COMMENT AND ANALYSIS

THE PETROLEUM INQUIRY REPORT: ITS CURRENT IMPLICATIONS

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INTRODUCTION

The Restrictive Trade Practices Commission's report *Competition In The Canadian Petroleum Industry* (Ottawa, 1986) attracted front-page headlines at the time of its release last June, after which it more or less disappeared from public view. While there is nothing unusual about that, it is unfortunate in this instance. The press concentrated upon just one aspect of the report, namely the Commission's repudiation of the so-called overcharge or "rip-off" allegations that the Director of Investigation and Research had made about the industry's conduct during a period of years ending in 1973. One would hardly have guessed from some press accounts that the *Report* deals largely with current conditions in the industry, that it finds cause for serious concern and that it proposes remedial measures. Excluding appendices and summaries, less than 100 of the *Report's* 498 pages are devoting to dismissing the overcharge allegations; the remainder deals with more current concerns.

Let it first be said that there was poetic justice in the treatment of the *Report* by the media. When the Director sent his voluminous Green Book with its allegations to the Commission in 1981, he broke all precedent by calling a press conference to release it. There followed a torrent of headlines about the industry having "ripped off" consumers to the tune of many billions of dollars. The industry had not even received any copies in advance and was left at a disadvantage in replying to the charges at the time. Thus there was an element of fairness in the subsequent emphasis by the press that the allegations had been largely repudiated by the Commission. Moreover, in this writer's view, the Commission was on solid ground in the harsh treatment it accorded the Director's Green Book. In particular its dollar estimates of extra costs allegedly borne by consumers of petroleum products could not be substantiated. In addition, by the time it appeared in 1981, much that was in it had been overtaken by events in a rapidly changing national and international energy situation. The Director did, however, deal with more current issues during the hearings that were held subsequently by the Commission.

At the same time, before moving on to matters of more current concern, the impression should not be left that the conduct of the industry prior to 1973 was above reproach. The Commission's report does establish the validity of some of the Director's concerns. For example, excessive prices were indeed paid for imports of crude oil by some of the multinational oil companies and this probably did encourage imports of high cost refined products; the extent of control over distribution by the refiners was and is restrictive of competition; and there were inefficiences in the retailing system.

The remainder of this paper examines the Commission's Report as it relates to more recent conditions in refining and in the supply and distribution of gasoline. Those were in fact the Commission's principal areas of concern. While the Commission considered the crude production and pipeline sectors as well, it made no recommendations relating thereto. There are also sections in the Report on heating oil and on crude oil imports, neither of which are discussed herein. All of the Commission's formal recommendations, including one involving heating oil, are mentioned herein.

More Recent Conditions

Many of the Commission's competition-related concerns had to do directly or indirectly with the conditions under which petroleum products, particularly gasoline, are distributed. Essentially, it found control by refiners over gasoline retailing to be pervasive and anti-competitive. It traced the root causes of many of the problems to be the oligopolistic structure of refining together with its vertical integration into retailing.

The refining sector constitutes a quite highly concentrated oligopoly, consisting of four firms with national markets (Imperial, Petro-Canada, Shell and Texaco) and seven with regional markets. Irving in New Brunswick is the largest of the regionals, followed by Ultramar in Québec, Suncor in Ontario, Federated Co-Operatives in Saskatchewan, Husky in B.C., Turbo in Alberta and Chevron in B.C. The four majors account for about 70 percent of total Canadian refinery production. Four-firm concentration ratios are consistently higher on a regional basis, and are highest in Atlantic Canada where there are just three refiners, followed by Québec where there are just four. As the Commission pointed out, however, those regions are rather narrowly defined and there is trade between contiguous regions.

Over 85 percent of retail gasoline sales are made through outlets each of which sells exclusively one refiner's brand and over the retail pricing of which the refiner exercises varying degrees of control. As is explained more fully below, the control may consist of outright ownership and operation of the retail outlet or simply of contractual arrangements.

The Commission noted that technological factors make high concentration unavoidable in Canada with its huge area and relatively small population. The most efficient scale of plant is now about 200,000 barrels per day (b/d); smaller plants may, of course be most efficient in areas of low population density after transport costs are taken into account. Total Canadian consumption is of the order of 1.5 million b/d, and there are now 28 refineries in operation with a total capacity of about 1.8 million b/d. Both production and capacity reached a peak in the late 1970's. While there have been a number of refinery closures since then, there remains substantial excess capacity, and the Commission considered that further closures of some of the smaller plants should be expected. Refining costs rise rapidly as output declines below full capacity, and the Commission attributed the prevalence of retail price wars in the early 1980's in part to the excess capacity.

