Restrictive Trade Practices Commission

Restraints on Competition in the Canadian Petroleum Industry

Imperial Oil's "Rack" Pricing Policy

Argument:
Director of Investigation & Research
Combines Investigation Act

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1. Introduction

This inquiry has shown that the presence of a strong independent petroleum marketing sector is essential if meaningful competition is to occur in this industry. The success of the independents has depended upon both their superior efficiency and their ability to exert buying power at the wholesale level. In June, 1985 Imperial Oil introduced what the company calls a "rack pricing policy". This new pricing strategy applies to motor fuels, stove oil, and furnace fuel. Under its new pricing policy Imperial is openly publishing its prices to large unbranded resellers and large commercial and industrial accounts. Significantly, Imperial has communicated to the other refiners in the industry that it will not offer any discounts to unbranded resellers from the rack price, a price which serves as a floor for other classes of trade. Imperial is leading the industry in an attempt to deprive the independent resellers and large industrial and commercial customers of the buying power that one would expect them to have in a free market.

2. Overview of Imperial Oil's Rack Pricing Scheme

Imperial Oil is posting or publishing prices for each of five different trade classes as follows:

(1) Rack Prices to Large Unbranded Resellers: Prices to unbranded reseller customers purchasing a minimum 20 million litres of motor fuel or 10 million litres of heating oil on an annual basis. There are no discounts permitted by Imperial from published rack prices for these domestic reseller accounts.

(2) Direct Delivered Prices (DDP): Prices to large commercial and industrial end users. Volume discounts off DDP are offered by Imperial to this class of trade. However, under no circumstances will Imperial permit volume discounts off DDP to result in transactions taking place at less than the rack price set out in (1) above.

(3) Agency Delivered Prices (ADP): Prices to farm accounts and small commercial end users served by Imperial's agent-operated secondary distribution facilities. Volume discounts off ADP are offered to this class of trade. However, under no circumstances will Imperial permit volume disounts off ADP to result in transactions taking place at less than the DDP set out in (2) above.

(4) Residential Furnace Fuel Prices (RFFP): The price to residential fuel oil customers. This is a fixed price,

subject to no discounts, and will always be higher than the ADP furnace fuel price set out in (3) above.

(5) Esso Dealer Price (EDP): The delivered wholesale price to branded Esso dealers, which will apply in approximately 100 geographic zones across Canada. This price does not necessarily bear any relationship to any of Imperial's other prices. Imperial's witness Mr. Stevens (Automotive Manager, Retail Division) admitted that the EDP *could* be set by Imperial at levels below the rack price to independent resellers. No discounts will be allowed off this price. Dealers, who will set their own retail prices, no longer will be offered price support in the form of consignment or temporary allowances. Finally, it should be noted that Imperial's company-owned-and-operated stations will not be subject to this price.

(Volume 192, pp. 40928-31; Volume 193, pp. 41064-5, p. 41120; Volume 194A, pp. 99-100)

3. Reasons Advanced for the Introduction of the Rack Pricing Scheme

Imperial Oil's witnesses offered a number of reasons for the company adopting its new rack pricing strategy. First, they claimed deregulation of crude oil prices on June 1, 1985 had some administrative implications for a number of Imperial's product supply contracts which were tied to the regulated price of domestic crude oil. Second, deregulation permitted free international trade in refined petroleum products, and Imperial viewed it as essential to have a posted pricing system that would relay price information to potential export customers and to domestic customers who have the option of importing refined products. Third, after thirty years the company finally decided that its dealer tankwagon pricing system, and the support schemes it offered to its branded retail network, were "burdensome" and "costly to maintain". (Volume 192, pp. 40921-6)

In addition to the above-stated reasons, Mr. Purdie, Vice-President and General Manager of the Marketing Department of Esso Petroleum Canada, explained that the company wanted to get away from what he termed the "irrationality in pricing that has seemed to become the norm in recent years in many markets" in order to improve its level of profitability. Mr. Purdie's full explanation of Imperial's desire to squelch price competition is repeated below in its entirety:

> "The final factor that has prompted Esso to make changes to its pricing mechanism is the irrationality in pricing that has seemed to become the norm in recent years in many markets. It is Esso's belief that, over time, prices should be

responsive to both changes in the costs of the seller and the purchasing preferences of the buyer. This would suggest that customer offerings that include more value would command higher prices.

