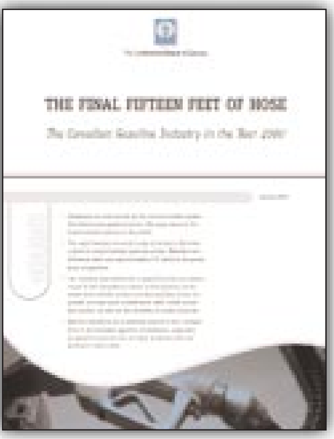
This Conference Board of Canada brochure takes a balanced look at the economics behind one of Canada's most controversial businesses.

The Conference Board of Canada is not a government agency. It is an independent, not-for-profit, applied research institution known for its balanced analysis and its expertise in building consensus among diverse groups.

Driving along, a motorist will notice that the price of gasoline doesn't change much from station to station. And it seems that the prices all move up at the same time, particularly when long weekends are coming.

In 2000, The Conference Board of Canada, one of this country's most influential research organizations, took a closer look at the gasoline industry. It aimed to gain a clearer picture of how the gasoline industry works and explore a series of issues that are important to Canadians. In order to do this, it extensively analysed 10 years of data taken from 16 cities.

As an outside, impartial body, the Conference Board was able to spend six months talking to stakeholders from every region of the country, including refiner-marketers ("the majors"), independent retailers, consumers and many others. These broad consultations provided fresh insight into a much-studied industry and helped to provide a balanced approach and final report.*



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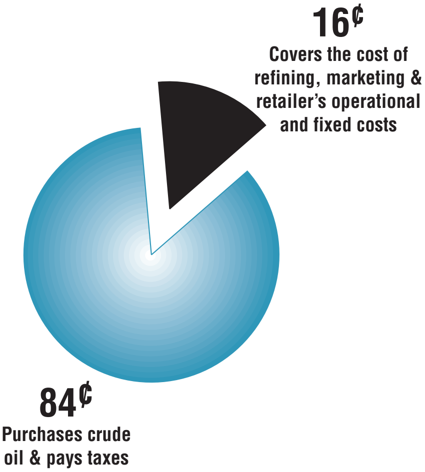
*The final report, *The Final Fifteen Feet of Hose: The Canadian Gasoline Industry in the Year 2000*, is available on The Conference Board of Canada Web site, www.conferenceboard.ca

Where does the money I pay for gasoline go?

When you buy a dollar's worth of regular unleaded gasoline, nearly 84 cents of that dollar goes to buy the crude oil and to pay taxes. This leaves only 16 cents out of every dollar to cover the costs of refining and marketing, as well as the retailer's operational and fixed costs. The service station where you buy your gasoline can influence, on average, slightly less than 6 cents of each dollar of the price you pay.



In fact, throughout the 1990s, increased efficiency meant that gasoline stations had to cut their retail margins—the difference between the cost of buying a product wholesale and selling it retail, before taxes. This saving has been reflected in lower pump prices than would otherwise be the case. Canadian consumers have benefited from this trend.

Moreover, many outlets make much of their money from their convenience stores, coffee shops and car washes, rather than on low-margin gasoline. This trend may accelerate when "big box" retailers make their mark in Canada and gasoline becomes one of many products sold at a particular retail outlet.

Why do gasoline prices change?

Prices respond to the economic laws of supply and demand. If supply goes down, or if demand goes up, prices will rise. If supply goes up, or if demand goes down, prices will fall.

If Canadians drive more kilometres in less efficient vehicles, for example, rather than fewer kilometres in more efficient vehicles, then demand will go up and so will prices. Likewise, when a cartel such as the Organization of Petroleum Exporting Countries (OPEC) cuts crude oil supply, then prices will rise at Canadian gasoline pumps.

Crude oil is the major input in gasoline production. A rising or falling crude oil price is thus the main culprit in rising or falling gasoline prices. In fact, the equivalent of a one cent a litre increase or decrease in the price of crude oil—there are 159 litres in a barrel—causes a similar change in wholesale gasoline prices and, therefore, in retail prices to the motorist.

Because Canada produces only about 3 per cent of the world's oil, it has no influence on the world price of oil. Canada is both an exporter and importer of crude oil. Eastern and central Canada rely on imported oil, while the prairie provinces are net exporters.

Gasoline prices change in unison and are the same in particular markets largely because consumers usually buy gasoline strictly on the basis of price and convenience, rather than out of loyalty to any particular brand or gasoline station. Motorists see gasoline as a standardized product—gasoline is gasoline. Thus, retailers have to cut prices when their competitors do or they may lose their customers. They can only raise prices when market conditions allow them to do so.

Gasoline prices are posted on large roadside signs, a marketing approach unique among consumer products. Thus, gasoline stations are under intense pressure to remain competitive with the lowest price. If they do not, they risk losing an important share of their gasoline sales. Therefore, prices are similar at all outlets within a market.

