

13. The high cost of switching

- 13.1. The ability of bulk end-users to switch LPG suppliers in a seamless manner (in response to a more competitive price offer, for example) was of interest to the Commission due to previous complaints²⁶² alleging that wholesalers cannot enter the bulk/industrial customer segment of the market. The ability of downstream bulk end-users to switch LPG suppliers plays a crucial role in determining the incentive for and ability of wholesalers to increase prices and/or reduce the quality of the service they provide. In a competitive market where end-users can switch LPG suppliers seamlessly and without incurring significant costs, efficient market outcomes are likely to be realised, as LPG suppliers will be constrained in their ability to increase prices. Costly switching confers some degree of market power onto LPG suppliers, allowing them to profitably increase their prices and/or reduce the quality of their service.
- 13.2. The analysis below assesses the extent to which switching LPG suppliers may be problematic for bulk end-users of LPG. The rationale for focusing the switching analysis on this narrow form of LPG consumption is three-fold:
- 13.2.1. The relationship between the LPG supplier and the end-user is determined by the form in which the end-user consumes LPG. End-users who consume LPG in cylinders can easily switch LPG suppliers by exchanging one brand of LPG cylinder for another. On the other hand, industrial and commercial end-users who use large volumes of LPG and hence typically consume LPG through a bulk tank or cylinder manifold are normally constrained in switching suppliers. The reason is that bulk and cylinder manifold LPG consumption requires capital investment in the installation of facilities on site.²⁶³ Notably, the required capital outlay can be made by either the LPG supplier or the end-user; hence, ownership of the equipment will reside with the party who made the outlay.
- 13.2.2. An important feature of the supply of LPG is that LPG is a hazardous substance. Safety considerations and regulations surrounding safety are an important feature of LPG supply and the LPG sector as a whole. In the case of bulk LPG and cylinder manifold LPG, the installations consist of several pieces of equipment, all of which are subject to the relevant safety standards.

²⁶² KayaGas vs Afrox (2012May0263)

²⁶³ This may be a bulk tank or a cylinder manifold installation (although the installation of cylinder manifolds requires less investment expenditure).

- 13.2.3. Given the existence of supply contracts for a minimum agreed duration, it is possible that the LPG supplier can extract higher than normal profits due to the increased costs end-users would incur when switching and/or assured sales as a result of end-users' volume off-take requirements.
- 13.3. Given the investment and safety regulations involved in the supply and consumption of LPG, the supply arrangement between the supplier and the end-user is normally co-ordinated through a contract. The assessment of the process involved in switching suppliers of LPG conducted below is considered within a narrower framework of the commercial contractual obligations that exist between a supplier and an end-user in the supply of a hazardous substance subject to regulation.
- 13.4. The Commission notes that the likely narrative of harm that may arise from contractual obligations between a supplier and an end-user in the supply of LPG is:
- 13.4.1. The potential foreclosure of wholesalers attempting to either enter or expand the supply of LPG to bulk end-users; and
- 13.4.2. Direct consumer harm in the form of higher prices and/or reduced levels of service being offered to bulk end-users due to the inability of the end-users to change their LPG suppliers in a seamless, timely and cost-efficient manner.
- 13.5. As industry regulations prohibit filling LPG cylinders or bulk tanks owned by a third party, once an LPG supplier has entered supply agreement with an end-user, rival LPG suppliers are precluded from supplying LPG to that end-user for the duration of the supply agreement. Thus, foreclosure occurs in the form of precluding rival LPG suppliers from accessing customers by locking customers in with a supply contract for a significant duration. This can potentially lead to a chilling of competition as rival LPG suppliers are precluded from accessing customers, reducing the competitive constraints on the incumbent LPG supplier.

