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Competition in the Canadian Petroleum Industry

Introduction, Conclusions and Recommendations

Restrictive Trade Practices Commission

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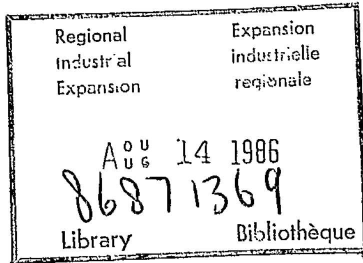
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Introduction, Conclusions and Recommendations

Restrictive Trade Practices Commission

Canada

The complete Report of the Restrictive Trade Practices Commission regarding competition in the Canadian petroleum industry encompasses over 700 pages. This volume consists of the introductory chapters and the conclusions and recommendations from that Report.

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May 16, 1986

Dear Minister,

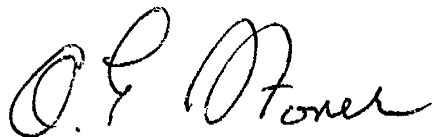
I am transmitting to you the French and English texts of a Report by the Restrictive Trade Practices Commission entitled "Competition in the Canadian Petroleum Industry".

This Report follows from proceedings carried out under section 47 of the Combines Investigation Act relating to the exploration for, and the importation, production, purchase, manufacture, storage, transportation, distribution, barter, sale and supply of crude oil, petroleum, refined petroleum products and related products.

The Report is accompanied by an abridged version containing its introductory material and its conclusions and recommendations. Most of the appendices are contained in a third volume.

The Commissioners have sought to fulfill their mandate with respect to the inquiry into the petroleum industry and as well, address the relevance of their appraisal and recommendations to Bill C-91, the new competition legislation now before Parliament.

Yours sincerely,



O.G. Stoner
Chairman

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Preface

If new legislation proceeds as now drafted in Bill C-91, this will be the last report of a section 47 inquiry of the Restrictive Trade Practices Commission. While the Commission has been asked in previous years to look at some very large industries, none can match the petroleum industry for complexity, volatility, size and influence. Apart from Petro-Canada, the Canadian "majors" are affiliates of enterprises that operate on a worldwide scale and are essentially supra-national entities. The growth and success of these very large undertakings, matched by parallel opportunities for independent or small business, make an inestimable contribution to the economic well-being of Canada. However, as with almost everything else, there must be some checks and balances — in this case national policies that can balance private good and public need. This report is about one of the checks and balances — an effective competition policy.

The Director's inquiry in this matter began in 1973, and the proceedings before the Commission in 1981, with attendant demands on all those involved. The last five years have been exhaustive and exhausting for the Commissioners, and the entire inquiry must have been even more so for the participants. As a measure of attrition of the length of this process, only two of the four original Commissioners remain to complete and sign the Report. We are certain that retirement, mergers and even acts of God may have reaped similar losses with the petroleum companies and other participants.

Mr. R.S. MacLellan who sat throughout most of the hearings, while no longer a Member since May 1984, has been of great help and moral support. He has considered our findings and agrees with the thrust of the Report.

We were ably assisted in our work by a small but effective staff including an Executive Director, and by counsel. We are indebted to them for their assistance and perseverance — especially the tiny group who remained to the end. Without them, our task would have been impossible. However, the contents of the Report are the responsibility of the Commissioners. On all Conclusions and Recommendations excepting those dealing with the alleged overcharge prior to 1973, there was full agreement between us.

The Commissioners wish to express their appreciation to each of the many witnesses and organizations listed in Appendix B who, at considerable effort, inconvenience and no doubt expense to them, patiently educated the Commission about the many aspects of this complicated industry and about various specific events that have occurred. The evidence came from large and small businesses, from government bodies and from consumer organizations. In each case it has been studied in detail by the Commissioners and has almost invariably been useful, even though it has not been possible to recite the detail of all the evidence in the Report.

The last months of the Inquiry were marked by major developments in the Canadian industry and in government policies that gave rise to widespread political and public reaction. The Commissioners have sought to deal with these matters, including a specific request from the Minister of Consumer and Corporate Affairs in January 1986, within the context of its mandate.

The Commissioners, in addition to setting out their appraisal and recommendations to the Minister with respect to industry practices have also related these, where appropriate, to Bill C-91 — the new competition legislation now before Parliament — in the hope that this will be helpful to both the Minister and Parliament in addressing issues of growing importance to all Canadians.

In addition to the full Report, an abridged volume containing the Introductory Chapters and the Conclusions and Recommendations, and a third volume containing appendices, are being submitted concurrently.

The Commissioners are appreciative of the patience of those who await this Report and trust that its modest contribution will be of help to governments, to the public and perhaps, even to the industry itself.

I

The Context, Mandate and Focus

1. Why An Inquiry?

The majority of Canadians are most acutely aware of the petroleum industry when they buy gasoline for their cars. Next to the weather, and perhaps taxes, few topics generate greater public comment than the prices of gasoline. It appears to many consumers that gasoline prices are established in markets that are insufficiently competitive. How else to explain why the pump prices at all service stations in a particular area are virtually the same and that those prices rise, and occasionally fall, in unison?

Despite the high visibility of the petroleum industry, it continues to have a certain air of mystery about it; it continues to be regarded by many with suspicion or skepticism. People wonder about the relationship between prices at the gas pump and crude oil prices. Do Canadian consumers pay more for their gasoline than their counterparts across the border in the United States? Why can pump prices be as much as 10-15 cents/litre(¢/*l*) higher in some provinces and municipalities than in others only a short distance away?

Whether or not they always realize it, those who ask the above questions are asking a more fundamental question namely, how much competition is there in the Canadian petroleum industry?

In Canada, the principal federal legislative instrument for protecting the public interest from anticompetitive conduct is the Combines Investigation Act — an Act "to provide for the investigation of combines, monopolies, trusts and mergers."

The Combines Investigation Act establishes two separate agencies for its administration: the Director of Investigation and Research, and the Restrictive Trade Practices Commission. As his title suggests, the Director is an investigator or "policeman". He conducts investigations in private and, on the basis of his assessment of the evidence and material he gathers, may recommend or initiate enforcement proceedings or other proceedings under the Act. People often confuse the role of the Director with that of the

Commission. During this inquiry the media has frequently described materials published by the Director as "reports" by the Commission. The Commission is entirely separate from the Director. The Commission acts as an independent review body or tribunal, not unlike a court in certain respects. It has certain responsibilities to report its assessments and recommendations to the Minister and is empowered in some types of proceedings (which this one was not) to make binding orders regarding certain types of distribution practices. In the performance of its responsibilities the Commission may, and did in this case, receive evidence in public from all interested persons.

The Act establishes the separate mandates and authorities of the Director and of the Commission. The sections of the Act under which this inquiry has been conducted provide in relevant part as follows:

> 47(1)(a). *The Director* upon his own initiative may ... carry out an inquiry concerning the *existence and effect of conditions or practices* relating to any product that may be the subject of trade or commerce and which conditions or practices are *related to monopolistic situations or restraint of trade...*
>
> 47(2). It is the duty of *the Commission* to consider any evidence or material brought before it under subsection (1) together with such further evidence or material as the Commission considers advisable and to report thereon in writing to the Minister, and for the purposes of this Act any such report shall be deemed to be a report under section 19.
>
> 19(2). The report ... shall review the evidence and material, appraise the effect on the *public interest* of arrangements and practices disclosed in the evidence and contain recommendations as to the application of remedies provided in this Act or other remedies.
>
> [Emphasis added]

The Act also makes provision for any six adult residents of Canada who believe a person (or company) has contravened or failed to comply with the Act or has done or is doing something remediable under the Act, to require the Director to conduct an investigation into the matter complained of. It was just such a "six citizen complaint" that led to the inquiry which is the subject of this Report.

In February, 1973, persons acting on behalf of the Consumers' Association of Canada requested that the Director investigate whether the gasoline and fuel oil price increases made a month earlier by a number of Canadian oil companies were the result of a conspiracy and to determine more generally, whether or not vertical integration had contributed to higher prices for gasoline and fuel oil.

The Director responded to the above application by launching a private and confidential investigation. When he began he could not have known what further proceedings, if any, might appear to him to be appropriate when his investigation was completed. His options, under the law, were to 1) discontinue the investigation, 2) submit evidence to the Commission, or directly to the Attorney General, for consideration as to whether criminal prosecution or other action should be instituted, 3) apply to the Commission for orders prohibiting certain types of conduct by specified persons or companies, or 4) submit evidence and material to the Commission for consideration under the provisions of section 47 of the Combines Investigation Act. He took the latter course.

The Director subsequently reported to the Commission that in the course of conducting his investigation he had exercised his statutory powers and had seized a large number of documents from the premises of several petroleum companies in 1973, 1974 and 1978. In 1975 he had examined several witnesses under oath, and in 1976 had obtained written returns of information from over 90 petroleum and pipeline companies. In addition, interviews had been conducted with gasoline and fuel oil dealers. Other information had been gathered from a range of public sources. Following the above investigative actions, the Director prepared a seven-volume "Statement of Evidence and Material" or "Green Book".

On February 27, 1981 the Director submitted his Green Book to this Commission pursuant to section 47 of the Act. That Green Book, entitled "The State of Competition in the Canadian Petroleum Industry" contained almost 1,400 pages of printed text. It was supported by approximately 100 volumes of seized documents and other materials. It reported on the Director's investigation relating to "the exploration for, and the importation, production, purchase, manufacture, storage, transportation, distribution, barter, supply and sale of crude oil, petroleum, refined petroleum products and related products."

The Commission is required by statute to consider the evidence and material received from the Director, together with such further evidence or material as it considers advisable, and to report its appraisal and recommendations to the Minister of Consumer and Corporate Affairs. It is important to appreciate the nature of a section 47 inquiry. Although much of the evidence and argument often relates to company conduct or government interventions and their respective consequences, a section 47 inquiry is essentially an examination of the workings of the market or markets involved. It is not a trial, not an adjudication of rights. No binding orders are being made adverse to someone's interests. The Commission's report is advisory. Decisions as to what action to take, if any, are the responsibility of the

Minister, the Government and law enforcement officials, and not the Commission.

The Green Book as submitted to the Commission in 1981 (and various press releases issued to the media by the Director shortly thereafter), represented nothing more than the Director's statement of what he believed, on the basis of such evidence as was available to him at the time, that he could "prove" in subsequent proceedings. At the time the Green Book was submitted to the Commission it was still a confidential document. No one had yet had a chance to challenge his understanding of the facts, or his analysis. His Green Book might be likened to a statement of a prosecutor's or a plaintiff's case.

As is indicated by the long formal title of the Director's material, the Green Book explored a broad spectrum of industry activities including the offshore and domestic supply of crude oil to Canadian refiners, shipping and pipeline transport of crude oil to the refineries, refining in Canada, and the distribution of refined product, particularly gasoline, to end users in Canada. In the broadest terms the Director concluded, on the basis of his private study of the material available to him, that there were conditions and practices in each sector of the industry that were undesirably monopolistic and restrictive, and that the fact that the same major firms were "dominant" in each of the sectors facilitated and magnified the effect of the undesirable practices.

Although the Green Book and the media reports following its release, focused on the conduct of a number of Canada's petroleum companies, the Green Book also reported on the Director's review of certain government policies which he believed had lessened competition in the industry.

Although the Director's Green Book dealt almost exclusively with facts and circumstances in the period 1958 to 1973, the Director reported in the Green Book, in 1981, that "the Director's experience with the petroleum industry right up to the present has confirmed that the issues that were important when the petroleum inquiry commenced in 1973 remain important today". He proposed 12 recommendations to the Commission that in his view were required to deal with "the monopolistic conditions and practices in restraint of trade that he found".

As has been stated, the Director's inquiry was conducted in confidence and the Green Book was confidential when it was submitted to the Commission. However, the contents of the Green Book and in particular petroleum pricing, involve subjects of intense and quite proper, public interest and concern. A wide range of persons, not the least of whom were the large

petroleum companies who were subjected to criticism in the Green Book, had an interest in the Director's study and in his recommendations. In view of the widespread interest in the operations of the petroleum industry and the broad issues raised in the Green Book concerning both energy policy and competition policy, the Chairman of the Commission ordered, pursuant to section 27 of the Act, that the Commission would hear evidence and receive comment and submissions in public. In the view of the Chairman and the Commission it was imperative that the petroleum companies and all other interested persons, including federal and provincial government agencies, have the fullest opportunity to present evidence and to comment regarding the Director's work and, perhaps more importantly so far as current and future public policy is concerned, regarding the post-1973 developments in both the upstream and downstream sectors which had not been addressed at any length in the Green Book.

The true nature or status of the Green Book was lost in the publicity which followed its release. Its publication was immediately followed by media reports that Canadian consumers had been "ripped off" (a term not used in the Director's statement of evidence) over a long period of time by Canada's major petroleum companies. There was an immediate outcry in Parliament and elsewhere as a result of the Green Book's allegation that Canadian consumers had been "overcharged" some 12 billion dollars by the oil industry and that the "overcharge" was continuing. The oil companies implicated in the Green Book immediately responded through their own media campaigns to deny that they had been involved in any illegal or unethical conduct. Various interest groups interpreted the Green Book and the media reports from their own, self-serving, perspectives.

The extreme and adversarial nature of some of the Director's criticisms and conclusions, and the way in which the Director had publicized them, resulted in the proceedings before the Commission being of an adversarial nature throughout.

The Commission's interest in a section 47 inquiry would normally be confined to matters of current and future concern, extending to historical information and material only so far as that was helpful to an understanding of the present. In this case, however, very serious criticisms of some petroleum companies, and to a lesser extent of governmental policies, were made by the Director relating to incidents, policies and practices that existed in the 1960s and 1970s, and sometimes in a form that inflamed public opinion when the Green Book was published. Considerations of fairness alone required that the fullest opportunity be given to those criticized to respond in detail, and for others who wished to support the Director's position to do so. Further, the Commission felt that it owed the public its judgement as to what

the evidence demonstrated about the criticisms after all the responses had been heard. This added considerably to what the Commission's task would normally have been because the relevant documentary evidence was extensive, but the reputations of companies who continue to solicit the business of consumers were involved. Thus the Green Book took on an importance greater than Statements of Evidence submitted to the Commission in earlier section 47 inquiries.

Over the years there have been various inquiries of one form or another into aspects of the petroleum industry in Canada. Some have been carried out by provincial bodies, some by federal bodies and, indeed, others have been carried out into very specific matters by this Commission. These reports were all reviewed with benefit by the Commission. Their work was not duplicated. None of those earlier studies, however, had the comprehensive scope of this inquiry or the general interest, given the inescapable fact that gasoline was roughly 11¢/*l* in 1971 and 50¢/*l* in 1985. Today, the interest of Parliamentarians, the public and the media is on falling world crude oil prices and on the relationship between those prices and retail product prices.

2. Conduct and Procedures of the Hearings

In view of the broad and complex subject matter of its proceedings, and in order to facilitate meaningful participation, the Commission took certain steps to ensure a full and fair opportunity for all who wished to respond to or to supplement the Green Book or other evidence, to do so. The Commission also realized that defining issues and making the hearings efficient was important. Following a general organizational pre-hearing conference held in July, 1981, the Commission adopted Rules of Practice and Procedure for its proceedings, one of the provisions of which was that the substance of all testimony to be given would be communicated in writing, in advance, to all persons who wished to receive advance notice for purposes of preparing cross-examination or other evidence. Second, after hearing opening statements, the Commission held hearings in various centres across Canada from December, 1981 to February, 1982 in order to facilitate the participation of local groups who wished to be heard and also to learn the range and degree of urgency of concerns, if any, that existed in any part of the country regarding the functioning of any aspect of the Canadian petroleum industry. These hearings, like the Commission's hearings generally, were publicized by advance notice in newspapers and other media.

The complaints heard during the regional hearings at the outset of the inquiry gave the Commissioners some initial insights into the grass roots' perception of their role. The early hearings, at which gasoline and heating oil

dealers and their associations gave evidence, set a pattern for the highly adversarial nature of the inquiry and gave notice of emotional undertones that were to run throughout its duration. Some of the issues raised during the regional hearings were outside the Commission's mandate; nevertheless, they served to expose the Commission to a lot of basic information about the way in which the industry operates. Consumers also had a chance to make their views known. Quite understandably, their resources and information were limited in relation to those of other participants.

Finally, it was clear that the pulse of the nation, if difficult to detect, was only of diagnostic value in proving that the patient was simply a bionic reproduction of several widely differing interest groups. In all of this, there was nothing new, and the Commission was obliged to look elsewhere to fashion its approach to the rest of the inquiry and in particular, to the preparation of its Report.

When it moved to Ottawa, the Commission, in interests of efficiency and economy, organized its hearings, so far as possible, into the subject-matter phases of the international, refining and marketing sectors in that order. Within each such phase of the hearings the Commission heard evidence first from the Director, then from other persons who were not refiners, and finally from the refining companies who were by then more fully familiar with the various criticisms being made of them and had a fairer opportunity to answer. Where witnesses whom the Commission felt would be helpful to it had not testified in the course of this process, the Commission itself arranged for them to testify.

The fact that inquiries are public tends to increase the scope of the evidence heard. While the Director is responsible for preparing the initial "material" to be heard by the Commission, interest groups and members of the public who are not the Director's witnesses often wish to be heard as well. An inquiry which is initially complex and broad is likely to be made more so by the participation of the public, including members of the industry who would like to bring a complaint before the Commission or to express a point of view. As in the case of other evidence, it was often difficult to decide beforehand whether or not these interventions would be useful in the determination of the essential issues.

The Commission held over 200 days of hearings and heard evidence from over 200 witnesses. The transcript is over 50,000 pages long. The record includes approximately 1,800 exhibits, many of which were lengthy and complex and one of which consisted of approximately one hundred volumes of documents that had been referred to by the Director in the Green Book.

