

THE SUPPLY OF BULK LIQUIFIED PETROLEUM GAS FOR DOMESTIC USE

RESPONSE OF FLOGAS UK LIMITED AND DCC ENERGY LIMITED TO THE

COMPETITION COMMISSION'S "EMERGING THINKING" PAPER

INTRODUCTION

1. Flogas UK Limited and DCC Energy Limited¹ note that the Emerging Thinking paper published by the Competition Commission ("CC") on 1 April 2005 and its annexes cover some of the same ground addressed in the CC's Statement of Issues published on 21 December 2004 and the draft working papers put to Flogas on 4 February 2005. The response of Flogas to the Statement of Issues and its comments made in response to the CC's draft working papers therefore remain relevant to the issues raised in the Emerging Thinking paper. Rather than repeat points made previously, Flogas has focused in this submission on what it understands to be key issues where it can add further to its previous submissions, mindful that its previous comments may yet be fully addressed and taken into account during the next stage of the CC's investigation. Where Flogas has not expressly addressed a particular view presented in the Emerging Thinking paper or its annexes, this should not be understood to indicate Flogas' agreement with that view. As regards the critical issue of safety, Flogas' views were addressed in a separate paper submitted to the CC on 15 April 2005. Comments on the individual Annexes² to the Emerging Thinking paper are attached to this document.
2. Flogas' submits that there are a number of critical factors of which the Emerging Thinking paper does not take proper account. These factors are summarised here and described more fully below:

¹ When referring to the bulk LPG business carried out in Great Britain, this Response will refer to Flogas UK Limited and, with regard to Northern Ireland, it will refer to Flogas NI. The two businesses together will be referred to as "Flogas".

² Save for Annex F: Financial performance of the major suppliers of bulk domestic LPG, which was received at a later date and will be addressed separately.

- the significance of the volatile price of propane paid by suppliers for LPG, which is reflected in the retail price to domestic customers. In recent years, retail prices have had to rise sharply to take account of rising propane costs - in these circumstances it is unsurprising if these price movements have given rise to consumers' dissatisfaction with the price of LPG they purchase;
- the lack of any evidence that the domestic LPG sector is excessively profitable or that it is operating inefficiently (i.e. that costs are higher than necessary). Where an industry is operating efficiently at profitability levels near the cost of capital, customers cannot be paying more than would be expected in competitive conditions. The conclusions on profitability therefore show that there are real constraints on the prices charged by operators in the industry, and that effective competition is taking place;
- in the context of an efficient industry where there is no excessive profitability, so called "price discrimination" operates as a competitive mechanism rather than as a barrier to competition; and
- the perceived low rate of switching by domestic LPG customers is not an appropriate basis on which to assess competitiveness in the industry. In practice, the threat of switching operates as an effective discipline on Flogas and the other suppliers, as customers are generally aware that they can negotiate prices with suppliers, and a significant proportion successfully do so, while overall suppliers do not make excessive profits from domestic bulk LPG customers.

THE WHOLESALE COST OF PROPANE

3. As Flogas has previously observed, by far the most important element in the retail price charged to domestic customers for bulk LPG is the wholesale cost of the LPG

product supplied to the customer. On average, over the last 5 years the cost of LPG amounted to [] per cent of retail sales value of LPG for Flogas UK Ltd and [] per cent of retail sales value for Flogas NI.

4. This cost is highly volatile. Propane prices can rise sharply and suddenly. For example, during the 6-month period between April 2000 and November 2000, the wholesale price of propane rose from approximately £160 per tonne to £250 per tonne – an increase of 56 per cent. Similarly, the period July 2002 to February 2003 saw the wholesale price of propane nearly double from approximately £135 per tonne to £260 per tonne.
5. Most suppliers and, in particular, non-vertically integrated suppliers, have limited ability to mitigate the risk of such cost fluctuations and will inevitably need to reflect such changes in cost in the prices they charge their customers. Indeed, the Emerging Thinking paper notes that “*changes in the input cost of propane are the main cause of changes in the retail prices of LPG*”.³ Customers for domestic bulk LPG will therefore experience changes to the price that they pay when wholesale propane costs change.
6. In those circumstances, and particularly following a period of rising prices⁴, it is unsurprising that, although customers are satisfied overall with their supply of LPG (reflecting the importance and value of service levels in this sector), they may express some dissatisfaction with the cost of LPG.
7. It is therefore a significant omission to seek to interpret levels of consumer dissatisfaction with the cost of LPG, (as the CC seeks to do at paragraph 5 of the Emerging Thinking paper), without taking account of the context of wholesale propane prices. If, as Flogas believes, consumer dissatisfaction arises from the level

³ Emerging Thinking paper, paragraph 1.

