BACKGROUNDER

COMPETITION BUREAU CONCLUDES EXAMINATION INTO PREDATORY PRICING COMPLAINTS IN THE GASOLINE INDUSTRY

Background

As a result of complaints from independent gasoline retailers, the Competition Bureau (the Bureau) carried out an investigation to determine if refinery-owned gasoline and large independent retailers abused their dominant position to lessen competition. While the Bureau examined each complaint, the focus of its review was on those from Ontario as well as New Brunswick, where the majority originated. 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.

Abuse of dominance

The Bureau examined these issues under the abuse of dominance provisions of the *Competition Act* (the Act), which address predatory pricing and margin squeezing.

Subsection 79(1) sets out three essential elements which the Tribunal must conclude have been satisfied before it can rule that a firm or group of firms have abused their dominance. The Tribunal must find that:

a) a firm, (or a group of firms), is dominant in the relevant market, which is generally based on evidence of high market share and the presence of barriers to entry to potential competitors;
b) the dominant firm, (or group of firms), has engaged in a practice of anti-competitive acts; and
c) the practice has had, is having, or is likely to have the effect of substantially preventing or lessening competition.

Any case brought forward by the Bureau under the abuse of dominance provisions must establish these three elements.

For predation, the Bureau uses an avoidable cost test to assess whether prices are below costs. Avoidable costs refer to all the costs that could have been avoided by a firm had it chosen not to sell the product or products in question.

Summary of the Bureau's findings

After a thorough examination, the Bureau reached the following conclusions:

- 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.

- The majority of complaints originated from the Ontario and New Brunswick. In these regions, the refinery-owned gasoline retailers and large independent retailers were not dominant at either wholesale nor retail levels.

- During 2004, no retail brand had more than 27% of the market in Toronto, based on sales volume, and in New Brunswick, the target of the complaints had fewer stations than at least four other brands.

- Confidential information was obtained from representative stations owned by the targets in the Greater Toronto Area and New Brunswick. Under various scenarios, gasoline prices from these stations were estimated to be above their avoidable costs during 2004.

- Although short periods of price inversions, where gasoline was sold below wholesale costs, were identified in Toronto during 2004, these inversions resulted from short-term, local price wars, and were followed by price restoration to levels consistent with the prevailing wholesale market.

- The price inversions were limited to regular grade gasoline. Gasoline stations are now earning more of their retail profits from sales of higher-grade gasoline and ancillary services, such as convenience stores and car washes.

- Some of the complaints pointed to declining retail margins as evidence of anti-competitive activity. In Canada, the volume-averaged retail margin per litre was stable at 4.4¢ in 2003, 4.5¢ in 2004, and 4.9¢ in 2005. While gasoline retail margins declined in some areas, such as Toronto, during 2004 they have increased in 2005 to normal levels.

- There was no evidence to support a claim of margin squeezing by national integrated firms and large volume independent gasoline retailers.

Industry Snapshot

The Canadian gasoline industry involves many players that operate in the wholesale, retail or both markets. There are three types of retailers in Canada: national integrated (i.e. Petro-Canada, Esso, Shell), regional integrated (i.e. Irving, Ultramar, Chevron), and independents. Independent retailers either represent the branded products of the integrated firms, or operate without branded products (i.e McEwen, Wilsons, Olco). Other independents use their own brand name, which is part of a larger retailing operation (i.e. Loblaws, Canadian Tire, Costco).

From 1998 to 2003, the number of retail gasoline stations in Canada has been declining but the sales volume per station has been increasing. The average number of stations for most major Canadian cities was 279 in 1998 and 254 gasoline stations in 2004, while, the average sales volume per gasoline station in Canada has increased from 2.9 million litres in 1998 to 3.5 million litres in 2003.

The Bureau has noticed that, increasingly, integrated firms are transferring the operation of retail outlets to independent operators. The integrated firm still controls and owns the fuel, and pays the operator a commission based on the volume of fuel sold. This arrangement offers the integrated firm cost control, while allowing the operator to find other revenue sources in addition to their commissions on gasoline sales. This arrangement has changed the way that most gasoline stations operate.