Although the Commission used its power to subpoena witnesses as required in the course of the proceedings, it generally received full cooperation throughout from the petroleum companies, from federal and provincial government agencies and, indeed, from most of those who appeared and from whom the Commission sought assistance. Each of the major petroleum companies presented comprehensive and detailed evidence through senior and experienced officials and personnel, all of whom submitted to extensive questioning by the Director, by the Commission and by others. The petroleum companies and many witnesses have also in large measure answered further Commission queries and requests for information in writing without delay.

Proceedings under section 47 have always been public, although evidence deemed to be confidential has been taken in private from time to time, upon application. The extent to which evidence received in private has been revealed has been guided by balancing the public's interest in knowing the facts against possible harm to the parties and to competition. Reports have always been made public in their entirety, which is the case with this Report. Care has been taken to avoid a violation of commercially sensitive information unless it was required for the essential needs of the Report.

Most of the hearings were open to the public. On a few occasions the Commission agreed with requests of witnesses that they should not be required to share with their competitors, or with others, certain confidential business strategies or policies. When the Commission heard evidence on those particular topics *in camera*, where an *in camera* session appeared to be the best way to meet the procedural objectives of fairness and efficiency, this was done with the general understanding that the Commissioners would subsequently review the evidence given in those sessions and, after providing an opportunity for further submissions, would place on the public record those portions of the evidence where aspects of the public interest or specific competition issues were raised so that all participants would be informed and could respond. Thus a general descriptive statement of the portion of the evidence that remained on the confidential record was made public in a form satisfactory to the Commission, to the Director, and to the person or persons whose private information it was.

Following the hearing of all the evidence on substantive matters, the Commission received written arguments regarding those matters from the Director, from others who had criticisms of the refining petroleum companies, and from the refining petroleum companies, in turn. The written submissions were lengthy and detailed and greatly assisted the Commission.

3. Mandate and Focus

The Commission's mandate is set out in the words of the Combines Investigation Act (and more particularly in this proceeding, under section 47 of the Act.)

Commission proceedings under section 47, concern "the existence and effect of conditions or practices relating to any product that may be the subject of trade or commerce and which conditions or practices are related to monopolistic situations or restraint of trade."

Even a casual examination of the language of sections 47 and 19(2) of the Act reveals that the Commission's mandate is set out in very broad and general terms. It is left to the Commission to interpret and define more precisely the terminology of the Act. In the Commission's view there are certain essential tasks it must perform. The first is to determine whether or not there is in fact a monopolistic situation or a restraint of trade. The second, is to determine whether or not the monopolistic situation or restraint of trade has an appreciable effect on the marketplace. Finally, it must decide whether there are reasonable applications of or changes in public policy that it could recommend which could eliminate or reduce the constraint or otherwise compensate for its effects.

These elements are colored by the requirement that the Commission "appraise the effect on the public interest" of the practices or arrangements in question. The Commission's view of the public interest must be guided by the context created by the Act. Nevertheless, it cannot ignore or treat in a cavalier fashion other public interest issues or other policy objectives of governments. In short, in seeking to carry out its mandate, the Commission must recognize that policy makers are often faced with conflicting public policy objectives and must balance or trade off these conflicting objectives.

With respect to the first of the three steps referred above, it is often difficult to determine whether a monopolistic condition or a restraint of trade exists. The answer is rarely obvious and there is usually much scope for judgement to be exercised. For example, the practice of consignment selling[1] discussed later in the Report can be viewed as a mechanism by which the oil companies provide financial support to their dealers during periods when pump prices have fallen below normal levels, perhaps during a price war. Alternatively, the same practice might be interpreted as a procedure through which the oil companies gain the right to set retail prices for their own

1. Under consignment selling the refiners retain ownership of the gasoline and the dealers, acting as their agents, receive a per-unit commission.

purposes. It may also be seen as having both effects. The Commission must then decide whether or not it can generalize about the balance of effects of the practice, or whether or not the practice is only harmful under certain market conditions and whether or not these conditions can be easily identified.

The second requirement in a section 47 inquiry is to decide on the degree to which the condition or practice in question affects competition in the marketplace. Isolated events which are not likely to recur, or those with marginal effects, are unlikely to be seen as requiring remedial action. There is a major strand running through the Act, which is the prevention of reductions in competition to a material degree. The presence of qualifiers such as "unduly" and "substantial" suggest that as a matter of public policy actors in the marketplace should be left alone unless there is an appreciable adverse impact on competition. The one possible exception to this general working principle is where the conduct in question, in the Commission's view, has no redeeming features from a public policy viewpoint.

For either or both of the first two requirements to be satisfied, the Commission must conclude that the condition or practice will create, increase or entrench *market power* — the power to limit supply and thus to increase prices. The potential for such control to exist is present when sellers are few and can easily have a meeting of minds on prices, when buyers are many and without bargaining power or good information, when supply cannot readily be increased through imports, when close substitutes do not exist, and when growth of smaller competitors or the entry of new firms is difficult. These are the criteria which are used in appraising or evaluating the market conditions against which the practices investigated in the inquiry have been assessed.

Churchill once suggested that facts are like butterflies — the last person to perceive them in full flight has the edge on their color and shape. While the factors underlying market power are easy to set out, there are often wide differences of opinion regarding their relative importance. They are also often difficult to evaluate in practice and are best viewed in an historical, dynamic context rather than as a snapshot frozen in time. Speaking generally, the weight to be given to the number of large competitors in creating market power has been in a state of flux in the legal/economic literature for a number of years. The same is true regarding what constitutes barriers to new entrants. While the Commission must recognize the changes in legal and economic concepts and the empirical studies associated with the identification of the variables that are important factors in creating, preserving or enhancing market power, at the end of the day it must be pragmatic and draw on the specific facts before it in forming its judgements.

Market power is one side of the proverbial coin. It is widely recognized that certain types of conduct can increase control over supply and price. It is also recognized that the same conduct can lead to the benefits of greater efficiency. This consideration must be taken into account when first evaluating whether the conduct or situation is indeed monopolistic. It recurs when consideration is being given to whether or not remedies should be recommended. The Commission must decide whether the effects on market power or on cost reductions dominate. The supply characteristics in the refining industry — large plants with high fixed costs — raise precisely those questions which involve the dual considerations of market power and efficiency. At what point would the public interest benefit more from having a larger number of competitors in a market than it would from having fewer competitors with larger, more efficient refineries? To what extent does the interest in reducing the risk, and cost, of the enormous capital investment that refineries require, justify long-term supply arrangements which tend to foreclose these markets to existing or potential competitors? In general terms, how responsive is the industry to forces of change, and would restraints on the industry's flexibility to adjust have a sufficient public-interest justification? These questions call for judgements that cannot, unfortunately, be reduced to simple quantitative calculations and comparisons of "costs" and "benefits". They must be made on the basis of information that is rarely free from ambiguity and which sometimes leaves room for reasonable differences of view.

This approach to evaluating particular situations or types of conduct obscures certain characteristics of the present inquiry which it shares with many of its predecessors. The practices cannot be evaluated in isolation. They must be examined against the background of other practices, the environment created by many government policies, and by international market forces. In reaching its conclusions and recommendations, the Commission has given considerable attention to government policies in order to see whether or not they create impediments to the smooth functioning of markets.

Furthermore, the Commission's role is not to protect individual competitors but rather to protect and promote competition. As a result, the Commission's mandate does not call for it to come to the assistance of or to protect a particular individual, group or company having a difficult time as a result of acceptable competitive tactics by competitors in the marketplace. No one should expect therefore that a report such as this will recommend protection or special advantages for particular participants facing legitimate competition.

Competition may mean very different things to different people, and unless care is taken to use the word precisely, it can frustrate communication and obscure analysis. *Price competition*, in the sense in which it is something in the public interest, represents a *process* by which prices are set. The actions by business rivals place an upper limit on the prices a firm can charge for its products. More importantly, such actions by rivals continuously pressure a firm to lower its costs in order that the highest prices the market will permit it to charge enable it to earn a sufficient return on investment to attract investors. This market condition requires that competitors continuously seek to attract business away from each other by price and other means and in turn, this usually requires a reasonable number of competitors. In competitive markets the prices of the various competitors inevitably tend towards the same levels because all available cost-saving techniques will be adopted by all the (surviving) competitors.

This is very different from saying that if prices of the firms in the market are approximately the same they are therefore, for that reason, "competitive" prices, and yet, on many occasions throughout the inquiry witnesses used the word "competition" in this superficial sense. Such a limited concept, characteristic of persons satisfied with "established" market shares, means only that the company prices at a level that prevents others from taking away its business. There is little or no striving for improvement in this concept of "competition"; it characterizes stagnant behavior by someone who merely wishes to preserve an established position, and implies a power and ability to set one's own prices with less regard for pressures from others than would be in the public interest. There are no, or at least insufficient, downward price pressures on costs.

Competition means therefore an effective functioning of markets which promotes and requires rivalry amongst competitors for the business of consumers. An effective functioning of markets also permits smaller competitors to expand if they meet the test, and the entry of new competitors and new ideas. Technological change and innovation are the large levers of competition in industry. They are sources of creative destruction by which monopolies or inefficiencies are destroyed and new entrants and greater efficiency are encouraged.

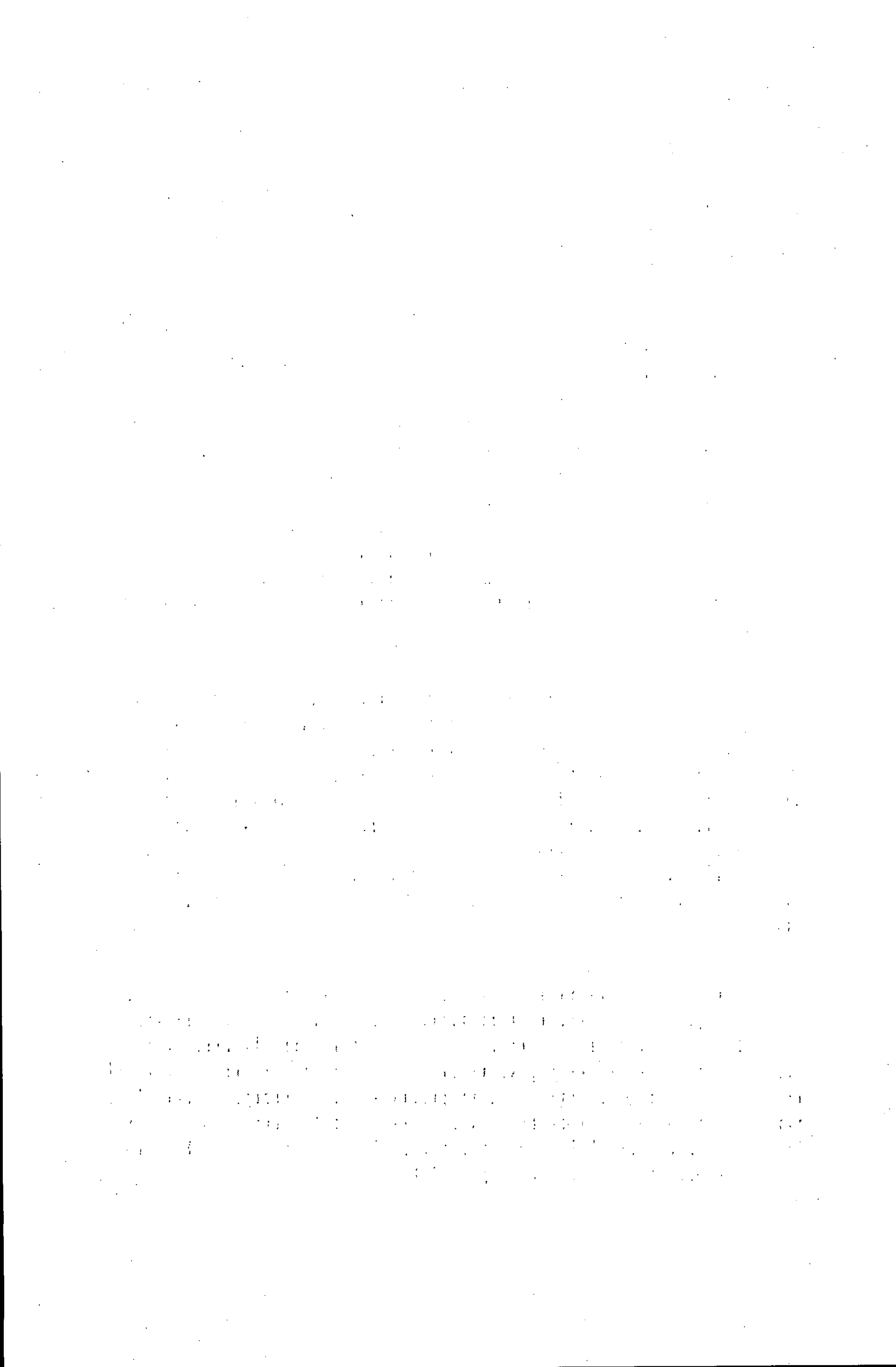
Nor does the proper meaning of "competition" leave room for notions about "fair" price levels. Businesses are not entitled to "fair" prices or to "satisfactory" profits. If they are relatively innovative, or reduce costs sufficiently, there will be a sufficient margin between the highest price the market will permit them to charge and their own costs that they will deservedly earn large and even very attractive profits. They are entitled to those prices and profits until others enter, perform as well or better and

compete those profits to lower levels. Those who cannot make the grade on a continuing basis leave the industry. Consumers do not owe them a sinecure. This is the basic function of prices and profits and the way in which they allocate resources in a market economy. It is, of course, dependent upon the elimination of unjustifiable barriers to entry.

Similarly, consumers are not entitled to "fair" price levels, but only to prices set by a competitive process. The latter clearly are in the best interest of consumers.

Finally, an inquiry and particularly a public inquiry, quite understandably, can give rise to a host of issues and a long list of complaints. Many of these may have little or nothing to do with competition and hence are not relevant to the Commission's mandate. For example, it is not the Commission's role to settle a specific contract dispute between a buyer and a seller or a particular dispute between a landlord and tenant. In Chapter III the Commission indicates, from amongst the breadth of concerns and recommendations presented to it during the inquiry, the relatively few that it considers to lie outside its mandate.

Before moving to other sections of the Report and to its Conclusions and Recommendations, the Commissioners considered it would be helpful to provide the reader with a brief layman's overview of the Canadian petroleum industry and then to outline the concerns and views of participants.



II

An Overview of the Industry

1. Introduction

The purpose of this "Overview" is to introduce the "lay" reader to the petroleum industry in Canada as background to the issues examined in the Commission's Report. The stages of production and distribution in the industry and their geographic location in Canada are described together with the relationship of the Canadian industry to the international industry and the evolution of domestic government policies, many of which have been introduced and amended in response to international pressures. Throughout this description an attempt is made to highlight the main industry trends. More specific industry, market and firm data are dealt with in the body of the Report. This chapter presents the canvas on which these details are painted.

The Canadian petroleum industry encompasses the exploration for crude oil and other hydrocarbons, their production, transportation and refining as well as the marketing of refined petroleum products in Canada such as gasoline, diesel and heating oil. Each of these sectors is somewhat unique in terms of the physical production process, the methods of distribution, the product's end use and the market forces that affect distribution. The principal end uses of petroleum products are as energy for transportation, for generating electricity and driving industrial machinery, for home and industrial heating, and in the manufacture of petrochemicals, lubricating oils and asphalt.

An important characteristic of petroleum products is their relative homogeneity. For example, most consumers are indifferent as to the brands of gasoline used in their cars or heating oil used in their homes. This has allowed refiners to distribute gasoline and heating oil under their own brand names, and at the same time, to supply products from the same tanks both to competing refiners under exchange agreements and to marketers who then distribute them under their own brand names. In short, gas is gas. This little explored aspect is addressed in Chapter XIII.

Parts of the Canadian petroleum industry are highly concentrated with a small number of firms accounting for a large share of the market. Most of the larger firms are vertically integrated with firms operating in more than one sector of the industry from the exploration for crude oil to the distribution of refined petroleum products. The level of concentration does, however, vary by industry sector, being highest in trunk pipelines and refining. A concern of public policy is that this combination of vertical integration and high concentration, which has emerged at least partly for reasons of efficiency in production and distribution, results in market power that can have adverse effects for consumers and society.

Numerous firms participate in the industry as crude oil producers, refiners and distributors. The largest and most widely known firms are the eleven refiners[1], the majority of whom are wholly or significantly foreign-owned, namely:

Company	**Foreign Shareholder**
Chevron Canada Limited	Chevron Corporation
Consumers' Co-operative Refineries Limited	
Husky Oil Operations Ltd	
Imperial Oil Limited	Exxon Corporation
Irving Oil Limited	Chevron Corporation
Petro-Canada	
Shell Canada Limited	The Royal Dutch Shell Group of Companies
Suncor Inc.	Sun Company, Inc.
Texaco Canada Inc.	Texaco Inc.
Turbo Resources Limited	
Ultramar Canada Inc.	Ultramar PLC

All 11 firms are integrated forward into marketing, and many are integrated backwards into crude oil exploration and production as well. Smaller firms also participate in the crude oil production and marketing-distribution sectors of the industry.

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1. Petrosar Limited, owned by the Federal Government, operates a petrochemicals refinery in Sarnia, Ontario. It produces some gasoline and heating oil as byproducts of petrochemical production.

The trunk pipeline systems, carrying Canadian crude oil eastwards and westwards from Alberta, are owned respectively by Interprovincial Pipe Line Limited and Trans Mountain Pipe Line Company Ltd., each of which is partially owned by some major refiners.

2. Stages of Production and Distribution

The various sectors of the industry from crude oil production through refining to marketing and end use are shown in Figure 1. Transportation and storage facilities link the sectors with pipelines, ships, railroad tank cars, trucks and related terminal facilities. Crude oil exploration and production are the "upstream" activities, while the refining and marketing of petroleum products constitute "downstream" operations. The economic structure of each sector varies. There are more producers "upstream" than in refining, due primarily to scale economies in refining which limit the number of efficient size plants needed to supply the Canadian market. Marketing is undertaken through numerous wholesale and retail outlets such as gasoline stations and heating oil distributors, but many of these small business operations are either owned by or tied to refiners through complex franchise agreements and other supply arrangements.

