

MARKET INQUIRY INTO SUPPLY OF BULK LIQUEFIED PETROLEUM GAS FOR DOMESTIC USE

The CC's 'emerging thinking'

Introduction

In the Issues Statement published on 21 December 2004,¹ the Competition Commission (CC) set out a number of issues which appeared to be relevant to our investigation and on which we invited comment. As part of the practice we are developing in market inquiries, we are now publishing a statement of our emerging thinking to give all parties to our inquiry the opportunity to comment further.

The CC has considered carefully the further written and oral evidence from parties that was submitted in response to the Issues Statement. In the light of this and other evidence submitted throughout the inquiry, it has begun to focus its thinking on the central issues that appear to merit consideration under the relevant provisions of the Enterprise Act 2002 (the Act). This note sets out what we currently think may be the situation with regard to the supply of bulk LPG for domestic use (which we refer to as domestic bulk LPG) in the UK. The legal questions we have to consider are set out in Annex A; we will also be publishing shortly summaries of supporting evidence in the form of a number of further annexes.² In addition, we have published on our website qualitative and quantitative surveys of users, a report by consultants on safety issues, and a CC working paper on safety.

During the next stage of the inquiry, the CC wishes to explore its thinking with parties involved in its investigation, and invites their additional views and evidence on the matters raised in this document and its annexes, including views on whether any matters might or might not amount to market features that prevent, restrict or distort competition, or whether any significant issues pertinent to the CC's inquiry have been omitted. The CC expects to hold further private hearings to explore the issues raised in this document, probably during April and May 2005.

Summary

In summary, our current thinking is that the main features of the market for supply of domestic bulk LPG in Great Britain may be as follows:

- (a) a concentrated market structure; one supplier currently accounts for about one-half of the market and the four main suppliers for about 90 per cent of supply. We also note that recent changes in market shares have been achieved primarily by acquisition;
- (b) a number of features of the market that give rise to difficulties in switching by users between LPG suppliers. These include the requirement when switching supplier invariably to change the LPG tank, the resulting monetary and non-

¹Published on the CC's web site.

²Annexes will be published on the following topics: market definition, switching, non-price competition and entry, pricing and profitability. These annexes will be based primarily on working papers which the CC is currently developing in consultation with parties to the inquiry, and will not in themselves be comprehensive, definitive or final. In particular, commercially sensitive information will not be published.

monetary costs of switching, and the pricing reactions of existing suppliers if customers threaten to switch (although there may also be possibly an element of customer reluctance to change supplier);

(c) limited constraints on the prices charged by LPG suppliers from the threat of entry or expansion by smaller suppliers;

(d) price discrimination by LPG suppliers; and

(e) limited price and non-price competition between LPG suppliers.

We consider that the supply of domestic bulk LPG in GB can be regarded as a relevant economic market in which to assess competition.

We are still evaluating information on the profitability of the main suppliers in GB but our preliminary analysis suggests that rates of return from the supply of domestic bulk LPG on average are possibly above, and certainly not below the cost of capital; we are also considering whether operating costs are higher than would be the case in a more competitive market.

The above suggests to us that competition in supply of LPG in GB is not fully effective, and prices for customers may be higher than they would be in a market with fully effective competition.

We acknowledge the overriding need to ensure safety in the supply of domestic bulk LPG. But our current view is that the above features of the GB market may not be a necessary outcome of safety requirements.

Our current thinking is that the supply of domestic bulk LPG in Northern Ireland can also be regarded as a relevant economic market, to which some of the above features also apply. The structure of the market in Northern Ireland is more concentrated than in GB, and also with very limited switching to other LPG suppliers (although with a higher degree of switching to other fuels as a result of recent and proposed development of mains gas); there also appears to be less scope for entry by smaller suppliers, and limited price and non-price competition between the LPG suppliers in Northern Ireland. The main suppliers in Northern Ireland price, however, according to list prices, rather than charging different prices to some individual consumers. The level of prices and profits currently appears to us to be lower in Northern Ireland than in GB.

The following paragraphs summarise our emerging thinking in more detail on these points. Other issues in the issues statement that are not included below are currently of less concern, although still subject to further consideration.

