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Speaking notes for Richard J. Taylor Acting Deputy Commissioner of Competition

Competition bureau

Nova Scotia Legislature Select Committee on Petroleum Pricing

to the Nova Scotia Legislature Select Committee on Petroleum Pricing

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Introduction

I would like to begin by thanking the Chair and members of the Select Committee for inviting me here today. I welcome this opportunity to discuss the Competition Bureau's role with respect to the issue of gasoline prices.

With gasoline prices hitting an all-time high in May and June 2004, Canadians have expressed concerns about gasoline prices, and naturally, they want government to do something about the issue. Canadian consumers react to temporary price hikes with frustration and anger, asking themselves whether major gasoline retailers are engaging in price fixing. Over the years, the Competition Bureau has committed significant resources to studying and investigating the state of competition in gasoline retailing and refining.

Just this past May, the Bureau commenced an examination of the Canadian petroleum market to determine whether the recent increases in retail gasoline prices may have resulted from a breach of the *Competition Act*. In particular, the examination focuses on whether the price increases result from a conspiracy among oil companies to fix or coordinate prices or other anti-competitive practices by one or more dominant firms in the industry, or whether there could be some other explanation such as worldwide and/or North American supply and demand changes.

Given that our examination is still on-going, it would not be appropriate for me to comment other than to indicate that we expect to publicly announce our findings this Fall. Today, I would like to explain the role and work of the Competition Bureau and discuss the advantages of free markets, as opposed to government regulation, in determining market outcomes in the petroleum products sector.

The Competition Bureau and the Petroleum Industry

The Competition Bureau is an independent law enforcement agency that promotes and maintains fair competition so that all Canadians can benefit from competitive prices, product choice, and quality service. Competition provides consumers with competitive prices and product choice and encourages companies to be efficient and innovative. Competition law helps Canadian business compete in an increasingly globalized economy and provides small and medium sized businesses with an opportunity to participate in the economy.

The core of the Bureau's enforcement efforts, as they relate to gasoline, involve reviewing mergers among competitors and enforcing the provisions of the Act dealing with abuse of dominance and conspiracies to prevent or lessen competition unduly. All of these provisions apply to the supply of gasoline and other petroleum products.

The Bureau reviews all significant mergers to ensure that they do not result in levels of concentration which could substantially lessen competition. Under the abuse of dominance provision, it is a contravention for a dominant firm to engage in anti-competitive or predatory behaviour that substantially lessens competition by excluding competitors in the marketplace. Finally, the Bureau devotes considerable resources to investigating conspiracies to prevent or lessen competition unduly. Agreements or arrangements among competitors to fix prices, restrict supply or allocate markets are strictly prohibited and involve serious criminal law penalties such as fines and imprisonment.

When gasoline retail prices increase rapidly, the Bureau often receives a large number of complaints from the public. Every complaint is addressed either by a telephone call from an investigator or a letter explaining how the *Competition Act* applies to the situation. If the Bureau has reason to suspect a breach of the Act, it can launch a formal inquiry. At this stage, the Bureau conducts an exhaustive investigation to determine all relevant facts.

In addition to our investigative role, in the case of gasoline, the Bureau determines whether price increases result from anti-competitive conduct or natural market forces by analysing prices as well as supply and demand data. We review gasoline prices in 12 major cities in Canada to make sure that, excluding taxes, they are in line with historic norms and increases elsewhere.[1] We compare the real retail price of gas, excluding taxes, to historic Canadian norms and to prices elsewhere in the world adjusted for exchange rates. We compare Canadian wholesale prices at various locations in Canada to prices posted on the New York Mercantile Exchange Index and at U.S. racks near the border to make sure increases reflect worldwide and North American prices. Finally the Bureau analyses wholesale and retail prices to ensure changes are consistent with such factors as rising crude oil or world and U.S. wholesale prices as opposed to anti-competitive conduct.