- 13.6. When an end-user switches to a rival LPG supplier, the incumbent LPG supplier is likely to remove its equipment because of its intrinsic value, under the supply arrangement between the incumbent LPG supplier and the end-user. Thus, the end-user is likely to incur switching costs (the cost that the end-user has to incur to switch to an alternate LPG supplier, as opposed to remaining with the incumbent supplier). If the switching costs are high relative to the value of LPG being supplied to the end-user, then the end-user is less likely to switch to a rival supplier. This allows the incumbent LPG supplier to increase prices and extract increased profits from the end-user and/or provide decreased levels of service.
- 13.7. It is not customary for bulk end-users to switch LPG suppliers. Switching is not always seamless and the ease of switching is peculiar to the circumstances under which the incumbent supplies the end-user. The degree of difficulty experienced in switching depends on how the contractual circumstances affect either the costs incurred by the end-user due to disruption of supply or the costs incurred by the incumbent LPG supplier in selling/removing their equipment. The common reason for not switching suppliers is that the end-user managed to renegotiate supply on more favourable terms, such as lower pricing.²⁶⁴
- 13.8. The Commission notes that the other reason for not switching suppliers may be that the costs incurred by the end-user outweigh the savings that can be earned by switching. This is dependent on the contractual circumstances surrounding the arrangement between the incumbent supplier and the end-user.

Evidence of switching among LPG suppliers in South Africa

- 13.9. Table 21 below shows some actual switches noted by the Commission.

264 See instances highlighted in Table 21

Table 21: Evidence of switching by end-users

End-user	Previous supplier	Incoming supplier	Type of installation	Transfer of equipment
[X]	[X]	[X]	Bulk reticulation	New
[X]	[X]	[X]	Bulk reticulation	Takeover
[X]	[X]	[X]	Bulk	New
[X]	[X]	[X]	Autogas (Cylinders)	New
[X]	[X]	[X]	Bulk	Takeover
[X]	[X]	[X]	Bulk	New and takeover
[X]	[X]	[X]	Bulk	Takeover
[X]	[X]	[X]	Bulk	New
[X]	[X]	[X]	Bulk	New
[X]	[X]	[X]	Cylinder manifold	New

Source: Various submissions from market participants

- 13.10. In some instances, the incumbent sold its equipment to the incoming supplier, while in others, the equipment was removed and a new installation was put in place.
- 13.11. The Commission also found numerous examples of attempted switches by end-users that proved to be unsuccessful. Some reasons provided for this included:
- 13.11.1. The end-user was able to renegotiate favourable supply terms with the incumbent LPG supplier;
 - 13.11.2. It proved too costly to switch in terms of the impact the disruption in the supply of LPG would have on the end-user's production process;
 - 13.11.3. The cost to switch LPG suppliers would have been too high due to the refusal of the incumbent supplier to on-sell its LPG equipment;
 - 13.11.4. Exclusivity arrangements between the incumbent LPG supplier and the end-user precluded the switch.
- 13.12. Table 22 provides an overview of the salient reasons provided by various end-users for not switching LPG suppliers.

Table 22: Evidence of end-users not switching

End-user	LPG supplier	Reason for not switching
[X]	[X]	Renegotiated favourable supply terms
[X]	[X]	Switching would be too costly (Disruption of supply)
[X]	[X]	Safety responsibility
[X]	[X]	Renegotiated favourable supply terms
[X]	[X]	Renegotiated favourable supply terms
[X]	[X]	Renegotiated favourable supply terms
[X]	[X]	Renegotiated favourable supply terms
[X]	[X]	Renegotiated favourable supply terms
[X]	[X]	Switching would be too costly (Refusal to on-sell equipment)
[X]	[X]	Switching would be too costly (Refusal to on-sell equipment)
[X]	[X]	Renegotiated favourable supply terms
[X]	[X]	Switching would be too costly (Disruption of supply)
[X]	[X]	Switching would be too costly (Disruption of supply)
[X]	[X]	Exclusivity between supplier and landlord
[X]	[X]	Supplier exclusivity
[X]	[X]	Switching would be too costly

Source: Various submissions from market participants

13.13. The instances of failed attempts at switching noted by the Commission above provide a cursory glance at the frequency of such attempts by end-users. It is clear that the switching of LPG suppliers by bulk end-users does occur. The reasons for this vary from one end-user to the next, but typically, more favourable prices and supply conditions are listed as the main reasons why end-users change suppliers, as shown in Table 23.