The emerging thinking

1. The CC remains of the view that the supply of domestic bulk LPG can be regarded as a relevant economic product and/or service market and that this provides a useful framework for assessing competition issues. Our main reasons for this view (see also Annex B) are as follows:

(a) Although the main suppliers have all argued that LPG competes with other fuels, in particular heating oil, we have found:

- There is limited switching between domestic bulk LPG and other fuels in response to price changes or otherwise (although a domestic LPG user is more likely to switch to other fuels than to a different LPG supplier). On the figures we have seen, for example, in 2003 only 1 per cent of domestic bulk LPG customers switched to heating oil.
- The scope for substitution between domestic bulk LPG and other fuel sources is limited by factors such as the costs of converting to other fuels from LPG; the limited periods when a customer may consider switching (eg, given the cost of a new boiler, when a boiler needs to be replaced); and (except in some areas of Northern Ireland where LPG is used) restricted availability of mains gas.

(b) We have found no evidence of changes in the prices of domestic bulk LPG in response to changes in the prices of other fuels. Other fuels do not therefore appear to constrain prices of domestic bulk LPG to customers to a sufficient degree to place them in the same relevant market.

2. We also consider:

(a) Although it was argued to us that supply to domestic bulk LPG customers could not be distinguished from supply to non-domestic customers since it is often economic for LPG tankers to deliver to a mix of customers, we believe those markets can be regarded as distinct. Our current view is that a commercial bulk LPG supplier could not, for example, readily respond to an increase in domestic prices by switching supply from commercial to domestic users, given factors such as supplier ownership of tanks we outline below.

(b) Northern Ireland can be regarded as a market distinct from that in Great Britain, given the separate arrangements for supply to users in Northern Ireland and that supply from a firm not already present in Northern Ireland would require substantial investment in marketing and distribution; this would also apply to supply from Republic of Ireland.

(c) We have not identified any distinct local markets in Great Britain or Northern Ireland: pricing appears to be broadly similar in all regions. Nonetheless, in GB one large supplier maintains standard prices that differ to some extent by region, but this variation seems to be insufficient to suggest that local or regional markets exist (also taking into account chains of substitution between such local areas).

(d) Supply to 'metered estates' in both GB and Northern Ireland, where a group of customers are supplied from a single tank installation, can be regarded as a sector of the market with the special features we discuss in paragraph 15.

Features in the domestic bulk LPG markets

A. Market structure

3. On the figures currently available to us, BP, Calor, Flogas and Shell account for about 90 per cent of supply of domestic bulk LPG in GB; Calor alone

accounts for about one-half of supply, although we were told its share was significantly higher when the market was first developed in the 1980s. This degree of market concentration is likely to have increased over the last 10 years or so primarily as a result of acquisitions. We remain concerned that this level of concentration may result from other features of the market we consider below that might prevent, restrict or distort competition. We are also still considering whether such a degree of concentration could facilitate any non-coordinated action on the part of individual suppliers or any coordinated effects, including some of the non-price practices set out below (for example, the carrying out of similar practices with regard to minimum contract periods, the low rate at which suppliers target each others customers, and the bundling of tank supply and LPG supply).

4. Calor and Flogas appear to be the only two suppliers in Northern Ireland with Calor accounting for well over half the market, giving rise to similar concerns.