Of course, it is not only motorists who complain about gasoline prices. In periods when prices are decreasing, when there are product shortages, or if two major suppliers propose to merge, the Bureau reviews complaints from participants in the industry. For example, several times in the last decade we have examined allegations by independent gasoline retailers that the major integrated oil companies are engaging in predatory pricing during periods when retail prices have fallen below published wholesale rack prices, known more generally as "price inversions" in the industry.

Previous Competition Bureau Investigations

The Bureau's recent involvement in the petroleum sector can be traced back to the research inquiry under the Combines Investigation Act, the predecessor of the *Competition Act*. This research inquiry, undertaken between 1973 and 1985, involved extensive hearings before the then Restrictive Trade Practices Commission ("RTPC").[2] In 1986, the RTPC issued its report entitled "Competition in the Canadian Petroleum Industry". Over the period covered by the inquiry, 1958 to 1985, the RTPC found no evidence of collusion or overcharging by the major petroleum companies, notwithstanding significant price increases resulting from the 1973 OPEC oil embargo and the loss of oil imports from Iran in 1979.

The RTPC also found that inter-refiner supply agreements, the so-called "swap agreements" between refiners, were not anti-competitive but efficiency enhancing. They also found that there was no basis to the allegations that independent gasoline retailers had been subject to predatory margin squeezes. Additionally, the RTPC found that regional price differences and wide price swings over time were due to variations in competitive conditions caused by supply and demand conditions. Though almost 20 years old, the Report is still relevant today because of the similarity of the issues and the applicability of some of its findings.

Since 1990, the Competition Bureau has conducted five major investigations related to the gasoline industry and found no evidence to suggest that periodic price increases resulted from a national or regional conspiracy to lessen competition, or from abusive behaviour by dominant firms in the market. In each case, prices had increased by about the same amount across North America. It should also be noted that, following each period in which prices had increased, market forces caused prices to decline to more normal levels.

For example, in the summer of 1999 the price of gasoline increased sharply. After conducting an examination, the Bureau concluded that the price increases resulted from the oil companies' independent pricing decisions made in reaction to normal market forces. Specifically, we found that these increases were attributable to increasing crude oil prices in world markets, which caused wholesale gasoline prices to rise throughout North America.

More recently, the Competition Bureau examined gasoline price increases in February and March 2003, and concluded they resulted from a series of international crises which disrupted crude oil supplies, such as the oil workers strike in Venezuela, and increased demand for petroleum products resulting from an abnormally cold winter in northeastern North America during 2002 / 2003. In November 2003, the House of Commons Standing Committee on Industry, Science and Technology tabled a report entitled "Gasoline Prices in Canada"[3]. This report was consistent with the Commissioner of Competition's testimony that the price increases did not result from anti-competitive behaviour.

For the most part, the work the Bureau has undertaken in this sector has not uncovered any evidence of price fixing among the major integrated oil companies, notwithstanding numerous exhaustive investigations over the past 30 years. Indeed, our conclusions are consistent with the findings of competition agencies elsewhere in the world, federal and provincial agencies and committees and academic studies.[4] In the past, the facts pointed to changing supply and demand conditions caused by shortages, supply disruptions and other market-based factors as the cause for gasoline price increases around the world. It is also important to note that the recent price increases follow a period in which prices were relatively low and these in turn followed a previous period of high prices. When prices go down with as much regularity as they go up, they are most unlikely to be fixed by agreement. According to MJ Ervin data collected in Halifax, for example, while prices reached an all-time high of 94.2 cpl in May 2004, prices were at 73.3 cpl in December 2003. Previous to this, in February 2003, prices were at their highest level in the last three years at 85.4 cpl. Over the last three years, prices in Halifax have been as high as 94.2 cpl in May 2004 and as low as 61.8 cpl in January 2002.[5] Such up and down variability is a sign of a competitive rather than a manipulated market.

The enforcement of the conspiracy provisions of the *Competition Act* is a very high priority of the Competition Bureau. The Act provides for formal court-authorized investigatory powers such as the power to subpoena, to search and seize and to intercept private communications. Over the past 10 years, the courts have convicted numerous corporations and individuals for conspiracy and imposed fines over $180 million. These convictions were largely the result of the Bureau's Immunity Program. This program encourages anyone with any evidence of potentially illegal conduct affecting competition to approach the Bureau in complete anonymity and seek immunity from prosecution in return for evidence of a potential offence.

