Market Inquiry into the Liquefied Petroleum Gas (LPG) sector

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competition regulation for a growing and inclusive economy

competition commission south africa

An Overview of Market Inquires

- In 2013, the Competition Act was amended to confer broad powers on the Competition Commission (Commission) to conduct **Market Inquiries**

- Market Inquiries entail an analysis of the state of competition in a particular market **rather than focusing on the conduct of individual firms**

  - Previously, the Commission **could only** investigate and prosecute only identified firms for infringements of the Competition Act (such infringements include cartels and abuses of a monopoly position)

  - A market inquiry is one instrument in the Commission's investigative tool box which is designed to ensure that markets operate in accordance with the objectives of the Competition Act

- The Commission is empowered to initiate and conduct a market inquiry at any time and may also do so at the request of the Minister

- To initiate an inquiry, two jurisdictional facts must hold:

  (i) The Commission must have reason to believe that ***any feature or combination of features*** of a market results in the prevention, restriction or distortion of competition

  (ii) The Commission must conduct a market inquiry ***to achieve the purposes of the Competition Act***

What happens after a market inquires

- Outcomes of a market inquiry may vary and may include:

  (i) Firms being referred to the Competition Tribunal for adjudication where it emerges during an inquiry that they may have engaged in a prohibited practice

  (ii) Policy, legislation and regulatory interventions by the Government

- The Commission must submit a report of the inquiry to the **Minister**, with or without recommendations and must publish the report in the **Government Gazette**

- The Minister is required to place the report before the **National Assembly**, within 10 business days of receiving the report

- In an inquiry, the role of the Commission is to identify aspects of the market that may result in the restriction or distortion of competition and to make recommendations *(if it decides to do so)*, to the Minister to enable the **National Assembly** to take steps to make the market more competitive

- Under the market inquiry provisions, the Commission has initiated market inquiries into the markets for private health, LPG and grocery retail sector

Process

Process

- On **15 August 2014**, the Commission officially announced the initiation of the LPG Market Inquiry

- The inquiry arose because the following features of the market were identified as a cause for concern:

  1. Structural features of the market
  2. High switching costs
  3. The regulatory environment and its impact on competition
  4. The limited usage of LPG at the household level

Evidence gathering

Various tools were used to collect evidence – a|. Calls for submission, b| Introductory meetings, teleconference calls and site visits, and c| Information requests – About 90 market participants participated

Assessment of state of competition

Range of different methodologies – both qualitative and quantitative – applied to understand the markets, draw conclusions and improve the evidential rigor

Reporting

Published various documents during the inquiry, including draft recommendations for public comment

LPG REPORT

Market Structure

Market structure

- Refinery level: **Five** refineries producing LPG
  - Limited refining capacity

NATREF, Sasol, PetroSA, ENREFand CHEVREF

  - **Price regulation at the refinery gate determined by DoE**

Limited but with potential to expand

80%

20%

- Wholesale level: **Four major wholesalers** accounting for **more than 90%** of the market

AFROX
ORYX ENERGIES
EASIGAS It's guaranteed
TOTALGAZ

- All four wholesalers have foreign origins with some level of BEE participation

15 %
Domestic Users

85 %
Bulk Users

  - **Price regulation at the retail level determined by DoE**

- Oligopolies, limited local refining capacity, regulatory replacement and limited infrastructure investment

Findings and Recommendations

Regulatory Environment - Pricing

Regulatory environment: Pricing

Two levels of the value chain under price regulation

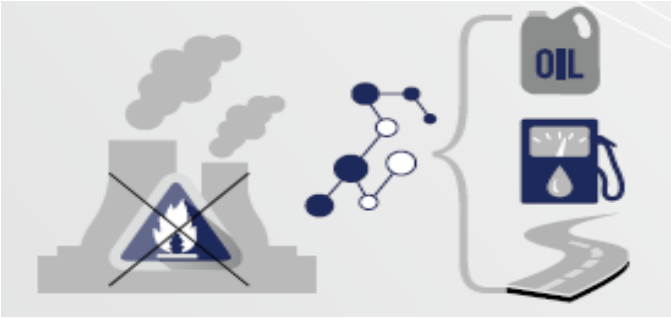
- Refinery level: Producers regulated to sell LPG from the refinery gate at maximum price determined by the DoE (**Maximum Refinery Gate Price**)

