

The supply of bulk liquefied petroleum gas for domestic use

Statement of issues

Introduction

1. On 5 July 2004, the Office of Fair Trading (OFT) made a reference to the Competition Commission (CC) under its statutory powers for an investigation into the supply of bulk liquefied petroleum gas for domestic use¹ (which we refer to as 'domestic bulk LPG'). The reference was made to the CC following a number of customer complaints to OFT, particularly in relation to:
 - the pricing of domestic bulk LPG;
 - the difficulty of switching between suppliers; and
 - certain other aspects of the relations between customers and their suppliers.
2. As a result of the reference, the CC is required to determine whether any feature of the market for the supply of domestic bulk LPG prevents, restricts or distorts competition.² In addressing these concerns, we have already received a considerable amount of evidence from customers, suppliers, trade associations, public sector bodies and other interested parties (some of which will be summarized on our web site), on the basis of which we have identified the issues set out in this statement. (We are also carrying out surveys of customers, and have commissioned consultants to carry out a review of technical matters, the results of which will also be placed on our web site when available.)

¹Originally the terms of reference referred to the supply of 'domestic bulk LPG' with domestic being defined as supplied for use by households as well as for use by businesses whose consumption of LPG by volume is similar to that of households. Following consultation by the OFT, the terms of reference were amended to refer to the supply of 'bulk LPG for domestic use' and the definition of domestic was removed. 'Bulk' means supplied by tanker to fixed storage tanks, as opposed to cylinders.

²We are required under our terms of reference and Section 134(1) of the Enterprise Act 2002 to decide whether any feature, or combination of features, of the market for the supply of bulk LPG for domestic use in the UK or a part of the UK (the 'reference market') prevents, restricts or distorts competition. If the CC decides that there is such a prevention, restriction or distortion, then there is an adverse effect on competition (Section 134(2) of the Enterprise Act 2002). It should be noted that a number of the issues raised may not in themselves directly prevent, restrict or distort competition, but may be relevant as indicating the presence of conditions that could give rise to, or facilitate, adverse effects on competition in that market, or those markets.

3. In the light of the evidence already received by the CC, we set out in this statement a number of issues which appear to be relevant to our investigation. However, no decisions have yet been taken on any issue set out in this statement. Its purpose is to expose the CC's current thinking as to the nature of the issues raised, and to invite comment on these issues (or any other issues parties may consider relevant). The CC plans to hold a number of hearings with interested parties to discuss these issues early in 2005. As our thinking develops, we may issue a further document for consultation prior to publishing our provisional findings. Should we then subsequently decide there are adverse effects on competition, we would then consider possible remedies.

4. At this stage, the central issue appears to us to be the difficulties (and costs) experienced by customers in switching to another supplier. To assess whether this is indeed leading to higher domestic bulk LPG prices than would be the case in conditions of effective competition and/or other harm to competition, we have to define the market(s) in which competition to supply domestic bulk LPG to customers in the UK occurs, and to assess competition in and affecting that market(s) taking into account in particular:
 - market structure;
 - switching between suppliers;
 - barriers to entry and expansion;
 - pricing;
 - profitability; and above all
 - safety.

Presentation of the issues

5. The detailed issues are as follows.³

A. Market definition

6. We will have to consider what is the relevant product market within which to assess competition. Our current view is that the supply of domestic bulk LPG can be regarded as a relevant product and/or service market and that this provides a useful framework for assessing competition issues, but we will need to explore the following issues in detail:

- (a) the scope for substitution between domestic bulk LPG and other fuel sources including LPG cylinders, mains gas, heating oil and electricity;
- (b) the extent of switching between domestic bulk LPG and other fuels. For example, the present rate of switching by customers to heating oil, although very low, appears to be higher than the extent of switching to other domestic bulk LPG suppliers, and we may need to consider whether this is indicative of a broader market, or of prices for domestic bulk LPG being higher than a competitive level;⁴
- (c) relative prices of domestic bulk LPG and of other fuels (given quality/feature differences), and whether these relative prices have changed over time;
- (d) the extent to which other fuels constrain prices of domestic bulk LPG to customers—taking account of availability (eg of mains gas), conversion costs, and the limited periods over which a customer may consider switching (eg, given the cost of a new boiler, when a boiler needs to be replaced); and