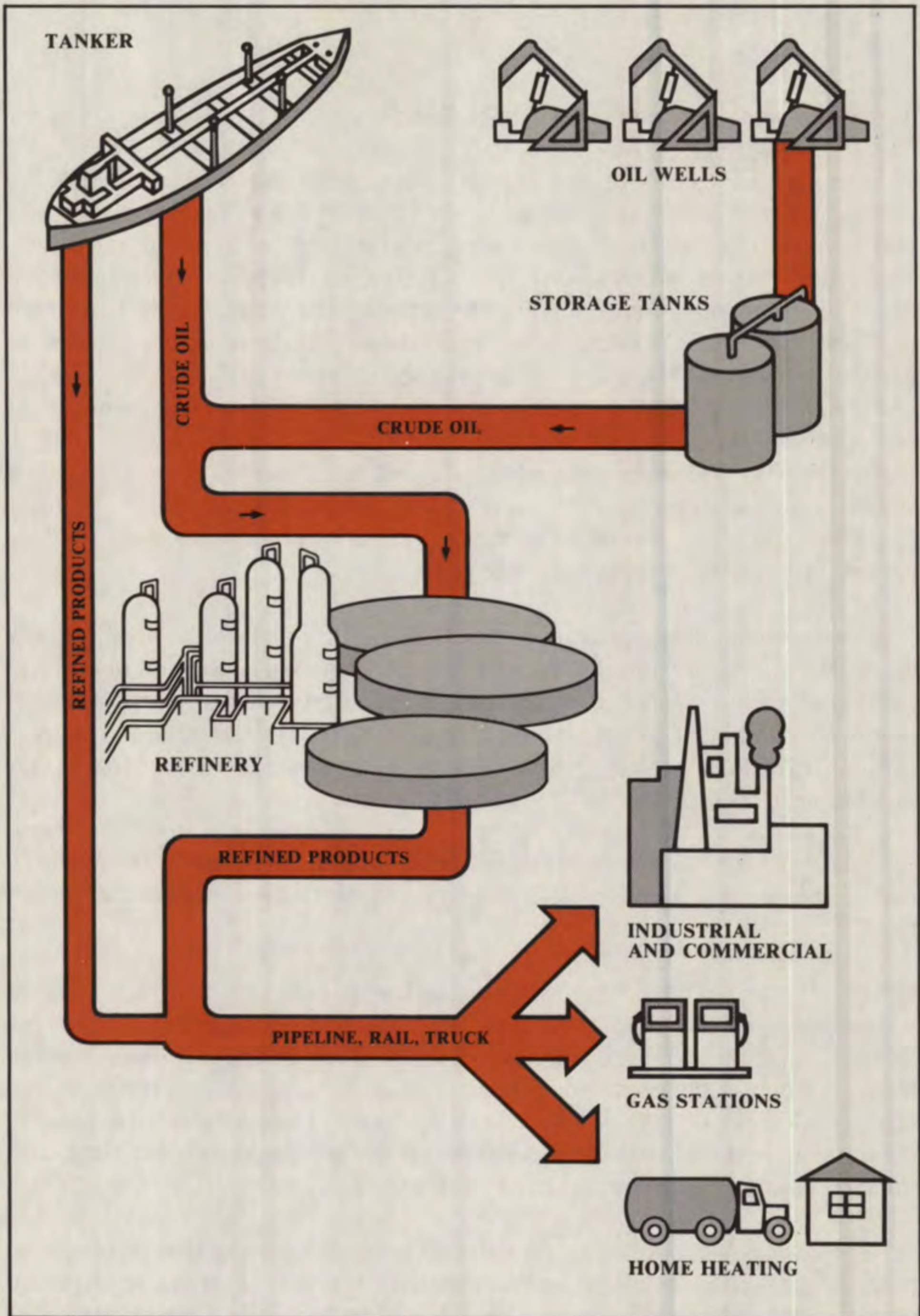
Scale economies in operating a pipeline similarly dictate the need for only a few operating companies in Canada and thus high concentration in order to provide efficient transportation services. The overall structure of the industry might be thought of as an hourglass; crude oil flows from many producers through a few firms owning trunk pipelines and refineries and out to a larger number of firms distributing the refined products.

The upstream sectors of crude oil production and pipelines are partially tied to the needs of the domestic industry and partially to export markets in the U.S.

The "upstream" and "downstream" sectors handle liquids, which must be contained from the time they leave underground storage in oil wells or deposits, until they arrive as manufactured products at the end users' storage facilities, such as the gas tanks of cars, trucks, ships, planes and trains, or the heating oil tanks of homes, offices and factories. There is clearly a limit to the amount of liquid that can flow through the system at any one time, and the installation of additional capacity takes time.

The successive stages of flow from crude oil production through to product marketing need to be coordinated in order to optimize capacity utilization throughout the system as a whole and to reduce operating costs.

FIGURE II-1.
Stages of Production and Distribution



Coordination is undertaken either by purchases and sales between independent firms, or by internal decisions made by vertically integrated firms.

3. Location and Industry Trends

The "upstream" industry is located primarily in Western Canada, with about 85 per cent of Canada's annual crude oil production occurring in Alberta over the past decade. More recently, extensive exploration and production has been taking place in the Arctic and offshore in Eastern Canada. The "downstream" refining segment of the industry is spread across Canada.

(a) Crude Oil Production and Reserves

Prior to the Leduc, Alberta discovery by Imperial Oil in 1947, there was relatively little crude oil production in Canada and refineries were supplied mainly with imported crude oil. Thereafter, domestic production of conventional crude oil expanded rapidly in the 1960s and 1970s reaching a peak of 635 million barrels in 1973 before declining to 465 million barrels in 1984, a decrease of 27 per cent from a decade earlier. Additional production comes mainly from synthetic (tar sands) crude oil and reached about 50 million barrels in 1984. Total production reached 515 million barrels or 1.4 million barrels per day in 1984, less than estimated production capacity of 1.5 million barrels per day and reflecting shut-in or unused capacity.

The estimation of Canada's oil reserves is difficult to forecast because of changing costs, prices and policies, uncertainty about future discoveries and the variety of crude oil sources. In addition to reserves of conventional and synthetic crude oil, some oil is produced as a by-product of processing natural gas. Some light oil can be produced by upgrading heavy oil as in the proposed Lloydminster and Cold Lake thermal recovery projects. Discoveries have also lead to reserves in frontier areas such as the Hibernia offshore field in Eastern Canada, the Beaufort Sea and the Arctic Islands.

The National Energy Board (NEB) forecasts that productive capacity will be marginally lower in 1995 (1.4 million b/d) relative to 1984 (1.5 million b/d). The relative importance of different sources of crude oil will change with synthetic crude oil, frontier production and light oil produced from upgrading heavy oil, being much more important in 1995 than in 1983. Correspondingly, conventional crude oil, which accounted for 83 per cent of

productive capacity in 1983, is forecast to account for less than 50 per cent of capacity in 1995 as reserves of conventional crude oil dwindle, even assuming some further discoveries.[2]

(b) Pipelines

In 1984, Canada had a pipeline network consisting of almost 40,000 kilometres of trunk, gathering and product lines. The main expansion of the network took place up to 1980. As illustrated on the map inside the back cover of this Report, major crude oil pipelines ship Alberta crude oil westwards to Vancouver via the Trans Mountain Pipe Line, and eastwards to Ontario, and more recently into Quebec, via the Interprovincial Pipe Line. Offshore crude oil is imported into Eastern Canada by tanker and through Portland, Maine, by pipeline to Montreal. As well, there are product pipelines, such as the Trans-Northern Pipe Line linking Toronto, Montreal and Ottawa, two pipelines between Sarnia and Toronto, and the Alberta Products Pipe Line between Edmonton and Calgary. An Interprovincial pipeline formerly used to ship crude oil is now used to ship products. The conversion of the Interprovincial line allowed some refineries on the Prairies to be closed and many Prairie markets to be supplied with refined products by pipeline from Edmonton. A similar situation could develop in the future in B.C. with the closure of Vancouver refineries and the shipment of products from Edmonton. At present the Trans Mountain Pipe Line carries products mixed in batches with crude oil from Edmonton as far as Kamloops.

(c) Refining

The location of Canada's 25 operating refineries in 1985, as well as those closed in recent years, are shown on the map at the back of this volume.[3] Some refineries are located close to crude oil supplies, as in Alberta. Others, in the Atlantic region and Quebec, are situated on tidewater and accessible to tankers. A third group, mainly in Ontario and near Vancouver, are supplied with crude oil by pipeline from Western Canada and are located close to large product markets. Two refineries now mothballed, at Point Tupper, Nova Scotia and Come-By-Chance, Newfoundland, were built primarily as

2. There is no unqualified statement that can be made about how long Canada's oil reserves will last. A clear discussion of the issues can be found in the Economic Council of Canada's *Connections, An Energy Strategy for the Future* (Ottawa, Minister of Supply and Services, 1985), pp. 27-36.

3. Not included in the 25 are two asphalt refineries, one owned by Petro-Canada at Moose Jaw, the other owned by Husky at Lloydminster, and Petrosar's primarily petrochemical refinery.

export platforms using imported crude oil and exporting largely bunker fuel to the U.S.A. Conditions in the U.S. market led to their demise.

Canadian refining capacity increased two and half times between 1950 and 1960, and then again between 1960 and 1980 with the increased demand for petroleum products. This expansion was fed by the increased availability of domestic crude oil supplies, due in part to the Federal Government's National Oil Policy. This was followed by a decline in demand and by the closure of several refineries amounting to a decline of 13 per cent in capacity by 1984. The number of refineries grew from 31 in 1950 to 44 in 1960, and then declined to 25 in 1985. Over time, the average refinery size in Canada has increased as smaller refineries have been closed and larger ones built.

The utilization rate of refining capacity in Canada averaged over 85 per cent from 1950 to 1980. In the 1980s the rate has fallen, averaging 75 per cent for the years 1982 to 1984. Lower utilization has occurred despite the closure of 10 refineries since 1982, representing over 375,000 barrels per day or 18 per cent of Canada's 1982 refining capacity. The most recent refinery closure, that of the Gulf refinery in Montreal in 1986, has raised particular questions about the adequacy of petroleum product supplies, including heating oil, in the Province of Quebec. This issue is addressed by the Commission in Chapter XIX. It may be noted however, that Canada is not alone in experiencing refinery closures; it is estimated that about one third of global refining capacity has been closed in recent years.

(d) Consumption – Prices and Products

Petroleum products are consumed in one way or another by all Canadians. Major changes occurred in consumption patterns in Canada and elsewhere as crude oil prices rose sharply in the 1970s, and further changes can be expected as prices continue to fluctuate.

Oil consumption rose in Canada between 1950 and 1980. However, with the sharp oil price increases in the 1970s, other forms of energy were increasingly substituted for petroleum products. As well, overall demand for crude oil was depressed following the recession of 1981.

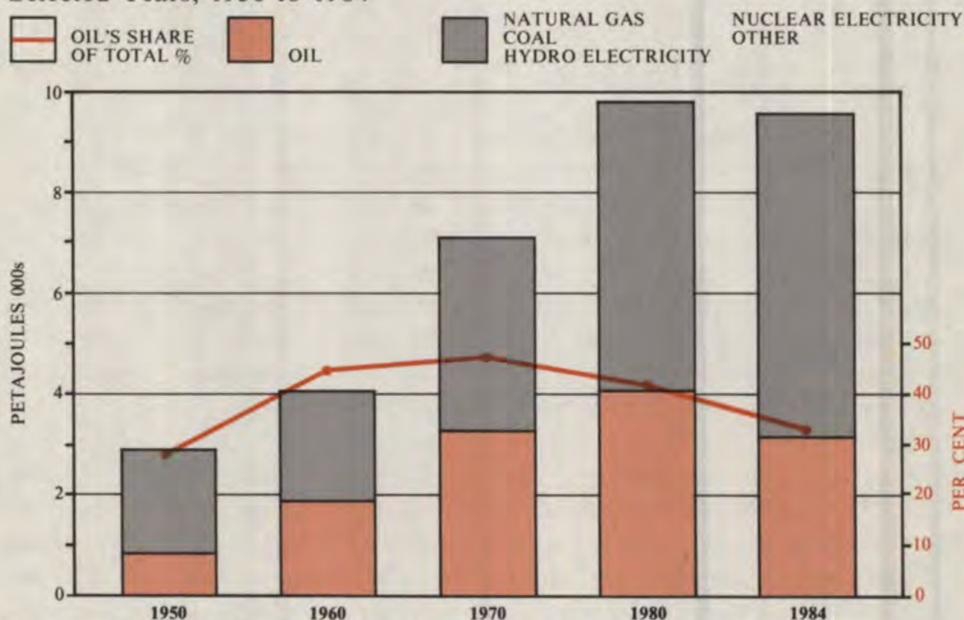
Total energy consumption in Canada rose almost three and a half times from 1950 to 1980, then declined by about 6 per cent by 1983 and in 1984 was still below the 1980 peak. Petroleum's share of total energy consumption reached a maximum of 48 per cent in 1965 and has since declined to 33 per cent in 1984. As shown in Figure 2, in absolute terms Canadian petroleum consumption reached a peak in 1979, and fell by almost a quarter by 1984.

Changing product demand led to changes over time in the yield of refinery products. In recent years, the main trends have been the increasing relative importance of motor gasoline and diesel at the expense of fuel oils (Figure 3). Conservation and the substitution of non-petroleum products such as natural gas, electricity and even wood for heating, have been responsible for changes in the slate of products produced.

Until 1950, Canadian refineries were heavily dependent on imported crude oil. Subsequently this changed and by 1984 Canadian produced crude oil accounted for 83 per cent of Canadian refinery feedstocks, compared with 24 per cent in 1950 and 9 per cent in 1947. Imported crude oil was replaced in most of Ontario by Western Canadian crude oil under the National Oil Policy instituted in 1961, after which imports supplied only markets east of the Ottawa Valley line. Canada has also been an exporter of crude oil, mainly to the U.S., and at various times has been both a net importer and a net exporter of crude oil and refined products.

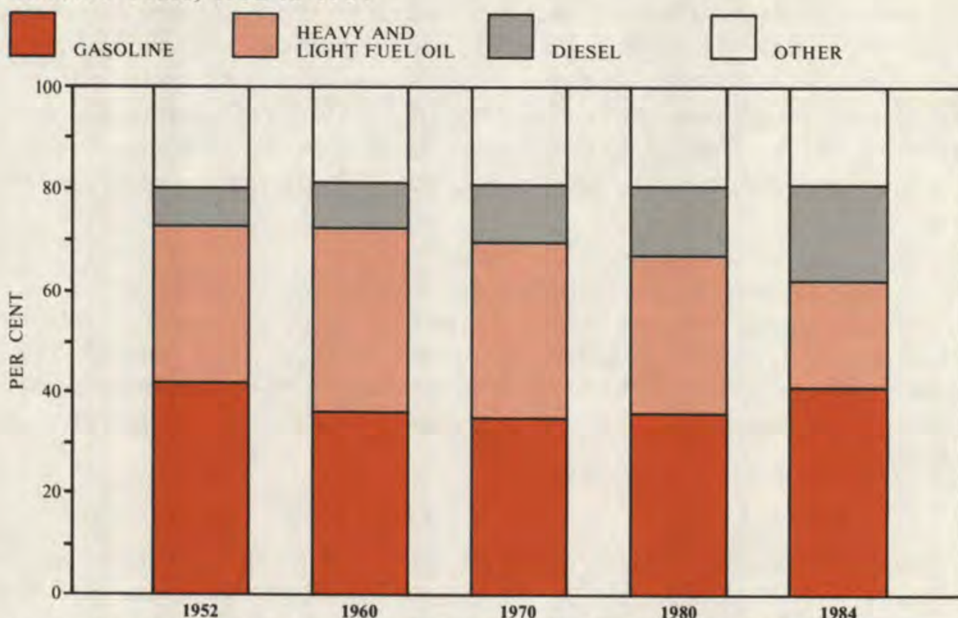
Two dimensions of the price of crude oil need to be considered, the absolute price level and the price of crude oil in Canada relative to the international price. The Canadian industry has had to respond to both

FIGURE II-2.
Canada — Energy Consumption By Source,
Selected Years, 1950 to 1984



Source: Canadian Petroleum Association, *Statistical Handbook*, Section VII, Table 4.

FIGURE II-3.
Canada — Yield of Refinery Products By Volume,
Selected Years, 1952 to 1984



Source: Canadian Petroleum Association, *Statistical Handbook*, Section VIII, Table 7.

aspects of prices. Prior to the early 1970s Canadian oil prices exceeded international prices. International prices then rose much faster than Canadian prices due to the actions of the OPEC cartel and restraining actions taken by the Canadian Government. By 1980 the Canadian price of oil was well below the international price. However, during the 1980s Canadian prices were allowed to approach international prices. The two were roughly equal by 1985, and the present price changes in Canada and abroad are taking place from similar levels. One of the reasons for the lack of synchronization of conditions in the Canadian and international oil markets has been government policies which have at times protected Canadian producers from lower priced imports, while at other times protecting consumers in Canada from higher domestic prices.

The more familiar price to Canadian consumers is the price at the gas pump. The average retail price of regular leaded gasoline in Canada climbed from 11¢/*l* in 1971 to 16¢/*l* in 1975, to 26¢/*l* in 1980 and to about 55¢/*l* in January 1986, a more than threefold increase over the past decade. Gasoline prices vary by province, tending to be highest in Newfoundland and lowest in Alberta, due in part to differences in provincial consumption taxes.

