

8 Conclusions

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Introduction

8.1. In this chapter we recall briefly the background to the reference and the public's attitudes and concerns about the industry. We describe the scope of the inquiry and the reasons for our finding that a complex monopoly exists. The main part of the chapter describes our conclusions on the various issues that we identified, both from the evidence put to us and from our own investigations, and the action we think should now be taken.

The petrol market

8.2. The MMC (and its predecessor the Monopolies Commission) have examined the petrol market three times in the last 25 years, reflecting its importance to the United Kingdom economy and to the consumer. The total value of petrol sales (including tax and duty) was £11.5 billion in 1988. Over two-thirds of this was spent by consumers for non-business purposes and accounted for over 3 per cent of their expenditure. This market is supplied by over 70 wholesalers, ranging in size from three large multinational companies each supplying between 10 and 20 per cent of the market to small operators supplying a handful of petrol stations. Fourteen principal wholesalers (11 of them also refining in the United Kingdom), each with a share of more than 1 per cent of the market, together supply over 95 per cent of petrol within the United Kingdom. Our inquiry has mainly focused on their activities. For some purposes we divide them further into three groups: the five majors, ie the five largest refining wholesalers (Esso, Shell, BP, Mobil and Texaco), which together supplied in 1988 some 65.6 per cent of the United Kingdom market; the mini-majors, ie the other refining wholesalers (Conoco (Jet), Petrofina, Total, Gulf, Amoco, Murco); and the three larger non-refining wholesalers (Burmah, Kuwait (Q8) and Elf, the last two of which have refining associates elsewhere in the EC).

8.3. Although the volume of petrol supplied to the retail market rose by over one-third between 1977 and 1988, the numbers of retail outlets dropped over that period from about 30,000 to under 20,000. The average throughput per outlet more than doubled to 1.6 million litres a year. Outlets vary in size from tiny rural sites, for example from pumps on hotel premises in the Scottish Highlands, which may be supplying less than 15,000 litres a year, to some hypermarkets selling more than 12 million litres a year, and motorway service area sites selling more than 15 million litres a year. Although the numbers of independent sites and of sites owned by wholesalers have both fallen, the proportion of sites owned by wholesalers and the proportion of total petrol supplied through them have risen. Wholesaler-owned sites tend to be larger than independent dealer sites, except for motorway and hypermarket sites. Hypermarkets are the most rapidly growing sector of the retail petrol market; their share has risen from about 1 per cent of total sales in 1977 to over 5 per cent of sales in 1988.

8.4. The last examination of the petrol industry by the MMC was in 1976 to 1978 when they were asked to consider whether a complex monopoly existed and to limit their consideration to three practices by wholesalers: discriminating between retailers in the price or terms on which they supplied petrol to them (including selective price support); promoting trading stamp or other gift schemes; and buying petrol stations through which only their own brand of petrol was sold. The MMC found that a complex monopoly existed because at least one-quarter of the petrol supplied in the United Kingdom was supplied by wholesalers who operated selective price support or owned petrol retail outlets, but they

concluded that the practices they examined did not and were not expected to operate against the public interest. They suggested, however, that the DGFT should keep the wholesalers' ownership of retail outlets under review in order to see whether the level of concentration was increasing, and whether this might be expected to lead to reduced price competition. They implied that such a development might lead to a further reference.

8.5. Since that report the OFT has collected the information on trends in company ownership suggested by the MMC, as well as continuing its general monitoring of the competitive state of the industry. At the end of 1987 the House of Commons Select Committee on Trade and Industry decided to inquire into petrol retailing. They took evidence from the OFT, from ten oil companies and from other interested parties, including a hypermarket, a licensee and the Petrol Retailers' Association (PRA); the latter two argued that the behaviour of the oil companies led to significant restrictions on competition. In their report the Select Committee described their concerns about a number of features of the market, including allegations of collusion over pricing between oil companies, the way in which pump prices are set, and the relationship between the oil companies and operators of their company-owned sites, particularly licensees, and they called for a further investigation by the MMC.

Attitudes to the industry

8.6. Some of the allegations of anti-competitive conduct by the oil companies which were put to the Select Committee appeared to reflect a public attitude to the oil industry which was at best suspicious and sometimes actively hostile. There are a number of features of petrol supply which, although individually they may not be unique to the industry, taken together have a major effect in influencing the public view of the industry and the state of competition within it.

8.7. Petrol is not purchased for its own sake but as a means to an end, motoring. Petrol is seen as a necessity rather than desired for its own sake. It is a product for which, in the short term, there is no substitute and one whose price, including duty and tax, makes it one of the most significant elements in the cost of business and private motoring. Consumers and organisations representing them are, therefore, sensitive to, and often highly critical of, general rises in the price of petrol.

8.8. Petrol is also for most practical purposes a standard product, meeting British Standards specifications for different grades. The various brands are perceived by most people as interchangeable. While some refining wholesalers told us that the additives in their brands of petrol improved performance and lessened engine wear, others claimed that there was no practical difference in performance of the various brands. The surveys we quote in Chapter 3 suggest that brand is not a major factor in most consumers' choice of petrol station. Consequently consumers have a belief that if the prices of some brands of petrol or of petrol sold at some types of outlet can be cut, others should be able to follow suit.

8.9. Petrol is an internationally-traded commodity. We explain in Chapter 4 that its cost to wholesalers in the United Kingdom is primarily determined by movements on international markets, particularly the Rotterdam market. Since transactions are in dollars, prices are also affected by movements in the exchange rate. In some periods these international petrol prices have moved very sharply, usually, though not always, reflecting changes in the price of crude. When these international price movements are combined with a weakening pound, they can lead to sharp rises in pump prices in the United Kingdom, to consumer resentment and to press criticism. Comments made when United Kingdom pump prices rose sharply in the early months of 1989 suggested a widespread lack of awareness of the underlying causes for these price increases. On the other hand price cuts normally receive less publicity.

8.10. The industry is highly integrated. Most of the larger wholesalers in the United Kingdom are part of multinational oil companies operating on a global scale with interests ranging from production and exploration through to refining, wholesaling and the ownership of or exclusive supply to the petrol stations at which their brand of petrol is sold. Shell, Exxon (the parent of Esso), and BP are amongst the world's largest ten companies. While the extent to which the oil companies supply their own refineries with their own crude oil varies, they tend in their wholesale and retail operations to supply petrol they have refined themselves (although as we discuss later they also exchange refined petrol with other wholesalers). This integration leads to suspicions in the public mind that pump prices are being kept artificially high and that the oil companies are either making excessive profits from sales of petrol or are able to conceal these profits within their total transactions. This suspicion is reinforced by the belief that the development of North Sea oil, in which all the leading United Kingdom oil companies have been involved, should have enabled these companies to reduce United Kingdom pump prices.

8.11. The way in which the five major companies' prices have tended to move closely together, both in their timing and the amount of increases, fuels public suspicions of collusive behaviour.

8.12. Later in this chapter we discuss these issues and give our own conclusions on whether these attitudes are supported by the facts.

Interpretation of the terms of reference

8.13. We are required by our terms of reference to investigate and report on whether a monopoly situation exists in relation to the supply of petrol by wholesale in the United Kingdom, and if so, by virtue of which provisions of sections 6 to 8 of the Fair Trading Act 1973 ('the Act') the monopoly situation is to be taken to exist and in whose favour it exists. In interpreting the scope of our reference we have taken 'supply by wholesale' to cover all supply of petrol other than that to the final consumer, thus excluding sales to industrial and commercial consumers. The term thus covers supply by refining and non-refining wholesalers to other wholesalers and to retail outlets, whether or not ownership of the petrol changes hands. Accordingly, we have included within the scope of our inquiry all deliveries to retail outlets whether or not the outlets are owned by wholesalers and directly managed by them or by commission agents. The definition of supply by wholesale also embraces exchange transactions or 'swaps' between wholesalers. In our view supply by wholesale excludes those suppliers, described by a number of companies as 'authorised distributors', who deliver petrol to the wholesalers' retail customers and are paid either a commission or a fixed margin on the petrol delivered, since these suppliers are effectively acting as agents for the wholesalers.

8.14. Our terms of reference also require us to consider, if we find a complex monopoly to exist, whether any steps are being taken by the wholesalers in whose favour the monopoly situation exists to exploit or maintain the situation; further whether any actions or omissions on their part are due to its existence; and whether any of the facts we find operate or may be expected to operate against the public interest. For this purpose we found it necessary to look more widely at the wholesalers' behaviour and its competitive effects, not only to examine their relations with those they supply (other wholesalers and retailers) but also to take account of the retail market and consumer attitudes. In some cases, where the wholesalers form part of an integrated business, we have needed to look at their downstream activities taken as a whole.

The monopoly situation

8.15. Section 6 of the Act defines two kinds of monopoly situation in relation to the supply of goods. First, a monopoly situation under section 6(1)(a) or (b), usually described as a 'scale' monopoly, is taken to exist where at least one-quarter of all the goods of a particular description which are supplied in the United Kingdom are supplied by or to the same person or by or to members of one and the same group of interconnected bodies corporate. The information on market shares in Chapter 3 shows that no one person or group supplies more than one-fifth of the petrol supplied by wholesale in the United Kingdom. Accordingly we find no scale monopoly exists.

8.16. Under the provisions of section 6(1)(c) and 6(2) of the Act a complex monopoly situation is taken to exist when at least one-quarter of all the goods of a particular description which are supplied in the United Kingdom are supplied by or to members of one and the same group consisting of two or more persons (not being a group of interconnected bodies corporate) who, whether voluntarily or not and whether by agreement or not, so conduct their respective affairs as in any way to prevent, restrict or distort competition in connection with the production or supply of those goods.

8.17. In May 1989 we notified certain wholesalers by letter that we had provisionally concluded that a complex monopoly existed in their favour, because those wholesalers together supplied at least one-quarter of the wholesale supply of petrol in the United Kingdom and conducted their affairs in one or more of the ways there described, relating to their owning petrol refining capacity, their entering into exchange agreements, owning retail petrol outlets, entering into solus agreements and exercising control over the retail price of petrol in various ways.

8.18. Some of these wholesalers, including all the refining wholesalers, rejected the provisional conclusions in respect of each of the forms of conduct identified. Their views are set out more fully in paragraphs 6.25 to 6.30. The main thrust of their arguments was that the various forms of conduct specified took place in a highly competitive market and themselves enabled competition to function more effectively. In particular, company ownership of refining capacity could not distort competition if petrol was available at market-related prices to non-refiners and to the wholesalers themselves, exchanges enabled wholesalers to sell in areas where they would otherwise find it difficult to compete, and the exclusive supply arrangements with both operators of company-owned sites and independent dealers enabled wholesalers to compete more effectively. Pricing policies, including the power to set prices at their own managed outlets, did not give the wholesalers the power to control retail prices, which were determined by local market conditions.

8.19. We have considered carefully all the arguments put to us. We are required to determine whether conduct 'prevents, restricts or distorts' competition in order to establish whether a complex monopoly exists. At this stage we are not required to consider whether the effects of the conduct are good or bad. These are among the matters which fall to be considered under the later parts of our terms of reference, including the requirement that we consider whether any facts found in our inquiry operate or may be expected to operate against the public interest.

8.20. Accordingly we confirm our provisional conclusion and find that the petrol wholesalers listed in Appendix 8.1 are persons who taken separately or together conduct their affairs in relation to the supply in the United Kingdom of petrol by wholesale in one or more of the following ways:

- (a) by owning refinery capacity which is used to supply the bulk of the wholesalers' requirements of petrol for supply by wholesale;

- (b) by owning retail petrol outlets whose operators are subject to restrictions imposed by the wholesaler as to the brand of petrol to be acquired or sold by them;
- (c) entering into petrol supply agreements whereby retail petrol outlets not owned by them are subject to restrictions as to the petrol to be acquired by or sold from these outlets (usually described as 'the solus tie'); and
- (d) exercising influence or control over the retail price of petrol by:
 - (i) setting the wholesale price of petrol supplied to retailers by reference to a target pump price and retailers' margin, as assessed by the wholesaler;
 - (ii) managing retail outlets at which the pump price of petrol is set by the wholesaler; and/or
 - (iii) altering prices charged to retailers in response to local retail price competition (usually described as 'selective price support').

8.21. We are satisfied that the wholesalers have conducted their affairs in one or more of the ways described for a number of years certainly during the period since the last report by the MMC and continue to do so. It will be noted that the forms of conduct described under (b) and (d)(iii) above formed the basis of the monopoly finding recorded in that report.

8.22. We conclude that as a result:

- (a) part of the United Kingdom wholesale petrol market which is supplied by refiners to wholesalers within the same company or group of companies is not open to supply by others;
- (b) operators of retail petrol outlets subject to a solus tie, including both those owned by the wholesalers imposing the tie and those owned by others, which together receive almost all the petrol supplied by wholesale, are for the duration of the tie prevented from acquiring petrol from other wholesalers; and
- (c) the prices charged by operators of retail petrol outlets are either controlled or influenced by their supplying wholesalers in the ways described in paragraph 8.20(d);

and that competition is thereby prevented, restricted or distorted.

8.23. We, therefore, conclude that a complex monopoly within the meaning of section 6(1)(c) and 6(2) of the Act exists in favour of the wholesalers listed in Appendix 8.1 who together supply at least one-quarter (indeed over 95 per cent) of the petrol supplied by wholesale in the United Kingdom and each of whom follows one or more of the forms of conduct described in paragraph 8.20.

The public interest

8.24. In determining whether any of the facts found in our inquiry operate or may be expected to operate against the public interest we consider the issues we identified under six main heads:

- (a) Are petrol prices in the United Kingdom, or in particular parts of it, too high as a result of limited or restricted competition between all or some of the wholesalers?
- (b) Are profits on petrol wholesaling unreasonably high; do wholesalers transfer profits on petrol wholesaling to other levels of the business; are profits reduced by unnecessarily high costs?
- (c) How far do exchange agreements and other supply arrangements between wholesalers affect competition?

- (d) Do exclusive supply arrangements and wholesalers' ownership of retail outlets have harmful effects on competition?
- (e) How far do wholesalers control pump prices, and does the practice of charging different prices to individual retailers, especially through the use of selective price support, harm competition locally or in wider areas?
- (f) Are there significant barriers to entry into either wholesaling or retailing?

These issues are clearly interrelated and some of the features of the industry we discuss can be seen as raising issues under more than one head.