³In addressing the issues that appear to arise in this inquiry, the CC has adopted the approach set out in the guidelines for market inquiries in its published document *Market Investigation References: Competition Commission Guidelines* (CC3). (A copy of this document is on the CC's web site. The relevant sections of CC3 for the purposes of this statement of issues are Parts 2 and 3.) As explained in that document, the CC's approach to market investigations will normally be framed in terms of two related matters. The first is the identification of the relevant economic market or markets for the goods or services concerned. These define the framework for the assessment of competition. The second is the assessment of competition and involves a consideration of whether any features exist that might prevent, restrict or distort competition within or affecting the economic market or markets concerned. Features which might adversely affect competition fall into three broad categories: structural features of the market, the conduct of firms in the market (whether as buyers or sellers), and the conduct of customers. In addition, CC3 suggests that other indicators of competition should be considered, such as prices and profitability.

⁴See the reference to the 'cellophane fallacy' in paragraph 2.9 of CC3.

(e) the implications of price discrimination when defining relevant markets, particularly in relation to the effects on profitability of a possible domestic bulk LPG price rise, which may, for example, narrow the relevant market to certain groups of customers or certain geographic areas.

7. We will also have to consider:

(a) whether supply to domestic bulk LPG customers is in a distinct market or markets from supply of bulk LPG to other customers, taking into account any scope for substitution by suppliers between domestic and other customers;

(b) The extent to which:

(i) domestic bulk LPG suppliers constrain each other's prices, or whether supply by each company could be regarded as a separate segment of the market; and

(ii) the distinction between competition for new customers and competitive constraints on supply to existing customers, and whether new and existing customers could be regarded as separate segments of the market.

(c) Whether there are separate markets for bulk tanks for use by domestic bulk LPG customers; maintenance of those tanks; and supply of LPG to those tanks; and

(d) The geographic extent of the relevant market, in particular whether local markets exist within Great Britain (taking into account possible chains of substitution⁵ between local areas) or Northern Ireland; and whether Northern Ireland is a market distinct from Great Britain.

Some of the points in paragraph 6, for example on the scope for substitution and on relative prices, would also apply to these issues.

⁵See paragraphs 2.29 to 2.31 of CC3.

8. The following issues are relevant to our consideration of whether any features exist (including any conduct of firms or customers in the market) that might prevent, restrict or distort competition in or affecting the supply of domestic bulk LPG.

B. Market structure

9. We will need to consider whether the high degree of market concentration affects competition. OFT estimated that Calor, Flogas, Shell and BP account for about 90 per cent of supply of domestic bulk LPG, with Calor alone accounting for close to 50 per cent.⁶ Calor and Flogas appear to be the only two suppliers in Northern Ireland. This degree of market concentration is likely to have increased as a result of acquisitions. We will need to consider:
- (a) whether these shares of supply figures are correct;
 - (b) how this level of concentration has been sustained (and increased) over a long period, and whether this is the outcome of any features that might prevent, restrict or distort competition; and
 - (c) whether this level of concentration facilitates any non-coordinated action or any coordinated effects.

C. Switching

10. OFT estimated that less than 1 per cent of domestic bulk LPG customers switch between LPG suppliers each year.⁷ This compares, for example, to annual switching rates of around 15 per cent for mains gas and 22 per cent for electricity.⁸ We will need to consider whether this low rate of switching by domestic bulk LPG customers is correct; and if so what features in the market cause this low rate of switching: particularly whether it is due to high expected costs or barriers to switching relative to expected benefits, the nature and size of any such costs or benefits, and/or any

⁶The OFT's reasons for making a reference to the Competition Commission, July 2004

⁷The OFT's reasons for making a reference to the Competition Commission, July 2004.

⁸Source: Ofgem—Domestic Competitive Market Review 2003.

uncertainty as to their nature and size. We must also consider the effect (if any) on competition of the low level of switching by domestic bulk LPG customers to alternative LPG suppliers, and whether competition may as a result be ineffective in constraining the level of prices charged to customers. The following issues may be of particular relevance.