(e) Distribution – Gasoline and Heating Oil

There have also been substantial changes in the methods of distributing petroleum products, especially gasoline. Some of these changes are of an organizational nature altering the way in which gasoline is sold and the types of contractual relationships between refiner and retailer. The similar external appearance of gasoline stations hide the many different contractual links affecting the station operator. Changes in the service and maintenance requirements of automobiles have also profoundly affected the operations of gasoline stations.

The importance of the retail gasoline market is evident from the fact that motor gasoline accounted for 42 per cent of refiners' volume of petroleum product sales in 1984. Most of the gasoline was sold through retail gasoline outlets (84 per cent) with the remaining sales going to commercial and institutional customers including agriculture, commercial transport and government.

In 1980 there were approximately 24,000 retail gasoline outlets in Canada, a decrease of one-third from 36,000 in 1970. The four major refiner/marketers[4] (Imperial Oil, Shell, Gulf and Texaco) accounted for 59 per cent of the outlets in 1980, down from 64 per cent in 1970. The decreased number of outlets and the increased demand caused the average annual volume of gasoline sold per outlet to more than double from 600,000 litres in 1970 to 1.3 million litres in 1980.

Retail outlets "fly the flag" of either a refiner who markets across the country, a regional refiner, or an independent marketer,[5] including cross-merchandisers. The acquisition of three regional refiners by Petro-Canada since 1979 created a fifth major, joining Imperial Oil, Shell, Gulf and Texaco. With Gulf's sale of its downstream assets west of Quebec to Petro-Canada in late 1985, the number of national integrated firms or majors has again been reduced to four.

In the last 20 years or so the changes in the retail gasoline market have included the introduction of second brands by most refiner/marketers, an increase in the number of outlets directly operated by refiners, the

4. "Major" is sometimes used in the Report to refer to all refiner/marketers in order to distinguish them from unintegrated marketers or independents. On occasion the term major is used to refer to the national majors and the remaining refiner/marketers are referred to as "regional refiners".

5. The term "independent" is used in this Report to refer to an unintegrated marketer selling under his own brand.

development of self-service outlets, a reduction in the price differentials for gasoline as between the majors and the independents, the closure of many gas stations, and increased cross-merchandising of gasoline with other products and services. The joint marketing of gasoline and automobile repair services has greatly declined.

The refiner/marketers and the independents have experimented with various marketing techniques. In the 1950s and 1960s the typical gasoline station owned by a refiner/marketer was a relatively low volume outlet with pump-island service plus maintenance and repair facilities. Independents began to enter the market in a significant way in the 1950s. Most did so on the strength of prices lower than those available from the refiner-branded outlets. Their approaches varied from "no frills" gas bars to the large scale cross-merchandising of gasoline with automobile repairs and the sale of automobile parts as in the case of Canadian Tire. Refiners responded by introducing various offerings including car washes, large diagnostic and repair facilities and second brands.

Later, in the mid-1970s, the refiners expanded the number of self-serve outlets. By 1980-1981, the proportion of major refiners' outlets that were self-serve varied between 10 and 26 per cent, accounting for 30 to 47 per cent of the total major brand retail sales.

Refiners also increased the extent of their influence in retail markets through consignment, other dealer support programs[6] and agency arrangements. The increased direct participation of refiners in retail marketing has been of concern to both the refiners' dealers and to independent marketers. So-called "dual distribution" by refiners, whereby they are both suppliers to and competitors of dealers and independents, has raised a number of issues in the inquiry. These include the terms under which the refiners make supplies available to various classes of customers, and the degree of control exercised by refiners over their customer/competitors through the use of measures such as consignment selling and support programs. In addition to vertical integration through refiners owning gas stations, various forms of quasi-vertical integration are created through certain types of refiners' supply relationships with other customers.

Households and industrial and commercial users of heating oil are another important market for petroleum companies. Unlike gasoline, for which substitutes of propane or natural gas are only economically feasible for

6. "Support" refers to changes in "normal" wholesale prices that provide branded dealers, and occasionally independents, with a minimum margin.

large volume users, heating oil faces substantial competition from natural gas, electricity and other energy sources. In Western Canada natural gas is used almost exclusively in place of heating oil, and so the observed market trends arise largely from changes which have taken place in Eastern Canada. For example, the sales of light fuel oils in Eastern Canada declined from 105.4 M barrels in 1970 to 47.8 M barrels in 1984, a drop of 55 per cent. During the same period, the proportion of Canadian homes heated by oil declined from 58 per cent to 25 per cent, while that of natural gas rose from 33 per cent to 44 per cent and that of electricity, from 4 per cent to 25 per cent. These changes have been due to a combination of changes in relative prices and government policies encouraging conservation and substitution away from fuel oils.

The shrinking market for heating oils in Eastern Canada has been accompanied by a decline in the number of heating oil distributors. For example, in Quebec, between 1977 and 1982, 422 local private brand distributors were either closed or acquired. The market share of independent heating oil distributors in Quebec has declined from over 40 per cent in 1978 to around 20 per cent in 1984, while in Ontario the drop has been somewhat smaller. Thus, the declining heating oil market has been associated with a larger market share of a diminishing market for major brand or refiner distributors.

4. International Dimensions

The petroleum industry is a multi- or supranational industry. It represents a high proportion of international trade and investment. The actions of foreign governments can have, and indeed have had, considerable impact on producers and consumers in Canada and in other countries. Over time, firms in the upstream and downstream sectors in Canada, as well as governments, have had to adjust to pressures emanating from outside the country. Canada can only isolate itself from these pressures if it is willing to adopt buffering policies which in turn will affect prices.

In 1983-1984, Canada had about one per cent of estimated world proved crude oil reserves, and about 2.5 per cent of world crude oil production, refining capacity and oil consumption. In 1983 Canada became a net exporter of crude oil for the first time since 1974, with net exports accounting for 2.8 per cent of crude oil production. In refined petroleum products Canada has been a net exporter since 1974, at about 48,000 barrels per day (b/d) in 1984. Although the volume of Canada's trade in both crude oil and refined products is small relative to world totals, both have been important to the industry in Canada. Crude oil imports have been a major source of supply

for refineries in Eastern Canada, while exports to the U.S. have generated earnings for crude oil producers in Western Canada. The United States has also been the destination for product exports, and the loss of markets in the Northeastern U.S. in the 1970s was largely responsible for two refinery closures in Eastern Canada. At different times, American energy policies have encouraged and discouraged petroleum industry developments in Canada.

International investment, in addition to trade, links the Canadian industry to outside influences. Foreign investment occurs in both the upstream and downstream segments, and is high in refining where in 1985 about 60 per cent of capacity was owned by six foreign-controlled firms, with almost half of a seventh, Irving Oil Ltd., being owned by Chevron Corporation. Canadian Government-owned Petro-Canada is now the second largest refiner with 23 per cent of Canadian refining capacity. Its entry and acquisitions since 1979 have sharply reduced the level of foreign ownership in the Canadian refining industry.

Foreign ownership has been associated with pricing questions where firms in Canada make purchases from affiliates abroad. Transfer prices pose a problem for tax authorities and can have implications for the competitive positions of Canadian firms. However the availability of imported crude oil and refined products can provide strong disciplining pressures on Canadian markets provided that there are no tariff or non-tariff barriers to imports, and no other barriers growing out of the structure of the industry.

5. Government Policies

The environment of the industry has been shaped in large measure by government policies. Government regulations apply to crude oil production, pipelines and in some areas marketing, and many government initiatives have involved a trade-off against the forces of competition. For example, at times crude oil imports have been restricted to provinces east of Ontario, and at other times lower compensation has been paid on imported refined products than on crude oil. Policies to achieve greater domestic security of oil supply, greater use of Canadian oil or the protection of Canadian jobs often mean subsidizing and protecting domestic firms at the expense of competition.

The evolution of Canadian government policies can be traced over time. Prior to the Leduc oil discovery in 1947, there was little reason for governments to become involved in the Canadian petroleum industry other than to provide incentives for exploration. Following significant crude oil

discoveries in Alberta, the Provincial Government imposed prorationing controls to regulate drilling and production in order to prevent inefficient production and a waste of resources and to allocate limited sales among producers.

The industry changed as domestic crude oil production began to account for an increasing share of Canadian requirements. The problem then for policy makers was to balance the interests of Canadian crude oil producers with those of consumers who could be supplied either through imports, which at times were cheaper, or from domestic production.

During the 1950s, increasing supplies of cheap crude oil from the Middle East led to protective measures for North American producers. The United States imposed voluntary (1955) and then mandatory (1959) crude oil import quotas in the name of national security. A U.S. Cabinet task force stated that crude oil imports should be limited to maintain "domestic production needed for projected national defense requirements and the capacity of the U.S. to meet national security requirements".

Canada followed suit with its National Oil Policy (NOP) in 1961 which had the effect of reserving the western Canadian market and most of Ontario for Canadian crude oil, while Quebec and Atlantic refineries were allowed to import their requirements. The NOP also served to maintain access for Canadian crude oil to the U.S. in that voluntary export quotas to U.S. markets were set by the two governments. However, in practice, Canadian export sales greatly increased and usually well surpassed the voluntary limits established for Canadian sales, especially to the U.S. midwestern market.

After 1973, the international market for crude oil sharply changed, and the measures taken by OPEC raised the international price of crude oil. Canadian crude oil prices fell below world prices and, instead of needing protection, producers could raise prices and still compete strongly through most of Canada and the Northern U.S. markets. However, after 1973 the Federal Government shielded Canadian consumers from the impact of rising crude oil prices by a combination of three measures: controlling the price of crude oil sold in Canada; paying compensation to Eastern Canadian refiners who still relied on imported, now high cost, crude oil; and placing an export tax on crude oil exported from Western Canada to the U.S. so that Canada, as a producer and exporter of crude oil, would benefit from the higher international prices.

In 1976, Petro-Canada was established as a state-owned enterprise to provide government with a window on the industry, and to increase the presence of Canadian-owned firms in the industry. A further layer of policies

was added in 1980 with the introduction of the National Energy Program (NEP) the nature of which is outlined in the following chronology.

Chronology of Main Federal
Petroleum Industry Policies in Canada

1957 (Borden) Royal Commission on Energy established.

1959 Report of the Royal Commission on Energy published.

National Energy Board (NEB) established under the National Energy Board Act with power to license pipelines crossing provincial borders, as well as petroleum imports and exports.

1961 National Oil Policy (NOP) introduced; area west of the Ottawa Valley reserved for Canadian crude oil.

1970 Mandatory controls on gasoline imports introduced, lasting until October 1973.

1973 NOP terminated. Government announces 60 day freeze on the price of Canadian produced crude oil. Government controls on the price of crude oil at the wellhead and on the prices of petroleum products begins and extends to June, 1985.

Oil Export Tax Act passed, introducing a crude oil export tax to equate the price of Canadian crude oil exports with that of other foreign crude oil sold to the U.S.

1974 Oil Import Compensation Program introduced in order to subsidize cost of imported crude oil and products.

1975 Petroleum Administration Act, an umbrella regulatory act, (subsequently called the Energy Administration Act) introduced.

1980 National Energy Program (NEP) introduced with three objectives; 1) security of supply through independence from the international market; 2) increased Canadianization of the industry through domestic ownership, and 3) fairness in the determination of prices and allocation of revenues.

NEP policies included:

1. A federally imposed schedule providing for a gradual increase in the domestic price of oil towards the international price.

2. The Petroleum & Gas Revenue Tax.
3. The Petroleum Compensation Charge.
4. The Canadian Ownership Special Charge.
5. Incentives to encourage consumers to substitute away from oil and to conserve energy.
6. Direct subsidies for exploration and development activity, the Petroleum Incentive Payment, to replace depletion and super-depletion allowances. Preferential treatment is given to firms based on their degree of Canadian ownership, and to exploration offshore and in the Territories (Canadian lands).
7. Provision for Petro-Canada to purchase one or more large subsidiaries of foreign petroleum companies with assistance from the Canadian Ownership Special Charge.
8. Reservation for the Crown of a 25 per cent interest in development on Crown lands, including discoveries prior to 1980 (the back-in provision).

1981 Agreement reached between the Federal and Alberta Governments for a schedule of oil price increases.

1985 The Atlantic Accord between the Federal Government and the Government of Newfoundland creates an equal partnership in the development of offshore resources.

The Western Accord between the Federal Government and those of the three Western provinces to remove crude oil price controls, to allow the price to follow world prices from June 1st, 1985, and to allow the immediate or phased removal of various energy taxes and levies, effectively abolishing the NEP.

In 1985, deregulation of domestic crude oil prices and related aspects of the industry occurred with the Atlantic and Western Accords between the federal and certain provincial governments, limiting the pervasiveness of formal government intervention.

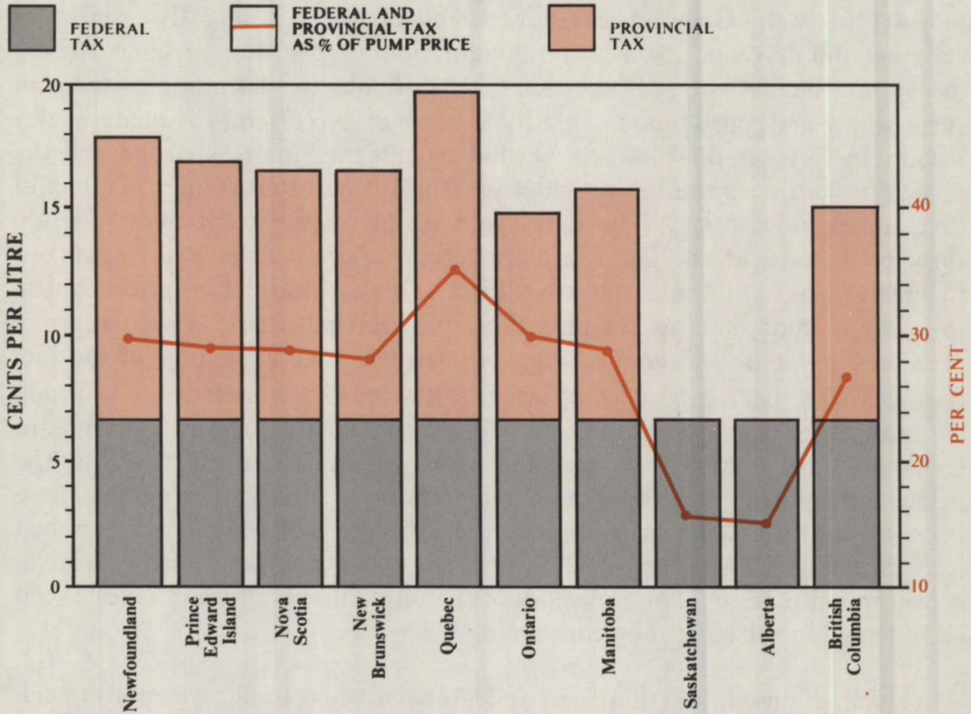
A chronological listing of major policy developments is of more than historical interest. The web of policies reveal the conditions within which competition in the industry has had to operate. The domestic and international pressures which gave rise to many of these policies are still present, although in different forms. In recent years surplus refining capacity around the world has intensified competition in international product markets

thereby making the option of importing products into Canada more attractive.

Energy taxation is a field of government policy which is almost an industry in itself. Governments have found oil to be a lucrative source of revenue and have not lacked in imagination in devising revenue raising measures. The effects of taxation are difficult to disentangle and not surprisingly are poorly understood by the public. No attempt is made in this Report to sort out these effects beyond recognizing their existence and the difficulties of interpretation which arise. It is difficult to sort out the effect of taxes on product prices. The taxes paid by petroleum companies fall into three broad categories. First, there are corporate profit taxes and local taxes, to which firms in all industries are subject. These will affect oil prices, but in principle no more and no less than those in other industries. A second group of taxes is related to attempts by governments to take advantage of the fact that there has been a positive difference between the market value of crude oil (and natural gas) and the cost of finding and producing it. Taxes are levied in other natural resource industries as well, but the taxes in the petroleum industry are tailored to the industry's specific character. These taxes do not affect the price of crude oil, the price of which is determined internationally. The third level of taxes covers federal and provincial consumption taxes. All, or almost all of the total amount of these taxes would be reflected in prices paid by consumers.

Gasoline, diesel, aviation fuel, and propane when used as a motive fuel, are taxed by the Federal Government and by most provincial governments. In October 1985, the Federal Sales and Excise Taxes on regular leaded gasoline amounted to 6.8 ¢/*l*, while the provincial taxes varied by province, from zero in Alberta and Saskatchewan to 12.9 ¢/*l* in Quebec. (That portion of the provincial road taxes which replaces general provincial sales taxes, and the federal sales tax, are not of course, unique to petroleum products.) The result is that the above federal taxes plus provincial consumption taxes as a percentage of the pump price of regular unleaded gasoline varied from about 15 per cent in Alberta and Saskatchewan to over 34 per cent in Quebec — Figure 4.

FIGURE II-4.
Consumption Taxes on Regular Leaded Gasoline
By Province, October 1985



Source: Energy, Mines and Resources, *Petroleum Utilization Highlights*, Oct. and Nov. 1985.

III

A Summary of Concerns and Views

1. General Public Concerns

Before summarizing the various concerns and views expressed directly to the Commission in evidence or formal submissions, it may be helpful to note the nature of the principal recurring concerns of the general public as they appear to the Commissioners from their review of general media coverage of the industry.

The most frequently expressed general public concerns and apprehensions relate primarily to retail gasoline prices and may be summarized as follows:

1. The absolute level of prices is too high. (This concern is increasingly expressed in conjunction with a comparison of Canadian retail gasoline prices with those in the United States or with the price of crude oil on world markets.)
2. Pump prices are nearly identical for comparable grades of gasoline at stations that are adjacent or neighboring, and leave little room for consumer choice.
3. In those areas of the country where pump prices fluctuate, they tend to edge downward over a period of weeks but then suddenly increase very significantly within a matter of hours at all outlets, and sometimes just prior to peak demand periods such as holiday weekends.
4. Significant differences in pump prices exist from time to time between neighboring communities, and some areas experience greater ongoing volatility of pump prices than do others.