Do big companies compete unfairly with independents?

Some Canadians suspect that the large gasoline companies control gasoline prices and are trying to increase their control by pushing smaller independent dealers out of the marketplace.

The major integrated oil companies both refine and market petroleum products. The largest companies are also involved in oil exploration and production. However, they do not produce sufficient crude oil to meet their refining needs and must buy oil from other producers at the world price for crude oil.

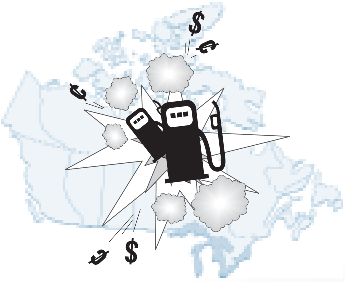
The "majors" are involved in the entire process, whereas independent gasoline stations sell only gas. Many independent gasoline station operators say that the majors use profits from the first half of their business to subsidize the second half, which allows them to cut prices below what the independents can afford to charge.

Using one activity to help cover the costs of another is an accepted practice in virtually all Canadian companies. It is neither illegal nor uncommon. Nevertheless, the gasoline industry is wary of this practice, fearing that big box retailers will force retail margins on gasoline even lower, thus hurting retailers who rely mainly on gasoline sales to make a living.

The Conference Board could not find any conclusive evidence that this phenomenon, called cross-subsidization, is a general pattern within the industry. We did, however, find that large refiner-marketers have an advantage over independents during price wars, since some firms temporarily support their dealers by providing a lower wholesale price or a guaranteed retail margin.

Why are gasoline prices different in different parts of the country?

In many cases, prices vary because of the cost of transporting gasoline, differences in taxes between provinces and sometimes cities, as well as differences in the amount of gasoline sold at a particular station. The volume of gasoline sold is a key determinant of retail margins and, as a result, of the price at the pump. In addition, local market conditions can push gasoline prices in directions that reflect intense rivalry among sellers.



For example, if a dealer is determined to increase market share at the expense of competitors, he/she will try to do this by selling at a lower price. This can bring about a price war—a situation where retail prices bear little relation to transportation costs, wholesale prices or normal margins. This unusual situation can last for as long as a price war is sustained. During price wars, motorists benefit from low gasoline prices—although local service stations may see their profitability cut dramatically and some may go out of business.

Prices will also be higher in smaller communities than in big cities. A big-city gasoline station will get more customers than a smaller, rural gasoline station. But both stations have fixed costs that they must cover, such as employee wages, property taxes and maintenance. For the rural gasoline station to stay in business, it has to charge more to cover its fixed costs and operating expenses because it has lower gasoline throughputs or volumes.

Do gasoline prices always rise before long weekends?

In theory, increased demand before a long weekend could produce higher prices. But in fact, the Conference Board found no empirical proof that gasoline prices actually do increase because of long weekends. But the sometimes weekly price changes we all see at the pumps led us to wonder how prices are set and why they are so volatile.

Essentially, the volatility results from the intense street-level competition in this business where prices are visible to motorists and where volumes play such an important role in the survival of individual players. Thus, gas station prices sometimes move up and down more than most consumers would expect as individual companies try to capture or retain market share.

Prices often rise mid-week during periods where retail margins have been lower than retailers feel are adequate to cover their costs and a reasonable return on their investment. This is called a “price restoration” and it usually occurs on Tuesdays or Wednesdays. It is almost always led by one of the larger oil companies. Gasoline prices, therefore, are just as likely to go up before any weekend of the year. But the reality is that we tend to notice the increase more before long weekends than before regular weekends, especially if we are planning a trip.

In conclusion

Canadian motorists are well served by the gasoline industry.

Once you subtract taxes, Canadians pay pretty much the same price that Americans pay for gasoline, even though we have fewer refineries and a larger geographic area to serve a smaller population base.

In fact, we enjoy some of the lowest gasoline prices in the world. This is because our gasoline is priced in response to "continental markets," allowing us to benefit indirectly from competitive conditions in the United States and the economies of scale associated with larger refineries and a bigger market.

Although there are some unresolved questions about cross-subsidization, it is clear that there is plenty of price competition at Canadian pumps, and that most of the fluctuation in the price of gasoline has to do with local market conditions and with the price of crude oil.

Crude oil has been the main driver of increased prices since 1999. The frequency of price changes we see at the pump reflects the intense street-level competition in gasoline retailing and the practice of posting gasoline prices for everyone to see.

For more information about this research, please contact:

The Conference Board of Canada at
(613) 526-3090 x 247.

Copies of the full report *The Final Fifteen Feet of Hose: The Canadian Gasoline Industry in the Year 2000* are available by contacting contactcboc@conferenceboard.ca