⁴ The end of 2004 saw propane prices rising again, reaching a new high in October 2004 of £263 per tonne, which was reflected in subsequent retail prices. In these circumstances, consumers surveyed in January/February 2005 are likely to have been particularly dissatisfied with the cost of their LPG.

NON-CONFIDENTIAL VERSION

and volatility of underlying wholesale propane prices, which affect all LPG suppliers, it is not surprising that this dissatisfaction is not manifested in switching by consumers. This is borne out by the belief or certainty of 46 per cent of respondents to the ORC quantitative survey who experienced price increases that other suppliers made similar increases, compared with the 2 per cent minority who thought that other suppliers had not made similar increases. Therefore, the CC's implied conclusion at paragraph 5 that low switching rates, among even those consumers who claim to be dissatisfied, is evidence of high switching costs and a lack of competition, is unfounded.

8. Indeed, it is interesting to observe that consumer letters to the OFT (as published on the CC's website) appear to have coincided with periods of rising propane prices. For example, of the 42 individuals whose letters pre-date the CC reference, approximately one third wrote during late 2000/early 2001 when propane prices had risen and were beginning to be reflected in consumer prices. Similarly, 7 individuals wrote to the OFT in the period January-March 2003, again following steep rises in the propane price in that period.
9. The analysis contained in the Emerging Thinking paper is therefore flawed in that it fails to consider the implications of the part played by underlying propane prices. The level and volatility of propane, and therefore LPG, prices which gives rise to consumer dissatisfaction is not a result of any feature that prevents, restricts or distorts competition; rather, it is the unavoidable consequence of the characteristics of the product concerned.

NO EXCESSIVE PROFITABILITY OR OPERATING COSTS

10. The Emerging Thinking paper does not find that the main LPG companies have been earning excessive returns for a sustained period, nor does it find that costs, other than possibly switching costs, are higher than they would be in a competitive market. As discussed at paragraph 15 below, switching costs are not high and it cannot be

assumed that alternative models obliging the transfer of tanks between suppliers would reduce overall costs.

11. The preliminary conclusions in the Emerging Thinking paper as regards profitability are that:

*“Accounting profit margins in GB currently appear to give rise to returns possibly above and certainly not below the cost of capital on average for the main suppliers over the last four years, although not consistently for all companies in all years”*⁵

and

*“The evidence we have seen suggests that the level of profitability in Northern Ireland may be less than in GB”*⁶

12. As regards operating costs, the Emerging Thinking paper makes the hypothetical statement that:

*“If competition is not fully effective, it might also be expected that the level of costs may be higher than in a fully competitive market”*⁷

13. In Flogas’ opinion, the expectation in a normal competitive market would be to find companies making a return that is on average somewhat, but not excessively, above the cost of capital. A consistent return below the cost of capital might suggest that presence in the market is unsustainable unless the business is peripheral to other activities and there may be some strategic reasons for a continued presence. The tentative findings of fact in the Emerging Thinking paper do not support a conclusion

⁵ Emerging Thinking paper, paragraph 13(a).

⁶ Emerging Thinking paper, paragraph 14.

⁷ Emerging Thinking paper, paragraph 13.

that competition in the supply of bulk LPG is not fully effective, but rather are entirely consistent with the position that would exist in a competitive industry.

14. Similarly, there is no basis to believe that costs in the domestic LPG business are higher than necessary. Flogas' own experience is that a successful LPG business must be tightly and efficiently managed, and there is no scope for unnecessary costs.

[]

Whilst the Emerging Thinking paper indicates that the CC is considering whether operating costs are higher than they would be in a more competitive market, at this stage, it has limited itself to suggesting an abstract possibility, rather than indicating where it believes excess costs may lie.

