10. LPG supply agreements with refineries

10.1. This section assesses the impact of refineries' allocation mechanism to particular wholesalers. It has been alleged that preferential allocation is given to wholesalers with historical relationships with certain refineries.

10.2. New entrants have also raised concerns around rationed supply being allotted to them by certain refineries in favour of preferential allocation to their formerly owned downstream entities.

10.3. Producers/refineries allocate LPG volumes to wholesalers on a contractual and/or spot basis. Producers tend to prefer long-term supply contracts as opposed to spot sales.[✂] The rationale for this preference is linked to factors like the reliability of upliftment, available supply, credit lines and payment history, to name a few.[✂] Of these factors, reliability of upliftment is considered to be particularly important,[✂] possibly due to refineries' current storage limitations regarding LPG.

10.4. The concern of the new entrants is the extent to which these supply contracts create a constraint on their ability to compete effectively in the market. In particular, some market participants noted the historical linkages that exist between producers and major wholesalers.

Historical relationships between refineries and wholesalers

SAPREF, Oryx and Shell

10.5. SAPREF is a crude oil manufacturing facility in Durban, KwaZulu-Natal, which was formed through a joint venture between BPSA and Shell, both of which have a 50% shareholding. The LPG produced at SAPREF is produced from crude oil imported by the shareholders individually.[✂]

10.6. The arrangement between the parties is one of toll manufacturing, with SAPREF manufacturing the product on behalf of its shareholders in terms of a management agreement.[✂] [✂].

Shell and Easigas

10.7. Prior to 2009, Shell SA was vertically integrated in the LPG market as a producer and wholesaler of LPG. In 2009, Shell SA disposed of its marketing business to Easigas, and is no longer active in the LPG market other than as a shareholder in SAPREF. In the case of Easigas' acquisition of the LPG component of Shell SA's business, the companies entered a supply agreement [✂].

10.8. The agreement will continue for as long as [✂] has a processing contract with [✂]. [✂] In addition to this agreement, Easigas sub-leases an import facility located in Port Elizabeth from Shell, which Shell in turn leases from the TNPA.[151]

BPSA and Oryx

10.9. In 2012, BPSA announced its intention to sell its LPG cylinder and bulk business along with some of its wholesale LPG activities in several countries.[152] In South Africa, the transaction saw BPSA sell all of its downstream activities relating to the wholesale of LPG, conducted by BPSA's LPG Business and Masana Petroleum Solutions (Pty) Ltd ("Masana").

10.10. At the time of the transaction, BPSA's LPG business was well established in the sale of LPG to distributors, wholesalers and end-users. The company sold LPG in cylinder form (to residential and commercial end-users) and in tanker trucks (to distributors, wholesalers and industrial customers).[153] Masana marketed BPSA's LPG to the business sector and large commercial entities in particular.[✂]

10.11. Oryx was selected as the preferred bidder for the purchase of BPSA's LPG business. Oryx had not been active in the LPG market prior to this acquisition. The transaction effectively resulted in Oryx entering the market for the downstream supply and marketing of LPG in South Africa.[✂]

10.12. The outcome of the transaction was the removal of BPSA from downstream activities in the LPG value chain; BPSA is only active in LPG production through its refinery activity SAPREF.[✂] Pre-merger, BPSA supplied all of its LPG to its BPSA LPG business in terms of a supply agreement. A similar agreement was entered between Oryx and BPSA upon its disposal of its LPG business.

151 Submission from ✂ dated 24 April 2015, p4
152 These countries included the United Kingdom, Portugal, Austria, Poland, Netherlands, Belgium, Turkey, China and South Africa.
153 Competition Commission Merger Report: Oryx Oil SA//LPG Business of BP SA and Masana Petroleum Solutions, July 2013 (Case No. 2013May0185)

10.13. [✂]

Other refineries

10.14. The Commission also examined whether any of the other refineries in South Africa, namely Sasol, Engen, Chevron and PetroSA, had similar historical supply agreements with any of the wholesalers or other market participants in the LPG value chain. While evidence was found of long-term supply agreements between refineries and wholesalers – for example, [✂] formal supply agreements with [✂] and [✂] – the Commission did not find any other instances of historical vertical relationships.