- Retail level: LPG sold to customers (**Maximum Retail Price**)

Regulatory environment: Pricing

MARKET INQUIRY FINDINGS

- MRGP **does not incentivise** refineries to prioritise the production of LPG over other petroleum products
  - Result: negative impact on security of supply



- For smaller volumes of LPG, the MRGP is **lower than the landed import price**
  - High cost of logistics as South Africa has limited import and storage facilities for LPG
- MRGP and MRP pricing methodology **has not been reviewed by DoE since 2012**
- **Price monitoring:** DoE does not monitor the MRGP and has limited resources with which to monitor the MRP
  - DoE only has 9 inspectors which are responsible for over 5 000 service stations
  - Results in pricing abuse by some market participants
  - Sanctions that protect against over-pricing are ineffective as DoE does not have prosecutorial powers

Regulatory environment: Pricing

RECOMMENDATIONS

- NERSA to undertake pricing and monitoring of MRGP and MRP
  - this is within the context of its mandate to attract investment, stimulate production and ensure regulatory certainty

- Price deregulation in the long term
  - Only once supply constraints have been resolved
  - The DoE must undertake a study on how price deregulation can be achieved

Regulatory Environment Non-Price

Regulatory environment: Non-price

BACKGROUND

- LPG sector has a myriad of regulations and licensing requirements at various levels of the value chain
- Regulatory environment raised as a concern due to the perceived **overlaps and misalignment** amongst the various regulators
  - Infrastructure licensing requirements
  - Wholesale licensing requirements

INFRASTRUCTURE LICENSING REQUIREMENTS

- Overlapping jurisdiction leads to projects being stalled:
  - Regulatory clearance for refinery: Takes up to 4 years
  - Regulatory clearance for wholesalers (with storage facilities): Takes up to 3 years

For example, On Infrastructure licensing

- *For construction of an import facility, a wholesaler will have to deal with the following regulatory bodies:*
  - ***DoE*** *- wholesale license*
  - ***ITAC*** *- import permit and supporting letter from DoE required*
  - ***TNPA*** *- concession agreement to build infrastructure on port land*
  - ***DEA*** *- environmental authorisation for the infrastructure*
  - ***NERSA*** *- construction license, tariff approval, operating license*
  - ***Local government*** *- site development plan, building plan, Flammable Substance License, occupation certificate*

Regulatory environment: Non-price

EXAMPLE 1: Construction of import and storage facilities at ports

- TNPA: responsible for granting concessions to infrastructure developers within port boundaries (enters into lease agreements with port users)
- NERSA: in terms of Petroleum Pipelines Act, it sets tariffs for the use of these pipelines and approves the tariffs charged for the use of storage and maritime loading facilities
- This leads to an overlap in jurisdictions as well as inconsistent policy outcomes

EXAMPLE 2: Duration of licenses (mismatch)

- TNPA may grant concessions (valid for 20 years).
- NERSA can issue licenses which are valid for 25 years
- Misalignment of policy is evident where NERSA can issue an import and storage license with limited consideration of the TNPA port development plans

Regulatory environment: Non-Price

RECOMMENDATIONS

- NERSA to be responsible for wholesale licensing activities and monitoring thereof

- NERSA and TNPA adjudication processes should be aligned
  - MoU signed by parties to give effect to this recommendation
  - In addition, there should be a sequencing of legal processes

Limited domestic supply

Limited domestic supply

MARKET INQUIRY FINDINGS

- Production of LPG in South Africa is limited
  - Imports are used to fill in the gaps in domestic supply
- Current import infrastructure is inadequate and has stifled the uptake of LPG
- A number of import facility construction licences have been granted
  - If these facilities are constructed, the supply bottlenecks currently faced by the country will be addressed

RECOMMENDATIONS

- Review of the regulatory frameworks applicable to the construction of LPG import and storage facilities as outlined in the applicable legislation including the National Ports Act and the Petroleum Pipelines Act

Long-term Supply Agreements

Long-term supply agreements

MARKET INQUIRY FINDINGS

- LPG is allocated to wholesalers on a contractual and/or spot basis

- Producers prefer long term contracts
  - Reliability of upliftment given storage limitations for LPG at refineries
  - Credit lines, payment history and availability of supply

- Major refineries allocate LPG mostly for internal consumption followed by contractual obligations and small portion for spot sales

- Challenges in securing supply from refineries poses a significant **barrier to entry**
  - Wholesaler competitiveness dependent on being able to obtain sufficient and consistent supply of LPG

- Alleged historic relationships between producers and certain wholesalers. Major wholesalers favoured (given preference in LPG allocation) through long term supply contracts.