The wholesale gasoline sector is driven by global market forces. Wholesale prices in Eastern Canada reflect the New York harbour spot price with some adjustment to factor in the transportation cost of moving the product to the retailer's tanks, terminal storage costs, and other operating costs. The wholesale price is therefore influenced to a large extent by international competition. Meanwhile, retail pricing is influenced by the prevailing wholesale prices but is also a function of the level of competition in the local markets. Short-term downward pressure on retail prices in a local market, despite having an immediate impact on retail margins, does not necessarily have any impact on the prevailing wholesale price.

What are the Competition Bureau's detailed findings?

Data gathered by the Bureau during the course of the examination pointed to short periods of price inversions, where the retail price in a particular market was below the wholesale market price of some of the independents. These inversions resulted from short-term, local price wars, which, continued to until the market began to restore the price to levels consistent with the prevailing wholesale market.

In the Greater Toronto Area during 2004, the market shares of the top four retail brands ranged from 10% to 27%. Under various parameters, the price of gasoline charged by the average integrated refiner-retailer was estimated to be above its avoidable costs. Based on average weekly prices, inversions occurred five times in 2003, eight times in 2004, and not at all in 2005 for regular gasoline. The longest price inversions lasted one week in 2003 and three weeks in 2004. There were no price inversions in 2003, 2004, and 2005 for premium gasoline.

In New Brunswick during 2004, information from an average station owned by the target of the complaints permitted estimations to show that its prices were above its avoidable costs. Indicating a lack of dominance, there were 11 other stations within a one-kilometre radius of this station. Within the province, the target of the complaints had fewer stations than at least four other brands.

The Bureau found no evidence that the pricing resulted from a coordinated attempt by a group of majors to discipline or eliminate the independent retailers in these markets. In particular, the majors have a different number of stations in local areas, sell different amounts of gasoline, and locate their stations in different areas. All these factors imply that the majors do not have the same incentives to behave in a coordinated fashion.

Economic and accounting analyses commissioned by the Bureau confirmed that ancillary services, such as car washes, are increasingly important factors of profitability in the retail gasoline market. The study, *What Determines the Profitability of a Retail Gasoline Outlet? A Study for the Competition Bureau of Canada*, was prepared by LECG and is available on the Bureau's Web site. It also suggests that a station's volume of gasoline sales is the largest driver of profitability as it means there are more customers to buy convenience store items and other services in addition to their gasoline purchases. Furthermore, it found that ancillary profits are comparable to the per litre profits derived from the sale of gasoline.

Did the Bureau notice any change in retail profit margins?

Retail profit margins, which reflect the difference between wholesale costs and retail prices, often fluctuate since the price paid by a gasoline retailer for wholesale gasoline may vary significantly from the market retail price. Therefore, if gasoline retailers purchase at a high price, they may suffer negative margins if retail prices drop.

The Bureau has studied retail margins using independent gasoline marketing data and data from previous studies. The Conference Board Study found that retail margins dropped in the early 1990s before stabilizing in the mid to late 1990s. Using the same data as the Conference Board, the Bureau did not observe any statistically significant change in retail margins since 2000. While daily margins fluctuate, the volume-averaged retail margin per litre was 4.9¢ in 2005. In Toronto, the average retail margin per litre was 5.0¢ in 2003, 3.8¢ in 2004, and 4.9¢ in 2005. In Saint John, the average retail margin per litre was 7.8¢ in 2003, 7.8¢ in 2004, and 8.2¢ in 2005.

How did the Bureau conduct its examination?

The Bureau gathered information from a wide variety of industry participants. The Bureau also consulted internal and external experts. In addition, it gathered proprietary data and obtained information from other federal departments as well as other government agencies.

The Bureau also hired Dr. Anindya Sen, from the University of Waterloo, and the LECG consulting group to perform an independent study on the profitability in Canada’s retail gasoline market.

How can I find out more about the Competition Bureau and gasoline prices?

For more information on the Bureau's role and activities concerning gasoline and other petroleum products, please visit the gasoline portal on the Bureau's Web site (www.competitionbureau.gc.ca). The portal contains frequently asked questions, information on Bureau activities, a consumer pamphlet and basic facts on the Bureau's role with respect to gasoline price complaints.

Competition Bureau

March 2006