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Shell Gas Limited (SGL)

Response to Issues Statement - 21 January 2005

Competition Commission inquiry into domestic bulk LPG

Simmons & Simmons

CityPoint One Ropemaker Street London EC2Y 9SS

T +44 (0)20 7628 2020 F +44 (0)20 7628 2070 DX Box No 12

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1. **Introduction**

1.1 This paper is submitted by SGL in response to request for comment by the Competition Commission to its Issues Statement of 21 December 2004. It is not intended as a (re)statement of SGL's views on every issue set out by the Competition Commission, and reference should be made in particular to SGL's Initial Submission of 29 July 2004 for an overview of its views.

1.2 The main points made in this paper, *[excised]* are as follows:

(A) SGL welcomes the recognition that safety considerations are, above all, important in this sector.

(B) SGL remains agnostic on the issue of whether the supply of domestic bulk LPG is part of a wider market, for example including heating oil or other energy sources – these are certainly at least partial substitutes, and therefore must provide competitive constraints;

(C) SGL considers that there is no question of each supplier forming a separate market, as each competes directly with other suppliers for customers, as evidenced for example by the results of price negotiations with its customers;

(D) While several separate markets for complementary products and services might be postulated, SGL believes that there are advantages to the consumer in the provision of a *bulk LPG System* under a single contract. These advantages arise partly out of safety issues, but also out of economic efficiencies and the fact that consumer preferences on the whole are better satisfied. This point is relevant to a number of the issues set out in the Issues Statement;

(E) In this context, the Competition Commission may wish to consider whether the relatively high degree of customer movement between domestic bulk LPG and heating oil evidences competition between the *bulk LPG system* on the one hand and the *heating oil system* on the other;

(F) On the issues of switching and pricing, we make the following comments:

(1) It is accepted that there are certain barriers to switching in this market, some but not all of which are related to the existing supply model;

(2) As a matter of economic theory, low levels of switching are not necessarily indicative of uncompetitive markets;

(3) SGL does not have a policy of price discrimination against longer standing customers. Indeed, analysis of SGL's data *[excised]* confirms that there is no practice of systematic price discrimination against such customers. *[Excised]* this evidences a competitive market, albeit one where the *nature* of competition is affected by the existence of switching costs;

(4) The Competition Commission is urged to consider whether there are efficiencies[1] arising out of the existing supply model (or indeed costs/inefficiencies with other models) as part of its broader consideration of prices and profits;

(5) Further, price competition is not the only indicator of a competitive market (indeed it is not the only form of competition) and the Competition Commission is urged not to limit its analysis to pricing alone. For example, high levels of customer satisfaction evidence the high degree of importance placed on offering the customer the best service (an indicator of competition amongst suppliers);

(6) As a subsidiary point, we comment on why the natural gas and electricity markets may have been taken as a comparison by some consumers (and indeed, as regards levels of switching, by the OFT) and why such a comparison is inappropriate;

(7) *[Excised]*;

(8) SGL acknowledges that there are a number of different operating models used in other countries but does not consider these to be compatible with the current HSE framework in Great Britain (or, it appears, customer preferences).

[1] **The legislative duty is of course to consider whether there is an adverse effect on competition (and, if so, to then consider if a remedy is required). It is submitted that this first step (is there an adverse effect?) does not require testing for negative factors alone, but – in particular where, as here, the logic of the case may well involve comparing different supply structures – the Competition Commission should consider efficiencies as part of this exercise.**

1.3 The following paragraphs address the issues A-I set out by the Commission in its Issues Statement[2]. We have mirrored a number of the headings but in certain sections we have merged the issues (so that, for example, the nature of competition in the market is dealt with under a single heading which encompasses switching, pricing and profitability). There are some issues on which we have not commented at all at this stage.

2. Market definition

2.1 It is considered that the most limited possible product market is that for the supply of domestic bulk LPG (though other forms of energy such as heating oil, LPG cylinders, electricity and of course natural gas where available are close substitutes and may in fact be part of the same market).