Price levels

The price of petrol

8.25. The retail price of petrol has fluctuated over the years and is affected by the sometimes volatile movements in crude oil prices and in exchange rates. There have been times, following major increases in crude oil prices and in exchange rates, when the retail price of petrol has increased faster than prices in the economy as a whole. At other times, for example during the period following the fall in crude oil prices in 1986, retail petrol prices have fallen in real terms.

8.26. The average retail price of 4-star leaded petrol, inclusive of duty and VAT, was 37.14 pence per litre (ppl) in January 1989 (see paragraphs 3.18 onwards). In January 1968 the retail price was 6.14 ppl. The general price level increased nearly seven-fold over this period so that the equivalent of 6.14 pence in January 1968 would be 42.40 pence at the beginning of 1989. The 1989 price, therefore, is about 12 per cent lower than the 1968 level (adjusted to January 1989 price levels). Adjusting for inflation the price in January 1989 was broadly similar to the price in January 1973 prior to the first major increase in crude oil prices.

8.27. In January 1989 about 68 per cent of the retail price was accounted for by duty and VAT; this was a higher percentage than applied in some earlier years. If comparisons are made of the wholesale price of petrol exclusive of duty and tax that is the element in price which wholesalers and retailers may be expected to influence then the January 1989 price of 11.86 ppl represented a fall of nearly 30 per cent since 1983 even before adjusting for inflation. After allowing for inflation the retail price, exclusive of duty and tax, had almost halved since 1983 and was lower than the equivalent level in 1973 or in 1978, at the time of the last MMC report.

8.28. The United Kingdom price, exclusive of duty and tax, was close to the average of prices in the other main European countries over the period 1978 to 1988 (see paragraph 3.23 and Table 3.4).

8.29. In our analysis of prices we concentrated on sales of 4-star leaded petrol. In the course of our inquiry sales of unleaded petrol increased from less than 5 per cent to more than 25 per cent of sales and we looked at the price of this petrol during 1989. Following tax changes in March 1989 premium unleaded petrol retailed at about 2.2 ppl below the price of 4-star leaded petrol and this provided a stimulus to demand. If duty and tax are excluded then the unleaded price was higher than the leaded but the margin between the two has been falling. In January 1989 the price of unleaded excluding duty and tax was about 1 ppl above the leaded price; by September this differential had fallen to about 0.4 ppl. We were told that there were higher unit costs for unleaded petrol associated with the introduction of a new product. Future developments are uncertain, but we would expect that if unleaded sales continue to grow this should lead to a reduction in unit costs.

8.30. We have also looked at the way in which United Kingdom retail petrol prices have moved in relation to the underlying price of crude oil and the international market price for petrol. In carrying out this analysis we have had to consider the general issue of how to assess the cost of refining crude oil and how best to value the petrol that is produced.

The cost of producing petrol

8.31. We have examined international market prices for crude oil as indicators of how that element in refinery cost has moved over the years. Crude oil prices are generally quoted in dollar terms and over the past 20 years there have been periods of considerable volatility in these prices. There were major increases in the dollar price of crude oil in 1973/74 and 1978/79. From 1980 to 1985 there was some fall in prices followed by a major reduction in 1986. Since then prices have increased slightly but are still well below the 1985 levels. In addition, the price paid by United Kingdom refiners will be affected by the sterling/dollar exchange rate. In some years, exchange rate movements have offset the effect of crude oil price changes, in other years they have added to them.

8.32. Individual oil companies vary greatly in the extent to which they purchase crude oil from third parties on the open market rather than relying on equity crude, ie crude oil produced by themselves or their associate companies. Even where a company has direct access to substantial amounts of equity crude oil it may still sell and purchase crude on the open market in order to meet the particular technical specifications which it requires in its refineries. As a result all refiners, whether or not they are major crude oil producers, are heavily involved in trading of crude oil. In particular, even those oil companies with access to North Sea crude meet only a part of their United Kingdom refining requirements from this source, trading the remainder or using it in refineries elsewhere in the world.

8.33. Any suggestion that equity crude should be valued at other than international market prices on the grounds, for example, that its production cost was substantially less than that price would be to ignore the existence of this international market and the fact that owners of equity crude can and do sell on that market at the quoted price. The appropriate basis for valuing the crude used in refineries is either the price paid for it in third party transactions, or, in the case of equity crude, the price that could be obtained if it were sold. We consider that the international spot market prices, as reported by a number of price quotation services, and converted into sterling at the prevailing exchange rate are good indicators of the cost of crude oil used in refineries. This approach is consistent with that adopted by the Oil Taxation Office of the Inland Revenue in administering the Petroleum Revenue Tax.

8.34. Refining can be carried out in different ways, each of which has different operating costs and allows the operator to produce refined products, of which petrol is one, in varying proportions. Refiners choose the input and output mix which they expect will maximise their profits. In doing this they take into account expected price movements in the markets for crude oil and for the various refined products. There is some flexibility in varying the operating regimes of existing refineries and in the longer term the mix of outputs can be altered by appropriate investment.

8.35. Whatever the refining mix chosen, petrol will be only one of several products produced from each barrel of crude. Because it is produced jointly with other products we have had to consider whether it is possible to identify a production cost for petrol alone. It was put to us by most of the refiners that, while marginal costs could be identified, it was not possible to separate total production costs in this way. They argued that while the total refining costs could be identified there was no basis for apportioning those costs to different products, and that any attempt to make such apportionments was arbitrary and would not provide information which was of value in taking decisions about the business. In these circumstances, it was argued, the only sensible valuation of individual products such as petrol was on the basis of market values. International market prices were therefore used as the basis for valuing internal transfers of petrol between refining and wholesaling.

8.36. We considered ways in which we might arrive at a specific production cost for petrol and carried out a major exercise with the refiners in which costs were allocated to particular products on the basis partly of that product's share in total volume of output and partly on the basis of its share in total value (see paragraphs 5.23 to 5.27). However, after extensive discussions with the industry and with independent consultants, we concluded that the joint production of refined products from a common raw material means that such allocations cannot claim accurately to identify the costs of individual products. This is not a problem confined to petrol; it arises in other industries as well, indeed wherever the production process results in joint products. While there may be circumstances in which such an allocation may be the best approximation to settling a value on a particular good, we consider that where there is an open market in which a homogeneous product is traded and there is a market price, it is more appropriate to focus on that market price as an indicator of the value of the product than to attempt to impose our own assessment of costs, which at best could be only a broad approximation.

The market price of petrol

8.37. Among the principal market prices used for assessing the ex-refinery price of petrol are those reported for trades on the Rotterdam spot market. A number of organisations collect information on deals and provide price quotation services on a subscription basis. The most commonly used prices are those compiled by Platt's European Marketscan although other organisations such as Petroleum Argus are also used.

8.38. We considered the extent to which Platt's and other quoted Rotterdam prices could be taken as representative of those of an active and continuous petrol market. Most of the petrol currently delivered from refineries in the United Kingdom has not been traded on the open market and this led us to question whether the quoted Rotterdam prices provided a sufficiently good guide to the value that could be obtained for petrol if much greater quantities were traded through the market. We received evidence from independent traders and from others with detailed knowledge of the Rotterdam market that there was sufficient trading to validate these prices, and that it was in the interests of the companies trading either in the market or through contracts linked to the Rotterdam prices that they should be reliable estimates. It is clear that Rotterdam prices are generally accepted throughout North-West Europe as a good indicator and used for wholesale contracts. Moreover, we were told by the Department of Energy and others that Rotterdam prices were closely linked to prices in New York where there was an active petrol market, involving both spot and futures trading.

8.39. We accept, therefore, that although the volumes of petrol traded are a small proportion of total production, the Rotterdam market is active enough in its own right, with trading linked to other international markets, for its recorded prices to be used as the best estimate available of an open market price for valuing transfers of petrol within vertically integrated companies.

8.40. The PRA presented an analysis of United Kingdom retail petrol prices in relation both to international crude and the Rotterdam petrol prices for the years 1977 to 1988. It was argued that rises in United Kingdom petrol prices following crude oil price rises between 1977 and 1984 had not been matched by equivalent falls when crude prices fell between 1985 and 1988. The PRA also suggested that there had been higher margins between the United Kingdom retail petrol price and the Rotterdam petrol price since the end of 1985 than in earlier years and that as a result United Kingdom petrol prices were higher relative to international prices than in the earlier period. It was argued that this reflected increased market power being exercised by the oil companies.

8.41. The Department of Energy carried out a more detailed analysis for us which also covered pump prices net of tax in several other European countries. The Department's analysis showed that in each of the countries examined, including the United Kingdom, pump prices responded to changes in Rotterdam petrol prices in very similar ways. Movements in spot prices were reflected in pump prices after a short time-lag. Evidence from a number of the oil companies supported the view that there was a close relationship between Rotterdam petrol prices and United Kingdom retail prices.

8.42. We carried out our own analysis of prices looking first at the relationship between the price of crude oil and Rotterdam prices for petrol, gas oil and fuel oil (see paragraphs 4.22 to 4.24). This relationship was unstable between 1979 and 1981 when crude prices rose rapidly. Since 1986, when crude prices fell substantially, there has been some increase in the Rotterdam price of petrol, for which demand has been strong, relative to crude and some fall in the relative price of fuel oil. However, when the price of a commodity such as crude oil moves significantly there is no reason to expect the prices of the refined products to show the same percentage change. It is more useful in these circumstances to examine the value of the margin between the raw material crude oil and the refined products rather than the ratio of their prices. We, therefore, examined the absolute value of the difference between the crude and Rotterdam petrol prices to see whether the value of this gross margin available to refiners had changed. We found that this margin had been high in the early 1980s but had fallen since then. In the last three years the margin has fluctuated within a fairly narrow range (see paragraph 4.23). In our view this change in margins is the result of competition between refiners at a time when new investments in upgrading capacity at refineries was bringing additional petrol on to the market. As a further check we looked at the comparison between the incremental costs of producing petrol and the international price to see if refiners had been able to achieve an increased margin over this measure of cost (see paragraph 5.29). This analysis did not show any increase of that sort. At the level of the relationship between international crude and petrol prices, therefore, we have not identified any evidence of market power being used to increase petrol prices.

8.43. We went on to consider the value of the gross margin between the Rotterdam petrol price and the United Kingdom retail price (see paragraphs 4.25 to 4.28). This margin has to be large enough to cover the costs of marketing and distributing petrol (which will largely be influenced by factors in the United Kingdom rather than international prices), and to provide for a reasonable profit at both the wholesale and retail levels. Over the years from 1983 to 1989 this gross margin (in out-turn prices) has varied from quarter to quarter but has broadly increased from a range of 3 to 4.5 ppl in 1983 and 1984 to around 5 ppl in 1988. Adjusting these amounts to January 1989 prices showed that this margin has fluctuated around 5 ppl but does not show a rising trend.

8.44. We have obtained estimates of the marketing and distribution costs for wholesaling and retailing from our analysis of oil company financial data. By deducting an average cost from the gross margin we have derived a measure of the net margin remaining as the wholesaler's profit. For 1988 and the first three quarters of 1989, this net margin (after adjusting for inflation) averaged about 0.7 ppl. This margin represents some improvement on the losses being made in the early part of the period but these estimates do not suggest that either gross or net margins are or have been high.

8.45. We therefore conclude that although there has been some rise in the monetary value of the gross margin between the Rotterdam and United Kingdom retail petrol price, it has been relatively stable in real terms. Since 1983 the monetary increase has been necessary to meet increases in the costs of wholesaling and retailing over the period. These costs are more influenced by the general level of inflation than by the price of crude oil. We find no support for the PRA's view that United Kingdom retail prices for petrol are higher than they might otherwise be as a result of market power being exercised by the oil companies. This conclusion is supported by our analysis of the profitability of these companies discussed in paragraphs 8.53 onwards.

8.46. We also considered whether the time-lag between Rotterdam price changes and pump price movements was different as between price rises and falls. There has been a tendency when the Rotterdam prices go up for pump prices to be held back in the short run but then to go up sharply with all wholesalers moving their prices at very much the same time. When prices come down the movement is earlier but usually more gradual. The price increases are more visible to the public, because they occur across the board, than are the price reductions, which tend to occur piecemeal and are less publicised.

8.47. We discuss this pattern of behaviour in paragraphs 4.69 onwards. When Rotterdam prices increase all the wholesalers face the same pressure on their gross margins and would like to raise prices. At the same time each one is hesitant to be the first to increase its price for fear that others will not follow its move, and it will lose sales of petrol as a result. In the short run, therefore, the wholesalers absorb lower margins, but when one company, usually one of the larger wholesalers, finally decides to increase its price this is usually (although not always) quickly followed by others. When the Rotterdam price falls wholesalers will hope to benefit from improved margins for as long as possible by maintaining their prices but competition for increased sales at the local level, which may be initiated by the medium-sized wholesalers, leads to a steady erosion of price.

8.48. The exact pattern of price rises and falls varies from case to case. There is a noticeable difference between the pattern of sharp rises and more gentle falls which occurred in 1988 and the more symmetrical pattern in 1989 when there were sharp movements in both directions. This, at least in part, is a reflection of the greater volatility of the Rotterdam price in 1989. But even when the pattern does show a difference in the way in which prices rise and fall we consider that to be a reflection of competition between the wholesalers and not as demonstrating a rapid passing on of price increases and slow price reductions. Looking at the general relationship between Rotterdam prices and retail prices over a period of years we find no evidence of differences in the overall time taken for increases and decreases in the Rotterdam price to feed through to the retail level.

Alleged collusion on prices

8.49. During the inquiry a number of allegations were put to us, and also reported in newspaper comment, that at times of rising international prices oil companies tended to raise their prices together and by the same amount, and that this was evidence of collusion.

8.50. We put these allegations to the principal oil companies which all denied in the clearest terms that they decided price movements in agreement with competitors or held discussions of any kind with them on the subject. No direct evidence was presented to back up the allegations, nor is it necessary to postulate some form of collusion to explain the timing and nature of the price movements that take place.

8.51. The wholesalers explained (see paragraphs 4.69 onwards) the situation that they face when prices are rising. The prices that the wholesalers pay for petrol, since they are based on Rotterdam prices, are similar; equally their other wholesaling costs, while they vary, are unlikely to be moving differently. Thus at a time of rising prices they all face similar pressures. Each wholesaler is aware that to move prices out of line with competitors may lead to significant losses of volume and that the earlier any one wholesaler moves the more likely this is to occur. Wholesalers tend to delay price increases until they are certain that both they and their competitors are under clear pressure to move. Which one acts first depends on the immediate financial circumstances facing each company and individual assessments of future market movements; but since all will already be facing similar pressures, a move by one is likely to be followed by changes of very much the same size by the others. This speed of response is helped by the transparency of prices in the market; our study of two periods of price change during spring 1989 showed that principal wholesalers become aware of competitors' movements in a matter of hours, either through feedback from dealers with agreements with a number of suppliers, or through press agency reporting.