Simply put, one would expect that a customer with short credit terms purchasing millions of litres of product at the loading rack would pay less than a motorist buying ten litres of gasoline on a credit card at a retail outlet many miles from a primary supply point.

Conditions such as realization on commercial business being less than rack sale prices, pump prices being less than tankwagon prices, domestic prices being lower than export values, and many other unusual price relationships have become common. Furthermore, in many cases, discounts bear no relationship to cost deficiencies [sic] and renegotiation of discounts has been to one end only, to make them larger.

It is Esso Petroleum's belief that the actual pricing mechanisms being used may have partially contributed to the situation. Pricing with many classes of trade becomes a one-on-one negotiation, and astute customers playing suppliers off against each other in [sic] attempt to negotiate prices down." (Volume 192, pp. 40925-6, emphasis added)

After outlining these specific reasons for adopting the new rack pricing scheme, Mr. Purdie explained Imperial's decision in the context of the entire industry's situation. He stated that "the profitability of the Canadian downstream petroleum industry has been clearly unacceptable for a number of years." Mr. Purdie lamented the fact that "depressed" prices had been borne by the refiners and that Imperial had not earned what it regarded as "an acceptable return on its downstream assets." (Volume

192, p. 40927) He further described Imperial's perspective of the industry's objective as follows:

> "Clearly, improved profitability is essential for the long-term survival of the Canadian refining industry, especially in Ontario and Quebec. While cost saving programs and productivity increases will contribute to this outcome, product price improvements are essential to return the industry to good financial health." (Volume 192, pp. 40927-8)

In cross-examination Mr. Purdie added:

> "Q. But, again, the real reason, the primary reason, I suggest, you are introducing is that you hope it will increase prices and restore profitability in the downstream sector; that is all there is to it, is it not?
>
> A. (Purdie) There are a lot of ways to improve one's profitability. Improved prices that give you improved margins are obviously one of those ways." (Volume 193, p. 41063; also see p. 41101)

4. <u>The Director's Analysis of Imperial's Strategy</u>

There is a mind-set in this industry, as revealed in Mr. Purdie's comments and in public statements typically made by the refiners when they raise prices, that existing price levels are somehow "unacceptable", "abnormal", "depressed", "unfair", or "artificially low", and that they are entitled to price increases to cover their costs, whatever they may be, in order to give the industry a "reasonable" or "acceptable" return on investment, as defined solely by themselves.

This arcane notion, which may be appropriate in a regulated industry setting but has no place in a competitive market, was debunked 10 years ago in Dynamic Change and Accountability In A Canadian Market Economy.[1] This landmark report, which was prepared to guide the government in reform of competition legislation, concluded that this approach "is inimical to the operation of a market system and, in a broader sense, is inconsistent with the operation of a dynamic, flexible economy."[2] In reaching this conclusion the authors, one of whom was W.O. Twaits, former President and Chairman of the Board of Imperial Oil, relied upon the views of a number of eminent authorities.

One of these authorities, Howard Clark Greer, may well have had the Canadian refining industry in mind when he made the following statement with respect to the rationale for the "fairness" approach:

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1. Skeoch, Lawrence A. and McDonald, Bruce C., Dynamic Change and Accountability in a Canadian Market Economy, 1976, pp. 260-76.

2. Ibid., p. 275.

> 'Among the most popular of the notions about fairness in pricing is the idea that a seller is "entitled" to a price which will cover his cost, plus a "reasonable" profit. Few propositions gain readier acceptance, particularly among persons supposedly sophisticated in business matters. It seems reasonable that a fair price should reflect the cost of production, that no one should be required to do business at a loss, that everyone should receive suitable compensation for his efforts.'[1]

Having set out the argument, Mr. Greer concluded:

> 'In a free economy no seller is "entitled" to a price which will cover his costs. He is entitled only to the price the market affords. He must learn to live on the price or quit. He cannot burden the buyer with excess costs: he must absorb them himself... .'[2]

Imperial Oil's rack pricing scheme has the basic objective of increasing prices and profits to levels that are "acceptable" to the refiners. Imperial Oil introduced evidence concerning the recent profitability in the downstream sector of the Canadian petroleum industry. (RTPC Exhibit S-87A) The Director totally rejects the notion that these levels of profitability, which are below what Imperial believes the industry is entitled to, somehow justify the adoption of an anti-competitive strategy such as Imperial Oil's rack pricing scheme.