Table 23: Evidence of switching as provided by LPG suppliers

LPG supplier	Total number of switches recorded	Comment
[X]	13	Common reason stated for losing customers – uncompetitive pricing compared to rival LPG suppliers
[X]	14	Includes mostly end-users consuming cylinder manifold LPG; and new equipment was installed
[X]	3	New equipment was installed in every instance

Source: Various submissions from market participants

Note: This table does not include instances of switching in the tables above to avoid double-counting.

- 13.14. Where switching was attempted yet proved to be unsuccessful, the most common reasons cited were: (i) The end-user was able to renegotiate more favourable supply conditions; and (ii) The cost of switching might have been too high, in the form of the perceived costs involved in the disruption in supply or the cost of implementing new equipment.
- 13.15. The analysis above further highlighted the importance of the terms and conditions of the contractual supply agreements signed by end-users and LPG suppliers. The features of these agreements are outlined in detail.

Contractual issues around ownership and financing of bulk LPG installations

- 13.16. The Commission notes two broad types of contractual relationship that wholesalers and end-users can enter, each with various implications regarding the relative ease with which an end-user can switch LPG suppliers.

13.16.1. *The first type of relationship:* The end-user takes ownership of the equipment by financing the installation.²⁶⁵ One scenario is that the equipment is purchased outright, with the result that ownership transfers to the end-user immediately. Another scenario is that the full price of the equipment is amortised over an agreed period and built into the price of the LPG, such that at the end of the life of the contract, ownership of the equipment is ceded to the end-user. The terms and conditions of the purchase of the installation typically form part of the contract entered for the supply of LPG.

13.16.2. *The second type of relationship:* The LPG supplier retains ownership of the equipment and hence ownership does not pass on to the end-user. The LPG supplier and the end-user enter a contractual agreement for the supply of LPG only. In this regard, should the end-user switch LPG suppliers, the incumbent supplier can either sell the equipment to the incoming supplier or remove their equipment, after which the incoming supplier can install its own equipment and begin supplying the end-user. The Commission noted at times this is not a seamless process, as there is also a possibility that the incumbent may refuse to remove its equipment or may neglect to do so in a timely manner.

13.17. Switching is likely to be problematic in the second type of relationship.²⁶⁵ Three major factors discourage industrial end-users to switch wholesalers. Each factor is discussed separately below.

Clauses related to switching in bulk LPG supply contracts with end-users

13.18. The Commission examined clauses from a sample of bulk LPG supply contracts between LPG suppliers²⁶⁵ and bulk LPG end-users to establish the degree of restrictiveness imposed on the bulk LPG end-users' ability to switch LPG suppliers.

²⁶⁵ In respect of the first type of relationship there is always a challenge around the parameters for the valuation of the equipment. This challenge exists whether it is a customer or a competitor purchasing the equipment.

- 13.19. *Exclusive supply.* The exclusive supply clause prohibits bulk LPG end-users from procuring LPG from any other LPG supplier during the course of the contract period. In cases where the contracted LPG supplier is unable to supply LPG in times of shortage not due to force majeure,²⁶⁶ the bulk end-user is allowed, with the permission of the incumbent wholesale supplier, to purchase the shortfall in its requirements from a supplier that has been nominated by the contracted LPG supplier, until such time as the contracted wholesaler can commence supply. This limits the LPG end user's choice of LPG suppliers. In addition, it may cause the end-user not acquiring LPG supply from the lowest-priced supplier, as the incumbent supplier may decide to use a supplier who charges a significant premium.
- 13.20. *Contract duration.* In most instances, contracts entered are for a minimum period of five years, with a renewal clause included in the contract upon notice being given by the party that wants to renew the contract. Under some contracts,²⁶⁷ if the wholesaler carries out any work or alterations to equipment at any point during the initial period of the contract, the contract duration will be extended by a period equal to the time which has lapsed since the initiation of the contract up to when the alteration was done, or even for a longer period.²⁶⁸ It is unclear what alterations encompass and whether it would be initiated by the wholesaler or the bulk LPG end-user. The clause may provide scope for suppliers to alter equipment at their discretion whilst attributing such alterations to changes in regulations or technological advancements.