8.52. We conclude, therefore, that there are no reasonable grounds for criticising the refining wholesalers' practice of relating their internal transfer prices and their market transactions to Rotterdam prices. Neither the absolute levels of retail petrol prices in the United Kingdom nor the way in which these prices have reacted to international price changes suggest that the wholesalers have been securing unjustified margins or that they collude in setting prices.

Profitability

8.53. The level of profitability is one of the key questions to be examined in a monopoly reference and the size of profits in an industry is an important, though not in itself decisive, factor in determining whether the prices charged are against the public interest.

8.54. As we discuss more fully in Chapter 5, the industry presents a number of special problems in identifying and allocating costs and profits. We have, therefore, examined the wholesalers' financial results at various levels of disaggregation and from a number of different viewpoints, paying particular attention to the results of the five majors. We consider that the results there presented form a sound base for our conclusions on profitability.

8.55. Since all the United Kingdom principal wholesalers, except Burmah, are integrated multinational companies involved in a number of countries in all stages of the oil business from production and exploration through to refining, marketing and selling petrol, and since there are frequent allegations that such companies use these integrated operations to 'hide' excessive profits, we thought it right to look first at their operations as a whole.

8.56. We established that the greater part of crude oil used by the refining wholesalers in the United Kingdom is purchased from third parties at open market prices and that the remainder, equity crude, is transferred in at market-related prices. We were also satisfied that the North-West Europe market prices for crude are broad based enough to be accepted as the appropriate basis for transfer prices. We, therefore, decided we could reasonably confine our examination to the downstream operations of the companies. However, since downstream operations are usually run by the companies as an integrated operation and, apart from exchanges, the bulk of the petrol supplied by refining wholesalers comes from their own refineries, we have looked first at the total downstream business, then separately at results for both refining and wholesaling (within which most companies include their investment in retailing) and at the basis for transfers between the two. These results covered all petroleum products produced in the refinery and we then attempted to identify the results for petrol wholesaling and retailing. As explained in paragraph 5.5, we have looked at the companies' results in separate groups: the five major refiners; other refiners (except Conoco); and the three larger wholesalers as earlier defined (see paragraph 8.2), and have presented results measured on both a historical cost operating profit (HCOP) basis, the accounting basis generally used by the oil company to report results in the United Kingdom, and on the hybrid replacement cost operating profit (RCOP) basis generally favoured within the industry for management accounting purposes.¹

8.57. The five majors and the majority of the other refining wholesalers told us that in providing information to the MMC they had used prices derived from Platt's Rotterdam petrol prices to transfer product between their refining and wholesaling operations. As explained above (paragraph 8.39), we accept these Platt's prices as the best estimates available for valuing transfers of petrol, and thus for establishing and separating the profits which arise in refining and petrol wholesaling.

Refining results

8.58. We obtained detailed financial information from the refining wholesalers on the results of refining in the United Kingdom. From the point of view of this inquiry, the main difficulty we had with this material was that it could not show the profits from refining petrol alone. As explained in paragraph 8.36, we accept that since petrol is a joint product, produced from crude oil and feedstocks in conjunction with other products, it is not possible to establish either the cost of the raw materials used to produce any one of these products in isolation or the overall cost of production of any one of the joint products on their own. It is, therefore, not possible to determine the profit or loss of refining petrol alone. The financial results of selling petrol from the refineries have, therefore, to be judged as part of the aggregate results achieved by the refining business as a whole.

¹The 'RCOP' results referred to here are those reported to us by the oil companies. When reporting RCOP results the oil companies generally only apply replacement cost to the materials used in products sold during the period and use historical costs for all other purposes. Therefore, the term RCOP is used in the report in this limited sense to describe this hybrid accounting convention.

8.59. It will be seen from Tables 5.1 and 5.3 that over the period 1983 to 1988 the five major refiners have made virtually no profits on refining, measured on an RCOP basis (see footnote to paragraph 8.56). Those of the other refiners have been small (although, as explained in paragraph 5.16, we consider that the transfer prices adopted by some companies somewhat overstate refining profits and underestimate wholesaling profits for this group over the period). The cumulative results over the period for the five major refiners combined showed a profit of £13 million and for the other refiners combined showed a profit of £94 million. These last results, however, do not include those of Conoco which we consider are likely to have been more profitable throughout the period. The results were extremely volatile year by year; for example, for the five majors taken together they ranged from a loss of £265 million in 1984 to a profit of £336 million in 1986, with resulting return on capital employed for those years of -21 per cent and +25 per cent respectively. The results of the individual companies were also variable, both within the totals for any one year and over the period as a whole.

8.60. Although, as we have explained in paragraph 8.36, it was not possible to establish the cost and, therefore, the profitability of refining petrol we examined the relative realisations for petrol and other products (see paragraph 5.42). This showed that over the period 1983 to 1988 the ex-refinery price of petrol had increased relative to the prices of fuel oil and other products. This has to be seen against the changes in relative demand for the various products, favouring petrol, which have led to investment in upgrading refineries, so as to increase the amount of petrol relative to other products that can be produced. Our examination of refining margins (sales revenue, less costs of crude, feedstocks and bought-in products) indicate that United Kingdom refiners' margins as a whole have been positive but small over the period.

8.61. It can be argued that refining profits would have been higher in recent years if all refiners had written off more of their assets, following the unforeseen downturn in the markets for petroleum products in the 1970s. There would then have been lower depreciation charges and consequently higher profits in the period we are considering. However, any such adjustments would have required subjective judgments about the future and in any event it seems unlikely that they would materially affect our overall assessment of refinery profitability.

Wholesaling and retailing profits

8.62. In most cases the wholesalers' businesses include trading in petrol and other refined products, income (including rentals) from their investment in company-owned retail sites, and other sundry income and expenditure. In addition, the wholesalers tend to judge the performance of their petrol wholesaling and retail activities together. To arrive at the net profit on petrol wholesaling it is, therefore, necessary to undertake a detailed analysis of the wholesale trading results of each company, progressively dividing the business horizontally across product groups and trade channels and vertically between the activities undertaken within the business from distribution and marketing through to retail property management. With the assistance of the wholesalers we therefore collated and summarised six years' wholesale trading results from 1983 to 1988, on both RCOP and HCOP bases. We have shown total wholesaling results with results for petrol separately distinguished.

8.63. The aggregate wholesaling results on an RCOP basis for the five major refining wholesalers show a six-year weighted average return on capital employed of about 10 per cent over the period and for the other refiners of 4 per cent on the basis reported to us (see paragraph 5.16). Again the results are volatile from year to year and between companies. Generally the HCOP results were worse. Over the six-year period the three main non-refining wholesalers achieved a modest average rate of return of 1.8 per cent per annum on an HCOP basis, but this masks disparate results between the three.

8.64. Within these aggregate results petrol wholesaling, including miscellaneous receipts from retail outlets, accounted for 38 per cent of the five majors' turnover over the period. For petrol wholesaling the yearly rates of return for the five majors taken together on an RCOP basis (again including miscellaneous receipts from retail outlets, such as rents and franchise fees) averaged 10 per cent over the period and ranged between -3.4 per cent to 24.4 per cent for the individual years. For both the majors and for the other refiners the RCOP rate of return on petrol wholesaling over the period as a whole was very similar to the return on aggregate wholesaling. The HCOP returns were again somewhat lower for both groups. For non-refining wholesalers, the results, on an HCOP basis, show a return on petrol wholesaling of less than 5 per cent.

8.65. In Tables 5.21 to 5.24 we have shown for both groups of refiners the net margins on petrol from the various trade channels in money terms and ppl. These figures, which do not include site rentals and other miscellaneous income, are based on allocations provided by the wholesalers and suggest that the best margins were achieved from wholesaler-owned sites. Indeed, over the period these estimates suggest that sales of petrol to wholesaler-owned sites were profitable while sales through other trade channels were loss-making. However, the companies have a major capital investment in their sites and explained that the higher prices generally charged to wholesaler-owned sites reflected the return on this investment.

8.66. In order to separate the returns arising from site ownership from those related to distribution and marketing of petrol and other products to wholesaler-owned and independent sites we asked the five major refining wholesalers to prepare an analysis of their 1988 results between these two activities. All sundry retail income and related expenditure was brought into account and site investment taken at current values. While there was a significant variation in the reported results from one company to another the overall figures show a 6.0 per cent return at current market values on the retail investments with a 2.9 per cent return for wholesaling, mainly marketing and distribution based on the historical cost of their wholesaling capital. In addition to the return of 6.0 per cent on the retail investment referred to above, we note that the oil companies also benefit from the unrealised capital appreciation over the year arising from their ownership of these retail sites.

8.67. We examined separately the costs of the five majors. Allowing for inflation we noted that in aggregate, marketing and distribution costs per litre increased between 1983 and 1988, by just over 5 per cent. However, three of the five companies had reduced these costs over the period. The other two companies told us that their increases were largely in marketing costs, intended either to increase or regain market share. Most companies told us that distribution costs had been reduced significantly in real terms.

Cost and profit profiles

8.68. In order to indicate the scale of the costs and profits that arise through the whole distribution chain, we decided to prepare cost and profit profiles for petrol. We recognise that such exercises are to some extent arbitrary (see paragraph 5.96 and Appendix 5.5) but consider our results useful in demonstrating the main elements included in the pump price to the consumer. Our information on retailing costs and profits was not comprehensive enough to prepare estimates for the whole industry for the years 1983 to 1988. However, a number of wholesalers were able to provide us with detailed results for their managed sites, which supply 14 per cent of the retail market. Using these we prepared profiles from the refining, wholesaling and these managed retailing results of the five major refining wholesalers (see Table 5.41 and Figure 5.4). These results indicate that duty and VAT are the major elements in price. For the wholesalers the major cost is the ex-refinery cost of petrol. Pump prices (net of VAT and duty) recover these costs and provide a margin for wholesaling and retailing costs and profits.

8.69. Our analysis indicates that the combined net margins on petrol obtained by the wholesaling and managed retailing segments of these five majors varied from year to year over the period and the aggregate ranged from a small loss to a combined profit for both retailing and wholesaling of less than 1 ppl. Individual company results varied widely, with one company showing profits in each year and two companies showing losses in four out of the six years.

8.70. We have explained that we have accepted the transfer prices used by the refining wholesalers to move product from the refinery to the wholesaling operation as appropriate for establishing and separating the profits which arise in refining and petrol wholesaling. However, if it were thought necessary to take these overall refining figures into account in an assessment of the oil companies' petrol wholesaling operations, the effect for the five majors would be to reduce the petrol wholesaling profits that have been achieved and would make only a slight improvement to those of the other refiners.

The overall picture

8.71. Looked at as a whole over the period 1983 to 1988, the downstream results of the five major refiners and the other refiners both show aggregate rates of return substantially below those reported by the Bank of England on a comparable accounting basis for all industrial groups excluding oil and gas.

8.72. Refining profits for both the five major refining wholesalers and for the other five refiners whose results we studied were volatile over the period and generally poor.

8.73. For each of the three groups of wholesalers we analysed total wholesaling results, which showed modest profits over the period, to isolate returns from wholesaling petrol. None of the financial results we obtained for petrol wholesaling (including returns from retail investment) suggested that over the six years from 1983 to 1988 the profits achieved by any of the three groups of wholesalers were excessive. Moreover, from year to year we noted that some companies achieved better results than others.

8.74. Information on the profitability of retailing, drawn from a variety of sources, suggested that neither the operations of wholesaler-owned sites nor independent retailers, including large chains and hypermarkets, are making large profits out of petrol. It must be borne in mind that for the independent site owners appreciation of site values, often linked to the volumes sold, is an additional benefit.

8.75. Overall, therefore, we conclude that there is no evidence of monopoly profits in the wholesaling of petrol or, for the refining wholesalers, in their downstream refining and wholesaling businesses, taken as a whole. Indeed at some periods some firms have clearly been making losses. The level of profitability varies from year to year and between companies. These features support the view that this is a competitive market.

Wholesalers' supply agreements

Exchange agreements

8.76. The refiners and the three largest non-refining wholesalers operate agreements under which they provide one or more of their wholesaling competitors with petrol at a specified location in return for the competitor supplying them with the same volume of petrol in a different part of the country. Because these exchange agreements operate on a like-for-like basis no payment is made for the petrol, although where transport costs and savings on the transaction differ between the two parties a payment is negotiated on the basis of sharing the saving which the exchange is thought to have brought about.

8.77. Substantial volumes of petrol are exchanged in this way. In 1988 over one-third of all petrol sold in the United Kingdom had not been refined by the company under whose brand name it was sold. The use of exchange agreements has not been concealed and it occurs in other countries. At the same time it is not well known and it was criticised both by the Select Committee and in evidence to us as being an uncompetitive practice involving co-operation between competitors. It was also argued that it could lead to customers being misled about the proprietary nature of the product being sold.

8.78. Exchange arrangements are unusual in that they are not the sort of contracts with an agreed price that are normally found in wholesale markets. We have, therefore, looked at them in detail in order to assess their effects.

8.79. The extent to which individual wholesalers are involved in exchange agreements varies. One company told us that exchanges had not exceeded 20 per cent of its petrol requirement in recent years. Some other companies rely on exchanges for more than half of their final sales volume. Most of the 14 principal wholesalers have exchange agreements with seven or more other wholesalers in that group of 14 companies.

8.80. The purpose of the agreements, as explained to us by the participants, is for each wholesaler to obtain access to supplies of petrol in parts of the country which are remote from its own refinery or other original supply source. In entering into an agreement each party has to judge the balance between giving up some competitive advantage near to its own refinery, where its transport costs will be low, against the benefit of obtaining supplies elsewhere at a lower cost than might otherwise be available. It also loses the opportunity to claim superiority for its own refined petrol, except in so far as this depends on additives. By setting up the agreements, it was argued, companies were better able to compete across a wider geographic area. We were told that increased competition occurred both at the retail level and in the ability to provide supplies at more locations to other wholesalers. It was pointed out that the alternative to exchange agreements was for each company to transport more of its own petrol to parts of the country away from its own refineries. The cost penalties involved in this would mean that the wholesalers' ability to compete effectively in areas away from its own refinery and distribution points would be reduced.