For want of a better explanation of the probable cause of these various phenomena, it is not surprising if members of the public adopt the occasional speculations of reporters, politicians or others to the effect that price fixing or other illegal, cooperative or manipulative action is the probable cause, or for concluding that in any event all cannot be well in the functioning of the gasoline market. Persons who read this report will realize, however, that there can be other explanations for the above phenomena. It may further be noted that the Director has at no time alleged that the voluminous evidence

tendered by him or by others to the Commission shows that a criminal offence has been committed by anyone.

2. Consumers' Associations

The Commission received submissions from the national office of the Consumers' Association of Canada ("CAC") and, in addition, from the CAC branch offices in each of British Columbia, Alberta, Saskatchewan, Manitoba, Nova Scotia and Toronto. Several of the submissions were supported by surveys of consumer experiences and views.

The basic concern of the consumers' associations is that there is insufficient price competition and too few alternative offerings in the retailing of gasoline in Canada. They are of the view that the insufficiency of competitive rivalry results from too high a degree of concentration and too much vertical integration, both of which have resulted in too much market power for the major oil companies at the retail level. They are concerned that the majors have the power to exclude or constrain independents by means of lower priced supply to retail outlets (particularly self-serve) that are owned and operated by the majors themselves. They are also concerned that government regulation in certain provinces and municipalities which restricts entry and the range of retail offerings (e.g. by restrictions on self-serves, gas bars and extended hours of business) exacerbates this condition. Overall, the consumers' associations are of the view that there are too few distinct enterprises engaged in the retailing of gasoline, too many stations resulting in too low average volumes and too high unit costs, and, in some markets, insufficient alternative offerings.

Perhaps because of the system of provincial regulation in Nova Scotia, the Nova Scotia branch of the CAC was particularly strenuous in urging the elimination of regulatory restrictions on the number and types of retail offerings. Further, it felt that dealer margins should not be propped up by regulation because inefficient stations were thereby preserved.

In general, the consumers' associations were concerned that the effect of provincial and municipal government regulation was to diminish retail competition to the detriment of the consuming public.

The consumers' associations also strongly recommended that retail gasoline outlets be required to post the pump prices of all grades of gasoline sold at the outlet, and in a manner that the prices are clearly visible from the street. They felt that this was important to the making of informed consumer

choices. (The practice of posting pump prices became common in the industry shortly after the regional hearings where these submissions were made.)

The Saskatchewan branch of the CAC proposed to the Commission that discounts for cash should be required to be given by gasoline outlets that also accept credit cards.

3. The Director of Investigation and Research

As with the other summaries in this chapter, the summary below attempts to capture the essence of the Director's views without reciting the detail on which those views were based.

The Director's assessment of facts and of the state of competition in the Canadian petroleum industry differed somewhat at the conclusion of the Commission's hearings from the views he had expressed in his Green Book. His recommended remedies also changed. Although the broad thrust of the Director's views remained largely unaltered over the course of the Commission's hearings, it may nevertheless be helpful to note the principal respects in which his views as expressed in the Green Book in 1981 were subsequently modified.

(a) Sourcing of Crude Oil

For reasons of availability and price, refineries in Eastern Canada have historically obtained most of their crude oil from abroad rather than from Western Canada or the United States. In the Green Book, which focused primarily on the period 1958-1973, the Director concluded from his private investigation that the eastern Canadian refiners, who imported crude oil almost exclusively from their international affiliates (who in turn, as multinational oil companies, produced the crude oil from their Venezuelan, Middle East or other concessions) paid "artificially high prices" for the crude oil. In the Director's view these artificially high prices were made possible by control by the multinational oil companies over crude oil exports to Canada, by a measure of "harmonization" of price levels as between the majors, and by their retail market power in Quebec and the Maritime provinces. The latter, in the Director's submission, permitted a pass-on of the "unrealistic" crude oil import prices in the form of higher product prices and thereby diminished downward competitive pressures on upstream costs.

As for the supply of domestic crude oil from Western Canada, the Director was critical of both the integrated oil companies and governments.

First, he was of the view that the production restrictions inherent in the prorationing scheme implemented by the Energy Resources Conservation Board of Alberta created an environment in which the industry could elevate crude oil prices. Second, he observed that the National Oil Policy, which limited competition west of the Ottawa Valley from imported crude oil sources during the period 1961 to 1973, helped insulate that part of the country from offshore competition at a time when international prices were sagging. Third, he believed that domestic crude oil producers took advantage of this reduced competition to keep domestic crude oil prices higher than they would otherwise have been. Finally the Director asserted in his Green Book that integrated oil companies, which dominated the ownership and the operation of the major pipelines, exercised that power in a manner that suppressed price competition among domestic producers of crude oil, and that also distorted competition among the refiners to whom the crude oil was transported.

The Green Book was not entirely clear as to whether the Director's general factual assessments outlined above were limited to the pre-1973 period or were meant to apply through to 1981. International supply conditions changed dramatically in the 1970s, notably as of 1973, leading to the discontinuance of the NOP and to the establishment of import compensation. In any event, it became clear during the Commission's hearings that insofar as the upstream sectors of the industry were concerned, and unless expressly stated otherwise, the Director only regarded his Green Book as speaking to the period up to 1973. At the conclusion of the Commission's hearings, the Director abandoned the remedial proposals relating to the domestic production and pipeline sectors which he had made in his Green Book. As for the prices paid for imported crude oil after 1973, he concluded, based on the evidence tendered during the Commission's hearings, that the prices had been "higher than necessary", due in part to the design and operation of the federal government's import compensation scheme, and in part to the failure of Canadian refiners to take advantage of the availability of foreign crude oils at prices lower than those established under their supply contracts with their international affiliates. The Director proposed remedies in his final argument with a view to changing the design of aspects of the import compensation program and to providing firmer guidelines for the determination of "fair market value" under the Income Tax Act as it applies to crude oil imports.

Because of the Government's decision in 1985 to allow Canadian crude oil prices to be set by market forces, the import compensation program has been discontinued and, therefore, this part of the Director's remedial proposals is no longer applicable.

The proposal regarding the tax guidelines falls within the realm of income tax enforcement, an area in which the Commission has no expertise and which is well outside its mandate. Although the Commission does not intend to make any comment on the proposal, it has been available to the Department of National Revenue for whatever assistance it may be to its officials. Moreover, the Commission does address the importance of strong tax enforcement in its conclusions.

(b) Refining Sector

The Director's position throughout has been that the Canadian refiners, each of whom unavoidably possesses a degree of market power as a result of the small Canadian market and the need for economies of scale in refining, coordinated their market power through and in conjunction with a comprehensive network of interdependent product supply agreements among themselves in order to restrain price competition in the marketing sector. More particularly, in his view, the purposes and effects of these product supply agreements have included the restriction of competition among refiners, restrictions on the supply of refined product to unintegrated resellers, and general coordination of capacity reductions and expansion in order to ensure that supply does not significantly exceed demand.

Although, in the final analysis, distortions of or restraints upon competition may manifest themselves primarily in performance deficiencies at the retail level, the Director was of the view that anticompetitive coordination at the refining level was central to the transmission of competitive deficiencies between sectors in the industry by virtue of the refining sector being the central link in the vertical integration chain. In the Director's words:

> Upstream, in production, the structure of the refining sector contributed to the concentration of crude control in the hands of a small number of companies. Downstream, in marketing, the interdependence that developed between firms at the refinery level enhanced the tendency of these same firms to adopt mutually reinforcing disciplinary policies that restricted competition.

In his Green Book the Director had proposed that refinery supply agreements be subject to approval of the National Energy Board, which would be required to consult with the Minister of Consumer and Corporate Affairs. In his final argument the Director urged instead that reciprocal or interdependent product supply agreements between refiners be essentially prohibited and that all other product supply arrangements be severely restricted in duration unless, following review by the Restrictive Trade Practices Commission, the agreement was found to have a beneficial effect upon competition.

(c) Marketing Sector

The Director's concerns regarding the marketing sector focused almost exclusively on the marketing of motor fuels, notably gasoline. Although he addressed heating oil peripherally, and some of his remedial recommendations in the Green Book related to heating oil as well as to gasoline, the Director's recommendations at the end of the Commission's hearings were directed solely to the marketing of motor fuels.

The overall allegation in the Green Book was that not only did the majors avoid significant price competition among themselves, but that since the 1950s, acting as a coordinated unit, they had engaged with considerable success in exclusionary conduct to delay, inhibit or prevent price competition and organizational change in the marketing of gasoline.

According to the Green Book, the "regional majors" at the time (Irving Oil, Petrofina, Supertest, British Petroleum, Sunoco and Standard Oil of British Columbia) followed and reinforced the practices of Imperial Oil, Gulf, Shell and Texaco (the national majors) by not competing in price among themselves. The Director attributed this in large part to a "mutual forbearance" among these companies that resulted in part from "linkages" at the production and refinery levels. Instead, in the Director's view, the integrated petroleum companies competed for volume by means of location and number of outlets, quality and extent of service, brand advertising, credit card facilities and promotions. In the Director's view this was very expensive competition, resulting in many low volume and high unit cost outlets, and led to high wholesale and retail margins.

These high margins in turn attracted no-frill, low price, unintegrated retailers including mass merchandisers, automotive supply companies and "unbranded discounters" to the potentially high volume urban markets. The Director's analysis of the facts available to him led him to conclude that rather than seeking to compete with the independents on the basis of performance, in terms of offering lower prices instead of the frills, the majors responded with exclusionary tactics with the purpose and effect of inhibiting entry and expansion of the independents, and of eliminating some of the lower priced competitors. The Director concluded that the majors sought to and did raise the entry barriers, protected their investment in their branded networks, and thereby entrenched and extended "the monopolistic position that they owed to their control upstream in refining and at the crude acquisition stage", by seeking to prevent or lessen competition on the basis of price at the retail level.

The Director's view as expressed in the Green Book was that the exclusionary or disciplinary tactics adopted by the majors varied within the time frame covered by this Inquiry. In the initial period of significant independent activity, 1959 to 1964, the majors were able to implement low prices at their own outlets by putting their dealers on consignment or by granting special allowances to dealers who set low pump prices. In the next period of significant independent activity, 1969 to 1973, the majors continued to use the first two tactics but also adopted second or "fighting" brands for stations owned and operated by themselves, by means of which they would target the independents with low prices.

The Director asserted that as international supply conditions changed in the late 1960s and the 1970s, and control by the multinational oil companies over international crude oil supply began to diminish, the interests of the national majors became directed to a greater degree than in the past at the elimination of the independents. In part, in his view, this was accomplished by buying out and merging with certain independents, limiting gasoline supplies to independents, and by squeezing the margins of independents by either increasing the wholesale price to them or by lowering prices at their own retail outlets so as to reduce the prevailing retail price.

The Director's assessment of the current problems in the retail sector of the market, and of the required remedies, changed during the Commission's hearings. His changed view is reflected in the following statement from his final argument. After referring to the types of practices alluded to in the Green Book, as described above, he stated:

> In the Director's submission, these practices all served to restrain the independent marketer. It should be added that many of these practices continue today.
>
> The competitive issues today, however, are different from those prior to 1973. The integrated companies are no longer attempting to control the reseller, that day has past. The present concern is that the integrated companies have embarked upon an ambitious program to control the price at which gasoline is sold throughout the economy.

The Director's principal concern in this regard related to evidence that over the last few years the integrated companies have acquired pump pricing control over a larger and larger proportion of total retail motor fuels sales by means of company owned and operated service stations (largely self-serve), the sale of gasoline in some cases on an agency basis through outlets owned by others, and by means of extensive temporary allowances and dealer support programs which, in the Director's view, have a price supporting effect.

The remedies proposed by the Director in his final argument pertaining to the marketing sector are examined in detail in this report. His principal recommendations were that no retailer be tied exclusively to any one supply source in its purchase of motor fuels, that suppliers of motors fuels be prohibited from obtaining direct or indirect control over pump prices at any marketing outlets other than those owned and operated directly by the supplier, and that any acquisitions by refiners of retail motor fuel outlets be subject to prior approval by a government agency.

4. Independents

The term "independent" is ambiguous but tends to be used in this industry to refer to a marketer of gasoline or heating oil who retails under his own brand but who does not own a refinery. The term is used in that sense in this Report, although the Commission recognizes that other marketers also enjoy varying degrees of independence from their suppliers.

As so defined the group includes large retailers such as Canadian Tire and Mohawk Oil, and retail chains that sell gasoline as agents for refiners. The group also consists in important part, of a number of smaller businesses that operate one or only a few gasoline outlets. These smaller businesses tend to be financially more precarious than the others and have a unique set of concerns regarding the functioning of the market.

Although some independents occasionally have crude oil processed for them under contract with a refiner, and import products and operate storage terminals and transportation facilities, in essence their business consists of purchasing supplies from one or more refiners for resale under their own brands. Independents in gasoline retailing, many of whom also sell diesel fuel, home heating oil and industrial fuel oil at wholesale and retail, are sometimes referred to as "unbranded" or "private brand" which, although perhaps confusing to someone outside the industry, means only that they do not conduct business under a "major brand" as a "branded" dealer.

The Commission heard testimony from several members of this group from virtually every province. In addition, the interests of many independents were represented during most of the Commission's hearings by a representative of the Canadian Federation of Independent Petroleum Marketers[1] (the "Federation").

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1. Despite repeated requests and undertakings to do so, the Federation did not advise the Commission of its list of members. It is known, however, that the Federation did not represent or speak for the larger chains of unintegrated resellers such as Canadian Tire and Mohawk.

The largest independents such as Mohawk Oil and Canadian Tire did not express concerns about the operation of the market.

The only domestic supply options for almost all independents are, directly or indirectly, their integrated competitors, and their main concern has to do with the terms upon which they obtain supply. To a lesser extent, they are concerned about access to product, including equitable access in times of overall shortage. They also complained that aspects of certain government programs, notably the import compensation regulations, the Domestic Transfer Compensation Program, federal sales tax and Ontario's fuel oil coloration requirements, prejudiced many independents. After examining the latter three complaints in some detail, the Commission concluded that they did not raise general competition policy issues.

As to the main concern regarding terms of supply from Canadian refiners, most of the representations related to the power of the majors to shrink the operating margins of the independents virtually at will, either by competing in a way that drives the prevailing pump price down or by raising the wholesale price. Smaller independents prefer to preserve their short-term flexibility to seek out the lowest cost supply options and often do not have supply contracts. Even when they do, their short-term (typically one year) contracts with specified minimum and maximum quantities, often contain no price guarantees. Independents told the Commission that if an independent does not wish to pay a price increase that is demanded, his only option is to seek another source of supply. Also, when the relationship between wholesale and pump prices is such that most branded dealers are on support, support payments or discounts to the independent are discretionary as to whether they are given, at all and as to their amount, and if they are given, it is frequently after the fact. Many independents claim that overall, the environment is such that they are inhibited from taking price initiatives. At the same time they believe that their costs of operation are lower than those of the major brands due to lower administrative and brand promotion overheads and to typically lower cost stations. They are of the view that they should be able to reflect these lower costs in relatively lower pump prices. A lower pump price is virtually the only basis available to them for attracting gasoline customers, and they feel unable to establish what they feel is an acceptable major brand/independent pump price differential in the market.

Some independents also complained that the majors' prices to commercial/industrial customers were such as to virtually exclude independents from that segment of the market.

As to how these concerns might be alleviated, the Federation urged a strengthened competition law. In particular, it strongly recommended

amendments to the Combines Investigation Act such as those contained in recent Government proposals. The Federation also strongly recommended a greater informal quasi-regulatory role for the Director, which it termed one of "moral suasion" or "mediation". This latter related to the concern of the independents that there be quick and effective remedies for misuses of market power which could most satisfactorily be achieved under informal, non-adversarial arrangements.

The Federation submitted that there should be no other form of government intervention in the petroleum products market place, although it did recommend that further private sector "Canadianization" of the downstream segment be encouraged. As for the continued role of Petro-Canada, the Federation submitted that "Petro-Canada should . . . behave within the industry under the same terms and conditions of the marketplace as comparable competitors in that it is profit-motivated and that the marketing activities of Petro-Canada should be judged as a separate operation and be reported on a segmented basis. Petro-Canada should set the example and lead other refiners in not treating its own marketing system with any preference relative to how independents are treated who compete in that same market."

The Federation recommended that the Commission reject the Director's proposals that exclusive dealing in motor fuels be prohibited, except where the supplier's price was not "reasonably competitive". It did not consider that it was necessary to require advance government approval of acquisitions of retail motor fuel outlets except under the foreign investment review controls. Further, it considered that implementation of the Director's recommendations that non-petroleum use covenants be prohibited, and that marketers be permitted to identify the manufacturer of the motor fuels they were selling, might well do more harm than good.

5. National Automotive Trades Association

The National Automotive Trades Association of Canada ("NATA") is a federation of eleven provincial associations, the membership of which in turn consists of approximately 6,000 gasoline retailers in addition to a number of new and used car dealers, auto body shops, towing companies, automatic transmission rebuilders and the like.

The typical gasoline retailer represented by NATA is a full service dealer who owns or leases his premises and who, in addition to purchasing gasoline from his franchisor/ supplier for resale under a major's brand, also operates one or more service bays. Many such service station operators testified before

the Commission. In addition, NATA made an opening submission at the start of the Commission's hearings and submitted lengthy argument at the conclusion of the hearings.

NATA and the gasoline retailers it represents, have one main complaint about the way gasoline is marketed in Canada: they feel that they are competitively prejudiced by being required to purchase gasoline at the dealer tank wagon price[2], an "artificially high wholesale price" and not "a realistic or true wholesale price". NATA told the Commission that its members compete against self-serve and second brand outlets, which are owned and operated by their suppliers, and against "private brand" independent resellers, none of whom pays the dealer tank wagon price and all of whom, for one reason or another, pay a lower transfer or wholesale price.