Cost of bulk installations and amortisation of equipment costs

- 13.21. The Commission obtained installation and equipment costs from various wholesalers. There is a huge variation in costs due to the varying sizes and complexity of installations. Table 24 provides an indication of the costs submitted by some wholesalers.

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Table 24: Cost of installation

Cost of installation	Wholesaler
Large installation	
R1 000 000 – R20 000 000	[✂]
+R10 000 000	[✂]
R2 910 000*	[✂]
Cylinder manifold installation	
R20 000 – R1 000 000	[✂]
R10 000 – R60 000	[✂]
Shopping mall	
R400 000 – R500 000	[✂]
+R500 000	[✂]

Source: Various LPG wholesaler submissions

Note: * refers to the installation of a 22.5m³ vessel with safety and isolation valves

13.22. Table 24 shows that the cost of large installations ranges from R1 000 000 to R20 000 000. One large component of the cost is the size of the vessels installed. [✂] submitted the price of the three most commonly used types of vessel [✂]:

13.22.1. 9m³ vessel – R 373 230.

13.22.2. 22.5m³ vessel – R619 740.

13.22.3. 45m³ vessel – R787 820.

13.23. Besides the cost of the differently sized vessels, other costs determine the overall price of installing a new LPG bulk tank for large users. These include the length of piping, the location of the vessel and pipes, vaporisers, electrical work, drawings and pressure regulators.

13.24. In addition to the cost of bulk tank installations, the Commission also obtained the cost of installing cylinder manifolds. The major cost components here are the manifold itself and an LPG pump/scale. Manifold installations vary significantly and can cost between R10 000 and R1 000 000 depending on complexity and desired consumption. Manifold installations are typically found in various standalone restaurants like KFC and Steers.

- 13.25. The capital investment made for the installation of LPG equipment puts the LPG supplier in a position of having to recover the cost thereof as part of the price charged for LPG supplied to the end-user. Typically, the LPG supplier depreciates the cost of equipment used until it equals the replacement value of the equipment. These costs are amortised over a period agreed with the LPG supplier, at which time the end-user takes ownership of the equipment. The period over which the costs are fully amortised in relation to the duration of the supply agreement is unclear.
- 13.26. The Commission notes that the period over which the cost of the equipment is amortised may not necessarily correspond to the duration of the supply contract between the LPG supplier and the end-user.¹⁰
- 13.27. The Commission notes that the period over which the cost of the equipment is amortised can be extended beyond the length of the contract in order to win customer business.¹¹ The LPG supplier takes on additional risk due to the possibility that the end-user will switch and the LPG supplier will be unable to recover part of the capital investment. In light of the mismatch between the amortisation period and the length of the supply contract, the incumbent LPG supplier will have an incentive to retain its customers in an attempt to recover the capital costs incurred for supplying the customer.
- 13.28. The possible loss that the incumbent LPG supplier may incur due to a mismatch between the amortisation period and the length of the supply contract can exacerbate the negotiation process for the following reasons:
- 13.28.1. The incumbent LPG supplier may be reluctant to remove its equipment at the time it is supposed to, as a longer period of supply will allow further recovery of capital costs.
- 13.28.2. The incumbent supplier may attempt raising the selling price to extract part of the capital loss from the incoming supplier.
- 13.29. Given that in many circumstances an incoming supplier cannot install its own equipment without first removing the incumbent's equipment, the incumbent LPG supplier may raise the price of the equipment above its replacement value. This cost is then likely to be passed on to the end-user, as the incoming supplier will seek to recover the additional cost of having to purchase the equipment.