8.81. We accept that exchange agreements are a means of enhancing local competition and we recognise that as the number of refineries has been reduced exchanges have increased in importance, particularly for those refiners which seek to supply throughout the United Kingdom or within a substantial part of it. At the retail level competition in the sale of petrol is a local matter and arrangements which increase the number of suppliers in an area should increase competition, help to keep prices down and improve the quality of service. In this respect exchanges are beneficial.

8.82. We do not, however, accept that the alternative to exchanges is for each company to transport fuel from its own refinery. We think it likely that in the absence of exchanges companies would enter into other forms of contract for local supply, with a price for the petrol involved perhaps based on (but not necessarily equal to) the Rotterdam market price. Such contracts would not necessarily involve the matched quantities which are a feature of exchanges but, in our view, they would allow wholesalers to achieve similar delivery cost savings. We do not, therefore, accept the claims that have been made by the wholesalers that exchange agreements are essential for the achievement of significant cost savings because we believe that those savings could and would be achieved in other ways, ie through sales at market prices.

8.83. Exchanges are a well-established feature of the United Kingdom and other petrol markets and companies have learned through experience to administer them effectively. They are a simple form of contract and any alternative system could well be more complex in administrative terms and would have a small cost penalty without producing any particular benefit for the consumer.

8.84. We looked for any disadvantages in exchange agreements which might offset their advantages or justify moving to different and potentially more costly forms of contract. We do not consider that exchanges involve or could be said to encourage collusion between wholesalers. Each contract is negotiated bilaterally on a 'closed book' basis with no sharing of commercial information. Nor do we believe that exchanges cause any blurring of cost differences which result from one company being more efficient than another. Cost advantages related to location are offset but costs of production continue to be borne by the individual companies and the incentives to improve efficiency are not reduced.

8.85. We also considered whether wholesalers which were not party to exchange agreements were at a disadvantage. Three wholesalers without United Kingdom refineries participate in exchanges and we were told that any company with contracted supplies regularly available at particular locations should be able to enter into exchanges and thereby extend its market. The negotiation of the detailed terms of exchange agreements offers the prospect of competition between wholesalers on terms and we consider that there is scope for other wholesalers with significant volumes to become involved in exchanges. Where a smaller wholesaler does not have large enough quantities of petrol to exchange it should not be at a disadvantage as long as it has adequate choice of suppliers to buy from in its chosen area. That choice is likely to be enhanced by the operation of exchanges or any similar arrangement.

8.86. Finally, we considered whether consumers were being misled because the petrol sold under a particular brand name might not have been refined by that company. Petrol is a standard product conforming to British Standard specifications. Some wholesalers told us that all brands are very much the same and that there were no significant differences which might get obscured by exchanges. Other wholesalers do make a point of using proprietary additives which, they claim, improve the performance of their brand. The benefits of these additives are featured in the marketing of those brands. Where such additives are used, they are added to the exchanged petrol when it is collected from the distribution point. We have not investigated the technical merits of additives but we are satisfied that where they are used they are included in the petrol whether or not it has been the subject of an exchange. We do not, therefore, consider that exchanges result in consumers being misled.

8.87. We have not, therefore, identified any adverse effects which result from the operation of exchange agreements. They do not increase cost, rather the converse. They are a means (although not the only means) of enabling wholesalers to operate an extended supply system and as such improve rather than restrict the competitive process. We conclude that the exchange of petrol between wholesalers is an act attributable to the existence of the monopoly situation but that it does not operate against the public interest.

Other agreements between wholesalers

8.88. We examined the main forms of contract under which wholesalers, particularly the smaller ones, obtain bulk supplies of petrol from other wholesalers. Nearly all of the refiners enter into such agreements. For some refiners these sales account for more than 10 per cent of their output of petrol. There appears to be a significant volume of petrol traded in this way and a choice of suppliers.

8.89. The principal noteworthy feature in most contracts was in the pricing of the wholesale supply. In most cases the price was related in some way to the retail price of petrol prevailing at the time of and in the area of delivery (see paragraphs 3.47 to 3.50). We questioned the main suppliers about this because it appeared to be a way in which the retail prices set by the smaller wholesalers might in effect be tied to the prices charged by the larger suppliers. We were told that this form of pricing was one which was sought by the purchasing wholesalers because it reduced their exposure to sudden fluctuations in international prices or exchange rates. A number of small wholesalers confirmed this. Refiners would be prepared to sell at prices linked to international markets, and some trading takes place in that way, but generally their customers prefer the existing arrangements.

8.90. We have seen that retail prices follow the Rotterdam price, but that link is not an immediate one. There are time-lags in changes feeding through to pump prices and the Rotterdam price is more volatile than the retail price. Most small wholesalers do not wish to be exposed to that volatility and see pump-price-related contracts as enabling them to compete successfully. If wholesalers wish to take the risk of exposure to the international market price, they are free to do so (although we can appreciate that a wholesaler in a small way of business might well think the complexities of purchasing abroad make buying from a supplier at home much more attractive).

Wholesaler supply to retail outlets

8.91. Almost all retail outlets are tied to a particular supplier in one of two ways: first, through exclusive supply arrangements (solus ties) with independent retailers, and secondly through the ownership of outlets to which a similar exclusive supply arrangement applies.

8.92. Since the last report was prepared the number of wholesalers in the United Kingdom market has increased, so far as we have been able to judge, from 36 in 1977 to over 70 in 1989. (We may have failed to identify a few very small wholesalers supplying a few outlets within a small area; however, their contribution to the total market must be insignificant.) Most of the new entrants are operating on a very small scale. The number of wholesalers with more than 1 per cent of the market has remained unchanged. Chevron withdrew in 1984 when its outlets were acquired by Texaco, although it has subsequently re-entered the market through its purchase of Gulf. ICI has sold its wholesaling interests and retail outlets to Burmah. Amoco is now seeking to withdraw. Kuwait has entered the market by acquiring the United Kingdom wholesaling interests of several smaller companies and the Spanish company Repsol has bought the wholesale business of Carless. Since 1977 the importance of the top five companies, in terms of volumes supplied, has declined and in 1988 their combined share of the market was 65.7 per cent compared with 69.6 per cent in 1977. The other eight principal wholesalers increased their combined market share from 25.4 per cent in 1977 to 29.8 per cent in 1988. Statistical measures confirm that this market is less concentrated now than it was in 1977, although there has been some year-to-year fluctuation rather than a continuous decline.

8.93. There are at present a little under 20,000 retail petrol outlets operating in the United Kingdom of which about two-thirds are operated by independent dealers and one-third are owned by wholesalers (see paragraphs 3.79 to 3.83). Since wholesalers tend to own the larger outlets (apart from hypermarkets and most motorway service areas) with the higher sales, the volumes of petrol passing through their outlets are higher; a little over half the total volume of petrol sold passes through these company-owned outlets and their average throughput is 2.5 million litres, compared with 1.1 million litres through independently-owned sites.

Solus ties

8.94. Solus ties with independent dealers were considered in depth in the 1965 report, at a time when these dealers supplied a considerably larger share of the market. The MMC then took the view that the solus system had produced some beneficial effects for the consumer in reducing costs of supply without restricting consumer choice and that the financial assistance provided by wholesalers under solus agreements had helped to improve the standards of retail outlets. They concluded that such a system did not necessarily operate against the public interest. They decided, however, that long-term agreements would tend to make market shares rigid, increase difficulties for new suppliers trying to enter the market, and also increase the opportunities for suppliers to control the retailers' trade more strictly. They therefore recommended a limit on such ties of five years. They saw no objection to loans for longer periods than five years being tied to exclusive supply provisions provided the retailer was able to repay at his option any time after five years from the date of the loan.

8.95. During our inquiry we received no representations against the principle of the solus tie, although we heard arguments for both longer and shorter terms for the tie than the present limit of five years, and for suspension of the tie in certain market conditions. It seemed to us that the general arguments in favour of solus ties identified by our predecessors still applied and we saw no reason to dissent from the general finding of the 1965 report that solus trading was not in principle against the public interest. We also noted the provisions of Regulation 1984/83 of the European Commission ('the Regulation') (see Appendix 2.5) which exempts from the provisions of Article 85 of the Treaty of Rome certain long-term exclusive purchasing agreements, including service station agreements, provided that such an agreement with an independent dealer must not extend beyond ten years. The recitals to the regulation make clear, however, that individual member states are entitled to require a maximum term for solus agreements of less than ten years.

The length of solus ties

8.96. Esso suggested that the maximum term of solus ties should be extended to ten years, the maximum permitted under the EC regulation. Some retailers suggested a shorter term than the present five years.

8.97. The figures in Table 3.15 show that there are still over 12,000 solus dealers in the United Kingdom. Not all of these will have solus agreements for the full five years allowed by the Undertakings. We were told that a significant number of dealers prefer a shorter tie and that some of the larger retailers prefer to negotiate single year contracts with large rebates and to make their own arrangements for financing site developments. The information provided by major wholesalers on their gains and losses of independent sites, which is summarised in paragraphs 3.99 to 3.101, suggests that as many as one-quarter of such sites may change supplier on expiry of a solus tie.

8.98. We have been told that competition to sign up independent retailers is strong. Although some years ago a number of oil companies shed some smaller-volume independent sites there is now interest in sites of all sizes. This has been reflected in larger rebates. Wholesalers put considerable effort into both signing up new prospects and retaining contracts with their existing dealers. We were told that negotiations for a new tie can start a year or 18 months before the old one expires and that the new deal is often introduced before that time.

8.99. The earlier concerns that overlong ties tend to freeze market shares and impede entry continue to be important, given the continuing decline since the MMC's last report in the numbers of independent dealers and their share of the volume sold. A longer-term agreement gives the supplier the increased security that may be needed if he is to underwrite major investment on a site through loans or grants on terms that may be more favourable than those obtainable from other sources of finance. The shorter the period of an agreement the more the benefits to the retailer are likely to be provided 'up front' in the form of rebates or other benefits directly linked to sales of petrol. A shorter maximum term would increase the proportion of sites coming up for renewal each year (although the effect might not be entirely proportional since we have been told that many are renegotiated before the end of their term). It appears, therefore, that a shorter maximum term would increase the scope for competition amongst wholesalers, particularly in relation to the smaller sites, and thus assist the new entrant. On the other hand, shorter terms would also increase wholesalers' costs of negotiating new ties. One wholesaler suggested that, if the maximum term were reduced to three years, it would need 10 per cent more area representatives to carry out the necessary contacts and negotiations. Moreover, not all retailers would welcome shorter ties as renegotiating contracts can be a source of pressure and insecurity.

8.100. We concluded that there were no compelling arguments in either direction to suggest any variation in the present limit of five years, which was supported by the majority of wholesalers and retailers who submitted evidence to us.

Wholesaler ownership of retail sites

8.101. Ownership of retail sites by wholesalers applies what is in effect an indefinite tie to the site. We noted the concerns expressed in both the 1965 and 1979 reports. The 1965 report expressed the apprehension (at a time when one-seventh of all outlets were wholesaler-owned and one-quarter of retail sales took place through them) that too high a level of ownership of retail stations by the petrol suppliers would lead to an undesirable degree of rigidity in the retail trade and as between petrol suppliers themselves.

8.102. The 1979 report noted that by 1977 30 per cent of all sites were wholesaler-owned and accounted for half the petrol supplied by retail. The MMC also noted, however, that the individual market shares of the three largest wholesalers had declined, and the number of substantial refining competitors and of non-refining competitors had increased significantly. They also noted the growth of hypermarkets. The MMC concluded that the concerns expressed in the 1965 report had not in their view been borne out. They noted the growth of managed outlets as a strong and increasing influence in the market but concluded that at its 1977 level company ownership, however such outlets were operated, did not operate against the public interest. They did, however, see possible dangers if wholesaler-owned outlets were to provide a very high proportion of sales in any major retail market, since this might reduce competition at both the wholesale and the retail levels (see paragraph 2.4), and suggested that the Director General of Fair Trading (DGFT) should keep the position under review, which he continued to do until our present inquiry began.

8.103. Against this background we examined the extent of wholesaler ownership of retail sites, both nationally and in particular areas, and considered its effect on entry, competition and control of retail prices, taking into account the different types of relationship between wholesaler and retailer in this sector.

8.104. Between 1977 and 1988 the number of wholesaler-owned sites fell by about 2,500. Over the same period there was a reduction of about 10,000 in the total number of outlets in the United Kingdom. The total volume of sales has risen by 37 per cent during these years, while sales at wholesaler-owned sites have risen by 45 per cent. As a result of these changes the proportion of wholesaler-owned sites has risen slightly (from 30 per cent to 33 per cent) as has the proportion of sales by volume through such outlets (from 50 per cent to 53 per cent). The proportion of sales through independent sites has shown a corresponding fall although within this group there has been significant growth in hypermarket sales which now supply over 5 per cent of the market compared with under 1 per cent in 1977.

8.105. Taking the wholesalers together, therefore, there has been little change in the relative importance of wholesaler ownership at the national level. For the principal wholesalers included in the OFT's monitoring of the industry the proportion of wholesaler-owned sites in the total supplied has risen from 32 per cent in 1977 to about 40 per cent in 1988 and the volume of their petrol supplied through these sites from 51 per cent to nearly 56 per cent.¹

8.106. We examined developments in wholesaler ownership in those selected localities (the major conurbations) which the DGFT has monitored back to 1977. The share of sales volume in these conurbations taken as a whole which is accounted for by wholesaler-owned sites has risen from around 70 per cent at the time of the last report to 77 per cent in 1988 but this pattern has varied from one area to another with the proportion sold through wholesaler-owned sites falling in some conurbations. The proportion of sales in these areas accounted for by the five majors has also varied with a decline in some conurbations and an increase in others. Taking the conurbations as a whole the five majors' share of sales rose in the early 1980s but has since fallen and in 1988 was slightly below the 1977 level.

Methods of operation of wholesaler-owned sites

8.107. While the proportion of sites owned by the wholesalers has not changed markedly since the 1979 report there have been significant shifts, particularly for some of the major wholesalers, towards licensees and direct management of key sites.

¹Kuwait's outlets have been excluded from this comparison because they only entered the OFT analysis in 1987.