(a) We have been told that suppliers seldom, if ever, allow customers to receive domestic bulk LPG from another supplier into their tanks; nor do they supply into the tanks of other suppliers.⁹ Moreover, domestic bulk LPG suppliers in general retain ownership of the tanks which they install in domestic premises, and remove these tanks at the end of the supply agreement. As a result, switching supplier entails removal of the remaining LPG from the existing tank, removal of that tank, and installation of a tank belonging to the incoming supplier. Among the implications we may need to consider are that:

- (i) each of these stages can entail a cost to the customer, along with the possibility of inconvenience and the risk of a break in supply during the process;
- (ii) direct charges for removal of an existing tank and installation of a tank from a new supplier are often below the level of costs, and in some cases there is no charge. But in some cases it is only apparent after the decision to switch has been taken whether or not a customer will be charged for removal of a tank, or what that charge will be;
- (iii) even if the direct charges to customers for installation of a tank from a new supplier are below the level of installation costs, such costs are ultimately passed on to the customer, which may reduce the incentive to switch to other suppliers; and

⁹Except if they have acquired the business of another supplier, including its customers' tanks. Some smaller suppliers do, however, supply some tanks owned by customers, as infrequently do some larger suppliers.

- (iv) the increasing use of underground tanks may further increase the costs of changing a tank and switching to another supplier.
- (b) Other barriers to switching may include:
- (i) the difficulties faced by customers in obtaining quotes for supply;
 - (ii) the use of three-year initial contracts (although the large majority of customers are beyond the initial term), and three-month notice periods for termination of contracts (even beyond the initial contract period) which give suppliers an opportunity to retain their customers following an approach from a competitor;
 - (iii) a possible lack of clarity in contracts, in particular any costs of changing supplier; and
 - (iv) uncertainty as to whether particular terms in contracts will be enforced.
- (c) On the other hand, we will need to consider whether requirements of safety justify all the precautions taken in supply of domestic bulk LPG and ownership of tanks which may inhibit switching (see section H).
- (d) The ability of suppliers to price discriminate between customers means that they can respond to competitive threats at a lower cost, by reducing prices only to those customers who appear likely to switch. Among the implications we may need to consider are that:
- (i) this may also discourage competitors from trying to win the supplier's customers;
 - (ii) in principle price discrimination may also enable suppliers to price more aggressively to each other's customers, but in practice the extent to which domestic bulk LPG suppliers approach customers of other suppliers appears to be limited; and
 - (iii) the ability of suppliers to sustain higher prices to existing domestic bulk LPG customers than to new customers (ie new to that supplier) may be

further evidence of significant switching costs, in that a large proportion of customers do not switch to avail themselves of these lower prices.

- (e) While competition for customers new to domestic bulk LPG may be stronger than for existing customers, the number of new customers is a small proportion of the market.

D. Barriers to entry and expansion

- 11. We will need to consider whether there are barriers to entry to the market or to expansion by smaller suppliers in the market, and if so what is their effect, including:
 - (a) whether switching costs referred to above may create a barrier to entry or expansion, for example:
 - (i) whether, in trying to win a customer, an entrant will always be at a disadvantage to the current supplier as, faced with equivalent price offers, the customer will prefer to stay with the current supplier to avoid switching costs; and
 - (ii) whether any such disadvantage may be particularly significant in a market with relatively few new customers where a new or expanding supplier would have less scope to grow its customer base by winning customers as they enter the market.
 - (b) the extent to which the market is expanding or contracting, and the implications for entry and expansion of smaller suppliers;
 - (c) the difficulty in finding or contacting current domestic bulk LPG customers;
 - (d) whether existing firms respond to entry/expansion and, if so, the implication of their doing so, including whether price discrimination enables them to respond to specific competitive threats without lowering prices to their broader customer base (as in paragraph 10(d));
 - (e) whether larger firms enjoy economies of scale from, for example, more sophisticated distribution systems, greater density of their customer base

reducing average delivery costs, ability to guard against future LPG price changes, wider brand recognition, the opportunity for upstream integration, or in acquisition of new tanks;

- (f) whether the need for qualified engineers certified for LPG work may act as a barrier to entry or expansion;
- (g) whether the market for tanks, both new and second hand, has implications for new entrants and smaller suppliers, for example whether they may be disadvantaged by the absence of a market for second hand tanks and any other difficulty in obtaining tanks; and
- (h) whether historical entry/exit patterns suggest it is difficult to enter the market, or subsequently expand, on any significant scale.