Of course, the ability to raise the price will depend on the terms and conditions regarding the removal of the incumbent's equipment outlined in the supply contract.

Disruption of supply

- 13.30. For some bulk end-users, LPG constitutes a significant portion of their total energy costs; alternatively, LPG is a critical input into their production. For example, the LPG that [redacted] uses constitutes nearly 40% of its total energy costs. [redacted] It has been using [redacted] services since its genesis in 1995, citing zero disruption in supply as the primary reason for never contemplating switching suppliers. LPG accounts for [between 50-60%] of [redacted] total energy costs. [redacted]
- 13.31. For other end-users, LPG has strategic value in the sense that a disruption in supply will interrupt their production process. For example, for motor vehicle manufacturers, LPG does not form a significant portion of operating costs (typically between 0,05% and 2% of annual operating costs) [redacted] but it has strategic value in the sense that supply disruption would cause production line stoppages. [redacted] [redacted] also noted that production line stoppages resulted in a loss in income. [redacted] The strategic value of LPG for end-users in the food industry, including restaurants and hotels, [redacted] is obvious: without LPG, restaurants cannot supply customers with food products. Other manufacturers use equipment in their production process designed specifically for LPG, [redacted] alternatively, equipment used in manufacturers' production process may be limited to LPG or other non-available substitutes as an input, [redacted] or manufacturers may find that using anything other than LPG in the production process would be inefficiently expensive. [redacted] One end-user also submitted that LPG was a key component of its manufacturing process as it was not merely an energy source but rather a component of the product itself. [redacted]
- 13.32. Given the significance of LPG to end-users, the Commission notes several factors that may heighten the possibility of a disruption of supply to the end-user, decreasing the likelihood of switching suppliers.

Long-standing relationships with incumbent LPG suppliers

13.33. Market participants cited their long-standing relationships with their incumbent LPG suppliers as a basis for procuring consistent supply of LPG. The Commission learned that [REDACTED], [REDACTED] and [REDACTED] had previously been approached by other suppliers, but opted to remain with their current suppliers primarily because of the guarantee of consistent supply necessary to ensure zero disruption in their daily production. The trend amongst large industrial end-users not to switch is also evidenced by [REDACTED], the largest industrial end-user of LPG in South Africa, who maintains long-standing relationships with its two largest suppliers, [REDACTED] and [REDACTED].

Time needed to install equipment

13.34. The Commission noted that some end-users had previously cited disruption to production as a hindrance to switching. This notion is closely linked to the time it would take to install new equipment. The longer the installation takes, the longer the disruption to production and the greater the possible loss in profits. [REDACTED] submitted that it could typically take up to two weeks to switch suppliers, provided that the equipment is readily transferred in the event that an industrial user does not own it. If a transfer is delayed by prolonged negotiations between wholesalers, this process can take up to eight weeks. [REDACTED]

Restrictions on switching under EIA requirements

13.35. The EIA report is a technical tool that identifies, predicts and analyses impacts on the physical environment along with social and health impacts. The EIA process including the report takes approximately nine months to complete. [REDACTED] In the context of LPG, one instance in which the regulations are triggered is when the total storage capacity of LPG on the end-user's site has increased by over 80m³.²⁶⁷ This is important, because under circumstances where the incumbent supplier refuses to move its equipment or delays doing so, the incoming supplier may be constrained. This constraint can take two forms as discussed below.

267 National Environmental Management Act No. 107 of 1998. Found under Activity 42 in Listing Notice 1 (GN R544 of 18 April 2010). Available at https://www.capetown.gov.za/en/EnvironmentalResourceManagement/publications/Documents/NEMA-eia_regulations_2010_gn_no_r.544_listing_notice_1_as_corrected_10dec2010.pdf. Accessed on 16 November 2015.