Petro-Canada has added significantly to the already high levels of concentration in refining. Its interests were originally in exploration and development. However, by a series of acquisitions beginning in 1979 it has become the second largest refiner in Canada and the largest retailer. The

Commission was strongly critical of Petro-Canada's acquisition in 1985 of the downstream assets of Gulf, then the second largest refiner in the country. Petro-Canada's earlier acquisitions of regional refiners (Pacific Petroleums, Petrofina and B.P.) had already made it the fifth largest with a national market penetration of about 15 percent. In commenting on the Gulf acquisition the Commission stated:

> When two of five firms in an oligopoly merge, serious questions arise about the extent to which independent competitive initiative will be inhibited. The concerns are magnified when the firms are vertically integrated and the principal product is as homogeneous as gasoline. The risk is as much from 'competitive interdependence' as from tacit understandings arising. There is less chance of discord developing from differing strategies among firms or from imbalances in supply and demand among firms. Petro-Canada's general growth up to the time of the Gulf purchase had contributed to an important loosening of the country's long-established oligopoly of four national majors, by virtue of Petro-Canada itself growing to the size of the other four, partially by taking market share from them. (pp. 338-9).

One result of the large size and long term nature of investment in a refinery is that refiners competing for markets on a national scale almost inevitably have surplus capacity in some regions and deficits in others over considerable periods of time. The time from initial planning to completion of a refinery may be of the order of ten years. As a consequence, refiners serving a wide area normally acquire petroleum products from other refiners in some regions and supply petroleum products to competing refiners in other regions. The volumes involved are significant. For example, the Commission reported that 16 percent of Imperial's product deliveries in 1981 came from other refiners and that it supplied comparable volumes to other refiners. The percentages for some of the other refiners including Petro-Canada have been much higher.

The arrangements under which these inter-refiner transactions are conducted vary widely according to circumstances, but many of them constitute reciprocal supply agreements. Typically, Refiner A agrees to supply Refiner B with a certain volume of product in one region for a period of a year or more, in exchange for which Refiner B will supply Refiner A with a comparable volume in another region. While the details of the agreement may be complex, it is essentially a trade, and price only enters in a marginal way to compensate for imbalances in the exchange.

The Commission found that, with capacity surpluses and refinery closures, the scope of exchange agreements had been increasing both in terms of duration and of volumes exchanged. They cited a series of agreements between Gulf and Texaco as probably the largest of such arrangements. It provided:

1. Gulf would process for Texaco in Edmonton.
2. Gulf would supply product to Texaco out of Edmonton in exchange for product supplied by Texaco to Gulf out of Nanticoke.
3. Texaco would process for Gulf at Nanticoke.
4. Gulf would process for Texaco at Montreal.
5. Texaco would sell to Gulf out of Dartmouth and Gulf would sell to Texaco out of Montreal.
6. Gulf would terminal for Texaco at Clarkson.
7. Texaco would terminal for Gulf at Calgary. (pp. 237-8).

The Director was strongly critical of reciprocal supply agreements, contending that they function "as a proxy for vertical integration where such vertical integration does not exist". He cited the following as anti-competitive effects of the system:

> First, the agreements permit the industry to co-ordinate capacity changes. Second, they entrench the market shares of those industry participants who own refining capacity. Third, they reduce the availability of product to marketers who are not integrated. *(Remedies Argument, p. 17).*

He proposed that all reciprocal supply agreements with durations in excess of 90 days be prohibited unless approved by the Commission. He hoped thereby to place refiner-marketers in a position more comparable with that of independent distributors when acquiring supplies in excess of their own productive capacities.

The Commission declined to recommend an *a priori* prohibition, preferring a process of case-by-case adjudication by the Tribunal under a provision of more general application. In any case, it seems doubtful that prohibiting that particular form of contractual arrangement would be sound in principle or would necessarily bring a larger untied wholesale market for gasoline. Moreover, the Commission took into account evidence from the refiners that exchange agreements offer certain economic advantages such as security of supply and in some cases the most favourable terms.

At the same time, the Commission was concerned that exchange agreements could seriously restrict competition by reducing the free wholesale market for gasoline. It also expressed concern about collateral terms in some exchange agreements, stating:

> There are, also, collateral terms in some of the inter-refiner supply agreements in evidence that are not necessary to the purpose of the agreements, that may have exclusionary effects in particular markets, and that should be subject to being reviewed under the *Combines Investigation Act.* Examples of such provisions are the following:
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> 1. Exclusive dealing provisions or preferential rights or options regarding additional supply whereby a supplier of refining or terminal capacity obtains or acquires a right to receive the total business of the customer.
>
> 2. Preferential rights or options on the part of the customer with respect to surplus processing capacity in the refinery.
>
> 3. Preferential treatment of a large volume customer, pursuant to contract, in times of supply shortage.
>
> 4. Lengthy duration of certain agreements for large volumes extending beyond the reasonable need. For example, although one can understand long term supply contracts being entered into in conjunction with a refinery closure, it is difficult to justify a contract duration that exceeds the 8 or 10 year planning horizon for even a large refinery.
>
> Each of these types of contract terms could have substantial foreclosure effects in particular cases, and a review process should be available to prevent unreasonable exclusionary effects. (page 249).

A matter that occupied a great deal of the Commission's attention was the degree to which the refiners control or influence retail prices. It found their presence to be pervasive and to be exercised in a number of ways depending upon the ownership or contractual relationship between the refiner and the retailer.