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1. Quoted in Ibid., p. 270.
2. Quoted in Ibid., p. 268.

The performance of Mr. Purdie would suggest that he thought he was appearing before a Public Utilities Commission considering an application for a rate increase. He explained that current prices do not permit his company to earn a decent profit, and argued that high costs entitled his company to a price increase, which it will seek to achieve through the medium of its new rack pricing strategy.

One would hope that, by the time this Commission has finished dealing with this matter, Mr. Purdie and his company will understand that they are supposed to be operating in a competitive market, with all the uncertainty about prices and profits that this entails.

A careful examination of the reasons offered by Imperial Oil for the introduction of the rack pricing system reveals that this is nothing more than a blatant strategy to eliminate price competition. The "irrationality of pricing" referred to by Mr. Purdie was simply competition at work in the market and the "unacceptable" profitability that resulted should be seen as his company's reward for its efforts. This competition was the result of large resellers being able to exert some buying power in their negotiations for the purchase of refined products, and their willingness and ability to subsequently reflect their competitively-gained advantages in lower gasoline prices at the pump.

The new rack pricing strategy of Imperial is designed to destroy the buying power of the independent reseller segment of the market, and to remove the strong competitive influence that the independent resellers have been able to exert on retail price levels generally at the pump.

Imperial's anti-competitive intent is clear from an examination of the new pricing strategy itself.

The new rack price to resellers applies to no more than a handful of Imperial's existing customers.[1] This fact alone reveals the lack of necessity for Imperial having to post the price publicly and have it published in Oil Buyers Guide and other industry publications. The Commission will no doubt recall that, throughout the hearings process, Imperial and the other refiners insisted that information about their current selling prices to their major customers was of the utmost sensitivity, so much so that it had to be kept confidential even in these proceedings. These prices were treated by the refiners as being among the most closely guarded secrets in the industry. The Director has always respected the companies' wishes to keep their transaction prices confidential as between one another. That is what one would expect firms to do in a properly functioning free market.

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1. For the exact number of independent reseller accounts see Volume 194A, p. 22.

Now, Imperial would have the Commission believe that somehow there is a pressing need to make these prices public. There is certainly nothing about the deregulation of crude oil prices that would necessitate public disclosure of its price to its largest reseller customers. And one would think that it is not a difficult or onerus chore to deal with only a handful of customers in a private fashion, as has always been the case to date.

The only conclusion that the Director can reach to explain this radical departure from traditional industry behaviour is that the posting and publishing of Imperial's rack reseller price must be for the benefit not of its own <u>customers</u>, but <u>of its competitors</u>, who historically could not know these prices with any degree of certitude in any other way short of being involved in explicit communications with Imperial.

The only conclusion that the Director can reach about Imperial's announcement that there are no discounts permitted from these published rack prices is that Imperial wants to reassure its competitors that the published prices are really its transaction prices. This amounts to the achievement of complete transparency with respect to Imperial's actual transaction prices, and is tantamount to an undertaking to its competitors that there are no hidden or secret deals that the competitors need take into account in establishing their prices to resellers in the market.

In view of Mr. Purdie's explanation of Imperial's need and desire for higher prices and higher profits, which objective is being achieved through the medium of the new rack pricing strategy, there is little room for doubt about what Imperial is trying to convey to its competitors.

This rack pricing scheme is nothing less than an open invitation to its competitors to jack up their prices, free from the fear that Imperial, a traditional price leader with enormous market power, will undermine the collective effort.

Contrast this with Imperial's new rack pricing scheme for the export market (in practical terms, the U.S. market). In the export market, where Imperial is trying to reach and attract the attention of <u>thousands</u> of potential buyers, it is quite reasonable for the company to post or publish the price at which it is prepared to do business. Also, it is instructive to note that Imperial <u>is</u> prepared to discount from its published rack price in the export market in order to secure business. This is just another way of saying that, in the export market, Imperial recognizes that, in order to actually make sales, it has to be willing to meet the price competition offered by others operating in that market. (Volume 192, pp. 40938-9, p. 40962; Volume 194A, p. 19, p. 89, pp. 91-3, p. 97)

Imperial's different (and quite appropriate) behaviour in seeking sales in the export market speaks volumes about the lack of competition in the Canadian market, a situation which Imperial seeks to worsen further through (it hopes) the adoption of its new scheme by its major Canadian competitors. Imperial recognizes that, if it can hold out the hope to its competitors of not competing with them on the basis of price (ie. no discounts off the published price), and have that hope acted upon by its competitors, competition in the Canadian market will have effectively been stifled. When one considers that the rack price to unbranded resellers is the floor price for other trade classes, it is inevitable that petroleum product prices will rise across the board.