2.2 In our Initial Submission of 29 July 2004 we put forward the view that there are possibly a number of related (complementary) markets within the domestic bulk LPG sector. These include rental of tank and associated pipework, installation, safety checks, maintenance and emergency cover (not all of these are mentioned in the Issues Statement at point 7(c), notably installation, safety checks and emergency cover). While these complementary products and services may be viewed as separate markets, it may also be helpful to think of these markets in terms of provision of a *bulk LPG system* provided to the customer under a single contract as there is a logic (in terms of safety, efficiency and customer preference) in providing them together. This has a number of important implications, including the safety issues mentioned in the Issues Statement, but also regarding the question of economic efficiencies, consumer preferences, and the nature of competition between LPG and heating oil (in essence, heating oil already offers a different supply model to consumers, while fulfilling the same domestic energy needs[3]).

2.3 The Issues Statement suggests that the relatively high level of switching to heating oil may suggest a broader market, or alternatively suggest a level of pricing that may give rise to the cellophane fallacy[4] (point 6(b)). In our view the level of switching reflects the fact that heating oil is a close substitute and therefore a competitive constraint on pricing: it can fulfil all heating functions of LPG[5], can be used for cooking with an Aga[6], and can

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[2] **We have not directly addressed the applicability of Articles 81 and 82 EC or remedies at this stage.**

[3] **Heating oil can fulfill all such needs, with only minor differences as detailed below.**

[4] **SGL accepts the economic logic of the statement, but does not believe LPG pricing is such that the cellophane fallacy issue arises in this case.**

[5] **The only differences are minor; for example, it cannot produce a "flame effect" gas fire.**

otherwise be combined with electricity or LPG cylinders to cover the range of energy needs[7]. Indeed, the LPG market is slowly shrinking partly because of a certain amount of switching to heating oil. We would also point out that the figures the Competition Commission has most likely examined to date (including SGL's own switching figures) will underplay the extent of interaction between the two products, *[excised].*

2.4 We strongly rebut the implication at paragraph 7(b)(i) of the Issues Statement that each supplier may form a separate market. As further detailed in paragraphs 3 and 4 below, LPG suppliers compete against one another to meet the aggregate competitive constraints which exist in this market. In particular, while there is a relatively low level of switching as a matter of fact, there is clearly competition on price (and level of service more broadly) in order to retain customers.

3. Market Structure

3.1 The reasons for a degree of market concentration are largely historic.

3.2 The market has only been established for 20-25 years. In the initial 10 years, a large number of small companies entered the market and contributed to a significant growth in the mini-bulk market by using their local knowledge and delivery logistics. Through the period of maturity, concentration increased as the larger companies bought the smaller independents to realise efficiencies within the mini-bulk market. *[Excised].*

3.3 Total market demand is now in decline (-2% per annum) particularly in the domestic segment (this is clearly reflected in the DTI Gas sales statistics for 2004). Domestic customers are being lost to other fuels such as natural gas as access to mains gas improves, and (as noted above) to heating oil (and/or electricity and/or LPG cylinders). Although there are some new customers entering the market from both the affluent and poorer ends of the spectrum, the trend shows a net loss. Pressure on volumes and margins has driven concentration of the market and this may be anticipated to continue as the need for critical mass will increase.

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6 **A not-unpopular choice of cooking facility for the normal customer profile for bulk domestic LPG consumers.**

7 **It is also more likely to be recommended by heating engineers than bulk LPG, and this is perhaps the single most important factor in a consumer's decision when changing boiler.**

3.4 Despite this increasing market concentration, competition between suppliers remains fierce, especially for new build properties. All suppliers must strive to compete against other suppliers across the spectrum, *[excised]*

3.5 We refute the suggestion that the degree of concentration facilitates any non-coordinated action or any coordinated effects in this market (point 9(b) of the Issues Statement). No indication is given of the nature of these actions or effects, such that it is difficult to fully address the issue without the provision of further detail. For the time being (and without suggesting that this comprehensively addresses all the potential issues that might be implied by the broad terms used in the Issues Statement), we would simply mention that the lack of transparency between suppliers (for example, there are no published prices or indeed standard prices) implies that both tacit and explicit co-ordination would be extremely difficult in this market. Further, the comments on the nature of competition in the market made below contradict the point.