One type of control is exercised by direct ownership and operation of an outlet by a refiner through agents or employes. This type of control has been increasing with the advent of self-serve. From a central management viewpoint, it is simpler to operate a self-serve outlet than one of the traditional kind with a servicing bay. In 1981 there were 19,401 outlets selling refiners' first or second brands of which 2,702 were self-serve, and a large proportion of the latter were probably owned and operated by refiners. The total number of outlets has undoubtedly declined since 1981 while the number of self-

serve outlets has increased. Moreover, average sales of self-serve outlets are substantially higher than those of full service stations.

The remaining 16,699 outlets selling refiners' brands in 1981 probably consisted for the most part of full-service stations operated by lessees but also included miscellaneous outlets such as country stores and garages. Leasing arrangements vary according to circumstances. According to the Commission, the lessee frequently owns the land and the refiner installs the facilities. The parties than enter into five-year cross-licensing arrangements whereby the lessee undertakes to sell the refiner's brand of gasoline exclusively and the refiner agrees to supply it.

Pricing arrangements between refiners and dealers were in a state of change when the Commission issued its *Report*, and the reader should bear this in mind. In what follows, after noting some of the Commission's findings, reference is made to changes which have apparently occurred since.

Refiners normally delivered gasoline to their dealers at the so-called Tank Wagon Price. It was a delivered price, tending to be on the high side and not very responsive to changes in competitive conditions. When, as was frequently the case, the prevailing retail price in an area left too small a margin for the retailers to survive, the refiners provided financial support for their lessees in one of two ways.

One way was for the refiner to offer to place the lessee on consignment, the latter receiving a commission of about three cents per litre on his sales of the refiner's gasoline. According to the Commission, some refiners' consignment arrangements clearly gave them control over what retail price would be charged.

For example, some were tied to a maximum retail price, with the dealer's commission falling or even being withdrawn as he lowered his price below the maximum level. In other cases, the locus of control over prices was unclear to the Commission, and it stated: "Any doubt or ambiguity about the dealers' authority over their prices is also a cause for concern" (page 367). The locus of control over the retail price is a matter of great importance both to the dealer and to the refiner. The dealer's volume of sales will decline if he is prevented from matching the prices of his neighbouring competitors, while the refiner's revenue per litre declines as prices fall. Figures obtained by the Commission from seven refiners including the four largest ones at the time indicated a rapid increase in the proportion of retail sales of their branded gasoline over which they exercised direct retail price control either through ownership of retail outlets or through agency arrangements. The proportion varied widely among refiners, but it was generally less than ten percent in 1970 whereas it ranged from 14 percent to 56 percent in the early 1980's. The number of outlets operating under agency arrangements is believed to fluctuate widely in response to changes in downward pressure on prevailing retail prices.

The other way that refiners offered financial support for their dealers was to offer to insert a clause in the lease whereby the dealer would be "placed on support" when the margin between the prevailing retail price and the Tank Wagon Price declined below a certain point in the region, usually in the vicinity of three cents per litre. In the cases of Imperial and Petro-Canada, maximum support was provided when a dealer's price was at or near prevailing levels, and it diminished rapidly as the dealer's price rose substantially above or below the prevailing price. The Suncor and Texaco programs were somewhat different in detail, and it was not clear to the Commission how those companies controlled dealer price reductions. However, on June 24, 1986 the District Court of Ontario in Toronto found Sunoco guilty on price maintenance charges and subsequently imposed a fine of $200,000.00. The case involved a Sunoco lessee on support who lowered his price to match that of an independent retailer. Sunoco refused to grant the lessee a compensatory increase in support, contending that the support program was only to enable the lessee to match the prices of neighbouring

Esso and Petro-Canada outlets. Sunoco's object was clearly to contain the extent to which retail prices could be reduced.

The Commission reported that independent wholesaler-retailers also received some support from the refiners, particularly during periods of low retail prices in 1982 and 1983. Sales to those buyers are priced on a different basis than sales to lessees for a variety of reasons, one being that the independents usually pick up the gasoline in their own tank trucks and distribute it to their retail outlets. According to the Commission, support to the independents was at a lower level of retail margins than for brand name outlets and was more sporadic. The refiners described the support as a way of adjusting the wholesale price. The Commission found no instance where refiners took control of an independent's pricing, but stated:

> It is, nevertheless, questionable whether independents felt themselves free to follow any pricing strategy they might choose. They would understandably feel constrained from engaging in aggressive price behaviour which could lead prices down, given the fact that the support was given at the refiners' pleasure. (p. 363).

Imperial Oil at certain times did have some agency agreements with independents whereby Imperial set the price. (p. 372).

The Commission's principal objection to the support programs was that they were tied in one way or another to a price or price range chosen by the refiners. The Commission stated:

> The most important objectionable feature of support programs is addressed by the Director's recommendation that support or changes in wholesale prices should not be 'tied' to retail prices. 'Predominant prices' create a target price. When prices are changed the refiners identify the 'predominant price' and thereby set the new price at which their dealers can earn the maximum margin or commission. Therefore, in spite of the fact that not all refiners set their dealers' prices under support, tying support levels to retail prices allows common prices as desired by refiners to become more quickly established than would occur if refiners simply stated wholesale prices. (p. 368).