And what do we know about the reaction of the other firms in the industry to date?

Shell was the only other refiner to appear before the Commission on the issue of rack pricing. Mr. Murray Hall, Manager-Marketing Systems and Administration, testified that Shell commenced posting rack prices in July 1985 for large unbranded resellers. While Shell's minimum volume requirements differ slightly from Imperial's (Volume 193, p.41203), Shell's system of rack pricing is "really identical" to Imperial Oil's. Like Imperial, Shell publishes a rack price and permits no discounts off this price. (Volume 193, p.41197) Mr. Hall stressed the necessity of publishing a price for the export market as one of the reasons for adopting Imperial's rack pricing policy. [However, Shell's policy is apparently less than a raging success in meeting this objective as Shell is still waiting to make its first export sale at the existing rack prices. (Volume 193, pp. 41248-9)]

In addition to Shell, Gulf is known to have begun publishing similar rack prices in July of 1985, but when it was acquired by Petro-Canada in September, the new owners stopped such publication, pending the development of an overall company policy with respect to rack prices. (Volume 193, p. 41099; Volume 194, pp. 41352-3)

While there is no direct evidence concerning Texaco's position, the President of that company has publicly praised Imperial for introducing the new system:

> "Mr. Dunlap congratulated Imperial Oil Ltd. of Toronto for its new rack-pricing policy, but declined to comment on whether Texaco would follow suit. Under rack pricing, refiners try to limit gasoline price wars by refusing to offer discounts to large wholesale purchasers.
>
> Downstream managers have 'got to get hold of the downstream business instead of scratching around for market share' through price wars, he said. 'That is riduculous. Everybody will go broke together'.

> He said that despite excess refining capacity and flat demand for petroleum products, there is room for profitable refining and marketing operations and for a steady return on capital employed." (Globe and Mail, Report on Business, October 23, 1985)

There can be little doubt, with Texaco now publicly congratulating Imperial over this new strategy and given the monkey-see-monkey-do mentality that permeates this industry, that Texaco will soon be aping Imperial's move.

5. Conclusion and Remedies

Throughout this inquiry the evidence has demonstrated that the integrated oil companies have employed a variety of anti-competitive policies and practices over the years to prevent or control competition from the independent sector. Imperial's new rack pricing scheme is simply another device with the same objective. To achieve success, Imperial is relying upon the other firms to follow its lead. That it could even begin to predicate its plan on the hope or assumption that others will follow only shows Imperial's attitude towards competition in refined petroleum product markets. In a truly competitive market Imperial would have risked the immediate loss of its largest and most important customers to its competitors.

Refining is by far the most highly concentrated sector of the Canadian petroleum industry. Imperial and Shell, who have already introduced rack pricing, control 38 percent of total refining capacity. These two firms, along with the industry price follower, Petro-Canada, control some 60 percent of capacity. (See Director's Petro-Canada Argument, Appendix III.) Through the widespread use of reciprocal exchange agreements the refiners share, manage and monopolize most refinery production among themselves.

The wholesale market to which the rack pricing policy applies is very thin. Imperial has only a handful of customers in all of Canada to whom its rack reseller price can apply. Most refined petroleum products are either tied-up in reciprocal exchanges or kept within integrated channels. Only a small amount of production is available on the wholesale market for independent resellers but it is the product sold through these independent reseller channels that has historically been the source of the most extensive price competition in the retail marketing sector. If the refiners as a group adopt Imperial's rack pricing scheme, with "open" pricing and no discounts, meaningful price competition in the retail marketing sector will be virtually eliminated.