E. Pricing

12. We will need to consider whether aspects of the pricing of domestic bulk LPG over time indicate, result from, or give rise to constraints on competition, in particular:

- (a) whether some or all customers are paying more than they would in competitive conditions, on the basis, for example, of:
 - (i) price comparisons with other, particularly smaller, suppliers; and
 - (ii) analysis of the dispersion of prices charged to different customers of the same supplier, and whether these seem to be objectively justified.
- (b) whether there is scope for and evidence of price leadership or coordination between suppliers;
- (c) trends in retail domestic bulk LPG prices, and the extent to which they reflect factors other than trends in wholesale LPG or other costs;
- (d) possible lack of price transparency, including:
 - (i) the difficulty for customers in comparing suppliers on the basis of current and future prices (including the difficulty in the absence of any easily accessible price lists in obtaining details of such prices); the extent to which

suppliers are unable or unwilling to commit to future prices; and any further difficulty for customers in making like-for-like comparisons of prices of different suppliers given the number of different prices (eg installation costs, tank rental or standing charges, and gas prices) to compare;

- (ii) the link for individual suppliers between increases and decreases in retail prices and prices of commodities (eg propane, crude oil); the extent to which this link is adequately explained to customers; and how the link to a fluctuating input cost affects price transparency at the retail level;
 - (iii) whether 'price smoothing' (delays in passing on input cost increases or decreases) and the timing of price changes have been to the benefit or detriment of customers; and
 - (iv) the extent to which costs of tank supply are not made explicit for customers and are recovered through higher prices for supply of domestic bulk LPG, and whether this reduces price transparency, or otherwise adversely affects competition.
- (e) the existence, nature and extent of price discrimination including its effect on competition (see paragraphs 10(d), 11(d) and 12(a)).

F. Profitability

13. The CC will need to consider

- (a) whether profits substantially in excess of the cost of capital, over an appropriate time period, of any firm or firms that represent(s) a substantial part of the market are earned on supplying domestic bulk LPG to customers as a whole, or to particular categories of domestic customer or on particular activities. We are therefore considering:
 - (i) the revenues and costs (appropriately allocated, at appropriate transfer prices) including capital costs for domestic bulk LPG suppliers: as domestic bulk LPG is not a stand-alone activity, costs will need to be allocated to this

activity; issues may also arise about the cost to suppliers of LPG if bought from a group company;

(ii) the profitability of domestic bulk LPG compared to the cost of capital, or in comparison with other LPG businesses; and

(iii) the appropriate cost of capital we should use in assessing whether profits are excessive—for example, that for a group as a whole, of whose activities the supply of domestic bulk LPG may only be a part; or a cost of capital specifically related to the supply of domestic bulk LPG as a stand-alone business.

(b) whether there is any evidence that the level of costs of any supplier is higher than would be sustainable in a more competitive market; and

(c) whether the vertically integrated companies derive a benefit from being so, and, if so, whether those benefits are passed on to customers of domestic bulk LPG.

G. Metered estates

14. We have received a number of complaints from residents of 'metered estates', where a group of customers are supplied from a single tank installation. In some cases the supplier supplies the domestic bulk LPG customer direct; in other cases it supplies the developer/estate owner, who then sells the LPG on to the domestic bulk LPG customer. We may need to consider whether there are issues specific to metered estates, for example:

(a) whether such developers/estate owners can also be regarded as suppliers of domestic bulk LPG;

(b) whether supply to metered estates or different categories of metered estate can be regarded as a separate sector of the market;

(c) whether customers on metered estates face additional barriers to switching, including the need to coordinate with other customers on the estate, or additional contractual barriers (for example, in contracts between the customers

and the property developers or estate managers, or between the estate manager and domestic bulk LPG supplier);

- (d) whether there may be particular barriers to entry or expansion by smaller suppliers to supply metered estates; and
- (e) whether prices to customers on metered estates charged by the domestic bulk LPG supplier and/or the developer/estate owner fail to reflect the cost of supplying those estates.