As indicated above, shifts have been occurring in the refiners' pricing procedures. Shortly before publication of the Commission's Report, Imperial adopted a system of so-called rack pricing. Prices are set for each of a number of broad classes of customers. They are subject to change in response to economic conditions, and the support programs have been eliminated. The Commission's reactions to Imperial's initiative were generally favourable. It did express concern about reports, later denied, that Imperial would not be granting any unpublished discounts to independents. Since the Commission's Report, there has apparently been some movement by other refiners away from consignment and other support programs in favour of zone prices that are altered in response to prevailing conditions.

It is clearly not possible, in this article, to document or evaluate whatever changes have occurred. It would be of great interest indeed if the refiners were found suddenly to have lost their interest in influencing retail price levels.

The refiners' dual roles as gasoline distributors to their branded outlets and as suppliers to independent distributors has lead to perennial concerns that the independent marketers might be subject to various forms of predation, including refusal of supplies and price squeezes. The only domestic sources of supply for the independents are refiners who compete with them at the wholesale and retail levels. Refiners must be sorely tempted at times to impose price or supply difficulties upon independents, whether to police price cutters or simply to preserve or increase their own retail market shares. Indeed, the mere existence of a potential for predation must exert some influence on otherwise autonomous business decisions by independents.

There is no doubt that predation has occurred down through the years because instances of it have come to light. For example, supply difficulties experienced by Perrette Dairy Limited were brought before the Restrictive Trade Practices Commission by the Director in July 1979. According to the Director, Perrette operated a chain of convenience stores in the Province of Quebec of which 32 had gasoline bars. Imperial and Petrofina would not agree to supply except on a consignment basis, and Irving's policy was and is not to sell to independent distributors. Perrrete was obtaining some gasoline from other sources but, by July, 1979, was only obtaining 60 percent of its requirements. At that time, Perrette called for tenders from 19 suppliers but none was willing to supply. In October, 1980, the Director withdrew his application to the Commission after Perrette had succeeded in obtaining additional supplies. The period was one of gasoline shortages, but it must be unsettling for an independent to find that his integrated competitors have first call upon available supplies.

Another example, that of Merit Oil Company Limited, is mentioned in the Commission's report. The company operated 47 retail stations around Vancouver and Victoria. In 1980, according to the Commission, Merit was having difficulty in obtaining better prices from some of its suppliers and in obtaining an increased supply from Petro-Canada, from whom it was receiving a satisfactory price. Merit sold out to Petro-Canada in 1981. The Commission stated:

> After the acquisition, Petro-Canada increased its supply to the former Merit outlets by accelerating its liftings under supply agreements in Western Canada, by reducing the amount of its tender business and by importing some product. (p.332).

As indicated above, Irving, whose refinery at Saint John is the largest in the country, refuses as a matter of policy to sell to independent distributors.

Notwithstanding the foregoing it appears that, by and large, the independents have been able to obtain supplies from Canadian sources in recent years. The Commission stated:

> Notwithstanding any opposition or concern on the part of their marketing departments, the corporate policy of most refiners is to supply independents as a matter of policy. At the present time Irving Oil is the only refiner that is known to refuse to supply independents as a matter of policy. In the Commission's view this is a critical area since the denial of supplies is the ultimate predatory weapon. There were some difficulties during a period of shortages in 1979-80. The policy of Irving Oil of refusing to sell to independents also raises a serious question since this company controls a large part of refining capacity in the Atlantic Provinces. (pp.2867-7).

That still leaves open the question whether independents have been subject to price squeezes. Once again, the Commission's answer seems to be in the negative, although with qualifications. Cost estimates presented by the Commission indicate that the levels of support were such as to permit reasonably well located and managed lessees to survive but certainly not to earn excess profits. There was, and may still be, an excessive number of full service outlets, and the less efficient ones were going out of business because of the competition of more cost-efficient self-serve outlets. The cost of reasonably efficient gasoline distribution seems to have been in the range of three to four cents per litre. The Commission concluded from its data and estimates that, at least in the period 1979-83 inclusive, the margins available to lessees and independents were not out of line with the net returns from refiners' own outlets or with costs. An exception was the smallest independents, whose margins were such that the Commission found it difficult to see how any such firms could long survive. (p.395).

There have been no government-imposed restrictions on imports of petroleum products since prices of crude oil were decontrolled in June, 1985. The Commission emphasized the importance of keeping the import option open, stating:

> Events over the past few years have greatly increased the importance of the import option as a check on the market power of domestic refiners. Declining sales of petroleum products from 1979 to 1984 have resulted in a number of refinery closures which, along with acquisitions in the industry, have led to increased concentration in the refining sector and higher rates of capacity utilization. Such changes, taken by themselves, tend to reduce domestic competitive pressures. Although offsetting economies or benefits may make particular closures and acquisitions in the public interest, they do increase the importance of the remaining ways to promote competition. (p. 253).

The structure and economics of the industry are, however, such that imports are not always a viable option for an independent who considers himself to be a victim of predation. The simplest but most expensive means of importing gasoline is by tanker truck from the United States. There are some such imports, but they are small and can be viable only where the final destination is close to the U.S. border.