- 13.36. *First scenario:* The first scenario is where, not to cause a disruption in supply, the incoming supplier installs a temporary tank or cylinder manifold to supply the end-user until the incumbent has removed its facility. The problem here is that such temporary facility must be under 80m³, because anything bigger will trigger an EIA, disrupting supply to the end-user. This can be extremely costly to resolve, particularly where the incumbent delays removing its equipment.
- 13.37. *Second scenario:* The second scenario is where the end-user wishes to expand its LPG capacity while at the same time considering switching to a new LPG supplier. Here, too, there may be circumstances where switching to the new LPG supplier will trigger an EIA, causing significant disruptions to the end-user. If the end-user is under severe pressure to expand its operations, the option to switch suppliers is significantly constrained and the end-user is likely to remain with the incumbent LPG supplier.

Contractual provisions relating to exclusivity

- 13.38. Besides the two instances discussed above, the Commission has learned of switching limitations due to contractual obligations as well. stated that it attempted to switch from but failed due to contractual obligations. made it clear that it attempted switching suppliers primarily due to poor service and pricing considerations. Contractual terms and conditions obstructed its ability to terminate the contract it had with its supplier. In addition to the contractual issues, also referred to “bulk tank fixtures” as an impediment to its attempt to switch, referring to the argument referenced by , and about the complexity of the installation of the equipment.

Contractual provisions relating to removal/on-selling of equipment

- 13.39. The Commission examined the relevant clauses pertaining to the removal/on-selling of LPG equipment.

- 13.39.1. *Equipment ownership:* Ownership of equipment typically resides with the LPG supplier and is not transferred to the bulk end-user at the end of the contract. Two LPG suppliers provide the end-user with the option to purchase the equipment in a limited number of their contracts. ✂ Notably, the clause regarding ownership of equipment is not accompanied by a clause regarding the removal of LPG equipment in the case of switching. Thus, the incumbent LPG supplier may delay the removal of its equipment whilst retaining ownership. This may heighten the barriers to switching if the end-user has knowledge that the incumbent may be about to undertake such a strategy.
- 13.39.2. *Contract termination.* Notice periods range from between 2 to 12 months across contracts and LPG suppliers. Some contracts ✂ state that notice of termination is not allowed during the initial period of the contract, indirectly further restricting the ability of a bulk end-user to switch freely.
- 13.39.3. *Early termination costs:* The contracts sampled suggest that, typically, the bulk end-user pays the capital costs, installation costs and removal costs for the equipment for the remaining contract period. The end-user does not play an active role in determining these costs, and is likely subject to the LPG supplier's choice of installer to remove the equipment.
- 13.39.4. *Transfer of ownership upon sale of business:* The successor clause in bulk supply contracts requires that in the event that a bulk end-user wants to sell its business, it must include a condition in its sales agreement stipulating that the new business owner must keep using the current wholesaler to supply it with LPG. This clause restricts the ability of the new business owner to freely choose new LPG wholesaler to procure bulk LPG from.
- 13.40. The clauses examined in the LPG supply contracts may also contain provisions that hinder the timely removal of equipment by the incumbent.

- 13.41. [REDACTED] submitted [REDACTED] its supply contract with the incumbent LPG supplier, [REDACTED], contained a provision allowing it first right of refusal. When [REDACTED] chose to switch suppliers, [REDACTED] exercised this right and refused to remove the equipment. The EIA for [REDACTED] site precluded the installation of additional tanks. [REDACTED] had to wait before acquiring a new LPG supply until [REDACTED] removed its equipment.
- 13.42. The incumbent may also refuse to on-sell the equipment by relying on an exclusivity provision in the supply contract that restricts the incoming supplier from installing its equipment until the incumbent supplier has decommissioned its own equipment. The Commission notes the submissions from LPG suppliers that on-selling of equipment to the incoming supplier is not common [REDACTED] and is the overwhelming barrier to switching from the customer's point of view. [REDACTED] LPG suppliers provided various reasons for refusing to on-sell equipment, including that the tank can be uplifted and used at an alternate location [REDACTED] and that the parties could not reach agreement on a selling price. [REDACTED] Typically, in such cases the incoming supplier will have to install its equipment. [REDACTED]
- 13.43. The Commission notes the experience of [REDACTED] where the incumbent LPG supplier, [REDACTED], refused to allow the incoming supplier to install its equipment on site or on-sell its equipment to the incoming supplier. [REDACTED] [REDACTED] only agreed to allow the incoming supplier to install its equipment after [REDACTED] instituted legal action against [REDACTED] at a cost of approximately [REDACTED]. [REDACTED] The negotiations with [REDACTED] delayed the switch to the incoming supplier by approximately one year.
- 13.44. The incumbent supplier also refused to on-sell equipment in the case of [REDACTED] Products Ltd ("[REDACTED]"). After [REDACTED] took a decision to switch LPG suppliers, the incumbent supplier, [REDACTED], refused to transfer ownership of its equipment to either the incoming supplier or [REDACTED], threatening to remove its bulk tanks should they switch suppliers. [REDACTED] Upon expiry of the contract and [REDACTED] refusal to transfer ownership, [REDACTED] elected not to switch suppliers. [REDACTED] agreed to on-sell the equipment at another [REDACTED] site to the incoming supplier.