Volumes allocated through long-term supply contracts

10.15. Producers allocate LPG volumes to licensed wholesalers on a contractual and/or spot basis. Producers have indicated that they do prefer long-term supply agreements as opposed to spot sales, as this provides them with certainty of volume upliftment.[✂] Specifically, producers indicated that reliability of volume upliftment by a wholesaler was an important consideration taken into account when signing a supply contract, as there were storage limitations at refineries for LPG.

10.16. For example, [✂] submitted that because it is vulnerable to LPG production levels exceeding its available storage capacity, its sales model is based on a longer-term contract with reliable wholesalers that have the capacity and ability to commit to meaningful and continuous purchases of LPG in high and low demand periods throughout the year. In addition to reliability of consistent upliftment, [✂] submitted that it prefers a customer that can readily resume procurement from [✂] after extended shutdown periods.

10.17. The Commission analysed several long-term supply agreements in place between producers and wholesalers, with the percentage of LPG volumes allocated to contract customers. The following emerged:

10.17.1. ENREF[✂] has long-term supply contracts with [✂], [✂] and [✂].

10.17.2. Sasol Oil has long-term supply agreement with [✂], [✂], [✂] and [✂].

10.17.3. Chevron has long-term supply contracts with [✂] and [✂], with the remainder of the volume being sold through the spot market.

10.17.4. SAPREF allocates the total volume it produces to its two shareholders, Shell SA and BPSA, [✂].

10.17.5. PetroSA has entered long-term supply contracts with [✂], [✂], [✂] and [✂]. PetroSA supplies a significantly larger proportion of its volumes to non-contracted customers, accounting for [between 40-50%] of its sales.

10.18. None of the refineries appear to have an official document or manual that sets out the requirements for a company to be granted a supply agreement. As mentioned above, [✂] submitted that it is mostly concerned with ensuring reliable offtake from customers and hence the cultivation of long-term relationships is vital.[✂] [✂] considers product availability; the availability of the required compliance documents; and the customer's business profile, ability to meet contractual obligations, financial standing, BBBEE status and previous year's offtake (vs requested volumes).[✂]

10.19. The Commission notes that the existence of these supply agreements act as a barrier to entry and to the expansion of new entrants at the wholesale level of the value chain. This is because the ability of a wholesaler to compete is dependent on it being able to obtain sufficient and consistent supply of LPG. Submissions and meetings with wholesalers[154] indicated that the procurement of LPG from refineries is indeed a major barrier to entry into the sector. This becomes increasingly difficult in a sector that experiences shortages in supply and declining LPG volumes from producers. [✂][✂] submitted that in their experience, the allocation of LPG from refineries is in the following order: (i) Allocate product to satisfy the refineries own operational needs; (ii) Meet their contractual obligations; and (iii) If there is surplus product, fill spot sales requests.

154 See 2015 submissions from Reatile, Afrox, Easigas, Wasaa, KayaGas and Totalgaz.

10.20. Given this framework, it is clear that the wholesalers with contracts may have a competitive advantage over others. In a sector where price is regulated and there are supply constraints, competition occurs in terms of volumes; the reliability of supply becomes increasingly important. Smaller wholesalers like [✂] raised concerns regarding the nature of contracts in the LPG sector, more specifically, on the pricing structure and the general relationships between refineries, on the one hand, and refinery-owned and former refinery-owned entities, on the other.[✂] [✂] also refers to vertical relationships that exist between refineries and wholesalers, in particular, former refinery-owned wholesalers.