4. **The nature of competition in the domestic LPG sector (including the issues of switching, prices and profitability)**

Introduction

4.1 At paragraph 10 of the Issues Statement the Competition Commission remarks upon the OFT's original assessment of levels of switching, suggests that it ought to test this, and further (and in our view more importantly) consider the effect (if any) on competition. A number of specific considerations are then outlined. In SGL's view, this set of issues is of central importance to the investigation. The issues need to be understood (as the Competition Commission clearly indicates) in the context of safety concerns, and in particular those issues outlined at points 15-18 of the Issues Statement. The Issues Statement thus reflects to some degree a recognition of the link between the putative existence of switching costs and the model of the market, and the link between both of the above and safety considerations. Below we set out certain observations in relation to the nature of price competition in the presence of switching costs on both a theoretical level and in relation to an analysis of how SGL behaves in this market.

4.2 Before turning to those issues, we would mention that there are other important dynamics which are not specifically dealt with in the Issues Statement, which are related to the issue of switching costs and the model of the market, and which should be borne in mind. In particular, the extent to which the industry competes to offer the best level of customer product/service through the package of goods/services provided under a single contract with the consumer. The focus in the Issues Statement on switching costs and price competition should not obscure important elements of non-price competition *[footnote excised]*, for example, or efficiencies in the existing market model and the degree to which such a model meets consumer preferences better than any other model.

4.3 Both SGL's own studies and the qualitative survey commissioned by the Competition Commission suggest high levels of consumer satisfaction. There is also a suggestion in the Competition Commission's qualitative survey carried out by ORC International that most customers would not want to own their own tank. While it has to be recognised that there is a degree of dissatisfaction with price on the part of some consumers, it must also be understood that consumers will not normally be aware of the degree of subsidisation of initial costs (and thus the level of risk), or the impact of recent increases in the oil price. They may also feel dissatisfaction arising out of a comparison – which we believe is an inappropriate comparison – with the liberalised network-based natural gas and electricity markets.

Comparison with natural gas and electricity markets

4.4 Regarding the use of the natural gas and electricity markets as comparators, in terms of rates of switching or for any other purpose, we note that the OFT made a comparison between domestic bulk LPG customer switching and levels of switching between customers for mains gas and electricity which has been cited in the Issues Statement. In our view, other than the fact that these markets also relate to domestic energy use, there are very few similarities between them and the LPG market due to fundamental differences in the nature of the product. Moreover we note that there are no economic reasons why switching rates in two different markets should be similar, even when similar competitive conditions prevail. It should also be noted that the OFT has itself pointed out that "the level of switching in the gas and electricity markets is relatively high compared with other sectors in the UK (such as fixed-lined telecommunications, mortgages, or current accounts)[8], such that it is particularly important to test whether these markets are in fact appropriate comparators.

4.5 While domestic customers may use natural gas and electricity as a point of reference (indeed virtually all domestic LPG customers will also be electricity consumers[9]), these markets are not at all similar to the LPG market in terms of economic dynamics. LPG is

[8] **OFT/DTI Economic Discussion Paper 5 – Switching Costs, Annex C at paragraph 2.1.**

[9] **This may lead to the assumption on their part that the ability to switch at short notice automatically drives down prices, which is a function of the introduction of competition at supply level that has gained wide publicity.**

not delivered through a network (with the corollary that there is no natural monopoly in infrastructure that requires price regulation), but rather on the basis of a significant investment in infrastructure on-site (namely the tank and related pipework), significant (variable) delivery costs in the form of individual supply by road tanker, and thus average supply costs (per therm) that will fluctuate widely between individual customers[10]. One consequence of this is that whereas a low-volume consumer of electricity/natural gas may nonetheless bring an economic return to the electricity supplier, the low-volume purchaser of domestic bulk LPG is likely to lead to the supplier making a loss, even over the longer term, as the price per litre paid will not be sufficient to recoup sunk costs (and/or the ongoing safety, delivery and maintenance costs).

4.6 Alongside the fact that it is rational to allow prices to vary with (inter alia) volume of consumption due to inherent cost structures (inherent given the nature of the product and the need to deliver individually), it should be borne in mind that this is a significantly smaller market than the electricity/natural gas markets such that per unit costs of intensive advertising or direct marketing *[footnote excised]* (e.g. by cold-calling) become prohibitive. Even if this market were to operate on the basis of separate tank (etc.) and gas supply, it would in SGL's view be quite wrong to assume that the level of marketing would approach the level seen in the natural gas and electricity markets *[footnote excised]*.