An independent distributor would have to incur significant investment and risk in order to import gasoline economically. He would have to acquire or have access to storage facilities for receiving shipload volumes at dockside. In addition, he would need assured access to a sufficiently large number of retail outlets to enable him to dispose of a shipload within a reasonable space of time. Gasoline formulas must be changed seasonally in Canada, and he would have to take that into account in arranging his imports. In addition, the volatility in recent years of world prices and of retail margins in Canada, the latter due in part to sporadic price wars, adds to the risks of importing. The lapse of time between arranging the purchase of a shipload and its disposal is much longer than that between a domestic purchase and its disposal.

Historically, oil product imports have consisted more of fuel oils than of gasoline, and reached their highest levels from about 1965 through 1973. During those years a number of independents had the necessary facilities both for gasoline and fuel oils. However, by the time of the Commission's report, only one independent had the facilities, and they were designed for fuel oils rather than gasoline.

Factors which led to a decline in imports included increases in Canadian refining capacity and the Import Compensation Program under the National Oil Policy. That Program, which existed in various forms from 1974 until April 1982, discriminated in favour of crude imports and against product imports, with a devastating effect on the latter.

Notwithstanding the discouraging history, there are at present no government-imposed restrictions on product imports. Consequently, if Canadian prices were to remain consistently higher than the landed cost of imports for a long period, there would be an incentive for independents to invest in facilities for importing. As the Commission pointed out, it is just possible that those conditions have begun to emerge.

The Commission's Recommendations

The Commission made twelve formal recommendations, all of which are reproduced below. Conceptually, they address the principal concerns expressed in the *Report*. Under the first Recommendation, the Competition Tribunal would be empowered to strike down "any conduct that

would substantially lessen competition". The new power would apply to all business and, with respect to the oil industry, it would certainly encompass refinery products exchange agreements, service station support programs, refusals to supply and price squeezes. The second Recommendation calls for the onus to be placed on suppliers with high degrees of market power to justify refusals to supply. The fourth calls for persons who are refused supply to have direct access to the Tribunal. Guidelines defining predation are provided in the seventh Recommendation..

Other recommendations call for no reimposition of import restrictions, no non-petroleum use covenants in service station property sales, tighter government control over anti-competitive practices by Petro-Canada, and no anti-competitive interventions in the industry by any level of government. With regard to anti-competitive mergers, reliance would be placed upon the newly enacted merger provisions. Oddly, however, the Commission favours allowing the government to exempt a merger from review by the Tribunal.

Many of the recommendations are to be welcomed and, if acted upon, would improve the industry's performance from a public interest perspective. However, the proposal to enlarge the powers of the Tribunal along the lines of Recommendation No. 1 is most unlikely to be implemented in the foreseeable future. The *Competition Act,* enacted a few days after the release of the Commission's Report, deals with abuse of dominant positions in s.51. It would clearly be premature to consider amendments relating to that section until it has been thoroughly tested in use. Yet, without Recommendation No. 1 or something approaching it, the Commission's concerns about potentially restrictive practices such as refinery products exchange agreements, service stations support programs or predation would be difficult to resolve fully.

Moreover, the desirability of a provision as broad as Recommendation No. 1 would require careful evaluation. The Commission enlarged upon that Recommendation as follows:

> Under such a section an order could be issued by the Tribunal wherever it could be established to its satisfaction that the conduct in question has or would substantially lessen comppetion. The Commission considers that such a provision ought not to 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. (Now section 51 of the Competition Act in somewhat revised form).

Even the ill-fated Bill C-256 of 1971 did not propose anything quite as sweeping as that. Under sections 37 and 41 of that bill, where two or more persons "acting in concert or apparently in concert", substantially control a market, a competition tribunal was to be empowered to prohibit such persons:

> from entrenching or extending or attempting to entrench or extend his or their monopoly position in the market in which he or they carry on business or in any other market by any action the effect of which would be to prevent the entry of any person into or the continuation or expansion of the business of any person in a market, or from so doing other than on terms and conditions prescribed in the order.

After fifteen years of often acrimonious public discussion, what emerged in law was Section 51 with its panoply of curbs on when and how the Tribunal could act against abuse of a dominant position.

A problem with comprehensive texts like Recommendations No. 1 is how to ensure that the adjudicators will understand the intentions of the legislators. The courts are the final arbiters of reviewable practices under the *Competition Act.* Many of the cases coming under the Recommendation would involve vertical restraints. The competition related effects of which are now a matter of lively dispute among economists. The courts would hopefully err on the side of caution, because otherwise there would be a danger of their placing curbs on the freedom of entrepreneurs to compete vigorously.

In any case, even without Recommendation No. 1, there is much of value in the Commission's proposals. Given a conscientious government, an alert opposition and a responsive industry, there is much that can be done even in the fairly short run. For example, when suitable cases arise that involve the provisions in the Act relating to abuse of dominant position or unreasonably low prices, the Director could test the willingness of the Tribunal and the courts to apply the Commission's guidelines for predation. The government could keep a closer eye on Petro-Canada to ensure that it maintains high standards of competitive conduct. All levels of government could keep the Report's strictures in mind in their regulatory activities. The refiners will hopefully adopt the maxim that an ounce of prevention is worth a pound of governmental cure.