10.21. The Commission assessed the percentage of LPG volumes allocated for contract and spot sales to major and non-major wholesalers to assess the validity of the concerns raised regarding the existence of long-term supply contracts. The analysis in Table 15 below considers the percentage of LPG volumes sold through supply contracts as opposed to spot sales by comparing the sales of three of the five LPG producers.[155]

10.22. The analysis shows that producers awarded the vast majority of sales to contract customers over calendar years 2010 to 2014. Specifically, a total of 891 661 tonnes of LPG was sold to customers on a contractual basis over the 2010 to 2014 period as opposed to 193 673 tonnes sold on spot basis. This means that at least 82% of the total volume of LPG produced over the period was allocated to contracted customers and approximately 18% allocated to spot sales. This indicates that contracted sales are clearly refineries' preferred way to sell LPG.

10.23. Disaggregating the contracted sales volumes between major wholesalers and non-major wholesalers shows that major wholesalers receive the bulk of the allocation as shown in Table 15 for FY2013/14.

155 Comparable data over the period considered was only available for Sasol, Engen and Chevron.

Table 15: Contracted supply allocations to major and non-major wholesalers in FY13/14

Wholesaler	ENREF		Sasol		PetroSA		CHEVREF		SAPREF	
	Volume (tonnes)	%	Volume (tonnes)	%	Volume (tonnes)	%	Volume (tonnes)	%	Volume (tonnes)	%
Major wholesalers contracted sales										
Afrox	[✂]	20-40	[✂]	30-50	[✂]	20-40	[✂]	40-50		-
Easigas	[✂]	-	[✂]	15-25	[✂]	0-10	[✂]	10-20	[✂]	50-100
Oryx	[✂]	-	[✂]	-	[✂]	0-10	[✂]	-	[✂]	50-100
Totalgaz	[✂]	20-40	[✂]	10-20	[✂]	15-25	[✂]	-	[✂]	-
Non-major wholesalers contracted sales										
Reatile	[✂]	10-20	[✂]	0-10	[✂]	0-10	[✂]	-	[✂]	-
Non-contract sales										
Other*	[✂]	20-40	[✂]	15-25	[✂]	40-50	[✂]	20-40	[✂]	-
Total	[✂]	**100%**	[✂]	**100%**	[✂]	**100%**	[✂]	**100%**	[✂]	**100%**

Source: Wholesalers and refineries

10.24. As shown, the majority of volumes were consistently sold to major wholesalers. On average, for 2013/14 period, approximately two thirds of sales volumes were awarded to the major wholesalers. [✂].

10.25. From this analysis, there is a limited supply of LPG available to non-contract customers. The Commission found at least 22% of total domestic LPG volumes remain available for customers that purchase on a spot basis. In addition, of the total volumes available for sale, [✂] was allocated at least 29%, constituting the majority of the volume of the LPG produced in the market.

10.26. The Commission notes despite the supply restrictions described above, new entrants have recently managed to secure short supply contracts.

10.27. Foreclosure and softening of competition at the wholesale level may harm competition, in particular, by increasing wholesale prices to those not contracted to refineries. Spot customers not able to procure directly from refineries will have to do so at a higher price, from wholesalers that do have supply agreements in place. The prevalence of long-term supply agreements between LPG producers and all of the major wholesalers, seen against the background of a limited number of supply agreements with other customers, has the potential of restricting or distorting competition. The ability of competitors to enter and/or expand at the wholesale level may be affected negatively due to foreclosure of supply. These effects may also be exacerbated due to the frequent occurrence of product shortage.

Other features of the supply contracts that garner preferential treatment

10.28. LPG producers have stated their preference for providing LPG supply through long-term supply agreements. These supply agreements are provided to a select few downstream participants (the major wholesalers) who mainly have historical links to the LPG producers. The Commission has considered whether these supply agreements bestow any additional advantage to the major wholesalers who are signed into a supply agreement. The main features of the supply agreements entered by the refineries and their clients are considered below. In total, 52 supply contracts were reviewed.

10.29. Of interest to the Commission was the extent to which the long-term supply contracts provided additional benefits to major wholesalers in terms of pricing. The likelihood that the major wholesalers were benefitting not only from receiving a security of supply through the supply agreements but also from these agreements bestowing upon them lower prices for LPG was assessed.