Were it not for the fact that the Commission held its recent hearings, the Director believes it is likely that more refiners would have followed Imperial's lead by now. If the industry does follow there will be an unwarranted, unearned transfer of hundreds of millions of dollars from consumers of petroleum products to the refiners every year.[1]

In the Director's view, it is imperative that the refiners not be permitted to jointly implement this pricing mechanism. It is unlikely that Imperial's rack pricing policy will succeed in its objective of eliminating price competition in the wholesale market if Petro-Canada, now the largest refiner-marketer in the industry, is prevented from following. Accordingly, the Commission should recommend that the Minister of Energy, Mines and Resources give Petro-Canada a specific direction under section 7(2) of the Petro-Canada Act prohibiting it from adopting Imperial's rack pricing policy or any similar program which openly communicates its transaction prices and discount policy to its competitors.

In addition, the Director urges the Commission to recommend the implementation of the various refining and

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1. For an estimate of the gain accruing to Imperial alone, see RTPC Exhibit M-793 Confidential.

marketing remedies already put before it during earlier phases of the hearings.

Adoption of the Director's remedies with respect to reciprocal exchange agreements would free up the flow of products to the independent resellers and other large wholesale customers. The bulk of refinery production is currently held within the confines of a few integrated firms. In the absence of extensive reciprocal exchange agreements, a much larger and more dynamic wholesale market will be brought into existence, in which the incentive of each refiner will be to optimize its own sales opportunities, rather than preoccupy itself with the economic health and well-being of its competitors or the industry as a whole. And if there remains any doubt about the existence of just such a preoccupation in the industry today, one needs only to re-read Mr. Dunlap's fervent plea to downstream managers to stop "scratching around for market share"; or to recall the Imperial Oil document authored by Mr. Ritchie in 1971 which acknowledged that, even then, because of what he termed the "industry refinery approach" embodied in reciprocal exchange agreements "... it will be very difficult for us to argue convincingly that ours is a truly competitive industry." (RTPC Exhibit R-31, serial 111864)

In the marketing sector, the Director recommended that price control mechanisms such as consignment and temporary allowances should be prohibited. Imperial has, on its own, abandoned the use of these practices with the introduction of the EDP portion of its new rack pricing policy. While the Director applauds Imperial for this action, he recognizes that Imperial's motivation for this move may have differed somewhat from the Director's rationale in making the original recommendation to the Commission.

The Director's intent in recommending that these practices be prohibited was to prevent the integrated refiner-marketers from using these devices to influence prices upwards and to limit the extent of price cutting in the market.

By introducing a new tool which gives them the power to exercise control over the price levels of independent resellers (ie. the new rack reseller scheme) and all of the other price levels for which the rack reseller price is just the "floor", Imperial has simply traded one set of anti-competitive practices for another.

The Director has no doubt that Imperial will want to re-institute consignment and temporary allowances if, for any reason, it is not able to make its new rack pricing scheme stick in the market. For this reason the Commission should continue to address itself seriously to the need for these practices to be prohibited. The Commission should not be swayed in its judgement of the issue by Imperial's temporary abandonment of these schemes.

Finally, the Director recommended that the practice of exclusive dealing with respect to motor fuels be prohibited. Under its new EDP pricing policy, Imperial continues to impose exclusive dealing contracts on its dealers. Imperial does not allow its dealers to purchase motor fuels from competing sources. In addition, the Esso dealer price is a "bundled" price that includes charges for items such as delivery, the Esso credit card, advertising, and promotion. (Volume 192, pp. 40956-7; Volume 193, pp. 41082-4, pp. 41095-8) A ban on exclusive dealing would lead to the unbundling of the price between the motor fuel, as a homonogeneous commodity, and the price of the various other items that constitute the "brand". This would surely encourage a more "competitive buying price" (the stated goal of Imperial's EDP program, Volume 192, p. 40931) by permitting dealers to bargain for the best deal with all suppliers in the market.

In summary, while it is important that the industry not be permitted to implement rack pricing, this will not cure the fundamental competition problems endemic to the industry. It will merely prevent a worsening of the existing situation. Vertical integration, high concentration, the widespread use of reciprocal exchange agreements and exclusive dealing contracts, and the perception of the refiner-marketers that they are all part of the same entity, with the same interests and objectives, coupled with their adoption of the same policies to achieve these objectives, cries out for sweeping and fundamental remedies of the kind the Director has already proposed.