8.108. There are problems of comparability of data but it appears that in 1977 about 17.5 per cent of wholesaler-owned sites were directly managed and that this proportion rose in 1988 to 25.6 per cent (see Table 3.13). These managed outlets are operated by company employees or commission agents, and the company determines the services to be offered, enforces standards of operation, and sets the price charged at the outlet. We have no split of outlets between tenants and licensees for 1977, when they together accounted for 82.5 per cent of the total of wholesaler-owned sites. In 1983 they accounted for 76.6 per cent of the total, within which 33.7 per cent were tenanted and 42.9 per cent licensed. In 1988, however, the proportion of licensed sites had risen to 48.8 per cent of all wholesaler-owned sites. For the three largest wholesalers, Esso, Shell and BP, the importance of licensees is much greater, accounting for no less than 84 per cent of the owned sites in 1988.

8.109. In considering the extent of the influence which wholesalers exert over the outlets they own we examined both the nature of the contractual relationship with the retailer and the other relevant non-contractual factors of the relationship, and particularly those with licensees.

Tenancies

8.110. Although the importance of tenancies has been declining, particularly for the largest wholesalers, some wholesalers, in particular Texaco, Mobil, Gulf and Amoco, still use tenancies to operate large numbers of sites. Most tenants are protected under the Landlord and Tenant Act 1954, as amended (LTA), although some companies offer new tenancies which exclude protection. We were told that a tenancy is particularly suitable for operating a site where other activities, such as workshops or used car sales, are important and are needed to provide a satisfactory level of income. But even those companies which retain substantial numbers of tenants operate their high-volume retail petrol outlets through a relationship either agency or direct management which gives them a greater degree of control over the way the site is run.

Licences

8.111. Licences normally grant occupation of the site for three years for the purpose of selling petrol. Shop and other activities are often covered by a separate franchise agreement. Licensees take ownership of the petrol they sell, usually on terms that require them to finance at least one load and to provide the stock for the shop, if they have one. We have been told that on average a licensee with a shop on the site has to make an initial investment in the region of £40,000. There is arbitration available to a licensee if a wholesaler refuses to renew a licence. If a new licence is offered on terms the licensee considers onerous or unreasonable, he can then only seek conciliation. The licensee has no interest in the business, apart from the stock, which he can sell on to a successor. The average income of licensees is, we understand, in the region of £23,000 per annum although some earn considerably more.

Commission agents

8.112. Agreements with agents show many points of similarity with licences. While ownership of the petrol and other fuels sold through the site remains with the wholesaler, which sets the pump prices, the agent is frequently given a franchise to run the site shop, providing his own stock. The capital required is, therefore, considerably less than for a licensee operation. One major wholesaler told us that its agents usually had to find about £6,000.

The extent of control

8.113. In examining these relationships we identified the provisions on security of tenure and company pricing policies as strong influences on retailers' behaviour. Commission agents do not have security of tenure, and licensees have little, as do those tenants whose leases exclude protection under the LTA. A tenant enjoying the protection of the LTA will normally have a reasonable degree of security of tenure, although upon the termination of his lease the landlord may be entitled to repossess the site for redevelopment, or for his own use if he has already owned the site for five years. Only the retailer who owns his own site has complete security of tenure.

8.114. Control over prices is discussed more fully in the following section (paragraphs 8.131 onwards). In considering the effects of ownership and contractual relationships, however, we note that where commission agents are used the wholesaler sets their pump prices. The extent of the freedom of the licensee to set his own prices is a matter of dispute. Major wholesalers with numbers of licensees told us that they regarded them as independent businessmen, free to set their own pump prices. Some licensees claimed that this freedom was illusory. The main wholesalers had access to detailed information about the operating costs of licensed sites (see paragraph 5.85) and from this were able to set prices for petrol sales to the licensee which left him insufficient margin to give him any freedom of manoeuvre on pricing. In addition, while most licence margins in 1988 were in the region of 8.0 ppg (1.8 ppl), Esso had split the retailer's margin for its licensees into two elements, a fixed operating allowance related to his expected volume of sales and a variable margin of 4.4 ppg (1.0 ppl). With such a margin structure the retailer is given some relative financial protection against the risk of falling sales volumes but equally less incentive to increase sales. Although Esso suggested that licensees would take account not only of the petrol margin but also of profits from associated shop sales, we were given no evidence that this led to licensees setting lower prices.

8.115. We concluded that pump prices at these outlets are effectively controlled by the wholesalers, but primarily through the narrowness of the margin. This in itself reflects the wholesalers' recoupment through a higher price to the licensee of the wholesaler's return on capital investment in the site. While tenants may receive slightly larger margins the extent to which they are able to cut prices will depend for them, like licensees, on the importance of other sources of income on the site.

The current level of ownership

8.116. Against this background we considered whether current levels of site ownership by wholesalers give rise to concern, and whether the assessment was affected by the nature of the relationship between the owner and the operator of the site.

8.117. Various of the larger wholesalers explained to us that their main aim in buying sites was to obtain increased security of outlet for their refinery production, with greater stability of return than could be achieved by selling on the open market. In addition, they saw themselves as directly involved as retailers, marketing their brand of petrol and related services in the same way as the major high street retailers.

8.118. The proportion of sites owned by all wholesalers has changed little since the last report, although the proportion owned by the principal wholesalers has continued to increase. We saw no evidence of diminished competition in the market, however: margins have not increased, and profits are not high. New retail chains are being established and are growing quickly and the hypermarkets' share of the retail market continues to increase. Competition does not always take the form of lower prices, but in most of the country there are sufficient outlets competing on price to give the great majority of motorists access to cheaper petrol at no great inconvenience.

8.119. We have taken into account in our assessment the effects of the different types of agreement between wholesalers and retailers. As explained above, we think that there is very little difference in the level of control over petrol prices exercised by wholesalers over their directly-managed sites, including those operated by commission agents, and over licensed sites and that tenants operating on similar margins also have little scope within that margin to cut prices. We, therefore, think that most of the sites owned by the principal wholesalers should be regarded as managed by them for pricing purposes, either directly or indirectly, and have reached our conclusions on this basis.

8.120. We conclude that neither the level of ownership nor changes in the methods of site operation have adverse effects on competition in present circumstances.

8.121. During our inquiry, we examined carefully a number of proposals put to us for controls over wholesalers' ownership or operation of sites, and looked into experience in other countries. A number of these measures including the possibility of divestment (the enforced disposal of wholesaler-owned retail outlets) and divorcement (under which wholesalers may own retail outlets but not manage them or apply an exclusive supply arrangement) were also the subject of some discussion in the media during the later stages of our inquiry. Since, as indicated above, we have concluded that levels of wholesaler ownership and methods of management do not in present circumstances have adverse consequences, we are not required to consider these further. However, studies of the experience of divorcement in Maryland, which were drawn to our attention, suggest that evidence on the effect of divorcement on prices is inconclusive but that it has been followed by shorter opening hours and lower standards of service.

Appraisal of the licence system

8.122. We received strong representations that the licence system, and the Esso licence in particular, should be abandoned. While many of the arguments put to us related to the licence system as such, much of the detailed evidence focused on Esso's agreements with its licensees. The company has a large number of licensees, it appears to have developed the system in greater detail than other companies, and during our inquiry we received more complaints about this system and its effects than about any other aspect of the industry, perhaps because Esso moved to introduce a new licence at about the time our inquiry started. This licence contains some new features, in particular an arrangement for Esso to take a percentage on that part of the turnover of a licensee's shop that exceeds £150,000.

8.123. It seems to us that a good deal of the dissatisfaction that has arisen over the new Esso licence arises from the way in which Esso shifted from tenancies to licences some years ago. Many of the current licensees were originally tenants who agreed to exchange their tenancies for licences in return for prospects of a more assured income, greater Esso support and the possible redevelopment of the site. They find the detailed control now exercised by Esso irksome. On the other hand, a new licensee, particularly one who has previously been an employee or site manager, may welcome the arrangement as giving him the opportunity to increase his income and possibly to start a business career.

8.124. The PRA, the Association of Esso Retailers (AER) and other individual licensees argued that the effects of the present licence system were against the public interest. The companies had given undertakings that they would offer licences on fair and reasonable terms but the present terms and the operating conditions imposed were neither. The licensee should be an independent businessman; if he were given freedom to operate the site, and in particular to manage the shop, he would provide an efficient service better suited to local needs and would compete on petrol price. They argued that to this end licensees should be given the status of protected tenants.

8.125. On the other hand, the three wholesalers with substantial numbers of licensees made clear in evidence that they regarded themselves as direct retailers to the public. Each felt themselves held responsible by the public for the way in which their petrol was sold and each was following a general trend in retailing by establishing a national marketing image. Each had researched consumer needs, invested considerable amounts in retail sites and the delivery of its product to the consumer, and provided a level of service which small retailers would not themselves be able to offer. It was reasonable that they should be able to exercise a level of control on their own sites which not only protected their brand image and their capital investment but also met consumer needs. Such control was not exercised unfairly and the fact that few licensees left their sites showed that most were satisfied with their agreements.

8.126. We should note here that we received a number of allegations from licensees, and mostly from Esso licensees, that pressure has been applied by local representatives to enforce new operating conditions, such as extended opening hours, or to ensure licensees' compliance with company pricing policy, under threat of non-renewal of licences or withdrawal of support. Esso and other wholesalers mentioned have firmly denied that they apply such pressure. They said that controls are applied non-discriminatorily and only to protect standards and that it is in their own interests to treat licensees fairly and reasonably. They were unable to comment further without details of individual cases. In those cases where unfair pressure was alleged, retailers have asked for their evidence to us to be treated in

confidence on the grounds that they feared reprisals. We, therefore, felt unable to seek the views of the wholesalers concerned on the individual circumstances and are thus in no position to reach any conclusions on these allegations of pressure that had been put to us. However, the nature of relationship between the wholesaler and the licensee is such that, even without any direct pressure, the licensee is bound to be apprehensive of the effects of disregarding the wholesaler's wishes. This, it seems to us, must be a major factor taken into account by the licensee in deciding his behaviour.

8.127. We considered carefully the position of licensees in general, in the light of the many representations received and of the concern of the Select Committee that the 'entrepreneurial petrol retailer has the maximum freedom to decide what to stock in his shop'. The licensees have entered into agreements which give most of them an adequate income in return for limited investment. The wholesaler for its part has taken expert advice and has risked considerable investment on its judgment. The level of its investment in the site compared with that of the licensee in our view entitles it to the main voice in how that investment is used. If a wholesaler decides to use the investment to promote a uniform company strategy, the majority of the clauses to be found in the current licence, franchise and agency agreements are what one would expect. This necessarily involves a considerable restriction on the manner in which business is conducted by the site operator.

8.128. We were not convinced by the argument that greater freedom for the licensee would lead to more competitive petrol pricing. On pricing, the narrowness of the licensee's margin, which itself reflects his limited investment in the site, is the main factor. Even with greater security and less tight control of their operations, licensees would have little scope for lowering prices unless margins generally were higher. Nor did the evidence we received suggest to us that licensees would be likely to pass the benefits of higher margins on to the consumer. We do not think, therefore, that licensees in general can reasonably expect to play an independent entrepreneurial role and we do not believe that reducing the level of control over their activities would lead to lower prices.

8.129. Many of the arguments of those who have submitted evidence to us on the position of licensees effectively invite us to decide between two different commercial approaches to marketing through petrol filling stations, a matter in which the parties to licence agreements have different and sometimes conflicting commercial interests. We do not see it for us to judge commercial matters of this kind except in the context of those public interest issues, including those which relate to competition, which we are required to consider and report on.

8.130. The Undertakings which bear on the position of licensees, and particularly Undertaking 19, that licences will be granted on terms that are 'fair and reasonable', have been quoted by licensees as a defence against companies' attempts to control their freedom to operate the sites they occupy as they wish and in particular against recent changes proposed by Esso. In accepting Part VI of the Undertakings the companies have recognised concerns over the licensee relationships. It is in their own interests to ensure that the relationship is conducted fairly and reasonably if the business is to be run successfully. We noted with interest that one wholesaler is exploring ways of giving its licensees increased security and a recognised, and perhaps assignable, stake in the business. However, we do not see Undertaking 19 as required for the purposes of promoting competition. In general we think disputes over the terms of licences and indeed of other forms of agreement governing occupation of wholesaler-owned sites are a matter either for arbitration, if the parties so agree, or for the courts.

Controls on pump prices

Price variations within local areas

8.131. Pump prices on any one day can vary considerably from one retail site to another. This variation can be seen within quite small local areas and across the country as a whole. Across the country as a whole the lowest group of prices identified in our survey in January 1989 were at least 6.2 ppl below the highest prices (see paragraph 4.84). We have also noted certain times when this price range has narrowed. We found that, of the widely available brands, the prices of those of the five major wholesalers (which together account for nearly two-thirds of United Kingdom petrol sales) were generally at the higher end of the range.

8.132. This wide range of prices of petrol of a standard quality, and the position of the largest suppliers at the top end of this range, is surprising and we have therefore looked in detail at the factors which underlie the retail price and the way in which prices are determined.

Determination of pump prices at the individual site

8.133. For most petrol stations the market in which they operate is essentially a local one and in setting their prices they will be competing with a relatively small number of nearby stations. Petrol station managers have good knowledge of local demand and of the characteristics of competing sites, and these factors will be taken into account by them in deciding whether their price should be set equal to or different from that at competing outlets. Managers should also be able to estimate the effects on their volume of sales if they or their competitors change their prices. In the case of some of the larger site owners this knowledge is formalised in the calculation of site by site price elasticities. A judgment about local competition and the expected reaction of competitors to a price change is therefore an essential element in price setting.

8.134. In part, retailers' decisions will be influenced by the general marketing strategies adopted by the wholesalers. In our discussions with the wholesalers we were told of a variety of different strategies. Broadly these amounted to differences in the emphasis placed on quality of service offered to the customer, closely linked to an identifiable brand image, and on price. The five majors and a number of the mini-majors put great emphasis on improving the quality of sites. Other companies put more emphasis on price competitiveness as a means of increasing market share, and adopted deliberate strategies of pricing below the market leaders or of pricing to be towards the bottom of the price range. Investment and wholesale pricing policies have been developed to implement each wholesaler's chosen approach and these will affect the supply terms to the retailer and his final pricing decision.