Switching in the context of shopping centres and residential estates

13.45. LPG installations can differ in their design and usage. The Commission notes a clear distinction between LPG bulk installations used by one end-user, on the one hand; and LPG bulk installations used by more than one end-user, where each end-user is a separate commercial and legal entity on the other hand. This relates to shopping centres having bulk LPG tanks installed on their premises reticulated throughout the shopping centre or to outlets at tenants that are the final end-users. As before, two scenarios are considered:

13.45.1. First scenario: The shopping centre owner possesses the bulk tank/cylinder manifold and reticulation system either by having purchased the equipment outright or by having financed the full cost of the equipment throughout the duration of the contract. In this case, ownership of the installation is ceded to the shopping centre owner. The shopping centre may purchase part of the equipment.

13.45.2. Second scenario: The LPG supplier remains the owner of the equipment for the duration of the contract and ownership is not ceded to the shopping centre owner. Thus, where the end-user chooses to switch LPG suppliers, the incumbent LPG supplier can choose to either sell the equipment to the incoming LPG supplier or remove its equipment. Should the incumbent LPG supplier remove its equipment, the incoming supplier will have to install new equipment. The incumbent LPG supplier may remove part of the equipment.

13.46. These two scenarios illustrate, similar to those discussed earlier, the critical feature related to switching is ownership (and the degree thereof) of the equipment. In the first scenario, the Commission notes that it is unlikely to cause significant costs if the shopping centre should want to switch LPG suppliers. The owner of the equipment can choose its LPG supplier without being constrained to one LPG supplier.

13.47. The second scenario may result in switching problems and significant costs. This has been discussed extensively above in the context of bulk LPG consumption and will not be repeated here, except for the differences.

Costs related to switching in the context of a shopping centre

- 13.48. Unlike in the case of bulk LPG consumption, multiple end-users who are independent entities housed inside a shopping centre complex consume LPG through a bulk installation and reticulation system. The costs associated with either selling or removing the incumbent's equipment may be higher.
- 13.49. There are two reasons why switching costs in the context of shopping centres may be higher:
- 13.49.1. Developers building shopping centres have to contract the initial LPG supplier during the development phase of the shopping centre. The reason for this is that the equipment has to be installed early on during the construction phase. The complexities of the shopping centre design as well as the fact that the reticulation system which carries the LPG from the bulk tank to the end-users tracks through the shopping centres walls, ceilings and underground must be considered. It is thus difficult to inspect the various parts of the LPG installation, to remove existing equipment and to build any temporary bulk tanks should switching occur.
- 13.49.2. Arrangements in the form of service delivery agreements ("SDA") have to be concluded between the LPG supplier and the owner of the shopping centre, and between the LPG supplier and final end-users operating on the shopping centre premises. This type of agreement typically includes terms and conditions that outline, inter alia, the responsibilities of each party, including those relating to the ownership, installation and maintenance of the equipment. The shopping centre will inspect the equipment (and report any faults to the supplier) and read the metres measuring LPG usage. The SDA does not make provision for the supply of LPG to the shopping centre – supply of LPG is contracted between the supplier and the actual end-user, for example, the shopping centre tenant. The shopping centre is a 'facility', and the supplier will contract with each tenant in the shopping centre individually. The contract between the supplier and the tenant will contain a clause determining the price the individual tenant will pay for LPG.