10.30. The maximum price a refinery may sell LPG is the MRGP, set by the DoE. In certain instances it appears that besides the MRGP, the customer may be charged an additional transport cost, a gantry fee, an admin fee, a fee for products not lifted (underlift) in the previous month, VAT, duty at source, further duties or levies, and other applicable taxes. These elements inform the final price that the customer has to pay.[✂] A producer may choose to offer a customer a discount depending on the volume that they purchase. Discounts offered to the major wholesalers are displayed in Table 16.

Table 16: Discount offered to major wholesalers

	Engen		PetroSA		Chevron	
	Yes/No	Discount on volume	Yes/No	Discount on volume uplifted	Yes/No	Discount on volume uplifted
Afrox	Yes	[✂] for a minimum of [✂] tonnes; and [✂] for quantities in excess of this minimum.	Yes	[✂] discount	Yes	[✂] for volumes in excess of [✂] tonnes
Easigas	No	-	Yes	[✂] discount	No	-
Oryx	No	-	Yes	[✂] discount	No	-
Reatile	Yes	An annual discount of [✂] of the purchase price is granted on all LPG uplifted.	Yes	[✂] discount	No	-
Totalgaz	Yes	The discount is [✂] on any quantity up to and including [✂]; and [✂] for any quantity above [✂] tonnes.	Yes	[✂] discount	No	-

Source: Submissions from wholesalers

10.31. Of the fifty-two (52) supply agreements reviewed:

10.31.1. Nine (9) contracts were found to have a provision for discounts.

10.31.2. No discount provision was found in any of the forty (40) [✂] contracts reviewed.

10.31.3. Six (6) out of the nine (9) [✂] supply agreement contracts made provision for discounts.

10.31.4. All three (3) supply agreements for [✂] included provisions for discounts. [✂].

10.32. The observations above indicate evidence of preferential pricing by some refineries. By way of example, [✂] receives an annual discount of 10% off the purchase price for all LPG uplifted in each contractual year from [✂].[✂] TotalGaz and Afrox receive annual discounts from [✂], although conditional on volumes lifted.[✂] Sasol submitted that it does not offer any discounts.

10.33. In a market with supply shortages, it is likely that preferential pricing confers particular advantages on certain players as opposed to others. This would likely have adverse effects on the competitive position of smaller players, notwithstanding the volume discounts.

10.34. [✂], [✂] and [✂] dispute the argument that these agreements and the preferential pricing advantages attached thereto enhance their competitiveness. These players submit that supply inconsistencies stemming from unplanned and planned refinery shutdowns and the deficit in the sector mean they do not enjoy any advantage, notwithstanding the contractual arrangements.

Commission's findings

10.35. The analysis conducted above reveals the perpetuation of the historical relationships that Shell and BPSA had with SAPREF regarding the allocation of LPG. The perpetuation of these historical relationships, through Shell and BPSA to Easigas and Oryx, is likely to afford these wholesalers a competitive edge in a market marred by insufficient and on occasion inconsistent supply.

10.36. The inability to secure supply of LPG from refineries is a significant barrier to entry for wholesalers. Wholesalers with long-term contractual agreements have a competitive advantage over other wholesalers.

Industry feedback

10.37. In light of these findings, the Commission considered the following potential remedies, which it then put to the industry for feedback. The remedies include: Firstly, decreasing the duration of the supply agreements entered by refineries and wholesalers to provide an opportunity for other wholesalers to compete for LPG supply. Secondly, cancelling all automatic renewal clauses in the supply agreements entered between refineries and wholesalers. Thirdly, implementing a new allocation mechanism wherein all wholesalers would bid for their required LPG volumes from all refineries and lastly, introducing a minimum percentage to be allocated to small wholesalers by each refinery.

10.38. In relation to the proposed remedy advocating for a decrease in the duration of supply agreements, the majority of market participants responded positively to this recommendation, with the exception of [✂], [✂] and [✂]. [✂], in its response to the proposed recommendation, stated that the long-term duration of supply contracts is necessary to justify investment in distribution equipment and to cater for supply volatility. [✂] and [✂] mentioned that efficiency benefits arise since long-term supply agreements afford them the ability to plan sales, compete and ultimately serve customers more effectively.