The branded dealers also had other complaints relating to what in their view, was excessive market control by the vertically integrated oil companies over the retail sector, and in particular, over retail pricing. NATA is of the view that downstream vertical integration developed largely as a result of attempts by the majors to "stabilize" the industry in the face of problems that occurred from time to time, and that it "necessarily had anti-competitive results". As expressed in NATA's final argument:

> The situation today is that there is no meaningful wholesale price and no meaningful independent business status for either branded dealers, lessee dealers or independent resellers. The independent resellers face the same control mechanisms as do the branded dealers; contracts are arbitrarily terminated, price support is given at whim. Virtually, only the larger independent resellers with numerous outlets remain viable. The exception to this statement proves the rule — they are the outlets with guaranteed margins whose proprietors' only role is to glean benefit from ownership of the real estate, with no involvement in the marketing of the gasoline.

NATA made several recommendations to the Commission to deal with the problems as it perceived them and to help achieve "pricing fairness and stability at the retail level". First, it recommended that "functional divorcement" be imposed upon the industry whereby a refiner, although it would be permitted to own retail gasoline outlets, would be prohibited from operating or controlling any outlet to which it supplied product, either directly or indirectly or pursuant to an agency or management contract. In conjunction with proposing functional divorcement NATA further proposed that a branded dealer have a right of first refusal to purchase "his" service station property should it be offered for sale by his supplier.

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2. The dealer tankwagon price (DTW) is the delivered wholesale price to major brand dealers.

Second, NATA proposed that "refinery gate pricing" be imposed upon refiners. It would require each refiner to charge the same posted price to all customers on the same day for each product and service, regardless of volume or class of trade. No other wholesale, tank wagon or transfer prices would exist. The "refinery gate prices" would apply to customer pickup at the supplier's refinery or bulk terminal facility. Additional products or services, including promotions and delivery costs, would be priced and paid for separately.

As a possible alternative to uniform refinery gate pricing NATA had urged in its opening submission to the Commission that the prohibition of price discrimination as contained in section 34(1)(a) of the Combines Investigation Act be strengthened to make clear that the wholesale supply of "branded" and "unbranded" gasoline would be treated as being the supply of products of "like quality" within the meaning of section 34(1)(a), thereby requiring that the same price be charged to competing retailers where the volumes purchased were the same. Consignment sales would also be prohibited.

NATA further proposed the enactment of a "Dealer Bill of Rights" which, unlike the voluntary service station lease guidelines that currently exist in Alberta, B.C. and Ontario, would provide legally enforceable protection against unilateral lease termination, non-renewal, site conversion and rent increases. The issues raised in this proposal lie, in the Commission's view, outside the scope of its mandate.

6. The Association des Distributeurs d'Essence du Québec

The Association des Distributeurs d'Essence du Québec (ADEQ), an association of some Quebec gasoline lessee-retailers, made a general submission to the Commission. ADEQ is of the view that the profits of its members are unfairly prejudiced by the direct operation of self-serves by refiners; by their members having to pay for gasoline at the time that it is delivered to them instead of when they resell it, with the result that they must finance the gasoline in the in-ground, storage tanks and must pay for gasoline that evaporates prior to the time of retail sale; by the insecurity of tenure when stations are leased from petroleum companies; by their members having to pay for equipment maintenance; by their members having to pay credit card charges; by having different prices and business hours imposed upon different stations by petroleum company lessors; and by their members paying rents that are too high, particularly for low volume stations. Further, ADEQ is of the view that its members should be empowered to negotiate

assured retail margins with their suppliers and to limit the entry of new gasoline retailers into their markets.

ADEQ proposed a series of remedies that in its view would meet the concerns of its members. It recommended to the Commission that refiners be prevented from selling at the retail level; that service station owners be required to pay for the gasoline supplied to them only as and when it is resold by them; that credit charges be prohibited; that service station equipment maintenance be paid for by petroleum company lessors; that lessees selling less than 300,000 gallons per year not be required to pay rent and that above that volume level, rent be limited by a formula related to profits; that greater assurances against lease cancellation and nonrenewal be provided; that uniform prices be charged by refiners to all retailers; that retailers be permitted to determine their own business hours; and that retailers be given control over the licensing of additional retailers in their markets.

The proposals relating to business terms between lessors and lessees deal with similar subject matter as NATA's proposed "Dealer Bill of Rights" and similarly lie outside the scope of the Commission's mandate. Here as elsewhere it should be clear that the fact that a matter is outside the Commission's terms of reference in no way reflects a Commission view of the merits of complaints or proposals.

Some of the other proposals in ADEQ's submission could have general competitive effects and are subsequently addressed.

7. Views of Governments

Although the Commission specifically invited submissions from all provincial governments and from such federal government agencies believed to have a special interest, only the then Government of Saskatchewan, as a government, made a submission. The submission was made orally and in writing by Saskatchewan's Minister of Consumer and Commercial Affairs in early 1982.

Although the Government of Saskatchewan questioned the current relevance of the Director's concerns regarding crude oil pricing in the period 1958-1973, it was generally supportive of the remedial recommendations made by the Director in his Green Book provided that the Commission found, after hearing all the evidence, that the Director's factual conclusions and analyses were warranted. The Government of Saskatchewan expressed no view as to whether or not those conclusions or analyses were warranted.

The Government of Saskatchewan invited the Commission to examine two general subjects about which the Government had some concern. First, it was concerned about the effects of unequal bargaining power between the refiners and the gasoline retailers they supplied, and in particular expressed the view that there should be no discrimination as among retail outlets operated by the refiner, those operated by lessees and those operated by independent or other resellers. The second general concern related to cost and price differences in gasoline as among different communities.

The Government of Saskatchewan also expressed support for the general strengthening of Canada's competition laws and, in particular, for proposals to decriminalize the competition laws so that remedial action could be taken without having to meet the exacting standard of proof required under criminal law.

8. Responses of the Integrated Oil Companies

The integrated oil companies responded primarily to the allegations, arguments and recommendations that were made by the Director, although they also responded to certain recommendations made by others.

The initial response by the major integrated oil companies to the Green Book was made in their opening statements at the commencement of the Commission's hearings. Each of them flatly denied both the historical and current validity of the Director's criticisms. They criticized the quality of his analysis and expressed outrage at the accusatory tone of the Green Book and the manner in which the Green Book had been released and publicized.

Each of the major integrated oil companies presented comprehensive evidence in each phase of the hearings through written submissions and panels of witnesses consisting of experienced officers. Each company's evidence, which was presented after that of the Director in each phase, outlined the history and nature of the company's involvement in the relevant sector and addressed the Director's assertions as they understood them to be at the time of giving evidence.

At the conclusion of the hearings, and after having reviewed the Director's lengthy concluding argument and recommendations, each of the integrated oil companies presented lengthy written argument. The Director had an opportunity to reply and did so.

In general, the oil companies claimed that the Director's analysis was superficial and was virtually totally lacking in objectivity. They criticized

many of the Director's submissions as being based on a fundamental misunderstanding of the evidence, sometimes on a deliberate misuse of the evidence, and sometimes as having no basis at all. Each of them emphatically denied being party to any concerted conduct in any sector of the industry at any time.

With respect to the international sector, the majors submitted that such reliable evidence as existed showed that they paid "fair market value", or no higher than a reasonable range of third-party prices, for their crude oil, and that in particular there was no evidence of an overcharge because there was no evidence of their having paid prices that were generally higher than third-party prices in comparable transactions. They submitted that the Director's assertion that they had paid artificially high prices to their affiliates for crude oil, resulted from speculative and theoretical calculations based upon faulty assumptions and unjustified inferences from the evidence. Further, they claimed that they obtained a degree of security of supply and flexibility through their long term contracts with their affiliates that they could not have achieved by relying predominantly upon spot market purchases.

Ultramar Canada Inc. submitted that the Director's concerns about international transfer prices were no longer relevant because "world markets are no longer dominated by a few international majors with common interests".

As for the Director's views regarding product supply arrangements between refiners, the oil companies submitted that longer term arrangements reflected the size of their marketing operations and the large scale of refinery investment. In their view the Director did not appreciate either the nature of the need for security of supply to a large marketing organization or the fact that the arrangements facilitate efficient utilization of refining capacity and thereby reduce costs. They submitted that reciprocal or interdependent product supply arrangements provide additional security of ongoing supply and thereby also facilitate the efficient utilization of refining capacity. Further, they denied that reciprocal or other supply agreements between refiners interfere or have interfered in any way with making product available to unintegrated resellers, and that in fact such agreements enhance competition by enlarging the competing supply options available to such resellers in the regions where the exchange occurs. As for the Director's allegation that unnecessary and anticompetitive exchanges of information occur or have occurred between refiners in conjunction with the negotiation or administration of product supply agreements, the submission of the refiners, in the words of Imperial Oil, was that "it is almost inconceivable, and there is certainly no evidence to suggest, that any company would

divulge to a competitor the substance, let alone the detail, of its policies and future plans".

With respect to marketing, the majors submitted that the Director's analysis was simplistic by purporting to measure "efficiency" or optimum performance by volume of sales per station, without reference to the complexity and continually changing characteristics of demand. They submitted that partly as a result of this, but for other reasons as well, the Director confused vigorous competition with abuse of market power and misunderstood the purpose of second brands, which they said were and are intended to cater to "the more price conscious segment of the market". They also submitted that the Director's analysis of price wars and price restorations was unrealistic and that in particular he misunderstood the purpose and effect of dealer support programs, which they said were to assist dealers to survive, at the expense of the refiners, during periods of intense retail price competition. Further, in the view of the majors an analysis of the realization data and other evidence refutes assertions of price discrimination.

Overall, the major integrated oil companies submitted that market shares or concentration were not reliable indicators of market power in gasoline retailing, that significant change had occurred and continues to occur in the industry, that vigorous new competitors enter the industry on a regular basis, and that the unintegrated reseller segment continues to thrive. They submitted that Canada has been and continues to be well served by its petroleum industry and that no changes are required to improve the way the various markets are operating.

The submissions made by the regional major, Ultramar Canada Inc., differed from those of the other integrated oil companies in one important respect relating to the fact that, in its words, "Ultramar shares some of the Director's concerns about the state of competition in the downstream sector of the oil industry". Ultramar was of the view, however, that the Director's remedial proposals relating to the downstream sector would do nothing more than reinforce the status quo. In particular, in Ultramar's view the Director's proposals regarding exchange agreements would prejudice regional refiners more than it would prejudice companies operating refineries in more than one region of Canada, and would further entrench the positions of the national integrated majors. In Ultramar's view "the single most important anti-competitive marketing practice today is concealed marketing by majors through controlled "independents" which involved a "strategy of selling below cost". In Ultramar's view this anti-competitive practice was facilitated by cross-subsidization of downstream losses by upstream profits, and that "the most effective method of dealing with the Director's key concerns would

be complete divorcement of marketing and refining from upstream operations". Ultramar recommended this solution.

9. Recent Developments

Following the conclusion of the Commission's main hearings and the submission of comprehensive written argument by all interested persons, certain events transpired that led to further hearings and to the reception of further evidence and argument in 1985 and early 1986. One was the adoption or imminent adoption by some refiners of what appeared to be a fundamentally new type of wholesale pricing practice (referred to as "rack pricing") that would affect some of the more contentious issues in the marketing sector. A second, was Petro-Canada's purchase of Gulf's refining and marketing assets west of Quebec. Third, Ultramar's purchase of Gulf's assets east of Ontario that, together with an aspect of Petro-Canada's earlier purchase, appeared to ensure closure of Gulf's Montreal refinery, raised certain questions regarding the balance of supply and demand for petroleum products in Quebec that the Minister of Consumer and Corporate Affairs asked the Commission to consider in its Report. The Commission has received evidence and argument on each of these three important subjects and addresses them in this Report.

10. A Word About What Follows

Part B of this Report addresses the allegations made by the Director to the effect that Canadians were "overcharged" by Canada's major petroleum companies during the period 1958-1973. Part C addresses more recent developments in the petroleum industry and current competition issues. Part D contains the Conclusions and Recommendations of Commission Members.

Some of the kinds of issues examined in this Report are also addressed in certain respects by Bill C-91, introduced into Parliament in December 1985 to amend the Combines Investigation Act. Where appropriate, the Commission has sought to relate its conclusions and recommendations to the legislative proposals contained in Bill C-91.

IV

Conclusions and Recommendations

1. Introduction

Some of the Commission's conclusions set out below arise from the analysis in specific chapters, and in other cases they relate to matters addressed in several chapters. The Conclusions and Recommendations emerge as the bottom line as the Commission saw it at the end of the day in April 1986 when the Report was completed.

A number of allegations and criticisms in the Green Book, largely historical, are addressed first. This is followed by conclusions relating to current issues, and then by the Commission's recommendations.

The analytical support for the conclusions is to be found in the chapter or chapters dealing with the relevant subject matter. The essence of the rationale for the recommendations is repeated here.

The Commission considers that several conclusions warrant as much review by governments, legislators and the public as the recommendations because actions by one or all of these groups may be required to bring about the better functioning of markets in the situations described.

2. Conclusions Regarding Historical Allegations and Issues

The Commissioners have written separate opinions about the allegations made in the Green Book regarding the so-called overcharge of Canadian consumers by the major oil companies in the 1958-1973 period, although in some cases the variance in their assessments is slight and interpretational. While the two Commissioners are agreed on all other conclusions and recommendations in the Report, their individual appraisals of the historical allegations of overcharge set out in the Green Book differed in some degree and their separate assessments follow.

(a) The "Overcharge" Allegation

(i) Views of the Chairman

The allegations in the Green Book relating to a deliberate overcharge of Canadian consumers by the major oil companies, referred to perhaps irresponsibly by the media at the time as a "rip off", needs to be examined from two perspectives — neither of which will come as a surprise to participants in the proceedings. First, did the Director prove these allegations to the Commission's satisfaction? Second, does the evidence regarding these historical practices have any relevance to the marketplace and the public interest today?

As to the first issue, my judgement is that the Director failed to establish the Green Book allegations. Apart from questions of "excess cost", there was no proof or indeed evidence introduced during the hearings by the Director to substantiate the claim of a pass-on to consumers of so-called excess costs. As to whether or not there were excess costs, we had to look at each area where the Director alleged such "excess costs" were present.

The first of these is that Canadian subsidiaries of major oil companies paid excessively high prices for crude oil imports. This is in part a tax question, and one with which National Revenue sought to deal with varying results. Efforts to maximize profits to the U.S. parent were legitimate corporate responses unless Canadian tax or other laws were broken. National Revenue sought to monitor so-called "transfer pricing" to protect Canadian tax interests and still pursues these objectives. Limitations of staff and expertise at National Revenue may have worked in the majors' favor. This, while not explicitly a competition issue, is addressed later in this chapter in terms of its current relevance.

The other side of the public interest might be analyzed by determining whether there was crude oil available in the world market at lower prices than the prices of crude oil that moved through major affiliated channels. The analysis in Chapter VII suggests that cheaper crude oil may have been available in limited quantities. However, in my judgement, this was meaningless since Canadian subsidiaries in this industry had neither the resources nor the liberty from their parents to exploit such opportunities. Their corporate creed was tradeoffs that worked in favor of buying crude oil from and using transportation facilities of their parents.

This is not to suggest that Canadian chief executives or perhaps the boards of directors of Canadian companies did not make efforts on behalf of their own operations or minority shareholders. As indicated in the previous paragraph, there was also testimony to the effect that matters like security of supply and the use of affiliated transportation systems were more attractive

than attempting to shop for cheaper crude oil. In the last analysis however, and despite occasional efforts to shop, they did not appear to have the necessary room to manoeuvre towards this objective, or a clear set of workable alternatives open to them.

Apart from the efforts of National Revenue and a rather superficial survey undertaken by the National Energy Board in 1972, the Canadian Government made no apparent effort to change these practices. This may have reflected the fact that relatively little pressure was exerted by consumers during the 1958-1973 period because of the relatively low price of gasoline and heating oil. Whatever the reason, it is incorrect to allege that the majors were "guilty" of overcharging consumers as a result of their crude oil pricing policies. However, as indicated in the previous paragraph, it is also clear that Canadian subsidiaries were subject to a high degree of control by their parent companies that left them committed to a pattern of supply through affiliated channels. It is useful to think of what lessons this has for the situation today with deregulation in Canada and, at least temporarily, a world glut of crude oil. It is clear that benefits of trade liberalization and world pricing can be undermined by parental control of Canadian subsidiaries in the petroleum industry or indeed in any other Canadian industry exposed to the forces of trade liberalization with the United States, as is now being widely discussed. Certainly for the Canadian petroleum industry and Canadian markets, it is essential that no barriers to free movement of crude oil or product or the prices at which these commodities move, be created by decisions taken by the parent.

A second element of the Director's overcharge allegations relates to a possible manipulation by the majors of the National Oil Policy (NOP) in the 1960s and early 1970s with consequential higher costs to consumers in some areas of the country. In my judgement, the views expressed in the Green Book reflect theoretical economic conclusions reached in isolation from broader policy objectives. The policy openly involved higher crude oil prices for those areas of Canada that had to substitute Canadian for foreign crude oil. I broadly support the analysis of the NOP in Chapter VI and consider that the Director was totally unjustified in attempting to attribute to the major oil companies the higher costs and prices that may have been brought about in Ontario west of the NOP line. Moreover, there is no relevance in any of the Director's case regarding the NOP, faulty as it is in my view, that has any bearing on today's situation. Unlike the National Energy Program of the 1980s, there was support for the National Oil Policy by successive governments from both parties in the 1960s and early 1970s — and like any national policy, its benefits and costs varied in different regions of Canada.

The final element of the so-called overcharge relates to excess costs related to gasoline distribution. For reasons explained in Chapter V, its inclusion in the overcharge allegations is also unwarranted.