There are other actions that might be considered in the slightly longer run. Improvements are clearly needed in s. 47 of the *Act* as it relates to refusal to deal. Little use has been made of that section since its first enactment in 1976, one reason being that there are too many loopholes in it. Many must share the Commission's concern that a major regional refiner like Irving can continue as a matter of policy to refuse to deal with independent distributors. Further down the road, enforcement experience may well establish the need for strengthening the newly enacted provisions respecting mergers and abuse of dominant positions.

In the meantime, reciprocal supply arrangements and the evolving pricing practices of the refiners should be monitored closely and the opposition parties should press the government to do so. The refiners should regard surveillance as part of the cost of maintaining a dual distribution system.

The Commission's Formal Recommendations

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.

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.

3. Jurisdiction to grant interim orders, particularly with respect to matters affecting supply, should be conferred by legislation. The Commission notes that Bill C-91 already provides for such orders in connection with the reviewable practices covered by the Bill.

4. Any person who has been refused supply should be entitled to apply directly to the Competition Tribunal for relief.

5. The Government should be empowered to exempt particular mergers from review by the proposed Competition Tribunal.

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.

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.

8. Refiners who have stated that they will not grant unpublished discounts off published prices should abandon this aspect of their rack pricing policies.

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.

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 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.

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.

12. Consumers should seek to strengthen their market position by drawing on their collective bargaining (or buying) power.

DELIVERED-PRICING UNDER THE NEW COMPETITION ACT

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Ottawa

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A case can be made that the provisions of Sections 52 and 53 on delivered-pricing are the real sleepers in the *Competition Act*. The principal factor that somewhat unexpectedly reinforces the thrust of these provisions is that deregulation of the trucking industry at last seems to be in prospect.

Delivered-pricing is a marketing strategy in which transportation costs are assumed by the seller. Transport costs are therefore included in the price quoted to the buyer. As we shall see, the strategy may be used by sellers in two quite different ways.

The quoting of delivered-prices on an ad hoc basis may be a convenient way for a seller in a concentrated market to cut prices, without advertising to his rivals the extent of the price reduction. Competitors will be left in doubt about whether the seller found a cheaper transportation rate, or actually cut the price, or did a little of both. They will be uncertain about how low a price they must quote to win an order in other territories.

Unsystematic freight absorption, in concentrated markets, is generally applauded in the economic literature. The uncertainty it creates can precipitate a breakdown in oligopoly discipline, introduce a measure of price flexibility where normally there is none, and even culminate in the erosion of a rigid price structure.

Economists generally treat systematic delivered-pricing quite differently. It is objected to on several grounds, but two are particularly relevant here. Most important, systematic delivered-pricing is criticized as a device that facilitates coordination among sellers. It is also criticized on the ground that it is likely to be wasteful of resources. Examination of these criticisms can throw light on the significance of Sections 52 and 53.

There are actually several varieties of systematic delivered-pricing. One variety involves a uniform price charged by a given seller all across Canada. Such country-wide pricing is likely to be used only for products perhaps like drugs or jewelry, whose value is very high compared to transportation costs, or for other relatively high-value items whose prices may be nationally advertised. As will appear later, the provisions of Section 52 and 53 do not apply to this variety of systematic delivered-pricing.

The principal varieties with which the legislation is concerned are zone-pricing and basing-point-pricing. In both systems, the products involved are normally physically standardized, fairly bulky products whose value is low in relation to transportation costs.

Zone delivered-pricing involves the division of Canada into a number of zones, with a different price applicable in each zone. Basing-point-pricing is more complicated. In this system, all sellers, wherever they may be located, quote delivered-prices that incorporate the base price at the closest point of production added to the transport charges from this closest point.

A hypothetical example may clarify the idea. Suppose there are only two producers of a good in Canada one located in Vancouver and the other in Montreal. If basing-point-pricing is used in the industry, the Montreal firm will quote delivered-prices that incorporate its base-price in Montreal plus freight to destination, for every delivery point up to a line - say the Manitoba/Saskatchewan boundary - where the delivered-price from Montreal exactly matches the delivered-price from Vancouver. If the Montreal producer chooses to penetrate further west, he must absorb freight in order to match the delivered-price quoted by the Vancouver producer. In the jargon of business, the Montreal producer will freight-equalize on Vancouver. Similarly, if the Vancouver producer wants to sell east of the Manitoba/Saskatchewan boundary, he will freight-equalize on Montreal.

In the case both of zone-pricing and basing-point-pricing, some customers may see a cost advantage in arranging for delivery themselves from the producing plant, or from some other point different from the point at which their place of business is located. This becomes a key issue in Sections 52 and 53.