Quality of sites

8.135. Substantial investments have been made in recent years, particularly but not exclusively by the majors, in upgrading sites to provide improved facilities and to present a strong standardised company image on the forecourt. Improvements have been made in access, pump layout, canopies, site design generally, and ancillary services such as car washes and shops. Investments of this sort are expected to generate returns from increased petrol sales and from the other activities. Shop and car-wash developments are seen as particularly attractive ways of generating additional profit. In addition, an overall higher quality of service on a site may allow that site to charge a premium on its petrol price without an offsetting loss of volume. We were told that the higher-quality sites were generally able to set their prices at the top end of the range in their local area. At the same time we observed cases where sites of very different quality charged similar prices and cases where high-quality sites were matching low prices.

8.136. Surveys of customers showed that the location of a site, rather than the facilities available or the price of the petrol, was by far the most important factor in determining their choice of petrol station. Therefore, although we accept that quality of petrol station facilities is a factor to be taken into account, the effect of quality differences on local prices appears to us to be very variable.

Wholesale prices

8.137. The wholesale price of petrol is determined in different ways by different companies. Most companies publish wholesale scheduled prices but because there is an extensive system of discounts and rebates, which vary from one site to another, these published prices are not a reliable guide to the prices actually paid by retailers. A broad distinction can be drawn between rebates and discounts which are specified in the retailer's contract with his wholesaler and those which are not contractual but are given at the wholesaler's discretion.

Contractual rebates

8.138. The principal contractual rebate appears in wholesalers' contracts with independent dealers. This rebate, of so many ppl off the scheduled wholesale price, will be negotiated by the dealer when setting up his solus contract. The level of rebate will depend on the particular circumstances of the retail outlet and on the degree of competition amongst wholesalers to sign up that dealer. New or renewed solus contracts usually include a per litre rebate on petrol supplied and often some form of assistance from the wholesaler, such as a grant, a loan on favourable terms or the supply of equipment. Dealers have some degree of choice in the balance between these two items. The average rebate varies from one wholesaler to another and in recent years these averages have been in the range 0.4 ppl to 2.5 ppl. On average in 1988 the value of the net price after rebates and discounts at which wholesalers sold petrol to independent dealers was about 1.2 ppl below that of sales to wholesaler-owned outlets. In addition, dealers may have received other forms of financial assistance.

Selective price support

8.139. The main non-contractual element in the price paid by retailers is selective price support (SPS) discretionary discount or rebate off the scheduled price. SPS was described in the 1979 report, when it was a relatively new practice. Since then its use has become a firmly-established feature of the United Kingdom market. All wholesalers of any size use SPS and, although the detailed administration varies from one company to another, the approaches adopted have common characteristics.

8.140. SPS is a means by which a wholesaler makes a special allowance available to an individual retail outlet in order for the operator to be able to reduce prices and meet local price competition without cutting into his gross margin. The main objective, we were told, is to enable the individual retailer to defend his sales volume and gross margin in the face of local competition. In general, wholesalers argued that SPS was used as a defensive tool in order to respond to price cuts initiated by competitors, but we were also told of cases when SPS had been provided as a means of initiating a local price cut.

8.141. The detailed mechanics of granting SPS are described in paragraphs 4.44 to 4.54. Generally the decision on whether to provide support at a particular site will be the result of discussions and negotiations between the retailer and the wholesaler (usually its local representative acting within guidelines set by his head office) following a price cut at a competing petrol station. Factors such as the extent to which volume will be affected by the price cut, the quality of the competing site and the possibility of the retailer matching some of the price cut out of his own margin will be taken into account. The outcome, if support is given, may be a full or partial matching of the initial competitor's price cut.

8.142. One condition on which SPS is provided is that the retailer will pass it on in full in the pump price and not use it to increase his margin. To help ensure that this occurs some wholesalers include a provision for maximum recommended retail prices in their agreements.

8.143. Because it is decided on a case by case basis the geographic spread of selective price support is difficult to determine, but the local variation in its use is one of the factors which contributes to price differences from one area to another. However, it was put to us by the PRA that the SPS system and other features of the market, particularly the use of recommended margins for tenanted and licensed sites, amounts to de facto control over retail petrol prices by the wholesalers and we have given further consideration to the way in which wholesalers might be able to exercise such control.

8.144. As background to our consideration, we noted that the EC Commission, as recorded in its Sixteenth Report on Competition Policy, had rejected a complaint that Shell's use of SPS in the Netherlands involved indirect resale price maintenance and price discrimination. We also reviewed the available information on experience in controlling SPS or its equivalent in other countries (see Appendix 3.2). This suggests that the results of controls on the use of SPS systems are not easy to assess and that there are difficulties in ensuring that support is not continued by other means.

Wholesalers' influence over pump prices

8.145. The evidence we collected shows that all the wholesalers sell petrol to the sites which they own at net prices which are around 1.2 ppl higher than the average price at which they sell to independent dealers; prices to supermarkets are lower by around a further 1 ppl. In addition, a number of wholesalers recommend or advise their retailers on what they consider to be an appropriate margin to be added to the wholesale price in setting the retail price. We were told that the differences in wholesale prices partly reflected the bargaining power of the independents and were a recognition that independents required a larger margin in order to earn a return on their own capital invested in the site. Conversely a return on capital invested in wholesaler-owned sites was included in the higher wholesale price charged to those sites. An alternative to this approach would be for wholesalers to charge all types of retailers a similar price, and to obtain the return on the investment in the retail sites which they owned in the form of a fixed rental or licence fee. The wholesalers argued, as noted earlier (see paragraph 8.114), that this would shift too much of the business risk to the retailers who were less able to support it, and as a result the development of their businesses would be inhibited. It seems to us that volume-related payments of this kind are one way in which different distributions of risk between the parties can be achieved and are not in principle objectionable.

8.146. In our view the wholesale pricing strategy adopted by all the main suppliers significantly limits the scope for tenants and licensees to engage in short-term price competition on their own initiative. The wholesale price of petrol to these sites (and thus the margin available, which sets a lower limit to any sensible price cutting) is higher to them than it is to independent sites, reflecting the wholesaler's return on its site investment, and the differential can be substantial. In addition, the recommendation of margins, although it is not legally enforceable, carries considerable weight for two reasons. First, the degree of security of tenure which some of these retailers enjoy, particularly the licensees, is small and they see a considerable risk to their whole livelihood if they do not conform with the wholesalers' proposals. Second, these operators rely on the provision of SPS to maintain their sales in the face of price cuts nearby. That support is given at the discretion of the wholesaler and the possibility of its being withdrawn or withheld is likely to make the operator unwilling to step out of line with general policy on prices. The net effect is therefore to give the wholesaler a very strong influence over the prices which are set at outlets he owns. We have seen little evidence to suggest that operators of these sites make use of their theoretical freedom to adopt a different pricing level from the one recommended by their wholesaler.

8.147. In the independent sector the wholesaler's influence over final prices is much reduced. Here the operator generally has the security of owning the site himself and the option of changing to a different supplier at the end of this contract. This enables him to negotiate a better wholesale price than at the wholesaler-owned site and gives him greater freedom of choice in deciding how much of his margin to use in price competition. However, his incentive to embark on a course of price competition is limited by the operation of SPS. The independent retailer is aware that if he embarks on a price reduction, financed out of his retail margin and in anticipation of increasing the volume of sales and total revenue, then the wholesalers supplying his competitors are likely to provide support which will largely neutralise his price cut. In this situation the incentive to cut price is reduced and in that respect the wholesalers, through the operation of SPS, may exercise a degree of control over the price levels of independent dealers.

8.148. The wholesaler itself will face much the same sort of calculations about its competitors' likely responses in deciding whether to support a retailer who wishes to cut prices. There are thus a number of factors including SPS which can work to discourage price cutting. But we know that prices are cut and, to different extents in different parts of the country, trigger periods of price competition. This demonstrates that each wholesaler's control over prices is far from complete.

8.149. The principal area of operation where wholesalers appear to exercise least control is amongst the hypermarkets. These operators are able to obtain better terms from wholesalers by virtue of their volume of purchases and because petrol sales form only a part of a large retail sales operation, the minimum required margin is likely to be different from that required by a traditional petrol retailer. The hypermarkets have consistently priced below the rest of the market to an extent which it may not have been possible for the wholesalers to match with SPS. As a result the hypermarkets' share of sales has risen and is likely to continue to increase rapidly over the next few years.

8.150. The control which wholesalers can exercise over retail prices, whether as a result of their ownership of sites, the contractual arrangements with retailers, or the use of SPS, is in our view limited in a number of ways. The independent dealers (including hypermarkets) remain influential in the market and account for nearly 50 per cent of sales. These independent sites are an important source of competition for the wholesalers' own sites. The continuing operation of SPS on a scale which varies from day to day and from area to area is in our view an indication that these independents have not been deterred from competing by any implicit threat of SPS being used to neutralise any price advantage.

8.151. In making its wholesale pricing decisions each company will take into account the competition it faces in the market from other wholesalers. There are six wholesalers with a market share of more than 5 per cent and a further eight which supply significant volumes of petrol. A number of wholesalers, including most of the mini-majors, told us of their plans to increase market share. We see the competition for market share amongst these wholesalers as a major factor inhibiting any one wholesaler from keeping prices artificially high and as further support for our view, in paragraphs 8.49 to 8.52, that wholesalers do not collude in setting prices.

8.152. Third, the pattern of competition, both between wholesalers as a group following a variety of price and quality strategies, and between wholesaler-owned sites and independents, varies from one part of the country to another. This affects the intensity of competition in a particular locality and makes it difficult for an individual wholesaler to set a standard national price. There have been periods, for example during the first half of 1989, when there has been relatively little variation in retail prices across the country. This has occurred at times when all wholesalers have faced increases in the Rotterdam price of petrol and have sought to maintain or improve their margins by withdrawing SPS. Such periods are generally followed by renewed local price competition, for example as individual site operators or individual wholesalers see opportunities to increase their sales through price cuts. Such competition is then met by wholesalers by the reintroduction of SPS on a case by case basis and, across the country as a whole, the range of prices will again increase. The range of prices which prevails across the country on any day is a reflection of differences in local competition.

8.153. We are faced, therefore, with a situation in which the wholesalers have the means to exercise direct and indirect control over prices in a substantial part of the market, but at the same time are faced with competitive forces which limit their ability to use these powers. In our view the competition that each wholesaler faces at present is considerable and at the local level we see retail outlets, particularly in the more densely populated parts of the country, responding rapidly to price and quality changes in the area. In that respect SPS is, in our view, operating at present in a way which allows this sort of local competition to exist without at the same time making retail sites uneconomic for their operators. Even where wholesaler-owned sites account for substantial shares of sales, as they do in some conurbations, different strategies adopted by individual wholesalers in those areas and SPS, as it currently operates, ensure that price competition continues to operate satisfactorily.

The Highlands and Islands of Scotland

8.154. We received a number of complaints about petrol prices in rural areas, and in particular complaints from a number of MPs, local authorities and individuals about prices in the Highlands and Islands of Scotland. We were aware that the Select Committee on Trade and Industry had drawn attention to the need for an inquiry into the true costs of supply in rural areas. Within the scope of our inquiry we regarded it as impractical to carry out a detailed examination of pricing and costs of supply in rural areas throughout the United Kingdom. We decided, therefore, to examine the situation in the Highlands and Islands as relevant to the problems of retail petrol prices in rural areas generally to which the Select Committee had drawn attention.

8.155. Petrol prices at the 319 outlets in the Highlands and Islands are significantly higher than those in the rest of Scotland and in the United Kingdom as a whole. For example, in 1988 on average the prices at sites supplied by BP (about half the total) were 2.7 ppl (12.3 ppg) higher than the average at United Kingdom sites supplied by BP. Population densities are low and outside the towns many large areas support only one outlet. The retail outlets on average sell very small volumes compared with other United Kingdom outlets. A third of the outlets sell less than 100,000 litres per annum and the average throughput is about one-fifth of the United Kingdom average. All but a handful are independently owned and virtually all are supplied by Esso, Shell or BP, using authorised distributors (and in one area a single distributor for all three). The three companies told us that their price policies on rebates, retail margins and SPS are applied nationally and without discrimination.

8.156. Wholesale petrol prices are higher in the Highlands and Islands than the United Kingdom average for a number of reasons. There is a small special zone wholesale price premium and various small load premiums, which together might account for 0.28 ppl (1.3 ppg) on an average load, though the smallest may pay a little over 1 ppl (or 4.5 ppg). The rebates offered to the independent dealers are smaller than elsewhere, partly because the sites have low sales volumes. Again, because there is little local competition there is little or no SPS. However, BP told us that when its price support is so widespread in the rest of the United Kingdom that it is converted into block discounts, these block discounts are also given to outlets in the Highlands and Islands.

8.157. These factors contribute to wholesale prices being higher than the United Kingdom average. We estimate that in 1988 the three companies' net proceeds on sales to retailers were between 1.0 ppl and 1.5 ppl (4.5 ppg and 6.8 ppg) higher than their average for all independent sites they supply in the United Kingdom.

8.158. The wholesalers' higher net proceeds, however, account for only part of the difference between retail prices there and elsewhere in the United Kingdom. We calculate that if retailers in the Highlands and Islands had achieved the same average retail gross margin in 1988 as the independent dealers supplied by their wholesalers throughout the United Kingdom their retail price would be about 1.0 to 1.5 ppl lower. We estimate, therefore, that higher wholesale prices account for about half of the 2.7 ppl difference; higher retail margins and VAT account for the rest. These are average figures. While there will be some variation in the terms offered by wholesalers, it is likely that in those areas showing retail prices markedly higher the average, retail margins are also higher.

8.159. We looked at the reasons for higher margins. At the wholesale level costs are higher. Only one of the three wholesalers in the area was able to distinguish for us the costs of supplying petrol from other products. Esso provided estimates for the extra costs of delivering in 1988 to various locations in the Highlands and Islands, which suggested that overall these extra costs absorbed the higher proceeds from deliveries in the area. Esso also told us that in 1989, with a narrowing of the differential between prices in the Highlands and Islands and average United Kingdom prices, it was not fully recovering its additional costs of supply to the area.

8.160. At the retail level, with comparatively low sales volumes at most outlets, retailers are likely to need higher margins to cover fixed costs and the lack of local competition enables retailers to secure them. Few sites can exist by selling petrol alone and virtually all petrol outlets have other activities on their sites to provide additional income.