Another priority for the Bureau is investigating allegations of systematic abuse of dominance by the major integrated oil companies aimed at predating, eliminating or disciplining independent gasoline retailers. While retail margins continue to fall across the retail sector, in the past there has been no evidence that this has been due to a desire by the majors to eliminate independents by engaging in predatory behaviour. Instead, the decline has resulted from increased efficiency brought about by vigorous competition at the retail sector. Thousands of older, less efficient stations have been closed over the past decade and replaced with fewer, much larger, and more efficient stations offering a greater array of products for consumers.

Moreover, it is not only the majors, like Esso and Petro Canada, converting to new retail formats. Well-organized independents such as Wilson Fuels and Canadian Tire, as well as a host of new entrants such as Loblaws/Atlantic Superstores, Safeway, Costco and Wal-Mart, are changing the face of gasoline retailing in Canada. Indeed the entry and expansion of the mass merchandisers into gas retailing is perhaps the most significant development to competition in the industry over the last decade. As a result, volumes per station and revenue from ancillary services have increased, costs per litre have decreased and competition has never been keener.

This is not to say that the Competition Bureau has been inactive in enforcing the Act in appropriate cases. Since 1972, Bureau inquiries have led to 13 trials concerning retail price maintenance cases related to gasoline or heating oil prices. Eight of these resulted in convictions. These cases, however, concerned local markets and isolated incidents involving petroleum suppliers attempting to illegally influence retailers to increase prices.

The Bureau has also been effective in dealing with competition problems that could arise from proposed merger transactions in the gasoline industry by:

- blocking potential transactions which could substantially lessen or prevent competition;
- requiring parties to divest significant assets such as refineries, terminals and service stations; and
- requiring refiners to supply product to independent retailers.

For example, the proposed joint venture between Petro-Canada and Ultramar Diamond Shamrock in 1998 would have resulted in Petro-Canada merging its three refineries and over 1,800 service stations with Ultramar's refinery and 1,300 service stations in Eastern Canada. The Bureau examined the situation and determined that the proposed merger of these two major players in Quebec and Atlantic Canada would lead to a substantial lessening or prevention of competition. This would have likely meant an increase in prices in Quebec and Atlantic Canada. As a result of the Bureau's aggressive opposition to the joint venture, Petro-Canada and Ultramar decided to abandon their plans.

Another example is the agreement the Competition Bureau reached to modify a covenant involving the refinery in Come By Chance, Newfoundland operated by North Atlantic Refining. Petro-Canada, the previous owner of the refinery, had required, as a condition of sale, a covenant which specified that products from the refinery could not be sold anywhere in Canada, except in Newfoundland, without compensation being paid to Petro-Canada.

The Bureau examined this situation and became concerned that the covenant was causing, or was likely to cause, a substantial lessening of competition. After the Bureau presented its concerns, the parties negotiated a solution. The modified covenant allowed North Atlantic Refining to market products from the refinery throughout Canada without having to compensate Petro-Canada to the extent that it would make the sale of those products unprofitable.

These are examples of enforcement action that has been taken under the Act where the petroleum industry has engaged in inappropriate activities. Additional information about the Bureau activities related to gasoline can be found on the Bureau website (http://www.competitionbureau.gc.ca).

Conference Board Study

In 2000, in an effort to build a better understanding among all parties ? the industry, governments and consumers ? with respect to how gasoline markets work, Industry Canada and Natural Resources Canada sponsored an independent study of Canadian gasoline markets by the Conference Board of Canada.