Let us now return to the objections that economists raise about systematic delivered-pricing and consider first the idea that it facilitates coordination or outright collusion in a concentrated industry. Canada has been described as a country that is 5,000 miles long and 300 miles wide. Although this is an exaggeration, it does underline the linear character of the country, and why transportation issues are so important to us. Because of the dispersion of its population, Canada divides itself rather naturally into regions. Sales of most products are similarly dispersed and it is not surprising that for some of them, Canada is divided into a number of zones, with a different price applicable in each zone.

If all sellers adopt zone boundaries that appear artificial or arbitrary, or if price differences between zones appear excessive, complaints are likely to be lodged with the Bureau of Competition Policy. However, if a buyer in a high-price zone is permitted to take delivery in a lower-price zone and bring the goods across the boundary where it is to his advantage to do so, this will help to ensure that neither the zone boundaries, nor the price differentials, are too arbitrary. This of course is what Sections 52 and 53 are intended to ensure.

The case of basing-point-pricing is more complicated. Critics of basing-point-pricing have argued that the practice can be maintained only by overt cooperation and agreement among competitors. However, the courts do not agree, either in the United States or Canada, that evidence of the existence of a basing-point system and nothing more, is evidence of a conspiracy - although they came close to making this finding in the United States.

The critics' argument relies on four main propositions. First, it is argued that the basing-point system is an effective device for helping firms to avoid price competition. Any device that informs each firm about what the "correct" price should be to every destination, serves equally well for this purpose. The essential thing is that it should be unambiguous, because ambiguity could lead to misunderstanding and price-cutting. The most direct way of achieving this objective, of course, is by direct discussion and agreement, but this has the disadvantage of exposing the firms to prosecution for conspiracy. Discussion and agreement may be difficult to avoid when freight rates between every basing-point and every conceivable destination are complex, and when the "correct" price has to be changed frequently. The critics contend that it does not matter much whether the firms agree on specific prices or whether they agree on the <u>method</u> by which prices will be calculated. Both produce non-competitive uniform prices at all market points.

Second, it is argued that basing-point-pricing requires competitors who are established in different localities, to refuse even small price concessions on profitable nearby business, while at the same time they pursue distant business at the "correct" prices there, which is less profitable in that it requires more freight absorption. Critics contend that this makes sense for individual firms only if they know that precisely the same course of action will be adopted by all their rivals.

Third, the critics say that the delivered-prices used by all sellers incorporate only published freight-rates (usually by rail). This means that delivered-prices frequently are not based on real transportation rates, either because freight-rates have changed since publication of the price lists, or because lower trucking rates are ignored, or because confidential rebates are not taken into account.

Fourth, the critics argue that the system relies on the refusal of all sellers at a base point to make delivery to a buyer who has arranged a cheaper transportation rate and wants to forward the goods himself to another destination. Sections 52 and 53 are designed to provide buyers with just this option.

Another important objection that economists generally raise, particularly against basing-point-pricing, is that it is wasteful of resources. This comes about in two principal ways. Under a rigid basing-point-pricing system, all producers charge identical prices at every destination. In these circumstances, customers have no reason to prefer to buy from the nearest plant. The result is an immense amount of unnecessary cross-hauling, unless producers decide to swap large quantities of their output, so that each can readily supply customers in regions where they do not produce. If they do agree on swaps, this reduces the cross-hauling, but raises the required level of cooperation among competitors.

Another element of waste arises out of the need for certainty and openness about freight-rates in a basing-point system. Because of this need, full rail costs are likely to be adopted as the standard in determining the "correct" prices. This discourages a search by producers for the most economical means of transport. Truck rates may change too frequently to provide certainty and confidential discounts by definition lack openness. A search by customers for the most economical means of transport is likewise discouraged by the general refusal of producers to sell f.o.b. plant except for local delivery.

Both excessive cross-hauling and the use of inefficient transport options increase the cost of products sold under the basing-point system. And higher costs tend to be reflected in higher delivered-prices for the product.

To summarize the discussion thus far, freight absorption or delivered-pricing that is unsystematic is likely to be pro-competitive. Systematic delivered-pricing is likely to be anti-competitive except where a uniform country-wide price is involved. The next question is - does it matter? Is the practice of systematic delivered-pricing sufficiently widespread that, under the new legislation, people are likely to have to worry about it? The answer, as we shall see, is yes. However only the Director of Investigation and Research can make an application to the Tribunal under Section 53, which is a civil provision, and therefore much depends on how he allocates limited enforcement resources.

Because of the distribution of our population in a long narrow band along the American border, transport costs are high in Canada. Because of the relatively small size of our market and the advanced state of our technology, oligopolies are very common in Canada. Because much of our manufacturing is resource-based, shipments of bulky, low-value products are relatively large in Canada. Although no comprehensive catalogue exists of the products that are sold on a systematic delivered-price basis, enough is known about the practice to permit the following observations.

Systematic delivered-pricing has been a feature of the marketing of:

- **construction materials** - notably cement, flat glass, gypsum wallboard, asphalt roofing, soil pipe and metal culverts
- **forest products** - including newsprint, lumber, plywood and wooden matches
- **petroleum products**
- **metals** - including steel, aluminum, copper, lead and zinc
- **chemicals** - including fertilizer, sulphur, caustic soda, chlorine, industrial phosphates and sodium chlorate
- **assorted fabricated products** - including electrical wire and cable and glass bottles.