10.39. In relation to the remedy highlighting the need for a new allocation mechanism to be put in place, the majority of parties who responded did not favour the recommendation. Refineries stated that a bidding process would be restricted by the regulated MRGP. Conceptually, the only way in which such a proposal could work would be if pricing were not regulated, which would then have the adverse effect of prices being driven up by large wholesalers who can bid at higher prices for LPG supply. Industrial consumer [✂] agreed that a bidding process would increase LPG prices.

10.40. [✂] raised concerns regarding safety, since safety risks increase when there are more wholesalers collecting product from refineries. Safety concerns were also raised by LPGSASA in that an increased number of wholesalers collecting from refineries would reduce efficiency in enforcing safety standards, which would further strain LPG supply to consumers. Concerned wholesalers stated supply is already limited and that such an allocation mechanism would further exacerbate the problem.

10.41. Given that the price of LPG is regulated by the MRGP, the bids submitted by wholesalers are likely to always revert to the MRGP and render the bidding process redundant.

10.42. In relation to the proposed remedy to introduce a minimum percentage to be allocated by refineries to small wholesalers, the majority of parties who responded were not in favour of this recommendation. Refineries were concerned that some of the small wholesalers do not have the capacity for larger off-take. This might lead to price increases, as some small wholesalers would not be able to take full truck loads, thereby incurring higher costs per tonne. If off-take agreements were not met, it would lead to a negative effect on refinery production due to excess LPG volume that could not be stored, creating a backlog in production.

10.43. Market participants stated that refinery supply is likely to decrease because of the recommendation, with refineries not likely to invest in infrastructure to supply small wholesalers. Wholesalers not in support of the recommendation concurred with refineries, submitting that the recommendation would exacerbate the problem of limited supply and that it was unlikely that small wholesalers could off-take the agreed-upon volumes allocated to them by refineries. [✂], an industrial consumer, stated that the recommendation could lead to price increases if small wholesalers acting as intermediaries should on-sell their allocation to other wholesalers.

Recommendations

10.44. The Commission recommends the following:

10.44.1. Existing evergreen agreements or agreements with more than a ten-year duration must be capped to a maximum of ten years. The ten-year duration will provide sufficient opportunity for wholesalers to recoup the cost of investment in bulk storage equipment required to store the large volumes of LPG as negotiated in the supply agreements. This contract duration will provide refineries with predictability of demand for LPG, so they can mitigate against situations of under- or over-supply. The ten-year duration was determined using the typical recoupment period required by wholesalers for the various investments they need to make prior to operating in the market.[156]

10.44.2. All automatic renewal clauses must be removed from all supply agreements.

10.44.3. To improve LPG access to small wholesalers, refineries must allocate a minimum of 10% LPG production (excluding internal consumption) to small wholesalers [157] on at least two-year supply agreements. The Commission believes that the 10% allocation must not be made available to small wholesalers on a take-or-pay basis, as this would increase the barriers created by financial limitations. In the event that small wholesalers are unable to purchase the entire 10%, the remaining LPG can be sold in the spot market[158] to any buyer.

10.45. These recommendations are a short-term solution to the supply constraints in the LPG sector, as it is envisaged that within five years South Africa's LPG import infrastructure and the storage facilities at its ports will support increased LPG imports, averting the domestic supply shortage.

156 For example, a standard bulk carrier, which is required by most entry-level wholesalers, has a 'payback' period of at least eight years, whilst a larger bulk carrier (with a capacity of 60 Kt) would require at least 10 years for the costs to be fully amortised.

157 The definition of a small wholesaler proposed by the Commission is any wholesaler that requires between 2 500 and 10 000 tonnes of LPG per annum. This definition was determined using the average volumes supplied to ✂ and ✂ over the 2010 – 2014 period.

158 LPG infrastructure at refineries is limited; should a refinery experience an unplanned shutdown, it will likely have only 1½ days of LPG in reserve. In such a situation, the refinery will be unable to accommodate spot sales, as the remaining LPG reserves will be allocated for internal usage.