8.161. We conclude that the higher average level of retail prices in the Highlands and Islands than in the United Kingdom as a whole is the result of sparse population and geographic factors leading to higher costs and to less intense competition in both the wholesale and retail petrol markets. We find no evidence of higher profits from sales after extra costs are taken into account. Were steps taken to reduce wholesale and retail prices to those prevailing elsewhere in the United Kingdom we think it likely that this would call into question the continued involvement of the three wholesalers and certainly result in closure of retail sites.

Advertising and promotions

8.162. We are aware that petrol promotions have recently been controlled in the Republic of Ireland, but we found during our inquiry that few people were critical of petrol advertising and expenditure levels in the United Kingdom. Wholesalers' expenditure on all advertising and promotions in 1988 was equivalent on average to about 0.3 ppl but, in terms of ppl, advertising expenditure is small. Retailers who participate in promotions also contribute to the cost, and their contributions are equivalent to perhaps a further 0.2 ppl. If there were no promotions and the lower cost were passed on in a lower petrol price, the effect might be to reduce the average retail price of petrol, of all brands taken together, by perhaps as much as 0.5 ppl (or about 2.2 ppg).

8.163. Only a few wholesalers, notably the five majors, actually engage in significant promotional campaigns. Therefore, if advertising and promotional expenditure was curtailed, any beneficial effects on petrol prices would appear in price reductions of perhaps up to 0.6 ppl for the affected brands but, at least initially, little change in the prices of other brands.

8.164. The major wholesalers argued that promotional campaigns were in addition to, and not substitutes for, price competition. They further said that consumers react favourably to promotions. At the same time our survey of consumers did not show any great importance being attached to the existence of promotions when choosing where to buy petrol. In our view the use of promotions is one of several ways in which companies have developed different strategies in petrol retailing and were their use curtailed, the wholesalers would seek other ways to promote sales of the product. Where this type of strategy is adopted it does not appear to us to have any adverse effect on competition.

Barriers to entry and expansion

8.165. A crucial element in assessing the competitiveness of the wholesale petrol market is the extent to which there are barriers to entry and growth either directly at the wholesale level or indirectly through limitations on the number of retail sites available to new or expanding wholesalers.

Availability of supply

8.166. The first, and probably the most important, potential constraint on entry and expansion is the availability of supply. This could be a matter of concern in a market in which the principal wholesalers are refiners, either in the United Kingdom or elsewhere in the EC. However, we had no complaints of refusal to supply and it is clear that the non-refining wholesalers have been able to secure product from the refiners at prices which have enabled them to compete. This has been during a period of surplus refining capacity in Western Europe as a whole and when the United Kingdom has moved from being a net importer to a substantial exporter of petrol; we were told, however, that experience showed shortfalls in supply are quickly made good.

8.167. We reviewed the difficulties that would present themselves for a wholesaler which wished to import directly from Rotterdam. We were left in no doubt that unless the market changed dramatically supply would be available. The various physical and administrative arrangements, together with the additional risk element, might make importing unattractive for someone with no past experience, compared with the relatively straightforward procurement from United Kingdom suppliers. However, one substantial retailer told us that it saw no difficulty in obtaining supplies from the Rotterdam market if it considered this expedient. Another, which operates a chain of cut-price outlets in the Cardiff area, told us that it planned to import directly from Rotterdam the bulk of its supplies.

Entry to the wholesale market

8.168. At the wholesale level it is possible to set up a small business with little more than a road tanker and a couple of staff, supplying retail outlets with deliveries purchased under the rack. Most of the new entrants to the wholesale market in recent years are operating on a fairly modest scale and have in some cases taken over the role of supplying smaller sites shed by the majors in rationalisations some years ago. Twenty-seven of the wholesalers account for 99 per cent of wholesale supply to retailers, but the remaining 42 wholesalers which are within the complex monopoly account for only 1 per cent.

8.169. A wholesaler wishing to establish a significant market share (say more than 1 per cent) will probably seek wholesaler-owned outlets. It may well already have crude and refinery capacity and will thus be seeking through such outlets both increased security for disposing of its product and a share in the value added to its product at the marketing stage. The majority of independent dealers it might supply will tend to be smaller-volume sites. As already discussed, the extent of wholesaler ownership of retail sites and the length of solus ties limit the scope for such expansion. Other factors, however, may hamper growth at the wholesale level.

Strategic stock requirement

8.170. We examined a number of other statutory or administrative requirements which it was suggested to us might hamper entry and expansion. Of these we paid particular attention to the strategic stock requirement. A number of wholesalers (particularly the smaller wholesalers) regard it as a barrier to entry and expansion generally and to relying on imported petrol. The Select Committee on Trade and Industry drew particular attention to the effects of the requirement. The way the requirement bears on the industry is complicated; it is described in some detail in paragraphs 3.123 onwards. Briefly, an EC Directive requires the United Kingdom to hold 76½ days' supply of petroleum products grouped in categories (of which petrol and aviation spirit are one), or the crude oil equivalent. Member states determine their own administrative arrangements to ensure that their obligations are met. In the United Kingdom refiners are required to hold stocks equivalent to 76½ days of their United Kingdom deliveries (as defined) into final consumption in the previous 12 months and non-refiners are required to hold 66 days' stocks. The total United Kingdom stock requirement for petrol and aviation spirit in 1989/90 is 4.55 million tonnes, of which all but 0.07 million tonnes (1.5 per cent) is borne by the 11 United Kingdom petrol refiners, ICI, and three major wholesalers, Elf, Burmah and Kuwait.

8.171. Any supplier of more than 50,000 tonnes of petroleum products into the United Kingdom market for final consumption is liable to an obligation unless it has acquired the products from a supplier who is prepared to regard it as an authorised distributor. Companies in the latter category may be wholesalers supplying retail outlets under their own brand, or retailers. There are about a dozen retailers selling in excess of 50,000 tonnes of petrol but in every case at present their stockholding liabilities are met by their refiner suppliers with no specific charge. The smaller non-refining wholesalers which are independent distributors, and which will not be supplying retailers of that size, bear the full 66 days obligation for the retail outlets they supply when they reach the 50,000 tonnes threshold.

8.172. In practice, a wholesaler which crosses the 50,000 tonnes threshold is likely to find that its refiner supplier will be ready to carry the requirement as part of a supply contract between the two, and this is the most frequent method used. In such cases the cost becomes one element in the negotiation and is not separately identified in the final price. Such a company would incur considerable costs if it actually held the petrol itself. However, the Department of Energy told us that it is not necessary for someone who is subject to a stockholding direction to hold the stocks himself, nor indeed for these to be held in the United Kingdom; there are bilateral agreements which allow stocks to be held in Denmark, Belgium, Ireland or the Netherlands, and there is immense storage capacity in the Antwerp-Rotterdam area. There are also call option arrangements through which a United Kingdom wholesaler subject to a stockholding obligation could pay a Rotterdam supplier to provide the stock on demand if called. These arrangements are used by some refiners but there is nothing to prevent a small wholesaler from holding a call option with a Rotterdam supplier. We were told that earlier this year such an option would cost about £7.65 per tonne per year. This would add 0.1 ppl to the pump price.

8.173. We conclude that for the smaller wholesalers and larger retailers who may be affected by the requirements the most important consideration is first whether refiners will carry the obligation and, if not, whether low-cost call options would be available. If so, then the impact would not be significant. However, if wholesalers and retailers had to carry their own stocks the cost could be a heavy, and perhaps unacceptable, burden. Potentially the area of greatest difficulty lies in the supermarkets' operations. Currently these generate a stockholding liability well in excess of 300,000 tonnes. Over the next two or three years this could increase sharply. At present the supermarkets' refiner suppliers carry this liability at no specific charge, but if their attitude were to change then the supermarkets would have to negotiate terms with them for the stock coverage or make alternative arrangements.

8.174. We note that a system of the type used in the United Kingdom where an obligation is incurred at a specific threshold inevitably involves some distortion of competition. We conclude, however, that the requirement should not at present be a significant barrier to expansion by retailers or by the wholesalers, although difficulties would arise if the refiners' willingness to carry their customers' obligations disappeared and if call options were not available at a reasonable cost. In view of the possibility that the implication of the requirement will be reviewed by the EC in the light of the 1992 single market we make no suggestions for change. There appears, however, to be a good deal of misunderstanding among both wholesalers and retailers about the way in which the United Kingdom scheme operates and how the requirement may be met, and we think it would be helpful for the Department of Energy to prepare a guidance note for inquiries which explains not only how the scheme

operates but also the ways in which the requirement may be met, including the circumstances in which call options are acceptable.

Availability of existing retail sites

8.175. The other barriers we considered all related to the availability of sites, both new and existing. We have already considered the effect of solus ties and ownership on the availability of existing sites, but site availability and cost can also be affected by restrictive covenants, first refusal clauses, safety requirements and planning constraints.

Restrictive covenants

8.176. The oil companies' practices on covenants vary widely in the extent to which, when they sell a retail petrol site, they impose a covenant to prevent the continued use of the site for selling petrol. Without detailed analysis it is difficult to judge how far these covenants are an effective constraint; in many cases the site will not be viable as a petrol station under any operator or may be more profitable for other use. Moreover, we thought it not unreasonable that a covenant should be imposed where an existing or replacement site supplied by the same company would be in direct competition with the outlet. We received no specific evidence that any potential retailer had been prevented by covenants from acquiring a site and we see no grounds for singling out the industry for regulation in this respect.

First refusal clauses

8.177. A few wholesalers include in their solus agreements relating to an independent dealer's site a 'first refusal' clause which gives them a right to purchase if the dealer wishes to sell the site during the term of the agreement, provided the wholesaler matches any competing bid. Such a clause may give the wholesaler an advantage in trying to turn a temporary solus tie into a permanent one in circumstances where that is desirable to him, but we think they would have only a marginal effect on the market or on the principal wholesalers' ownership of prime sites.

Safety requirements

8.178. One retailer suggested to us that when a site owned by an oil company was vacated the empty fuel tanks were filled with concrete in order to render the site incapable of any future use by competitors. Such measures are usually taken to meet licensing authorities' safety requirements and follow the Institute of Petroleum Safety Code. We received no other evidence to suggest that this is a serious problem.

Planning controls

8.179. The need for new petrol stations is largely determined by changing road and population patterns. At the same time there will be a need for new sites to replace existing sites no longer satisfactory for various reasons. At any time there will be a limited number of suitable sites for development. It was put to us by wholesalers and retailers, including hypermarkets, that the system of planning controls was a major constraint on developing these sites. However, those giving evidence accepted that there are strong environmental and safety reasons for the present planning controls and it was not suggested that they are unduly restrictive or applied unreasonably. Against the background of a continuing decline in total numbers of petrol outlets in the United Kingdom, the material we quote in paragraphs 3.106 to 3.117 on site developments and the growth in independent retailers do not suggest that planning constraints have been a serious impediment to growth.

Cost of sites

8.180. All these factors taken together mean that good sites, both new and existing, are scarce and, therefore, expensive. It was further put to us, by the PRA and individual retailers, that the major wholesalers bid up prices by paying higher prices for prime sites than independent dealers considered justified by potential returns, thus shutting the latter out of the high-volume market. The wholesalers told us that the price paid for any site was based on their estimate of the site's potential gallonage, taking into account the cost of any redevelopment, and the need for this to satisfy their target rate of return. The expected sales volumes were calculated using detailed models, and while there were inevitably misjudgments the outcome usually justified the expenditure. We received a good deal of evidence that the larger independent retailers compete successfully with the principal wholesalers for prime sites. We conclude that within the necessary planning and safety constraints, there is a competitive market in sites.

Assessment of barriers to entry and expansion

8.181. So far in this section we have considered a number of individual constraints, some arising from legislative requirements, which may affect entry and expansion in the wholesale market. Overall, however, they have not prevented entry to or expansion in the market at various levels. At the wholesale level, entry has been generally on a very small scale but one new entrant, Kuwait, has managed to secure about 2.5 per cent of the market by acquiring and developing contracts from existing wholesalers. In considering the constraints on site availability we noted also that independent retailers were able to compete successfully with the principal wholesalers. Major retailers like Heron, Oakstead and Norfolk House have shown that it is possible to acquire and develop significant numbers of good-quality sites. We see no ground, therefore, for suggesting any modification to present arrangements on any of these matters.

Appraisals of the competitive situation

8.182. In the preceding paragraphs we have commented on the evidence put to us by a number of parties, representing consumers and retailers, on the state of competition in the industry. The most comprehensive and detailed arguments were put to us by the PRA and are set out in the summary of its evidence in paragraphs 7.33 to 7.71. The PRA argued that the refining oil companies exercised de facto control over petrol prices at wholesale and retail level, that this control was also a consequence of vertical constraints, particularly wholesaler ownership of retail sites and control of the licence system, and was supported by barriers to entry at the wholesale and retail levels. As a result prices in at least some parts of the retail market were significantly above competitive levels. Control over retail prices was maintained through controls on margins, the arrangements for notifying price changes, and the system of selective price support.

8.183. It advanced evidence to support this argument, suggesting first that margins between retail prices and crude oil costs have widened significantly since the mid-1980s and that retail prices have also diverged from the Rotterdam petrol prices in the same period. Secondly, it argued that continuing price differences between different parts of the country exceeded any identifiable differences in costs, and that price reductions by retailers and other wholesalers were inhibited by various measures including use of selective price support.

8.184. As our earlier detailed discussion shows, we accept some elements of the PRA analysis, in particular that there is effective control by wholesalers of pump prices at a large proportion of their own sites and that selective price support could be used as an anti-competitive weapon-although the evidence available to us suggests it is offered more widely than the PRA realised and that its overall effect in present circumstances is to assist competition.

8.185. We do not accept the PRA's view that United Kingdom retail prices are higher than they might otherwise be because of the exercise of market power by oil companies. Our analysis suggests that the margins available to wholesalers on sales of petrol have been no more than are needed to cover costs and leave a small wholesaling profit. We have had the advantage of more detailed cost and profit information from oil companies than was available to the PRA. We have not found high profitability either at the wholesale level or taking the companies' downstream operations as a whole (see paragraphs 8.53 onwards). Moreover, profits have been extremely volatile from one year to the next. Neither of these are features associated with the successful exploitation of monopoly power.

8.186. Our overall appraisal differs from that of the PRA and some other witnesses from the industry on three main issues. First, we do not consider that barriers to entry at either the wholesale or retail level have been sufficient to prevent significant entry and expansion and, therefore, competition. Over the period since the last report two significant EC refiners, Kuwait and more recently Repsol, have entered the market, together with a number of small wholesalers. At the retail level operators like Oakstead, Norfolk House and Heron have shown that it is possible to build up large chains of moderate to high-volume sites offering competition on price and quality of service. The hypermarkets, which at the time of the MMC's last report held 1 per cent of the retail market, in 1988 held more than 5 per cent and are expected to continue to increase their share of the market by opening new sites and offering keen and effective price competition.