Most of the examples mentioned have been documented in reports or prosecutions under the *Combines Act.*

We are now in a position to examine, in detail, the provisions of Sections 52 and 53. Delivered-pricing is defined in Section 52 as the practice of refusing delivery to a customer or would-be customer at any place where the supplier makes delivery to other customers, on the same terms that would be available to the first-mentioned customer if his place of business were located there.

To make a case before the Tribunal under Section 53, the Director must prove three things. He must first prove the existence of delivered-pricing as defined in Section 52 (involving as we have seen, refusal to make delivery to one buyer in a location where delivery is made to others). He must next prove that the practice is widespread in the market, or is engaged in by a major supplier. Finally, the Director must prove that as a result, the customer is denied an advantage that would otherwise be available to him.

A number of significant points may be noted. First, because it is only the practice of refusing delivery that is covered, all unsystematic freight absorption or delivered-pricing, which, as we have seen, is likely to be pro-competitive, is exempted.

Second, all systematic delivered-pricing that does not rely on the device of refusing delivery to out-of-town customers is likewise exempted. This exemption may be more apparent than real, however, because it may be difficult to prevent a delivered-pricing system from being eroded if customers are permited to take delivery at a low-price destination and to arrange for transportation to a high-price destination. In the case of a simple country-wide price, there is no low or high-price destination and no refusal to make delivery, so the sections do not apply.

Third, the out-of-town customer is entitled only to the trade terms for which he qualifies at home. There will no doubt be arguments about this. By Subsection 52(2) trade terms include reasonable technical and servicing requirements. The customer may therefore be disqualified from taking delivery at the out-of-town point if he can't provide such servicing, or if the product is hazardous or requires refrigeration and he can't provide appropriate storage or transportation equipment.

Subsection 53(1) provides that the Competition Tribunal may prohibit the practice where it finds that the practice is engaged in by a major supplier or is widespread in a market, with the result that a customer is denied an advantage that would otherwise be available to him. These clear grounds for prohibition are muddied by Subsections 53(2) and 53(3).

Subsection 53(2) excuses the supplier from accommodating any additional customers at a given locality if in order to do so, he would be forced to make significant capital investment. This invites all sorts of arguments particularly in the context of customer pick-up at the plant, about scheduling and about the meaning of significant investment. One can envisage various tactics by suppliers to avoid the requirement of the section. One obvious tactic would be for the supplier to discontinue customer pick-up for everybody and to arrange even local delivery via supplier-owned trucks or contract carrier. If this happened, it might still pay an out-of-town customer, depending on the cost of loading and unloading, to open a local depot to take delivery.

The potential impact of Subsection 53(3) is even less certain. This permits refusal of delivery of an article that a customer sells in association with the supplier's trade mark, where the Tribunal finds that the practice is necessary to maintain the quality of the article. One can envisage an argument being made about the danger of spoilage of food products or of contamination of gasoline, where out-of-town customers arrange for their own transportation. But even in these cases the customers have a vested interest in maintaining good quality. It might therefore be hard to persuade the Tribunal of the need to permit refusal of delivery. Thus the application of this subsection seems likely to be narrow.

What can be said by way of overall assessment of the delivered-pricing provisions? In my judgment, they will not much hamper the use of zone-pricing, but they will help to ensure that zone boundaries and the price differentials between zones are reasonable. In my judgment, however, the practice of basing-point-pricing will be undermined in the not-distant future by the interaction of the delivered pricing provisions and the deregulation of truck transport.

Although the data are hard to come by, it has been estimated that private carriers (using their own and leased trucks) account for 50 to 70% of the ton miles attributable to all truck transport in Canada. All private carriers are precluded by current provincial regulations from soliciting backhaul traffic. The folly of thus requiring huge numbers of trucks in Canada to run empty, in my opinion, will not long survive the demonstration effect of deregulation in the United States. Competitive pressures on Canadian manufacturers and processors, whose American rivals enjoy lower rates on both inbound and outbound traffic, will force deregulation on the trucking industry in Canada, notwithstanding the lobbying of the trucking firms and their unions.

Deregulation in Canada will likely remove the protective cover from what amounts to price-fixing by existing carriers in the tariff bureaux; it will likely make entry easier for new carriers; it will likely enable highly competitive U.S. trucking firms to offer attractive through-rates on cross-border traffic; and as I have suggested, it will likely permit private carriers to solicit backhauls.

Deregulation of trucking will mean frequent changes among the thousands of different rates. Producers who use basing-point-pricing will either have to find new ways of signalling such changes to their rivals, or the freight rates incorporated in the delivered prices will become more and more arbitrary and unrelated to the real costs of transportation. In either case, it will be increasingly difficult to argue that the schedules of delivered prices do not represent explicit agreement. At the same time, Sections 52 and 53 will be encouraging more and more customers to breach basing-point-pricing systems by buying at points where prices are low, particularly where they are free to backhaul with their own trucks. I do not believe that there is any acceptable cooperation among competing producers that can prevent this erosion of basing-point-pricing in the long run.