B. Switching

5. There is, as shown in Annex C on Switching Costs, a very low rate of switching; only about 0.5 per cent of domestic bulk LPG customers switch between LPG suppliers each year. Some suppliers have argued to us, amongst other things, that this low rate of switching results from a high level of satisfaction of LPG users with their suppliers, and our quantitative survey confirms that overall more users are satisfied than dissatisfied with their LPG supplier (76 per cent compared to 14 per cent). However, fewer users are satisfied than dissatisfied with the value for money they get from their LPG supplier (31 per cent compared to 51 per cent). Customers do not on the whole believe that their supplier is better than others in the market, and yet switching is low even among those who describe themselves as dissatisfied.
6. Some suppliers also argued to us that the low rate of switching underestimated its importance in that suppliers responded to customers who threatened to switch by reducing their charges. But the proportion of customers who threaten to switch each year or who otherwise successfully negotiate some reduction in prices is also low.³ Moreover, in contrast to utilities such as gas and electricity, the ability of suppliers to price discriminate between customers (see also paragraph 11 below) means that they can respond to competitive threats at a lower cost, by reducing prices only to those customers who appear likely to switch.
7. The low rate of switching may in part result from an element of customers' reluctance to change supplier which, together with price discrimination, reduces the role of marginal consumers. But we remain concerned that the main reasons for this low rate of switching are the difficulties in switching due in part to the high costs of removing and installing tanks, the extent to which those costs are reflected in charges to customers for switching, or other barriers to switching relative to expected benefits, and/or any uncertainty as to their nature and size. Customer awareness of offers from alternative suppliers appears low, and this may be an outcome of barriers to switching—with customers having limited incentive to investigate these offers, and the alternative suppliers having limited incentive to market them. We remain

³One supplier told us that a substantial proportion of customers had avoided a standard price increase in 2003. Other evidence suggests that fewer than one in twenty LPG customers know they can negotiate prices, or do so.

concerned that competition may, as a result, amongst other things, of those switching costs, be ineffective in constraining the level of prices charged to customers and other aspects of performance.

- (a) As noted in the Issues Statement, suppliers seldom, if ever, allow customers to receive domestic bulk LPG from another supplier into their tanks; nor do they supply into the tanks of other suppliers.⁴
- (i) Moreover, domestic bulk LPG suppliers in general retain ownership of the tanks which they install in domestic premises, and remove these tanks at the end of the supply agreement. As a result, switching supplier entails removal of the remaining LPG from the existing tank, removal of that tank, and installation of a tank belonging to the incoming supplier, at a total cost to the old and the new supplier of over £500 (considerably more if underground tanks are involved).
 - (ii) Suppliers adopt different policies on the extent to which specific charges are levied on customers for removal and installation of a tank; or those costs are subsequently recovered in other charges levied on those specific customers; or those costs are borne by the supplier (and likely to be largely reflected in the overall level of charges). Direct charges for removal of an existing tank and installation of a tank from a new supplier are therefore often below the level of costs, and in some cases there is no charge. But, as noted in Annex C, the up-front charges to the customer when switching between suppliers is often substantial—standard charges (although not paid by all customers) typically being between £250 and £350—in relation to the potential savings available.
 - (iii) Charges are waived in a substantial proportion of cases, but the uncertainty whether or not a customer will be charged for removal of a tank or for early termination of a contract, or what that charge will be, is likely itself to deter customers from switching.
 - (iv) Even if the direct charges to customers for installation of a tank from a new supplier are below the level of installation costs, to the extent that such costs are ultimately passed on to the particular customer (if, for example, smaller suppliers have to offer a higher introductory price than they otherwise would) this may reduce the incentive to switch to other suppliers. To the extent that such costs would be borne by the supplier, or passed on to all of the supplier's customers, this may also affect their willingness or ability to compete.
 - (v) The need to recover switching costs is also given as a justification of longer-term contracts, which are a further barrier to customer switching.
 - (vi) There is also the inconvenience associated with having to change a tank, for example from the need for heavy vehicles to be driven over

⁴Except if they have acquired the business of another supplier, including its customers' tanks. Some smaller suppliers do, however, supply some tanks owned by customers, as infrequently do some larger suppliers.

a user's property, although we were told that, under the LPG code of practice, there is little or no risk of a break in supply during the process.