Customer satisfaction

4.7 While the OFT's comparison with natural gas and electricity is in SGL's view misplaced, SGL accepts that levels of switching are in fact not high. It does suggest that the fact that levels of switching (to other LPG suppliers or to heating oil) are quite low *[footnote excised]* is consistent with the high degree of satisfaction with LPG exhibited in SGL's own market survey and the qualitative market survey commissioned by the Competition Commission. Given that the choice of heating solutions involves a decision between a *bulk LPG system* and the quite different heating oil model (in which the householder generally purchases its own heating oil tank, but then has choice of supplier for oil) it is submitted that it may also suggest general satisfaction with the supply model – i.e. provision of a system under a single contract - currently existing in LPG. Heating oil is cheaper per therm once installed for the consumer, and has fewer obstacles to switching supplier of oil (the householder generally purchases its own tank).

Price competition

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10 **This is in contrast to the natural gas/electricity supplier facing comparatively minor fixed costs.**

4.8 Perhaps most fundamentally, low levels of switching do not in and of themselves suggest ineffective competition. In our Initial Submission of 29 July 2004 *[excised]*, we have referred to the fact that new customers will consider the initial cost of installing the tank and also the LPG price that they will be charged in the subsequent years of use. If a supplier has a reputation of raising its prices after an initial period, that supplier would be unlikely to attract a large number of new customers. This reputation effect *[footnote excised]* helps protect longer standing and less price sensitive customers. *[Excised]* analysis shows that new customers to SGL have not been paying consistently lower prices than existing customers and that amongst existing customers, more recent customers have not been paying consistently lower prices than older customers. This is consistent with our view that new customers protect those existing customers who consider themselves locked in or captive to their existing supplier and this implies that the two groups of customers are not separate segments of the market.

4.9 In summary of what follows on the issue of price competition:

(A) low levels of switching do not necessarily indicate a lack of competition;

(B) in the absence of price discrimination, competition for new customers and "switchers" effectively prevents existing customers from being exploited;and

(C) the empirical evidence in this case is consistent with the existence of effective competition in this market. Specifically:

(1) the costs directly attributable to the installation of tanks (excluding the capital cost of the tank itself) are not fully covered by the installation charge made to the customer, *[excised]*

(2) there are relatively low levels of switching (i.e. very few customers switch to SGL from a rival LPG supplier, or vice versa), but this is not necessarily indicative of ineffective competition;

(3) there is no significant price discrimination between old and new customers. The price per litre of LPG paid by individual customers does not seem to have any relationship with the number of years they have been supplied by SGL *[excised]*; and

(4) effective competition is ensured by the fact that customers have the concrete possibility to switch more than by high levels of switching in themselves.

Indeed, levels of switching may be low in a competitive market, as firms adjust their price to prevent customers from switching. *[Excised]*

4.10 *[Excised]*

4.11 *[Excised]*

4.12 *[Excised]*

4.13 *[Excised]*

4.14 *[Excised]*

4.15 Turning to non-price competition, the high degree of consumer satisfaction shown by surveys evidences the importance SGL (and in the case of the Competition Commission's own survey, other companies) places on non-price competition. *[Excised].*

5. **Metered Estates**

5.1 SGL has less than *[excised]* of its customers on metered estates *[excised]*.

5.2 Metered estates are typically greenbelt developments which have one or several tanks supplying a group of individual domestic units. The size of this group may range from 2-3 units to as many as 50 units. *[excised]*

5.3 *[Excised]*

5.4 The decision to install the metered estate infrastructure lies with the developer/estate owner. It is often impossible to install individual tanks given the limited extra space available on housing estates (and indeed on caravan/camp sites), the alternatives of cylinders may be unattractive for practical and economic reasons, and heating oil cannot operate on a metered basis. On a metered estate, safety distances surrounding the LPG tank are maintained and residents benefit from the advantages which gas has to offer.

5.5 Given the collective nature of such estates, metered estate customers are inevitably in a different position to individual customers. *[Excised]* indeed the qualitative survey carried out by ORC International reports that there are little differences in the views between customers on metered estates and individual customers. SGL recognises that customers on metered estates do face a number of choices. *[Excised]*. There is also the real possibility for individual customers to switch to an alternative fuel supply such as electricity or LPG cylinders.

5.6 *[Excised]* The possibility of individual customers switching to heating oil is limited largely because of spacing requirements.

5.7 *[Excised]*

6. Safety

6.1 SGL welcomes the recognition that safety considerations are important in this sector.

6.2 Although different operating models are used in other countries, SGL does not consider these to be compatible with the current legal framework in Great Britain. Nor, indeed, are alternative models preferable in order to best meet consumer preferences in aggregate (including competitive pricing).