15. Given the concerns that the CC has expressed in section D of the Emerging Thinking paper, it may be that it is focusing on switching costs as an area where it believes unnecessary costs are incurred. However, given the high rates of customer retention, the costs associated with switching do not contribute meaningfully to operating costs. Further, it would be incorrect to suppose that alternative arrangements on switching, such as transfer of the tank in situ to an incoming supplier, would reduce costs substantially. Whilst the costs of physically changing tanks may be reduced, additional costs and inconvenience may be added as suppliers will have to verify the adequacy of the tanks they take on, modify them as necessary, and negotiate a purchase price for a tank with an outgoing supplier. In addition, uncertainty may arise as to responsibility for the tanks in the event of accidents, and incentives may be created to drive down safety standards overall, as those suppliers with better maintained tanks will find competitors more willing to take over their tanks than vice versa.

16. There is therefore no basis in the evidence summarised in the Emerging Thinking paper for the CC's conclusion that the information on profitability suggests that *"competition in supply of LPG is not fully effective, and prices for customers may be higher than they would be in a market with fully effective competition"*. Indeed, on

the basis of what the CC has set out, it would be more appropriate to conclude that prices for consumers are no higher than they should be and that competition in the supply of LPG is therefore entirely effective.

THE SIGNIFICANCE OF SO-CALLED “PRICE DISCRIMINATION”

17. In section D of the Emerging Thinking paper, having highlighted the practice of suppliers charging different prices to different customers,⁸ the CC goes on to express the concern that:

“Customers are paying more than would be expected in competitive conditions. If competition is not fully effective, for example, the overall level of prices would be somewhat higher than necessary, reflecting either higher profits or higher operating costs than would be the case in more competitive conditions.”⁹

18. Flogas would add that unless the overall level of profitability and prices are shown to be substantially higher than would be expected in a competitive market, there is no basis for the CC to be concerned about a pricing policy chosen by suppliers in response to conditions of competition in their market. Flogas itself operates a standard pricing policy in Northern Ireland, but an individual pricing policy in Great Britain. As discussed at paragraphs 10 to 16 above, neither high profits nor high operating costs appear to be prevalent in the industry in either geographic region, suggesting that competitive pressures do operate to maintain overall competitive prices for consumers.

19. Flogas chooses to price differently to different customers in Great Britain for a variety of reasons, all consistent with a competitive environment:

- []; and
- []

⁸ Emerging Thinking paper, paragraph 11(a).

⁹ Emerging Thinking paper, paragraph 11(b).

20. However, Flogas' pricing policy also ensures that:

- changes in the cost of the most important price component, propane, are reflected in price changes applied across the board to all customers; and
- it is open to all customers to individually negotiate prices with Flogas.

21. In an environment where the overall level of profitability and prices is not excessively high, Flogas does not believe that differences in prices between individual consumers should be of concern. Such price differences may result in a more efficient outcome overall, with some lower prices available that would not meet costs if they were generally applied, but which might allow wider distribution of LPG than would otherwise be the case. In this regard, it is important to emphasise that if standard prices were used in Great Britain, prices would not fall to the lowest currently available price.

SWITCHING

22. The CC continues to concentrate on the rate of switching as the key indicator of competitiveness in the market.¹⁰ As Flogas has previously emphasised, and as noted in the OFT/DTI economic discussion paper on switching costs¹¹:

“Contrary perhaps to initial perceptions, the level of switching in a market is not necessarily a good indication of the presence or importance of switching costs. It is perfectly possible for there to be a low level of switching suppliers even if switching costs are low as for example, prices may adjust to pre-empt switching.”

23. The potential for error that arises from concentrating solely on switching costs is illustrated by an aside in Annex B to the CC's Emerging Thinking paper, where it is observed that:

¹⁰ See, for example, the discussion at paragraphs 5 to 7 of the Emerging Thinking paper.

¹¹ OFT 655, paragraph 1.9.

“Indeed, it could be argued that heating oil is a more important price constraint than other LPG suppliers: a customer who is considering changing to heating oil might be expected to compare prices over a longer period (i.e. the life of the boiler), and so to be less easily dissuaded from switching by a temporary discount. In practice, LPG suppliers lose around twice as many customers to heating oil as to each other.”¹²

24. This is entirely counter-intuitive and contradicts the practical day-to-day reality of competing in the LPG market – Flogas is constrained by and pays attention to suppliers of heating oil, but considers itself as competing most closely with other LPG suppliers. Of course, the paradox is resolved when the “temporary discount” offered by an LPG supplier to a customer who may potentially switch is understood as an instance of the operation of competition, which may be just as effective as actual switching by customers. Unlike customers for LPG, customers wishing to switch to heating oil for reasons other than price cannot find their concerns addressed by a price decrease from their existing LPG supplier. Consequently, although the switching rate to heating oil might be higher than that between LPG suppliers, the explicit or implicit threat of customers switching to an alternative LPG supplier results in the greater competitive restraint, reflected in individual price negotiations.