- (vii) The use of underground tanks may, if it increases, further increase the costs and inconvenience of changing a tank and switching to another supplier.
 - (b) Other particular barriers to switching about which we are concerned are the use of three-year initial contracts (although we understand that the large majority of customers are beyond the initial term), and three-month notice periods for termination of contracts (even beyond the initial contract period) which may be longer than required, and give suppliers an opportunity to retain their customers when a customer expresses an interest in changing suppliers (we noted some suppliers have shorter notice periods); a lack of clarity in some contracts, in particular as to the costs of changing supplier; and uncertainty as to whether particular terms in contracts will be enforced.⁵
 - (c) As regards the ability of suppliers to price discriminate, reducing prices only to customers who appear likely to switch, we remain concerned that:
 - (i) This may also discourage competitors from trying to win the supplier's customers.
 - (ii) While in principle price discrimination may also enable suppliers to price more aggressively to each other's customers, the ability of suppliers to sustain higher prices to their existing domestic bulk LPG customers than to new customers (ie new to that supplier) suggests that price discrimination has not had a competitive outcome⁶ and is further evidence of switching costs, in that a large proportion of customers do not switch to avail themselves of these lower prices.
 - (iii) In practice the extent to which domestic bulk LPG suppliers approach customers of other suppliers appears to be limited. For example, only 9 per cent of respondents to our survey said they had ever been approached by an alternative LPG supplier.
 - (d) While competition for customers new to domestic bulk LPG may be stronger than for existing customers, the number of new customers is a small proportion of the market and it is not clear that this is sufficient to lead to a competitive outcome in the market overall.
8. The extent of switching between LPG suppliers is even lower in Northern Ireland and points (a), (b) and (d) above apply to a greater or lesser extent to Northern Ireland, as well as to GB. We discuss in paragraphs 16-20 whether, as argued to us by many of the parties, requirements of safety justify all the precautions taken in supply of domestic bulk LPG and ownership of tanks which may inhibit switching.

⁵We understand a number of aspects of contract terms have been modified or accepted as unenforceable by suppliers as a result of discussion with the Contract Regulation Unit at the Office of Fair Trading, but consumers with existing contracts may not always be informed.

⁶Paradoxically, while the ability to price discriminate may be pro-competitive in a market with switching costs, the competitive outcome would be all customers paying a similar price (or prices that varied with the cost of supply).

C. Barriers to entry and expansion

9. As discussed further in Annex D (Non-price Competition and Entry) there has been both entry to, and exit from, the market (often as a result of acquisition). But few small suppliers have been able to grow other than by acquisition, to a market share of above 2 or 3 per cent. We therefore remain particularly concerned there are barriers to expansion by smaller suppliers in the market, and about their effect, in particular:
- (a) that switching costs referred to above may create a barrier particularly to expansion, for example:
 - (i) in trying to win a customer, an entrant will always be at a disadvantage to the current supplier as, faced with equivalent price offers, the customer will prefer to stay with the current supplier to avoid switching costs; and
 - (ii) any such disadvantage may be particularly significant in a market with relatively few new customers where a new or expanding supplier would have less scope to grow its customer base by winning customers as they enter the market;
 - (b) that, as noted in paragraph 7(c), price discrimination enables existing firms to respond to specific competitive threats without lowering prices to their broader customer base, deterring entry and expansion;
 - (c) that the prospect for, at most, modest growth in the market could discourage entry and expansion of smaller suppliers; and
 - (d) that larger firms enjoy economies of scale (for example, more sophisticated distribution systems; greater density of their customer base reducing average delivery costs; ability to guard against future LPG price changes; wider brand recognition; and the opportunity for upstream integration), the absence of which may inhibit smaller operators from expanding in the market; although some of the evidence we received suggests there may be offsetting advantages enjoyed by smaller suppliers.

In consequence, there may be limited constraints on the prices charged by LPG suppliers from the threat of entry or expansion by smaller suppliers.

10. It was generally agreed that there was very little prospect of entry into supply of domestic bulk LPG in Northern Ireland, given the recent and expected development of mains gas in some of the areas in which LPG is currently supplied.