Long-term supply agreements

MARKET INQUIRY FINDINGS (cont.)

- Analysis of long-term supply contracts (refineries and large wholesalers s)
  - **Evergreen contracts:** renewed for 25 years (unlimited renewal)
    - Entrenches incumbency advantage for parties involved
  - **Discounts off MRGP of up to 10%**
    - Same discounts not available to smaller wholesalers
    - Small wholesalers have to price competitively against large wholesalers, despite declining volumes in spot market and without any discount benefit

- Effect of long-term supply agreements
  - Give large wholesalers a degree of **competitive advantage**
  - Offered on a **preferential basis;** allowed large wholesalers to maintain market position despite new entry

- Reform to a more competitive market entails enabling small wholesalers to secure sufficient volumes of LPG on a consistent basis

Long-term supply agreements

RECOMMENDATIONS

- Supply agreements to be capped at a **10 year duration**
  - Sufficient opportunity for wholesalers to recoup investment in storage
  - Provides refineries with predictability of demand

- **Removal of automatic renewal clauses** in supply agreements
  - Prevents supply agreements evolving into evergreen contracts

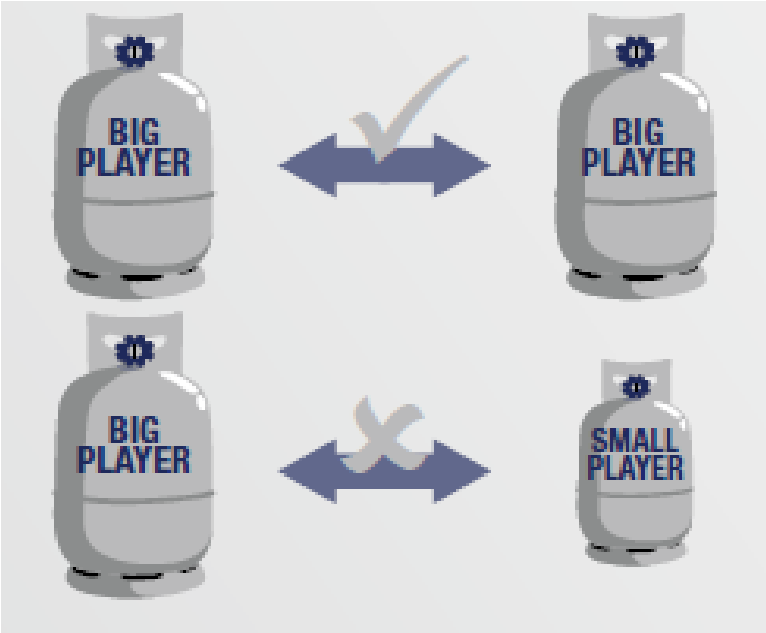
- Refineries to allocate **a minimum of 10%** of LPG production (excluding internal consumption) to small wholesalers, and **not more than 90%** should be allocated to long-term wholesalers
  - The 10% allocation should be made through a supply agreement of at least 2 years
  - If small wholesalers are unable to purchase the entire 10%, the remaining LPG can be sold on the spot market

Cylinder Exchange

Cylinder exchange

CYLINDER EXCHANGE PRACTICE

- Cylinder exchange def.: practice amongst wholesalers and distributors where empty cylinders are exchanged between, or returned to, owners
- Distortions in competition through the cylinder exchange practice
  - Exchange practice governed through bilateral agreements and new entrants struggle to participate
  - Potential barrier to entry into the cylinder market

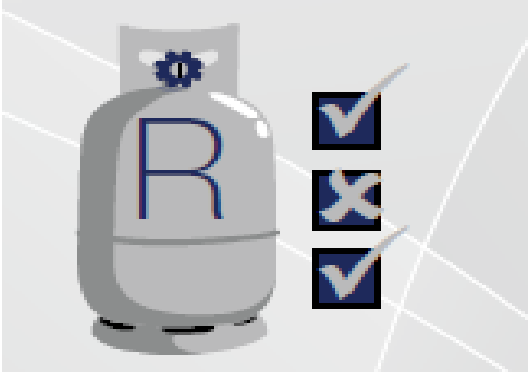


Cylinder exchange

CYLINDER DEPOSIT FEES

- Cylinder deposit def.: Deposits are paid by end-users in order to gain access to a full LPG cylinder
- DoE limits deposit fees on cylinders to a **maximum of 45% of landed price** of cylinder
- Challenges with deposit fee:
  - DoE has **not reviewed** the deposit fee since 2010
  - Evidence of **collusion amongst wholesalers** to increase deposit fees