25. Flogas notes that the CC appears to be unpersuaded by the evidence put to it by Flogas that customers are aware that it is possible to negotiate individual prices, and that a substantial proportion do so, preferring instead other evidence which apparently suggests fewer than one in twenty LPG customers know they can negotiate prices or do so.¹³ In this regard, Flogas would note the following:

- Flogas UK Limited’s figure of [] per cent of its customer base achieving effective price reductions is based on comprehensive data of prices charged to all its customers in 2003 and its knowledge of price increases that were

¹² Annex B, footnote 3.

¹³ Emerging Thinking Paper, footnote 3.

automatically put through to all Flogas UK Limited's customers. As exclusions from these increases require specific instructions, Flogas believes this data provides an accurate and robust indication of the extent to which the explicit or implicit threat of switching constrains its pricing behaviour;

- These constraints are corroborated by other data illustrating the extent to which price changes prompt calls from customers – [];
- Flogas UK Limited's experience also appears to be similar to that of at least some other companies – Flogas notes the submission of Countrywide Energy, which states that 31 per cent of its customer base individually negotiated price reductions during the course of 2003;
- Finally, Flogas UK Limited's experience reflects the results of the ORC quantitative survey commissioned by the CC, which found that 29 per cent of customers surveyed stated that they had tried to negotiate a lower price and, of these, 65 per cent had been successful.¹⁴

26. Even if the CC considers for some reason that switching levels among LPG customers are too low, there is no evidence that enforcing standard pricing policies would impact on consumers' behaviour. In Northern Ireland, where for a variety of historical and economic reasons, Flogas NI and Calor both operate standard pricing policies, switching levels are not above those in Great Britain. Furthermore, switching can never be regarded as an end in itself. If, as appears to be the case, customers as a whole are not paying high overall prices, this also supports the conclusion that alternatives to switching, such as price negotiation, are acting as an effective constraint on LPG suppliers and the market is operating competitively.

CONCLUSION

¹⁴ Footnote 2 of Annex C relies on the ORC quantitative survey to state that 12 per cent of respondents said they had tried to negotiate in the previous year, of whom 60 per cent had claimed to be successful. It is not clear how these figures are derived from the survey results. In any event, in assessing the awareness of customers of the potential to negotiate prices, the overall figure of 29 per cent is more relevant as, at a minimum, all of these customers are aware that negotiation is possible.

27. There is no adequate basis for finding that there are features of the supply of domestic bulk LPG that prevent, restrict or distort competition resulting in an adverse effect on competition or consumers. It would therefore be entirely inappropriate to consider remedies in this context, which could jeopardise the efficient and safe supply of bulk LPG.

**FLOGAS' SPECIFIC COMMENTS ON THE ANNEXES TO THE CC'S
EMERGING THINKING PAPER**

Flogas' specific comments to each of the Annexes to the Emerging Thinking paper are set out below. As noted above, where Flogas has not expressly addressed a particular view presented in the annexes, this should not be understood to indicate Flogas' agreement with that view.

Annex B: Market definition

Paragraphs 6-7: As Flogas has stated on a number of occasions, although suppliers of LPG do compete on price, they also compete on the basis of a number of other factors, including service levels. For example, Flogas has made significant efforts to improve service [], all of which may be reflected in slightly higher charges than might be the case if its service were provided to a lower standard (see also comments on Annex D: Non-price competition and entry, below). It is therefore not appropriate to imply "*that each supplier is in a separate market*" from the fact that one supplier has sustained average price levels of more than 5 per cent above others: the price difference may well reflect the added value of other features of supply.

Paragraph 8: The CC's analysis of the relevant market from the supply side does not take account of the fact that a supplier of bulk LPG specialising in supply to commercial and agricultural customers has more or less the same ability to compete for domestic customers as an alternative supplier specialising in distribution of bulk LPG to domestic customers. A supplier in this position, with established infrastructure in place, and capable of supplying domestic customers, cannot be regarded as equivalent to a new entrant. The supposed barriers to supplying the customers of another LPG company that the CC emphasises (namely tank ownership and exclusive supply by existing domestic bulk LPG suppliers) are overstated, in that the majority of domestic customers are outside

their period of exclusivity and these factors cannot be regarded as absolute barriers to supply side substitution.