8.187. Secondly, like the PRA we see an industry in which each oil company uses vertical integration and other means to control or strongly influence not only the price but also other aspects of marketing of its petrol and often the overall operation of the retail site. However, we do not see this behaviour as inconsistent with the maintenance of a competitive retail market. In current market conditions we do not regard the moves by some companies to invest heavily in the sites they own, and lay down operating standards in order to achieve a consistent brand image and to offer a standardised service to the consumer, as reducing competition. We have noted great differences in the extent to which wholesalers attempt to manage their sites closely, and in their strategies for ownership generally. Some have large numbers of directly-managed sites; others consider that direct management of more than a certain number of sites will lead to inefficiency. Some use employees and others commission agents to run their managed sites. Some wholesalers rely heavily on licensees and think tenants may not be sufficiently dedicated to marketing the brand, while others consider that a tenancy produces a better operator and a more satisfactory working arrangement. Where companies do use licensees and commission agents the extent to which they attempt to exercise control over site activities varies. However, wholesalers compete vigorously with each other with a range of strategies and different packages of price and services. We see no competition grounds for constraining those companies which want to rely on closer control over the operation of wholesaler-owned outlets. The wisdom of their strategy is ultimately tested by the consumers' reaction.

8.188. Thirdly, it has been suggested to us that operators of wholesaler-owned sites could be given higher margins, and thus could lower their pump prices, if the margins and rebates offered to the independent retailers, including hypermarkets, were reduced. We have seen no convincing evidence that such greater independence for the operators of wholesaler-owned sites, and particularly licensees, is likely to lead to lower prices or other benefits to the consumer. The main constraint on a licensee's freedom to set prices is the price charged to him by the wholesaler but the narrowness of the margin that this provides is a reflection of his limited stake in the site compared with that of the company. The margins for independent retailers appear to have increased over recent years but their level is settled in competitive negotiations and determined by the retailers' required return on capital.

The present state of the industry

8.189. We drew attention at the beginning of this chapter to public suspicions that the industry was using a position of power to exploit the consumer. As our analysis has shown, we think that in current conditions these suspicions are misplaced. While we have described an industry characterised by powerful, long-established companies operating on a multinational scale, it is nevertheless competitive and the wholesalers are now largely subject to the market discipline of international prices. We do not find either the general level of United Kingdom ex-tax pump prices or recent trends in prices unreasonable, either against Rotterdam petrol prices, European prices, or the general trend of consumer prices.

8.190. Since the last report, as we describe in paragraph 8.92, there has been a slight decrease in concentration in the wholesale market and in the share of the five majors together, and within that group shares have changed. Several of the mini-majors have expanded their shares of the market. One relatively new wholesaler, Kuwait, has entered the market by acquisition and Repsol has also recently entered the market. There has also been an increase in the number of small wholesalers. Competition for market share has led to higher site standards with improved access, layout, opening hours and other on-site facilities such as shops and car washes. Each company seeks the security of outlets for its products through vertical integration and exclusive supply contracts. In the outlets it owns, it ensures that its product is marketed in the way and at the price that fits its retail strategy and has encouraged the independent sites to promote the same brand strategy.

8.191. At the same time we were impressed by the diversity of approaches for attracting the consumer. This reflects the vigour of the competition for market share by majors, mini-majors and other wholesalers, and by the independent retailers, particularly the hypermarkets, who offer strong competition and have increased market share steadily over recent years. In most areas of the country consumers have available in their neighbourhood a range of petrol prices prominently displayed and different standards of service from which to choose. Many are prepared to pay higher prices in return for service and convenience. The reality of the competition to secure their custom is in our view shown by the level and volatility of profits over the period we have studied.

8.192. Thus on the basis of our examination of the structure and behaviour of the industry over recent years we conclude that the facts found do not at present operate against the public interest.

8.193. We also find that no steps are being taken by wholesalers in whose favour the monopoly situation exists to exploit or maintain that situation. As stated in paragraph 8.87, we find that the exchange of petrol between wholesalers is an act attributable to the existence of the monopoly situation but does not operate against the public interest.

Future outlook

8.194. We turn now from the present situation to the future. We are required to consider not only whether any facts found in our inquiry operate against the public interest but whether they may be expected to do so in future. We have already noted that some features of both the structure of the industry and the behaviour of the wholesalers could in certain circumstances have adverse effects. We noted in particular that selective price support has potential for competitive and anti-competitive use. At present its operation taken as a whole appears to assist competition but the control it gives wholesalers over prices at both independent and wholesaler-owned sites could be used to damp down competition. We would be concerned by significant changes in the forces which we have identified as encouraging competition, in particular:

- (a) an adverse change in supply conditions for petrol;
- (b) a further and significant increase in wholesaler ownership of sites and in the volume of petrol sold through those sites, with corresponding reduction in the role of the independent retailers;

- (c) a significant reduction in either the number of wholesalers or their geographic coverage, or both, particularly among the 14 larger wholesalers; and
- (d) anti-competitive changes in the use of selective price support, either by wholesalers failing to respond to local price competition or by using it as a pricing weapon to deter price cutting in local markets by rendering such operations unprofitable.

8.195. An adverse change in the conditions of petrol supply would be a cause of concern. Over the last 15 years, as a result of the oil price shocks of the 1970s and their dramatic consequences for the long-term demand for oil products, the industry in the United Kingdom and North-West Europe has been dealing with the consequences of a surplus of refining capacity. There are signs that the process of adjustment, which has required major scrapping and rationalisation of capacity, is now almost complete. The move to unleaded petrol and other environmental measures under consideration will reinforce this tendency. The sharp rise in Rotterdam prices in the early months of 1989, in response to temporary shortages of unleaded and higher-quality petrol, may be seen as an example of the sensitivity of prices to a temporary shortfall in supply. If shortages were to develop and were more than temporary, refining wholesalers could have less incentive to enter into contracts on very narrow margins and would, therefore, be less likely to offer the favourable terms which have been available to other wholesalers, and to the larger independent retailers and hypermarkets, when present contracts come to an end. The incentive for price competition might be reduced, even with existing levels of ownership and control. We received differing views on whether such shortages were likely to occur and, if so, on when such shortages might occur, their seriousness and, perhaps most important, on how quickly refiners would be able to react to such shortages, and the higher margins they would generate, by upgrading and expanding capacity.

8.196. We have explained in paragraphs 8.116 to 8.120 why we consider that the present level of wholesaler ownership of retail outlets and the contractual relations under which they are run do not currently operate against the public interest. However, if the proportion of outlets owned by independent retailers fell sharply this would reduce the opportunity for new entry to the wholesale market and opportunities for growth would increasingly depend on acquisition from other wholesalers. We would be particularly concerned if the hypermarkets failed to expand their share of the market. These potential adverse consequences could arise at some stage well short of complete wholesaler ownership of all retail sites.

8.197. Whether or not the proportion of all sites owned by wholesalers were to increase, we should also be concerned if there were a significant fall in the number of principal wholesalers and ownership of sites became concentrated in fewer hands. At some point those remaining wholesalers could see their interests best served by lessening competition. The degree of control they have over the retail market, and particularly their ability to change the way they use selective price support, might enable them to impose higher prices. Indeed, it is possible that other factors in the industry could change in a way which could lead to such consequences even at current levels of ownership, for example if there was more than a temporary shortfall in supply. We think it impossible to predict the critical levels of ownership or concentration in advance; they would be demonstrated by market behaviour including the level of prices and of profit margins.

8.198. Members of the group varied in the weight they attached to possible shortages of refining capacity, developments in wholesaler ownership and pricing policies and the effect that these might have on entry to the market. Having regard to the current competitive state of the industry we decided that the likelihood of such developments, taken individually or together, was not sufficient for us to conclude that the facts found may be expected to operate against the public interest.

8.199. We recognised, however, that conditions could change for the worse in a number of ways, some of which we have discussed in the preceding paragraphs. Although members varied in their assessment of the likelihood of adverse developments, all agreed that the importance of the industry and the potentially serious consequences of a decline in competition were such that continued monitoring of the industry was necessary. The OFT already keeps the competitive situation in the industry under review, both in overseeing the oil companies' compliance with the Undertakings given after the 1965 report and in considering representations and complaints from petrol retailers and members of the public about oil company activities. Following the suggestion in the 1979 report the OFT has also collected annual information on the extent of wholesaler ownership of sites.

8.200. We consider that further information should be collected to enable the OFT to review on a regular basis the competitive state of the industry, from which it can reach a judgment on whether barriers to entry and expansion have reached a level at which larger wholesalers are able to develop existing control over the market to raise prices above the competitive level.

Monitoring future developments

8.201. The main indicators of whether competition is working effectively are prices and profitability, and these are the chief areas we suggest for monitoring. However, supporting information will be needed on the structure of the market, in particular on the level of wholesaler ownership of sites. We set out in Appendix 8.2 our suggestions, drawn from the analysis in the report, for the main indicators to be monitored. It will be seen that we think that monitoring should be based on a limited range of indicators derived from some of those included in this report. This will enable a continuous database of information to be constructed and information required from wholesalers will be in a form familiar to them. It will be for the OFT, as the responsible body, to draw up detailed proposals.

8.202. Some of this information can be collected by the OFT from external sources or bought in from consultants. Where information has to be provided by the wholesalers we envisage that it would be sufficient to collect most of the data from the principal wholesalers, currently those 14 with a market share of more than 1 per cent, and that on profitability, information on the results of the five major wholesalers would be sufficient. The OFT will need to keep under review which wholesalers should be asked to provide information, in the light of changes in the structure of the industry and in the numbers of larger wholesalers.

8.203. Although we have indicated in general terms the types of development and the features that should be monitored, we have not attempted to lay down precise levels of ownership, prices or profitability which should trigger action. We envisage that the OFT will use its judgment in examining the picture as a whole.

8.204. If on an annual review of the information, including that provided by the principal wholesalers, the DGFT decided that the competitive situation gave grounds for concern, or that the information provided appeared inadequate and required deeper investigation, we would expect a further reference to be made to the MMC.

8.205. We have made clear in this report that we think much of the criticism of the industry is based on public misunderstanding of the forces determining petrol prices and of the oil companies' behaviour. Publication of the results of the OFT annual review may assist in informing the public.

8.206. In drawing up the format of information to be required of the principal wholesalers, we have aimed to keep the requirements to the minimum necessary. We believe that, whilst the requirements will place some burden on the companies concerned, much of the information will be a continuation of that provided to this inquiry and should therefore be manageable. So far as the OFT is concerned, the collation and study of the material will be an appreciable task and we consider that the OFT should be given sufficient resources to enable it to be undertaken effectively.

The Undertakings

8.207. The OFT will doubtless wish to examine the Undertakings first given in response to the 1965 report and reviewed in 1976, in the light of the comments in this report and of other developments, in particular the introduction by the European Commission of Regulation 1984/83. Articles 10 to 13 of the Regulation contain special provisions for service station agreements, and deal with many of the matters covered by the Undertakings.

Summary of main conclusions

8.208. We now briefly recapitulate our main findings in this concluding chapter.

8.209. We have found that a monopoly situation exists in the wholesale supply of petrol, in favour of 69 wholesalers which together supply virtually all the petrol delivered to retail petrol outlets in the United Kingdom.

8.210. We examined a number of public interest issues. We found that United Kingdom pump prices are primarily governed by international prices. We conclude that there are no reasonable grounds for criticising the way in which integrated companies' base their transfer prices on international prices and that neither the absolute levels of United Kingdom petrol prices nor the way they react to international price changes have been unreasonable over the period we studied.

8.211. We have found no evidence of collusion among the principal wholesalers to fix pump prices; nor was a collusion theory required to explain the way in which prices moved.

8.212. We have found no monopoly profits either in wholesaling petrol or in the downstream business as a whole.

8.213. Exchanges of petrol between wholesalers are a result of the monopoly situation but they do not have adverse effects; they probably increase competition and reduce the cost to the consumer.

8.214. We found that solus ties in this industry do not operate against the public interest and see no grounds for changing the present five-year limit on their length.

8.215. We found the present level of wholesaler ownership of retail sites, nationally and in particular localities, does not operate against the public interest.

8.216. We see no competition grounds for regulating the way in which companies decide the operation of the sites they own.

8.217. We conclude that the ownership of sites and current pricing arrangements give wholesalers varying degrees of control or influence over pump prices at the sites they supply. In current circumstances, however, we found the effects of SPS on the market are on balance competitive and that regional price differences result from variations in the level of local competition.

8.218. The higher level of prices in the Highlands and Islands than in the United Kingdom as a whole is attributable to higher margins at both the retail and wholesale level, resulting from less competition between sites, lower sales volumes and higher costs. We found no evidence that wholesalers were making excessive profits from sales there.

8.219. We do not see grounds for concern in present levels of expenditure on advertising and promotions.

8.220. We found no evidence that the decisions of individual wholesalers to adopt higher price and quality strategies in the market harmed the consumer, given the diversity of offerings available to most consumers.

8.221. We do not think that attempts by individual wholesalers to impose a uniform marketing strategy on the sites they own is against the consumer's interest, given the range of competition in the market.

8.222. We noted a number of features of the market, including legislative and administrative provisions, which limit the availability of new petrol sites or in other ways are potential constraints on entry and expansion. We concluded that in present circumstances none of these acts as a significant barrier to entry to either the wholesale or the retail market.

8.223. We conclude, therefore, that the present state of the industry is competitive and that none of the facts found operates against the public interest.

8.224. As to the future, we decided that the likelihood of adverse developments occurring was not sufficient for us to conclude that any of the facts found may be expected to operate against the public interest. Members' assessment of this likelihood varied but all agreed that the importance of the industry and the potentially serious consequences of a decline in competition were such that continued monitoring of the industry by the OFT was necessary.

8.225. We suggest indicators for monitoring prices, profitability and the structure of the industry, to assist the OFT in reviewing developments. Should the competitive situation at some stage in the future give grounds for concern we would envisage a further reference to the MMC.

M S LIPWORTH (*Chairman*)

J G ACKERS

C C BAILLIEU

M E BEESLEY

P H DEAN

G WHITTINGTON

S N BURBRIDGE (*Secretary*)

20 December 1989