D. Pricing

11. We note in Annex E on pricing that across the industry as a whole prices charged to individual customers in 2003 varied significantly, the highest prices charged to some individual customers being over 50 per cent more than the lowest prices. We remain concerned that in GB the following aspects of the pricing of domestic bulk LPG over time indicate, result from, or give rise to constraints on competition:

- (a) As noted in Annex E, suppliers charging different prices to different customers. Cost differences appear to explain at most only a small amount of the variation in prices. The main reasons for such price differences would appear to be price discrimination according to:
 - (i) customers desire or ability to negotiate, eg by threatening to switch to other suppliers, with the effects on competition noted in paragraphs 7(c) and 9(b);
 - (ii) geographical zone; or
 - (iii) whether the customer is new or existing.
- (b) Customers paying more than would be expected in competitive conditions. If competition is not fully effective, for example, the overall level of prices would be somewhat higher than necessary, reflecting either higher profits or higher operating costs than would be the case in more competitive conditions. We also note in Annex E that some suppliers are able to charge higher average prices than others.
- (c) A lack of price transparency, including the difficulty for customers in comparing suppliers on the basis of current and future prices (such as the difficulty in obtaining details of such prices in the absence of any easily accessible price lists or other information on relative prices); and the inability of most suppliers fully to commit to future prices.
- (d) The extent to which costs of tank supply and maintenance are not made explicit for customers and are recovered through higher prices for supply of domestic bulk LPG, which may reduce price transparency, or otherwise adversely affect competition.
- (e) Trends in retail domestic bulk LPG prices: although these primarily reflect changes in LPG input prices (subject to some 'smoothing' of changes in input prices by suppliers, to reduce the fluctuation in prices to users), we are continuing to investigate whether in some cases prices tend to adjust somewhat more rapidly to increases than to decreases in those prices.

The above suggests to us limited price competition for the bulk of customers; we have also seen little evidence of any unique features in the offerings of the main suppliers which distinguish one from the other such as might suggest significant non-price competition in the market.

- 12. Although each supplier in Northern Ireland prices according to a list price, the other points above apply to a greater or lesser degree in Northern Ireland.

Other relevant factors

Profitability

- 13. In considering the level of prices, and as a further possible indicator of the extent of competition, our initial analysis (see Annex F) suggests that:

- (a) Accounting profit margins in GB currently appear to give rise to returns possibly above and certainly not below the cost of capital on average for the main suppliers over the last four years, although not consistently for all companies in all years.
- (b) We are still considering the basis of these analyses including:
 - (i) the allocation of costs to domestic bulk LPG (appropriately allocated, at appropriate transfer prices) within the suppliers financial statements;
 - (ii) the appropriate cost of capital we should use in assessing whether profits are excessive—for example, that for a group as a whole, of whose activities the supply of domestic bulk LPG may only be a part; or a possibly different cost of capital specifically related to the supply of domestic bulk LPG as a stand-alone business.

If competition is not fully effective, it might also be expected that the level of costs may be higher than in a fully competitive market.

- 14. The evidence we have seen suggests the level of profitability in Northern Ireland may be less than in GB.

E. Metered estates

- 15. As noted in the Issues Statement we have received a number of complaints from residents of 'metered estates'. In some cases the supplier supplies the domestic bulk LPG customer direct. In other cases (which the suppliers tend to categorise as part of their commercial business) it supplies the developer/estate owner, who then sells the LPG through a central tank or tanks on to the domestic bulk LPG customer. We are considering whether such developers/estate owners can also be regarded as suppliers of domestic bulk LPG, but note that, since they supply from a central tank through pipes to individual sites, they may not be regarded as supplying to fixed storage tanks, as specified in our terms of reference.⁷ We are also considering whether there are features of the markets specific to metered estates, for example:
 - (a) whether customers on metered estates face additional barriers to switching to other LPG suppliers, including the need to coordinate with other customers on the estate, or additional contractual barriers (for example, in contracts between the customers and the property developers or estate managers, or between the estate manager and domestic bulk LPG supplier);
 - (b) whether there may be particular barriers to entry or expansion by smaller suppliers to supply metered estates; and

⁷We are aware of a consultation paper issued by the Office of Fair Trading in October 2004 on unfair terms in holiday caravan agreements (*Guidance on unfair terms in holiday caravan agreements. A consultation paper.* Guidance on the Unfair Terms in Consumer Contracts Regulation 1999, Office of Fair Trading, October 2004). The draft guidance included as examples of terms that could potentially be considered unfair those which without good reason tie caravan owners to purchasing services supplied by the park owner such as caravan accessories or the supply of LPG. The document also noted more generally that occupiers of park homes may have additional protection under other legislation. We also noted that the Office of the Deputy Prime Minister recently issued a consultation document on Park Home Statutory Instruments (Park Home Statutory Instruments, Consultation on Implied Terms and Written Statement, Office of Deputy Prime Minister, July 2004).