The fact that most LPG suppliers supply both domestic and non-domestic customers does not mean that the possibility of supply-side substitution can be ignored. In practice, LPG companies seek to balance a mix of domestic, commercial and agricultural business, to take account of e.g. achieving density, addressing seasonality, seeking profitable business and will deploy their resources accordingly. Were, for example, supply to domestic customers to become more attractive, it is likely that LPG companies would adjust the deployment of their efforts and resources accordingly.

Annex C: Switching costs

Paragraph 3: The emphasis on standard uplift and installation charges is entirely misleading, as in practice these are rarely charged. The ORC quantitative survey commissioned by the CC itself found that the mean cost of switching identified by those who had switched was £58.95 and the median charge was £7.

Paragraph 17: As Flogas has noted previously, the analysis is flawed for a number of reasons, in particular in taking standard installation and removal charges as a basis. Further, while the CC considers the non-monetary switching costs (such as inconvenience) into account, it fails to give similar weight to non-monetary incentives that might lead customers to stay with their existing supplier despite a cost advantage (such as loyalty, security of supply and overall satisfaction).

Annex D: Non-price competition and entry

Paragraph 6: Suppliers of LPG compete on the basis of a number of non-price factors, including service levels and the security of supply. One example of this is that, []]. Security of supply is of paramount importance to

domestic customers and will have a significant effect on the level of satisfaction they have regarding the service they receive.

Paragraph 9: The CC acknowledges that it can be difficult to provide robust evidence on non-price competition; nevertheless it appears not to accept that the level of non-price competition is high. Flogas would emphasise that hard evidence of the extent of non-price competition will invariably be difficult to identify, particularly given that the LPG business operates on a much smaller scale than businesses the CC might typically examine. Flogas' day-to-day experience is that it invests significant effort in improving its service to its customers and relies on these higher levels of service in promoting itself to potential customers. For example, Flogas' systems ensure that as few of its customers suffer "run outs" as possible: [].

Paragraphs 10-13 and Paragraph 3 of the Emerging Thinking paper: Paragraph 3 of the Emerging Thinking paper refers to the CC considering whether the current market structure could facilitate non-coordinated or coordinated effects (through for example the use of similar contract periods, the low rate at which suppliers target each others' customers, and the bundling of tank supply and LPG supply). There appears to be no factual basis for this hypothesis, and no further evidence presented in the relevant Annex. Indeed, other statements in the Emerging Thinking paper and its annexes suggest considerable variation in the practices of suppliers, for example in the standard charges they set for installation and removal of tanks and the extent to which those charges are waived (Annex C, paragraph 3), the terms of the contracts which may be 3 or 5 years (Annex C, paragraph 10),¹⁵ the contractual notice period used which may be one or three months (Annex C, paragraph 6), pricing policies whereby at least one supplier prices on a local level while others do not (Annex B, paragraph 11), use of introductory prices and standard charges (Annex E, paragraph 5).

¹⁵ Note that the terms of consumer contracts will also be shaped by the requirements of consumer protection legislation rather than co-ordination between suppliers.

Paragraph 18(d): See Flogas' letter of 6 April 2005 – Flogas believes the current acquisition rate is approximately £[] per tonne.

Paragraph 25: There is no evidence that the growth of smaller players has in any way been constrained by an inability to make the necessary investments in tanks.

Paragraph 27: There is no evidence to support the statement that “dominant retailers are also the dominant purchasers” or to suggest that smaller suppliers have difficulties in obtaining a competitively prices and secure supply. From Flogas' own past experience, and its experience in acquiring smaller suppliers of bulk LPG, smaller suppliers are able to purchase LPG on similar terms to those of larger non-integrated suppliers, and obtain security of supply.

Annex E: Pricing

Paragraph 10: See Flogas' letter of 6 April 2005 – an accurate analysis of the data would show an inverse correlation between price and volume.

Paragraph 13 and paragraphs 17, 18: See Flogas' letter of 6 April 2005 – data from Flogas' legacy British Gas business appears to show clearly that customers are sensitive to price changes [].

Paragraph 15: See Flogas' letter of 6 April 2005 – an analysis of price reductions made by Flogas shows that a significant proportion relate to circumstances where a customer referred to neighbours or others in the same village receiving lower prices. Given this evidence, the CC cannot conclude that “it is not clear that such comparing of prices is widespread in the market as a whole”.