The most important contribution the Commission can make is in its *appraisal and recommendations regarding competition in the Canadian marketplace today.* This has been done and our agreed conclusions and recommendations are set out accordingly. Nevertheless, given the seriousness of the Green Book's allegations regarding the so-called overcharge and the media's reaction at the time, I consider it very important to set the record straight based on my assessment of evidence and argument received by the Commission in the lengthy part of the hearings devoted to this issue because of the Director's allegations in the Green Book.

The Director's case that Canadian consumers were overcharged between 1958 and 1973 as a result of actions of the major petroleum companies was misconceived. There was no proof placed before the Commission that Canadian petroleum companies overcharged consumers by 12 billion dollars or that, indeed, any measurable excess costs were passed on in any significant degree between 1958 and 1973. Efforts by the Director devoted to that bit of history could have been much more productive in examining current practices in the industry and would have shortened the inquiry.

(ii) Views of Dr. Roseman

For reasons set out in Chapters IV to VII, I have concluded as follows with respect to the Green Book's allegations that excess costs were incurred and that they were passed on to consumers:

(aa) Regarding the importation of crude oil:

- There was an excess cost.
- There is no way of responsibly calculating the excess although the Green Book overstated it.
- There is virtually no direct evidence of a pass-on. To the extent that there may have been a pass-on it would have presumably taken the form of higher gasoline prices caused by deficiencies in the operation of Canadian markets.

(bb) Regarding the NOP:

- There was no excess cost attributable to actions of the oil companies. Any higher costs resulted directly and predictably from Government policy.

- In any event the Green Book calculation of the higher costs was substantially overstated.
- Most of the higher costs resulting from government restrictions imposed by the NOP were passed on to consumers in Ontario west of the NOP line.

(cc) Regarding alleged inefficiencies in marketing:

- The conceptual difficulties of attempting to identify, let alone calculate, any excess cost or pass-on in this regard are so severe that the "overcharge" framework of analysis is not helpful or illuminating. It is an extremely narrow and static framework in any event, and it is particularly so when the essential question has to do with the speed and nature of industry adjustment in differing markets and over a lengthy period of time. The underlying issues require a more complex and judgemental analysis.

(dd) Regarding imported products:

- There was an excess cost to the extent that products were imported as a result of unnecessarily high costs of imported crude oil. Some imports probably occurred for these reasons but the proportion is unknown.
- Therefore, the extent of the excess costs cannot be responsibly calculated although the Green Book undoubtedly overstated them.
- Whatever excess costs existed were passed on, primarily to consumers east of the NOP line.

(b) The "Harmonization" Allegation

The Commission found no evidence of collusion in any sector of the industry. While the Director's case technically did not include a direct allegation of collusion, there are a number of statements in the Green Book which clearly point in that direction, and in the interests of fairness the Commission wishes to make its view of the matter clear.

3. Conclusions Relating to the Post-1973 Period

(a) Domestic Crude Oil Production and Pipelines

The Commission does not see a need for additional public policy action with regard to domestic crude oil production or pipelines.

In his Green Book remedial proposals the Director had called for greater regulation of pipelines and for modification of the policies of the Alberta Petroleum Marketing Commission (APMC). Both are part of the reality of 1986. All aspects of pipeline operation, including tariffs, are regulated today. The APMC sells less than a third of the total light oil production in Alberta and must respond to market conditions like any other seller. Buyers have many sources of supply. Today, following deregulation, domestic crude oil prices are largely determined by competitive forces in the Chicago and Montreal markets where Canadian crude oils compete with foreign oil prices.

The Director did not maintain his Green Book recommendations regarding domestic crude oil production, and the Commission notes further that the deregulation of domestic crude oil pricing in 1985 has, if anything, made access to domestic crude oil by potential users even more open than it was previously.

Nor did the Director maintain his Green Book recommendations relating to divestiture of pipelines or aspects of their regulation.

The current regulatory structure is adequate, in the Commission's view, to deal with potential problems of excess profits and access to and the use of pipelines that could arise as a result of the unavoidably high concentration in this sector.

(b) Imported Crude Oil After 1973

There is no evidence that companies paid higher than third-party prices for crude oil imported into Canada after 1973 except for certain transactions described in Chapter IX.

From 1973 to 1980 most crude oil was traded internationally, and imported into Canada, at the Official Government Selling Prices (OGSP) of the producing countries. These prices were equal to or lower than those paid, on average, in third-party transactions. There then followed a period of a year or so when, after allowing for various non-price concessions, term prices exceeded OGSP price levels.

The softening of crude oil prices since 1981, their sharp drop over the last few months and the recent deregulation of crude oil prices in Canada have created a situation that, as in the 1960s, requires firms to shop diligently in order to minimize their crude oil costs. It is not an easy task, however, given the volatility of prices. It is, of course, even more difficult for government agencies, as outside parties, to evaluate the purchasing performance of firms,

and transfer prices of imported crude oil become a matter for concern given the importance of the "import option" for both crude oil and product. Nevertheless, the enormous growth in the third-party market and in the volume of spot transactions eases the task of the authorities (and of the firms themselves). The development by National Revenue of carefully monitored records on the prices of different types of third-party transactions, and of their relative importance, should provide the tax authorities, given adequate resources, with an effective means of establishing fair market value standards for the various types of crude oil imported into Canada.

(c) The Refining Sector

The nature and extent of inter-refiner supply agreements, including the extensive degree of reciprocity and the long-term nature of some of the agreements, do not give rise to competition problems that require general prohibitions or advance approvals.

Inter-refiner supply agreements, even when they involve reciprocity and are long-term, usually facilitate the process of structural adjustment in the refining sector in order that it may respond to new pressures and take advantage of new opportunities. They can reduce the risk and cost of both adding to and reducing production capacity or, in other words, they can facilitate both entry and exit.

Nevertheless, the magnitude and risk of refinery investment is increasing, and with it comes a greater tendency towards a "joint venture" approach to certain refinery investment. The Commission is concerned that there is not adequate provision in Bill C-91 to ensure the opportunity for the Competition Tribunal to review long-term arrangements between refiners involving large volumes, that could reduce supply or the number of suppliers to the point where on balance the arrangement lessened competition to a degree that was contrary to the public interest. Such a provision is recommended below.

To this end, the Director should be notified of inter-refiner product supply agreements longer than five years in duration, including such agreements currently in force with longer than five years left to run.

Although a preference for reciprocal deals may on occasion add to the cost of entry by regional refiners, and may make vertical integration more pervasive, the historical record of entry suggests that these barriers were not of a sufficient magnitude to justify remedies curtailing the agreements. Part of the added cost of entry is offset by improved efficiencies for the other parties to such agreements. These conclusions, however, are considerably less certain in an environment of little or no growth.

The detailed evidence on particular inter-refiner supply agreements clearly indicates that typically each refiner enters into such arrangements solely with a view to preserving and improving its own individual competitive position as against the rest of the industry, even though this also presumably involves an improvement of the competitive position of the other party to the agreement. It might also, however, produce benefits to firms who are not party to the particular agreement by facilitating a reduction of capacity such as might occur with a merger.

It is not a characteristic or effect of such agreements to stabilize market shares or to deprive unintegrated marketers of supply. It is, however, important to distinguish between essential aspects of the agreements and collateral conditions that might exist in specific agreements. Should any agreement, whether involving refiners or anyone else, restrict in any way the distribution of the product being supplied, or amount to market sharing, or limit in any way the supply or terms of supply to others, or involve a commitment to limit supply or involve any other type of exclusionary commitment, then the rules and procedures under the Combines Investigation Act that apply equally to all industries should provide sufficient remedy. The Commission does however make a recommendation below regarding the scope of a supplier's general duty to supply.

(d) Gas is Gas

The quality of gasoline produced by Canadian refiners is of a uniformly high standard. In fact, refiners themselves frequently sell, under their own brands, gasoline refined by a competing refiner. Similarly, independents receive the same high quality gasoline from Canadian refiners.

As for imported gasoline (and both refiners and independents import to some extent), evidence of sub-standard quality is virtually non-existent.

There was no evidence of quality differences between gasoline as sold to consumers by major-brand outlets and that sold by independent or private brand outlets.

(e) Mergers

A number of mergers in the refining and marketing sectors have increased concentration and removed effective competitors. The merger proposals in Bill C-91 should deal adequately with this subject in the future.

(f) Vertical Integration and Marketing

(i) **The Commission is concerned about the trend over the last decade towards greater centralization in the hands of refiners of the power to set pump prices. Supply arrangements under which refiners obtain partial or complete control over the retail prices of customers with whom they would otherwise compete at the retail level tend to lessen competition.**

In the Commission's view support programs that relate the amount of support to particular retail prices (as is the case with all margin support programs referred to in the evidence), and that are widespread in the industry, are contrary to the public interest. Similarly, the competitive harm becomes significant when extensive arrangements are entered into between refiners and retailers under branded and unbranded agency agreements.

(ii) **A comparison of the available cost information with the margins earned by major-brand gasoline dealers, and by independents in both heating oil and gasoline distribution, does not support allegations or fears that independents have generally been subjected to a predatory margin squeeze in recent years. However, the margins of the smallest independents in gasoline distribution appear to have been severely compressed throughout most of 1979-1983, the period for which information is available.**

(iii) **Regional price differences and swings in prices over time are due largely to variations in competitive conditions caused in part by the number of refineries, the number and types of marketers, the degree of excess refining capacity and the availability of imports. Tax differences and other government interventions also affect prices on a provincial basis.**

(iv) **The Commission finds it difficult to envisage a market restriction in this industry that would not, in its view, be contrary to the public interest.**

For example, processing or otherwise supplying product to persons for export only, on condition that it not be distributed in Canada, seems impossible to justify. Also, unbranded resellers are occasionally prevented by their suppliers, by contract, from reselling in any way other than through their own consumer outlets. On balance, however, in view of the scope of existing legislation and the few current instances of market restriction in evidence, no specific recommendation in this regard is being made.

(v) **All retailers should retain full freedom to offer discounts to customers who pay by cash rather than by credit card.** The Commission considers, however, that the existing price maintenance prohibitions in the Act are sufficient to ensure this freedom, and accordingly recommends no change to the law in this respect.

(vi) **Non-Petroleum Use (NPU) covenants obtained by refiners when they sell former retail gasoline sites have no purpose other than to create an entry barrier into gasoline retailing and, therefore, are not in the public interest.**

While it cannot be concluded that the covenants are always an important barrier to entry, they have no redeeming feature.

(vii) **Recent changes in wholesale pricing practices, referred to as "rack pricing", adversely affect competition insofar as they involve openly stated policies that confidential discounts will not be granted off published prices.**

The effect of public announcements by suppliers in a tight oligopoly to the effect that they will not be granting unpublished discounts off published or widely-known supply prices, can produce an effect very much like that of a horizontal agreement. It communicates past and current actual transaction prices to competitors of the supplier and to competing customers, and where the products are as homogeneous as petroleum products it presents a real risk to the intensity of price competition. Such is the case with the emerging so-called "rack-pricing" policies of Imperial Oil and other refiners. The no-discount aspect of those published policies is not necessary to their legitimate purposes. The expectation of the refiners, and the probability, is that retail motor fuel prices will be stabilized by such a policy and raised above levels that would otherwise exist.

(viii) **The characteristics of the heating oil market with respect to the lack of readily available information on prices and the tendency of consumers to settle on a supplier for at least the duration of a heating season requires consumers to shop actively in order to get best value for their money.**

In some cases this shopping is performed on behalf of consumers who are members of voluntary organizations who negotiate discounts on their behalf. Individual consumers can also be effective in negotiating better prices, for what is a major household expenditure, if they take the trouble to try.

(ix) **A viable independent sector operating efficiently in the retailing of gasoline (and heating oil) contributes to the health of markets in Canada by decentralizing pricing decisions and other strategic competitive initiatives.** The following three conclusions and the related recommendations support this objective.

(x) **The unavoidably high concentration in petroleum refining, together with pervasive vertical integration and dual distribution, makes it very important to take all reasonable steps to maximize the assurance of supply to unintegrated marketers. One avenue is to clarify the scope of the duty of domestic refiners to supply product to others. Secondly, it makes the import option an extremely important competitive factor in areas of the country open to imports.**

These ways of assuring ready access to supplies are more important in Canada than in countries such as the United States which, by virtue of their larger markets, have more refiners, wholesalers and retailers and stronger general competitive pressures.

(xi) **It is important that there be a legal standard of "predation", which is to say a line beyond which conduct by one firm that has harmful effects on another firm's ability to stay in business or to compete, is unjustifiable and against the public interest.**

The Commission considers that the existing law, particularly if supplemented as proposed by Bill C-91, is adequate in this regard. In view of the generality of the existing law, however, the Commission's recommendations set out guidelines for its application to pricing in a dual distribution context.

(g) Government Policies and Programs

There is a need for improved understanding at all levels of government of the effects of government policies on the petroleum industry. There is also a need for improved consultation regarding the purposes and implementation of government policies affecting the industry.

There are so many facets of the "public interest" in this industry, affecting everything from feedstock reserves to retail product markets, and involving the federal, provincial and municipal governments, that some overlap or even conflict of public policies is inevitable. Even within the Federal Government, officials of agencies whose main concern is ensuring overall security of supply, and other officials whose main concern is the healthy functioning of markets (assuming adequate overall supply), do not always appear to agree about priorities where their respective policies interface.

The maintenance of open competition and healthy markets is surely a major dimension of Canadian public policy, and yet it is a truism that

frequently as much damage, distortion and cost of a serious and long-term nature is inflicted on the operation of markets, and on the public, by government programs or by their implementation or administration, as by any private sector conduct that contravenes the competition laws.

With respect to the upstream sector, concerns were expressed in the Inquiry about the harm done to markets, perhaps unnecessarily, by aspects of the Oil Import Compensation Program, by prorationing in the Province of Alberta and by aspects of crude oil marketing as carried out in the past by the Alberta Petroleum Marketing Commission.

As to retail marketing, regulatory regimes in Nova Scotia and to a lesser extent in recent years in Prince Edward Island, and also in several municipalities in British Columbia, restrict the establishment of self-serve outlets, full-service gas bars and various forms of cross-merchandising and thereby deprive consumers in those jurisdictions of lower-cost options available to consumers elsewhere in Canada. Such restrictions cripple the ability of the industry to adjust to meet consumer demand, and to charge lower prices made possible by lower cost distribution of gasoline and induced by competitive pressures. The variety of offerings across the country by independent marketers and by integrated firms illustrates the value of allowing each business the freedom to meet consumer needs as it best sees fit in order to strive at all times to maximize its appeal to members of the public by giving them what they want.

In more general terms there was evidence to the effect that rapidly changing government policies, and bureaucratic complexity and discretion, have themselves constituted barriers that were particularly inhibiting to smaller entrepreneurs.

(h) Petro Canada

Government ownership of Petro-Canada affords unique opportunities to correct certain market defects.

The rapid growth of Petro-Canada by acquisition since 1979 has been a mixed blessing in terms of competition in the downstream sector. Although it has increased concentration significantly, it has at the same time consolidated the regional refining and marketing operations of several companies into a potentially stronger competitive force throughout Canada.

Petro-Canada witnesses testified that the company endeavours to comply with the Combines Investigation Act, and if Bill C-91 is enacted it will be

required by law as an agent Crown corporation to do so. The fact that it is Government-owned, however, offers a unique opportunity to go further and to use Petro-Canada's potential to promote competition in an industry where the extent of concentration in conjunction with vertical integration continually threatens the vigor of market forces. The small and geographically dispersed nature of the Canadian market, and the magnitude of refinery investment due to economies of scale, in particular, make significant degrees of market power in the Canadian downstream sector unavoidable. Petro-Canada gives the Government the opportunity to reduce the competitive restraints and associated public cost of that market power, not only without having to pass special laws, but also in an ongoing pervasive way that probably could not be achieved by laws.

The Commission does not have in mind the possibility of Government pressures or directives to Petro-Canada with respect to particular aspects of performance, such as reducing pump prices at particular places or times or in particular amounts, because such regulatory-like interventions may do more harm than good. Rather, the Commission has in mind the pursuit of broad market policies, relating for example, to negotiated discounts from listed rack prices, that can limit the oligopolistic similarity or identity of practices that normally would tend to develop and that can have many of the adverse effects of horizontal agreements among competitors. The Government could have this influence by ensuring that possible improvements to the operation of product markets in Canada were given some priority when Petro-Canada's corporate plans and capital budgets were being settled.

(i) Refinery Closures and Supply in Quebec

(i) **The relatively large decline in petroleum product demand in Quebec in the early 1980s made the closure of Montreal refineries that occurred in 1983 a virtual necessity**. Furthermore, the closures themselves produced a secondary effect, namely a further decline in total sales from Quebec refineries to areas inside and outside the province resulting from the fact that the vertically integrated firms who closed their refineries supplied part of their requirements for the Quebec region from their refineries elsewhere. This secondary effect created pressure to close additional refining capacity.

(ii) **The sale and closure of Gulf's Montreal refinery cannot usefully be evaluated on the basis of whether there was "enough" remaining capacity in Quebec, in view of the ready movement of product regionally and internationally**. The principal relevant questions relate to the effects of the closure on competition in Quebec and surrounding areas (principally New Brunswick and Ontario). By reducing surplus capacity the closure no doubt diminished

competitive pressures in those areas, but the Government of Canada, by approving Petro-Canada's acquisition of Gulf's Texaco processing contract and subsequently Ultramar's acquisition of Gulf assets, determined that on balance those transactions were in the overall public interest.

4. Recommendations

Recommendation No. 1: To deal with several practices in the petroleum industry and those that may from time to time arise in other industries, a section should be added to Bill C-91 that would allow the Tribunal to issue orders requiring the discontinuance or non-repetition of any conduct that would substantially lessen competition.

Under such a section an order could be issued by the Tribunal whenever it could be established to its satisfaction that the conduct in question has or would substantially lessen competition. The Commission considers that such a provision ought not apply to conduct that was only "likely to" substantially lessen competition, and that it ought only apply to situations where the harm was more certain. At the same time, the proposed provision would not suffer many of the limitations currently contained in section 51 as proposed by Bill C-91.