In its report released in January 2001 entitled "The Final Fifteen Feet of Hose"[6], the Conference Board concluded that Canadians are well-served by the current market system that determines gasoline prices. The price of gasoline in Canada, in real terms, excluding all taxes, is lower than it was in the 1980s.[7]In addition, there is no significant difference in the base price of gasoline (excluding taxes and adjusting for the exchange rate) between Canada and the United States. Furthermore, as reported by the International Energy Agency, Canada has lower gasoline prices than most industrialized countries.[8]

The Conference Board also concluded that the response of the retail price of gasoline to both increases and decreases in crude oil prices was the same. Allegations of "rockets up, feathers down" where suppliers take advantage of crude oil price increases but are slow to reduce retail prices when crude prices fall, were not supported by the Conference Board. These findings are consistent with other studies by economists as well as independent studies commissioned by the Competition Bureau.

Gasoline Prices in Perspective

The Bureau and others who have studied the sector have consistently found that, for the most part, retail prices increase and decrease periodically due to changes in the wholesale price. These changes are often brought about by changes in the world price of crude oil, the major cost component, of gasoline. Canada represents only about 2% of world oil production, and has a minimal impact on world oil prices. As a country we are "price takers", and this is especially important in eastern Canada, a region which relies on oil imports. Other factors which have affected the supply of gasoline in recent years include rising worldwide and North American demand for gasoline and shortages of refining capacity resulting from changing environmental regulations mandating lower sulfur gasoline in both Canada and the United States. Over the last 25 years, no new refineries have been built in North America due, in part, to high capital costs which can exceed $1 billion per refinery.

Retail prices within a region or town can change significantly at a point in time because of competitive forces. It is not uncommon for a gas station to change prices more than 20 times per week. Street level pricing is cyclical in nature as competitors attempt to increase market share by cutting prices or by restoring prices when operating margins fall to unsustainable levels. In gasoline retailing, where prices are visible to motorists, the constant cycle of price changes is driven by a combination of the identical nature of the product and consumer willingness to switch brands due to very small price differences. These characteristics result in competitors rapidly adjusting prices to identical levels without conspiring.

The Bureau consistently receives requests from the public asking why gasoline prices vary from region to region. Not surprisingly prices vary due to differences in provincial tax levels, transportation costs, station efficiency and the degree of local competition. Only provinces which regulate retail gasoline prices based on a margin over a price index, such as Newfoundland and Labrador, appear to have uniform prices.

Price Regulation

It is important to note that the federal government does not have constitutional authority to regulate prices, except in a national emergency. That responsibility rests with the provinces. Most provinces have decided not to regulate but to let market forces determine the price of gasoline. Nova Scotia deregulated gasoline prices in 1991.As a matter of general principle, there is no doubt in my mind that the best regulator of prices is a competitive marketplace. Prices set by government rather than the market, though less volatile, usually result in higher prices to consumers and a less efficient industry. Certainly a casual review of prices in Eastern Canada lends support to this general principle. According to MJ Ervin yearly average data collected from January 2001-June 2004, retail gasoline prices excluding tax in the regulated market of Charlottetown, PEI have been 2.39 cents per litre higher than prices in Halifax, NS and 1.34 cents per litre higher than prices in St. John, NB. Similarly, retail prices excluding tax in the regulated market of St. John's, Nfld have been 2.44 cents per litre higher than prices in Halifax, NS and 1.39 cents per litre higher than prices in St. John, NB. Before any firm conclusions can be drawn, however, a more detailed study would need to be done taking into account differences in transportation costs or volume efficiencies.

The American experience regarding gasoline pricing legislation is instructive. The Federal Trade Commission in the United States conducted several studies of so-called divorcement legislation and below cost sales legislation. Under divorcement laws in effect in several U.S. States, refiners are not permitted to participate in gasoline retailing, while below-cost sales legislation prohibits gasoline retailers from selling at prices that are below wholesale cost. In both instances, the industry-specific legislation stemmed from lobbying by independent gasoline retailers seeking protection from competition from larger enterprises.

The FTC studies provide compelling evidence of the benefits of free markets over regulation in delivering lower prices for consumers. On divorcement, the FTC study[9] concluded that divorcement raised retail gasoline prices by 2.7 cents per gallon, forcing consumers to pay an additional $100 million annually. As for below-cost sales legislation, the FTC believes that such legislation is unnecessary and has a significant potential to be anti-competitive. Retail prices in States with below-cost sales legislation are higher and the retailers themselves do not enjoy higher margins. It is important to note that the *Competition Act* already addresses such below-cost sales through its provisions addressing predatory pricing.