- (c) whether prices to customers on metered estates charged by the domestic bulk LPG supplier and/or the developer/estate owner fail to reflect the cost of supplying those estates. On the evidence we have seen to date, average prices charged by the main LPG suppliers to customers on metered estates tend to be close to or somewhat below the prices charged to other customers.

Safety

- 16. We acknowledged in the Issues Statement that safety considerations were a key issue in this inquiry. We are continuing to consider the extent to which any features of the market outlined above, which may have detrimental effects on competition for the supply of domestic bulk LPG, are justified by the need for safety—in particular the ownership of a tank by the supplier of domestic bulk LPG to that tank, and the need for the customer to change tank if changing supplier. (We noted above, however, that there are some suppliers who do supply some customers' tanks and that some suppliers supply tanks acquired as part of the business of other suppliers). This includes consideration of the extent to which current arrangements are necessary given the various legal requirements associated with safety both of supply of domestic bulk LPG and of supply, maintenance, record keeping and removal of domestic bulk LPG tanks.
- 17. Our current view is that there are no *technical* reasons, such as differences between filler valves, or in the characteristics of various tanks, for suppliers not to supply domestic bulk LPG to tanks owned by other parties.
- 18. We accept that the current arrangements, whereby the supplier of domestic bulk LPG generally installs and owns the tanks to which it supplies, are one means to ensure clarity in responsibility for safety of tanks. The companies also argued that current arrangements are the most cost-effective way of ensuring safety of supply of domestic bulk LPG and of tanks (including insurance costs associated with supply of domestic bulk LPG, although the apportionment of the liability to consumers and consumers' understanding of their liabilities is far from obvious in some of the contracts we have seen). We also remain concerned that switching of tanks may increase safety risks to LPG suppliers, consumers and the public.

Alternative arrangements

- 19. Nonetheless, we remain concerned that the current arrangements for ownership of tanks may unnecessarily impede switching of suppliers. In order to reach a view on whether current arrangements are necessary to maintain an acceptable level of safety, we are considering, in the nature of a counterfactual against which to compare the current market, whether other more competitive alternative arrangements could have been adopted, which could also have provided an acceptable level of safety, but which could have led to lower switching costs, for example, by removing the need to replace tanks when changing supplier.
 - (a) One alternative arrangement that we are still considering is an arrangement whereby the existing domestic bulk LPG supplier could have transferred the ownership of the tank to the new supplier at the point of switching. In considering this, we are continuing to consider

whether transfer arrangements could have been made, on reasonable terms and conditions (including the price of the transferred tank) and maintaining an acceptable level of safety;

- (b) Other possible arrangements could have involved ownership of the tank other than by the supplier of the domestic bulk LPG: for example either by the customer or by a separate company. We are considering the arguments of almost all the LPG suppliers from whom we have heard that wider ownership of tanks by customers could prejudice safety, in that important safety regulations concerning tank maintenance obligations and written schemes of examination may not apply in the absence of ownership—or control—by the LPG supplier; and that customers may be less conscious of safety requirements.
20. We are continuing to consider whether there are any contractual terms which would have been necessary and/or sufficient to have maintained safety under such possible alternative arrangements (for example a contractual obligation on the LPG supplier to maintain the tank), and the technical and operational implications of such possible alternative arrangements, including the argument that ownership of tanks by a separate company would increase the costs of ensuring safety. On the other hand, we may have to consider whether, in the market for the potentially hazardous product of LPG, some customers, and possibly some potential suppliers, may not fully understand their obligations.

F. Possible remedies

21. As noted in the Issues Statement, the question of what, if any, remedial action might be necessary remains a matter which the CC will address, if necessary, at a later stage (see Annex A). We would nonetheless still welcome any views on possible remedies from any parties who may consider that there is an adverse effect on competition, for our consideration if appropriate at that stage. Should we consider possible remedies, we would be required to consider the effect on any relevant customer benefits.