6.3 SGL would like to comment briefly on the issues flagged by the Competition Commission under "Operational Issues" (paragraph 17). SGL agrees that it is important that clarity in responsibility in maintaining and installing tanks and related pipework[11] as well as providing emergency services is important, as is cost-effectiveness (the underlined terms go beyond the scope of the Issues Statement). Further to those comments in the Issues Statement, SGL would add that it is also important to consider whether the responsibility falls on the person(s) best placed (in terms of technical/safety knowledge) and with the right incentives (including economic and reputational incentives) to best carry out maintenance and safety checks, provide emergency services/engineering works. However much clarity there is, it would not be appropriate to place such responsibilities on the homeowner, for example.

6.4 Further issues also arise (which may be called "operational" or concerned with "possible alternative arrangements") concerning not just safety of tanks, but responsibility for any adverse incident or other damage to the tank and pipework during delivery. *[Excised]*

7. Possible detrimental effects on customers

7.1 A comment that SGL has previously made is that it is difficult to divorce individual issues such as barriers to switching, pricing, safety, costs, efficiencies and profitability from the broader consideration of the model of the market (or indeed to divorce consideration of each such issue from the others – they are strongly interrelated). Certain potential

[11] **This typically includes underground pipework from the tank to the building(s) being supplied.**

additional costs – such as insurance – have been mentioned by the Competition Commission already.

7.2 There are several other likely costs and losses of efficiency that will occur, depending upon the model in question. For example, the buyer power of the suppliers may lead to reduced maintenance costs where such work is contracted out, and this would not occur if individuals had to arrange their own services. By way of further example, unless tank supply is undertaken by the supplier of fuel and power, the reduced rate of VAT (5%) would not apply, but rather the tank supply (though not gas supply) will move into the standard rate of VAT (ie 17.5%)[12].

7.3 It is natural for some consumers to complain about price rises, and particularly so where recent rises in the oil price have required a number of price increases. It is also perhaps natural for some customers to be spurred by comparison with the liberalised natural gas and electricity networks to assume that choice of supplier automatically brings benefits through enhanced competition.

7.4 However, while switching costs do affect the nature of competition, they do not in and of themselves tell us anything about whether competition is likely to be effective. *[Excised]* analysis of SGL's data suggests that there is no significant price discrimination and a number of factors which economic theory would suggest indicate that there is likely to be effective ex ante competition. *[Excised].*

7.5 *[Excised].* Most customers do not wish to own (let alone maintain, etc) their own tanks. Further, provision of a *bulk LPG system* under *[excised]* year contracts protects low-usage consumers from facing a disproportionate burden; if the tank and other services were provided separately, the cost of gas[13] may become prohibitive to a number of users (and if the market shrinks this may have the effect of increasing unit costs).

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12 **This is SGL's understanding of the position, confirmed by HM Customs & Excise Notice 701/19, in particular at point 2.2 (final 3 paragraphs), available at:**

www.hmce.gov.uk/channelsPortalWebApp/channelsPortalWebApp.portal?_nfpb=true&_pageLabel=pageHome_ShowContent&id=HMCE_CL_000510&propertyType=document

13 **The costs of tank rental plus other services will be separated out and charged directly to each customer under such a model. While a heavy user may offset this against lower average LPG prices over time (though this itself depends upon a number of assumptions – not least that increased search and attract costs do not outweigh the "benefit" of not recouping certain sunk costs through the gas price), the low-volume consumer would presumably be likely pay more per therm than currently.**

8. Concluding remarks

8.1 As mentioned above, SGL cannot at this stage address every point in the Issues Statement (not least because some issues are at a very high level of generalisation). SGL would welcome further insight into the Competition Commission's views and in particular the relative degree of importance attached to the individual issues as this inquiry progresses.

8.2 In due course it may well be important to more fully address issues raised by the various models in contemplation by the Competition Commission. In SGL's view this would best be done once the nature of the perceived adverse effects is further elaborated[14]. SGL welcomes the recognition of the importance of safety, and would welcome a broadening of the debate to include efficiencies, costs, consumer preferences and other aspects of the market referred to above.

[14] **Indeed, some these issues may be more suitably addressed in full at the remedies stage (if required).**