As noted earlier, only the provinces have the constitutional authority to regulate gasoline prices. However, given our knowledge of competitive markets, in particular the ones relating to gasoline, and our responsibility for enforcing the Act across Canada I would be remiss if I did not mention a number of considerations which might be relevant to this Committee going forward:

1. In the case law, it is clear that provincial regulation of a sector can override the application of the *Competition Act* to that sector in respect of aspects being regulated. If you regulate gasoline prices, the Act may not apply anymore.
2. Extreme care must be taken in the design and implementation of a regulatory scheme to make sure you are not unintentionally facilitating anti-competitive conduct. Forcing large companies to give advanced public notice of price increases may well have the effect of making it easier to increase prices and reduce incentives to lower prices. "Rockets up, feathers down" could become the new reality. This is particularly the case given 1. above.
3. In the vast majority of cases, free markets which rely on competitive forces provide the best mechanism for competitive prices, quality products and efficient production. Regulation of prices cannot hope to match the flexibility, transparency and efficiency of the free market and the result is therefore often higher average prices in return for price stability.

Conclusion

As a general principle, there is no doubt in my mind that the best regulator of prices is a competitive market.

In closing, I want to add that I am of the view that overall the Competition Bureau has the appropriate tools to investigate anti-competitive conduct and deal with structural problems that could arise in the petroleum sector.

I would also like to reiterate that anybody on this committee, or any citizens of Nova Scotia who have evidence of an agreement to fix prices can approach the Bureau and bring this matter to our attention. Should the Competition Bureau obtain any evidence of conduct contrary to the *Competition Act*, we will not hesitate to take appropriate measures.

We are leaving with you today all the studies that the Competition Bureau has done in the past, the Conference Board Report of 2001, the former Commissioner of Competition's remarks before the 2003 Standing Committee on Industry, Science and Technology and the Petroleum Inquiry report.

Again, I appreciate having been asked to appear before you today. I would now be pleased to answer any questions you may have.

1 See attached chart "Retail Prices for Halifax and Cdn. Average, Regular Unleaded Gasoline (Ex-tax), January 2001 - June 2004" (Source: MJ Ervin).

2 The *Combines Investigation Act* was repealed by Parliament in 1986 with the passage of the *Competition Act*. In 1986 the Competition Tribunal was established under the authority of the *Competition Tribunal Act*, and replaced the Restrictive Trade Practices Commission in the adjudication of non-criminal matters under Canada's competition laws. The research inquiry power of the Director of Investigation and Research (now Commissioner of Competition) was abolished with the 1986 amendments.

3 Lastweka, Walt (Chair), *Gasoline Prices in Canada: Report of the Standing Committee on Industry, Science and Technology*, House of Commons Canada, November 2003.

4 See for example *Inquiry into August 2003 Gasoline Price Spike*, Energy Information Administration, US DOE, November 2003, or Kovacic, W. *Market Forces, Anticompetitive Activity and Gasoline Prices - FTC Initiatives to Protect Competitive Markets*, Prepared Statement of the Federal Trade Commission, April 7, 2004 or *Midwest Gasoline Price Investigation*, Final Report of the Federal Trade Commission, March 29, 2001.

5 See attached chart "Retail Prices for Halifax, Regular Unleaded Gasoline (Including Tax)", January 2001 - June 2004 (Source: MJ Ervin).

6 *The Final Fifteen Feet of Hose: The Canadian Gasoline Industry in the Year 2000*, The Conference Board of Canada, January 2001.

7 See attached chart "Average Price of Regular Gasoline in Canada in 1980$", July 23, 2004. (Source: NRCan).

8 See attached chart "International Retail Gasoline Prices", May 2004. (Source: IEA, MJ Ervin & Associates, and NRCan).

9 Vita, Michael G., *Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies*, Federal Trade Commission, July 21, 1999.

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