The proposed section would, for example, permit the following types of conduct or practices in the petroleum industry to be remedied:

(a) large volume, long-lasting exchange agreements where the effect of the agreement was to reduce supply in a market to the point where competition would be lessened substantially; and

(b) support programs or agency or other agreements where the supplier obtains complete or substantial control or influence over a customer/competitor's prices and competition is thereby lessened substantially.

It would be a mistake, in the Commission's view, to enact a new series of provisions limited in scope to the form of each type of arrangement, conduct or circumstance that one could imagine, that could lessen competition substantially (e.g., "exchange agreements", "agency agreements", "support allowances" and so on). Legislative focus on the *form* of a potentially harmful practice rather than on functional *effect* invites firms to introduce new ways of accomplishing the same result that are untouched by the legislation. It also would have the result of proliferating legislation, with the costs of delay and consumption of Parliamentary time as "loopholes" are continually patched to protect the public interest.

Like much of Bill C-91, the section proposed here does not have the degree of specificity or provide the extent of advance certainty or guidance to businessmen that would be required if it were to be criminal law. But then, the great advantage of civil law review is that the public interest can be more effectively protected from conduct or practices that, while in most cases they may promote the public interest or at least not harm it, nevertheless in other circumstances may be found on review to harm the public interest. There is no way of completely dealing with the concern that business disruption and loss may result from a prohibition order, but this problem is common to any competition law. The Director can, of course, be consulted to learn whether he would bring the conduct in question before the Tribunal. Additionally, it may be assumed that the Tribunal would consider all the circumstances when issuing an order and would seek to minimize unnecessary hardship.

Recommendation No. 2: Suppliers who hold high degrees of market power should not be entitled to refuse supply to others except to the extent that they can establish sufficient reason for refusing supply. Market power being a matter of degree, the greater a person's market power is over supply the less should be the need to prove that the refusal injured someone or that it substantially lessened competition, and the more the focus should be on the adequacy of the supplier's reasons for refusing supply.

In deciding whether or not to issue such a supply order the court or tribunal, as appropriate, would no doubt consider all relevant factors, including the number of supply alternatives in the market, the reasonableness with which supply facilities in the market could be duplicated by others, the extent if any to which the supplier and the customer compete, the extent to which the prospective customer is or is likely to be prejudicially affected in his business by an inability to obtain supply from the supplier on usual or reasonable trade terms, and the supplier's reasons for refusing supply on usual or reasonable trade terms.

The Commission considers that in the context of supply by petroleum refiners to independents, for example, the market circumstances are such that unless a refiner could establish sufficient justification for refusing supply on usual or reasonable terms, supply orders would be made.

Recommendation No. 3: Jurisdiction to grant interim orders, particularly with respect to matters affecting supply, should be conferred by legislation.

In making this recommendation the Commission notes with satisfaction that Bill C-91 proposes that a comprehensive power to grant interim orders

exist for all matters within the proposed new Part VII jurisdiction of the Competition Tribunal.

Recommendation No. 4: Any person who has been refused supply should be entitled to apply directly to the Competition Tribunal for relief.

The advantages of direct access are that complainants could thereby avoid the delays of having to go through the Director's office when seeking redress of their supply problems, and they could direct the presentation of evidence and argument.

The concern that is sometimes expressed regarding direct public access to the Tribunal is that such access could be used to threaten or harass suppliers. These fears are based largely on experience in the United States with treble damage litigation and have little relevance here. The Tribunal could be relied upon to discourage any possible abuses of its procedures, like any other court.

Recommendation No. 5: The Government should be empowered to exempt particular mergers from review by the proposed Competition Tribunal.

It is possible that two acquisitions considered to have been in the overall public interest by the Government (Petro-Canada's and Ultramar's respective acquisitions of Gulf's downstream assets) would have been brought before the Competition Tribunal had Bill C-91 been law. This means that acquisitions considered to be in the overall public interest by the Government might have been prohibited by a decision-making body applying narrower public interest criteria than those used by the Government. There should be some means of implementing broad public interest criteria with respect to mergers, and only the Government is capable of so doing. A general exemption power would also place domestic mergers on a basis comparable to that of foreign mergers under the Investment Canada Act. Concerns about the independence of the judiciary that could arise if the Cabinet were given power to override a judicial decision would not arise if Cabinet approval or exemption were given before a case was brought before the Tribunal. Although there would be a cost in terms of the loss of a thorough and open assessment of competition policy concerns, it may be assumed that government intervention would only take place when there were other clear and persuasive public interest reasons for an acquisition to go ahead. It would be desirable for the government to articulate publicly its reasons whenever it declared such an exemption, as well as any terms of the exemption.

Recommendation No. 6: Refiners should not impose non-petroleum use covenants on land they sell, and should declare publicly that they will not enforce the covenants they hold on properties they have already sold.

Recommendation No. 7: Further to the conclusion regarding the standard for identifying predation, suppliers and the Director should apply the following guidelines in determining the limits of appropriate pricing in the dual distribution context of the petroleum industry:

1. *Independents should not be required to pay more, at any time, than the lowest retail price charged in the independents' market area by the supplier (i.e., at outlets where the supplier sets the pump price), less reasonable product transportation cost.*

2. *A refiners' net return from retail sales should be no less than the net return on its sales to either branded dealers or independents in any market area.* The calculation of net returns for the purposes of this test would necessarily depend upon the time frame involved and on whether the industry is depressed, static or expanding.

Recommendation No. 8: Refiners who have stated that they will not grant unpublished discounts off published prices should abandon this aspect of their "rack pricing" policies.

Recommendation No. 9: With respect to Petro-Canada:

(a) It would be in the public interest to require the recommendation of the Minister of Consumer and Corporate Affairs, in addition to the ministerial recommendations that are required under existing law, as a precondition for the approval of Petro-Canada's capital budgets, corporate plans and any amendments thereto, and for Government directives to Petro-Canada.

(b) Even though it may not be required by law to do so:

  i) Petro-Canada should not provide to others any assurances that it will not grant confidential discounts off its published prices to resellers or other large volume customers.

  ii) Petro-Canada should abandon its practice of obtaining and enforcing non-petroleum use covenants.

  iii) Petro-Canada should continue to pursue a policy of open and non-discriminatory supply from its refineries to unintegrated marketers to the best of its ability to do so.

(c) Petro-Canada and its employees should be made fully subject to the provisions of the Combines Investigation Act, except to the extent that acts are done pursuant to specific directive or approval of the Governor in Council.

(d) As long as the company is publicly owned, a Committee of Parliament should review the Petro-Canada Act and the purposes

and operations of Petro-Canada every five years. Such a review would be facilitated by a special report from Petro-Canada, and by a report from the Minister of Consumer and Corporate Affairs as to Petro-Canada's effect on those aspects of the public interest for which he is responsible.

Recommendation No. 10: With respect to federal, provincial or municipal government interventions into any aspect of the petroleum industry:

(a) The Commission commends to the federal, provincial and municipal governments alike, in regard to any regulation or contemplated regulation of entry, pricing or output, the basic principles embodied in the Federal Government's policy proposals entitled *Freedom to Move: A Framework for Transportation Reform* (1985). In particular, the Commission's examination of provincial and municipal regulation of gasoline retailing persuades it that the public would be better served if any government licensing decisions regarding new entry and proposed new offerings were guided by a test of "fit, willing and able" instead of "public convenience and necessity".

(b) The experience and knowledge of the office of the Director of Investigation and Research should continue to be made fully and openly available, through both private consultations and public hearings, to assist agencies, departments and officials of all governments in regard to such regulation of specific industries as may be thought necessary in the public interest.

(c) Aspects of the organization and performance of the downstream petroleum sector are of such general public interest and importance, that it would be desirable for federal and provincial governments to consult more systematically at senior levels in order to review industry performance and to coordinate their objectives and policies to the extent possible.

Recommendation No. 11: Restrictions on the importation of petroleum products into Canada should be avoided in order to promote competitive markets in Canada. To the extent that the Government supports continuation of a policy of open access it is important to let the industry know.

This would indirectly benefit consumers and would directly benefit potential importers and other wholesale buyers who are faced with decisions regarding investments in facilities or the duration and types of supply contracts into which they might enter.

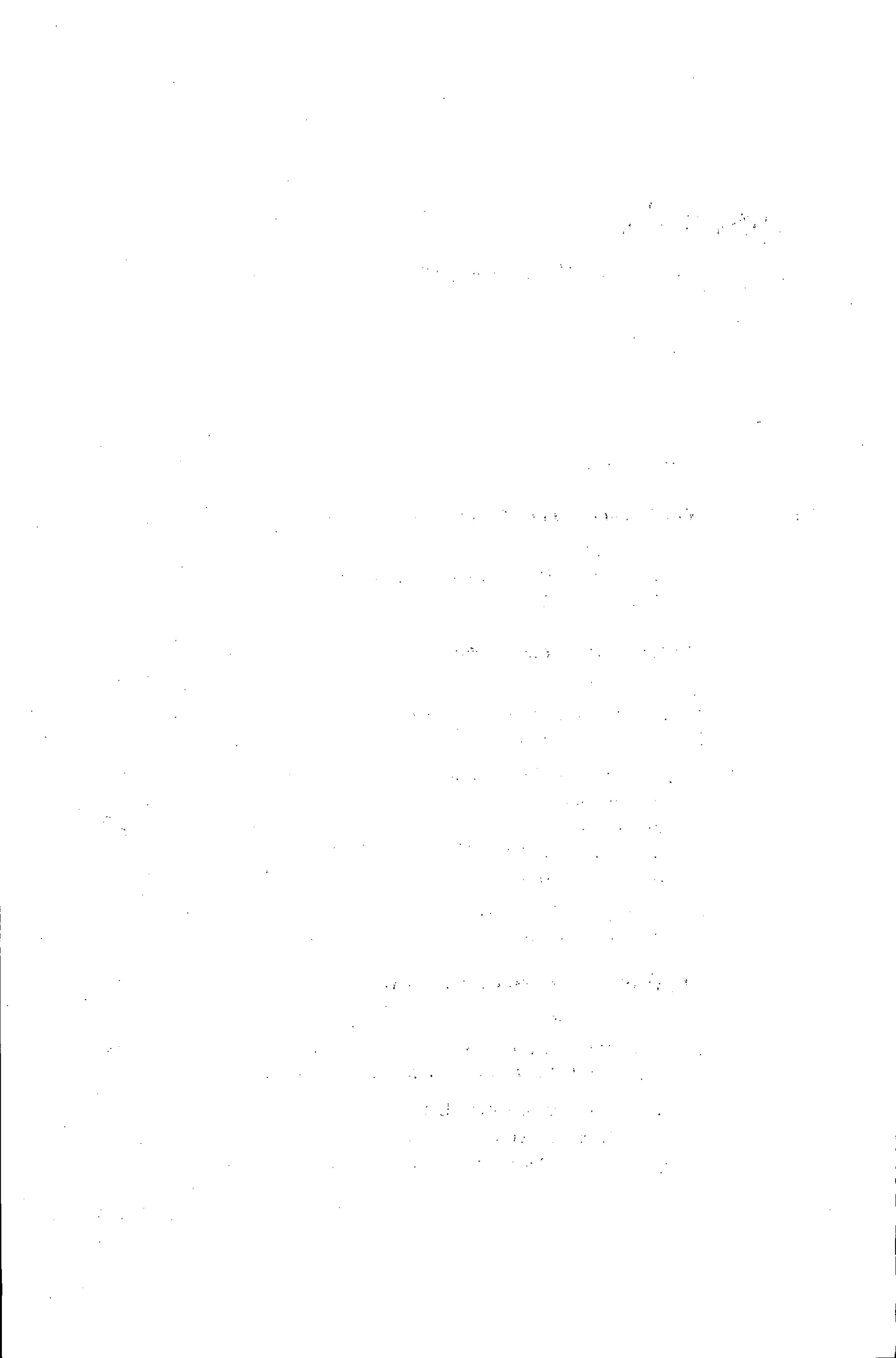
Recommendation No. 12: Consumers should seek to strengthen their market position by drawing on their collective bargaining (or buying) power.

Many organizations, including automobile associations, could usefully explore the feasibility of obtaining price concessions on gasoline on behalf of their members in a similar way that this is accomplished by a number of organizations with respect to heating oil.

Chairman

Member

Ottawa
May 16, 1986



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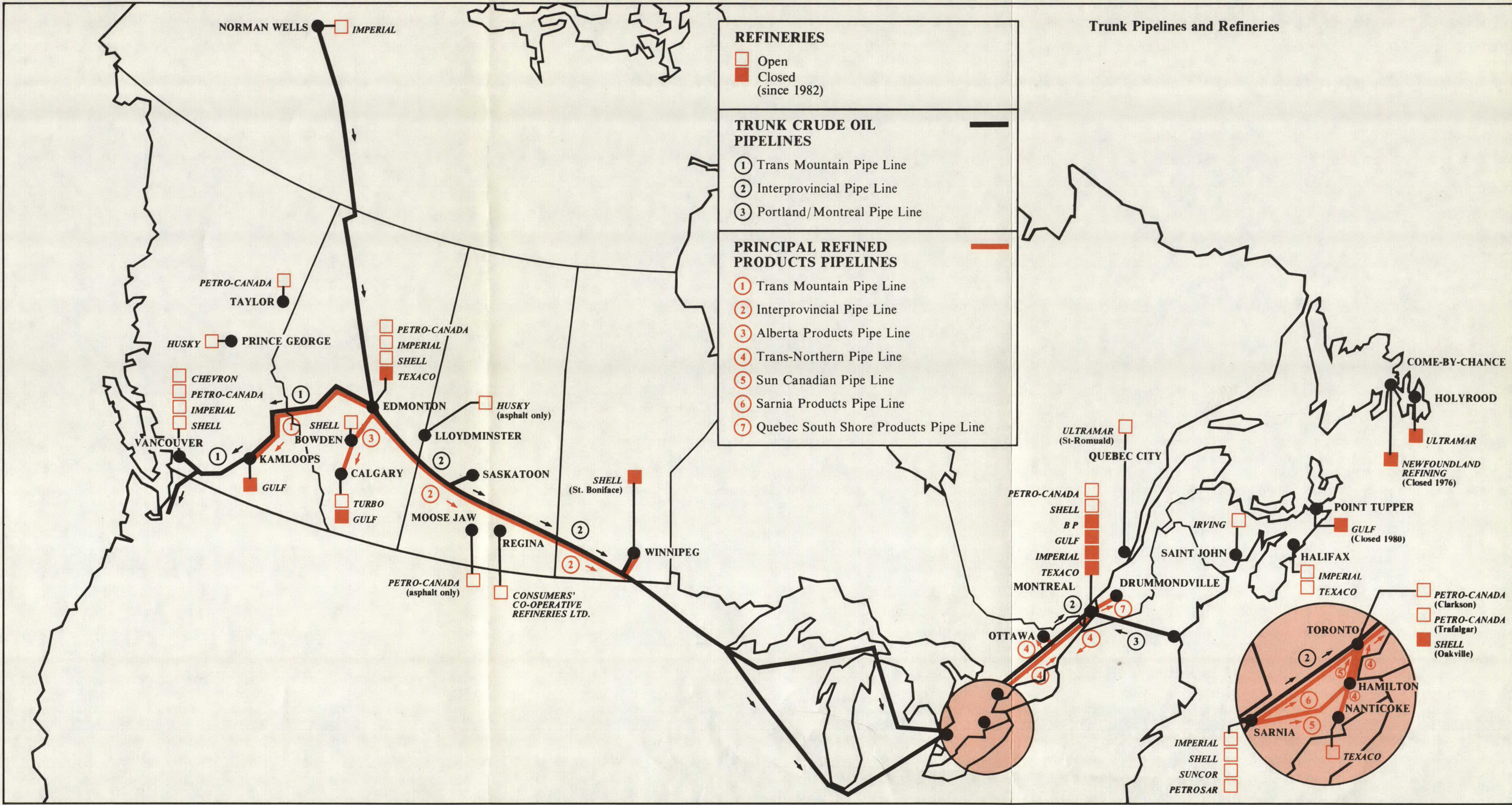
Trunk Pipelines and Refineries
REFINERIES
Open
Closed
(since 1982)
TRUNK CRUDE OIL PIPELINES
1 Trans Mountain Pipe Line
2 Interprovincial Pipe Line
3 Portland/Montreal Pipe Line
PRINCIPAL REFINED PRODUCTS PIPELINES
1 Trans Mountain Pipe Line
2 Interprovincial Pipe Line
3 Alberta Products Pipe Line
4 Trans-Northern Pipe Line
5 Sun Canadian Pipe Line
6 Sarnia Products Pipe Line
7 Quebec South Shore Products Pipe Line
NORMAN WELLS
IMPERIAL
PETRO-CANADA
TAYLOR
HUSKY
PRINCE GEORGE
CHEVRON
PETRO-CANADA
IMPERIAL
SHELL
VANCOUVER
KAMLOOPS
GULF
PETRO-CANADA
IMPERIAL
SHELL
TEXACO
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SHELL
BOWDEN
CALGARY
TURBO
GULF
HUSKY
(asphalt only)
LLOYDMINSTER
SASKATOON
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REGINA
PETRO-CANADA
(asphalt only)
CONSUMERS' CO-OPERATIVE REFINERIES LTD.
SHELL
(St. Boniface)
WINNIPEG
ULTRAMAR
(St-Romuald)
QUEBEC CITY
PETRO-CANADA
SHELL
B P
GULF
IMPERIAL
TEXACO
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HALIFAX
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(Closed 1980)
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HOLYROOD
ULTRAMAR
NEWFOUNDLAND REFINING
(Closed 1976)
PETRO-CANADA
(Clarkson)
PETRO-CANADA
(Trafalgar)
SHELL
(Oakville)
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