H. Safety

15. We will need to consider the extent to which any current arrangements which may have detrimental effects on competition for supply of domestic bulk LPG are justified by the need for safety. Such arrangements may include the ownership of a tank by the supplier of domestic bulk LPG to that tank, and the need for the customer to change tank if changing supplier (although we noted above that there are some suppliers who do supply some customers' tanks and that some suppliers supply tanks acquired as part of the business of other suppliers). This will include consideration of the extent to which current arrangements are necessary given the various legal requirements associated with safety both of supply of domestic bulk LPG and of domestic bulk LPG tanks. The following are among the other main issues on this point.

(a) Technical issues

16. Although we have been told that most tanks are technically similar, we will need to consider the extent to which, due to the lack of compatibility between certain key fittings and some of the tanks installed or differences in configuration, suppliers are unable to supply domestic bulk LPG to tanks owned by other parties. Specific issues include:
 - (a) possible differences between filler valves and the need for adaptors;

- (b) possible safety concerns associated with the use of adaptors; and
- (c) lack of practicality of training drivers in the characteristics of various tanks (which would be needed to be able to carry out safety checks).

(b) Operational issues

17. We will need to consider whether current arrangements, whereby the supplier of domestic bulk LPG generally installs and owns the tanks to which it supplies, are necessary to ensure clarity in responsibility for safety of tanks. We will also need to consider whether such current arrangements may be the most cost-effective way of ensuring safety of supply of domestic bulk LPG and of tanks (including insurance costs associated with supply of domestic bulk LPG).

(c) Possible alternative arrangements

18. On the other hand we may need to consider whether the current arrangements for ownership of tanks unnecessarily impede switching of suppliers:
- in order to reach a view on whether current arrangements adversely affect competition in the market, we need to consider whether alternative arrangements including those set out below may have maintained an acceptable level of safety, but may have led to lower switching costs by removing the need to replace tanks when changing supplier;
 - one alternative arrangement that we need to consider when assessing whether current arrangements adversely affect competition is an arrangement whereby the existing domestic bulk LPG supplier could have transferred the ownership of the tank to the new supplier at the point of switching. In considering this, we will need to consider whether, as some customers have suggested, transfer arrangements could have been made, on reasonable terms and conditions (including the price of the transferred tank) and maintaining an acceptable level of safety;

- other possible arrangements could have involved ownership of the tank other than by the supplier of the domestic bulk LPG: either by the customer or by a separate company;
- we will need to consider whether there are any contractual terms which would have been necessary and/or sufficient to have maintained safety under such possible alternative arrangements, and the technical and operational implications of such possible alternative arrangements.

I. Possible detrimental effects on customers

19. We will need to consider whether any effect on customers in the form of higher prices, lower quality or less choice of goods or services, or less innovation has resulted from, or may be expected to result from, any adverse effects on competition in the relevant market or markets.

J. The applicability of Articles 81 and 82 of the EC Treaty

20. Under the EC Modernisation Regulation,¹⁰ national competition authorities applying national competition law must also where applicable ensure that Articles 81 and 82 of the EC treaty are applied to agreements or conduct that have an effect on trade between member states¹¹. It is therefore appropriate for the CC to consider whether Articles 81 or 82 of the EC Treaty are applicable to any agreements or conduct in the relevant market or markets.

¹⁰Council Regulation 1/2003/EC, article 3(1).

¹¹In addition the CC is subject to Article 10 of the EC Treaty, which requires that Member States cooperate fully with the European Community in the attainment of the objectives of the EC Treaty, and that application of national law must not prejudice the full and uniform application of EC law, including Articles 81 and 82.

K. Possible remedies

21. The question of what, if any, remedial action might be necessary is a matter which the CC will address, if necessary, at a later stage.¹² We would nonetheless welcome any views on possible remedies from any parties who may consider that there is an adverse effect on competition, for our consideration if appropriate at that stage. Should we consider possible remedies, we would be required to consider the effect on any relevant customer benefits.

¹²If the CC decides that there is an adverse effect on competition, it is required under Section 134(4) of the Enterprise Act 2002 to decide the following additional questions:

- (a) whether action should be taken by it under section 138 for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition;
- (b) whether it should recommend the taking of action by others for the purpose of remedying, mitigating or preventing the adverse effect on competition concerned or any detrimental effect on customers so far as it has resulted from, or may be expected to result from, the adverse effect on competition; and
- (c) in either case, if action should be taken, what action should be taken and what is to be remedied, mitigated or prevented.