  - **Uniform deposit rate** across cylinder sizes is not justified
    - Domestic end-users (use cylinders below 9kg) are paying the same deposit as commercial customers (use cylinders 19kg and above)



Cylinder exchange

CROSS-FILLING

- Cross-filling def.: when an industry players refills a cylinder belonging to another wholesaler.
- Implications of cross-filling:
  - Limits the returns owners of the cylinder can get from their cylinders
  - Safety concerns
  - Unlawful in the absence of an agreement (or another form of consent)

FINDINGS

- Cross-filling is a **prevailing practice** (either legal or illegal) in the sector
- **Safety and competition** considerations important for sustainability and investment in LPG
- To encourage competition amongst wholesalers, **customers ability to safely fill cylinders at any accredited site is important**
- Cross-filling sites require accreditation and training of fillers

Cylinder exchange

RECOMMENDATIONS

On cylinder exchange programme:

- Any licensed wholesaler should not be unreasonably refused participation in cylinder exchange programme
- Current hybrid cylinder ownership model should continue
  - For 9kg cylinders and below: customers can either lease or purchase a cylinder from a wholesaler or retailer
  - Leased cylinder: customer may only refill cylinder at the respective wholesaler or designated distributor, or may exchange the cylinder at an accredited exchange site
  - Purchased cylinder: customer may fill cylinder at any accredited filling site

On cylinder deposits:

- The deposit fee should be linked to the landed cost of importing cylinders
- NERSA should perform the review of the cylinder deposit rate
- Commission will continue with its ongoing cartel investigations separate from the market inquiry process

On cross-filling of LPG cylinders:

- Cross-filling of cylinders should occur within the confines of the law

High Cost of Switching

High cost of switching

BACKGROUND

- Ease of switching (for bulk customers) depends on **costs incurred due to disruption of supply**, which may result from:
  - Protracted negotiations between incumbent and new suppliers re: sale of equipment
  - Delays in transferring equipment between incumbent and new suppliers re: valuation of equipment

- Reasons for **not switching**:
  - Re-negotiation of supply contract between end-user and supplier
  - Cost to switch supplier > potential savings derived from switching

High cost of switching

FINDINGS

- **Switching does take place** although not seamlessly

- **Problems** experienced in switching:
  - Capital investment required
  - Ownership usually resides with the LPG supplier
  - Safety considerations and regulations
  - Restrictive supply contracts between wholesalers and end-users

- **Structure of supply agreements** are of concern
  - Vague with respect to equipment ownership during as well as after the expiry of the supply agreement
  - Limited disclosure on when the costs of the installed LPG equipment will be fully amortised and whether the end-users will ever own the installed equipment
  - Typically, the wholesaler retains ownership of the equipment (even after costs are fully amortised)

High cost of switching

FEATURES OF SUPPLY AGREEMENTS

- **Ownership** of installed reticulation systems typically **rests with the supplier**, even where equipment costs have been fully amortised by the property owner

- **Staggered contracts:**
  - One contract for installation and operation of equipment; second contact for supply of LPG
  - Misalignment of termination periods – hampers switching

- In some instances, LPG wholesaler pays the property owners a **rental fee/commission** linked to the volume of LPG consumed by tenants
  - May provide perverse incentives to landlords to continue using a certain LPG supplier, thereby discouraging switching

High cost of switching

RECOMMENDATIONS

- **Separation of agreements:** separate LPG supply agreement from the LPG equipment agreement
  - LPG equipment agreement to provide for the end-user to own the installed equipment after costs have been fully amortised
- **NERSA to develop and publish guidelines setting out the appropriate valuation methodology of LPG equipment**
- **Mandate of NERSA to be expanded to include the resolution of disputes relating to the valuation of equipment**
  - In the event of a dispute in the interpretation and application of the valuation methodology, such disputes should be referred to NERSA

Thank you