- 13.50. Several contracts will be in place as the supplier will contract individually with each tenant, and the timing of these contracts is likely to be staggered. Contracts between the tenants and the supplier will not be signed, renewed or terminated at a single point in time but will be spread out over time as old tenants left and new tenants enter the shopping centre. This will result in the perpetual existence of contracts between tenants and the incumbent LPG supplier. Given that the LPG supplier will at any point in time be required to supply to at least one tenant by virtue of a contractual arrangement, and given that regulatory and safety concerns do not allow more than one supplier to supply a shopping centre, switching from an end-user's perspective would become extremely costly, if not impossible.
- 13.51. Several costs are associated with switching LPG suppliers. The Commission has already noted the costs associated with switching in the context of a bulk tank installation.
- 13.52. Due to the nature of the LPG installation in a shopping centre, much of the reticulation system is installed in the walls of the shopping centre and is not directly accessible. This construction aspect can frustrate the switching process by making it more difficult for the incumbent supplier and the incoming supplier to reach agreement on the value of the incumbent's equipment. The reason for this is that it will most likely not be possible to do a visual inspection of the reticulation system to assess its quality. The incoming supplier may attach a lower value to the reticulation system than the incumbent supplier will accept.
- 13.53. The nature of the installation also makes removal of the equipment extremely costly. The result for the incumbent supplier is that removing the equipment for use elsewhere may cost more than investing in new equipment.
- 13.54. Due to the increased likelihood of a hold-up being caused by these factors in the event of switching LPG suppliers, the incoming supplier can install temporary LPG equipment to ensure there is no disruption in the production process. Temporary tank will increase the cost of switching, and in the context of a shopping centre, where space is limited; only certain temporary tanks can be used. These tanks may be less efficient than the larger bulk tank that would have been installed by the incumbent.

13.55. [X]

13.56. Given the above factors, it is also highly likely that many of the tenants that may have experienced difficulties with switching LPG suppliers are not included in the sample the Commission considered. Based on the evidence gathered, the Commission notes that switching LPG suppliers in the context of shopping centres and residential estates is not costless.

Commission's findings

13.57. In light of the analysis conducted above, the Commission has found that switching takes place at the bulk LPG segment of the market, but it does not occur seamlessly. The Commission found some problems bulk end-users experienced in switching included: (i) the substantial capital investment required to install LPG bulk and cylinder manifolds; (ii) the ownership of equipment usually remains with the party that provides the capital outlay (typically the LPG supplier and not the end-user); (iii) safety considerations and regulations; and (iv) the existence of highly restrictive supply contracts between LPG wholesalers and end-users.

13.58. The Commission analysed the terms and conditions of supply agreements between LPG suppliers and end-users. The Commission found bulk LPG supply agreements are structured in a vague manner regarding equipment ownership²⁶⁸ during and after the expiration of the initial supply agreement. In particular, the Commission found there is limited disclosure on when the costs of the installed LPG equipment will be fully amortised and whether the end-user will ever own the installed equipment. An examination of the supply agreements revealed that in the majority of cases, equipment ownership lies with the wholesale supplier and that equipment ownership is not transferred to the bulk end-user at the end of the term.

268 The equipment referred to above includes bulk tank and the reticulation system.

- 13.59. Supply agreements entered by tenants and proprietors/property developers at shopping centres are structured in an equally vague manner that does not facilitate switching. The same is also true for residential estates where a supply agreement is entered between the body corporate and a supplier. The following salient features were of particular concern to the Commission:
- 13.59.1 Ownership of the installed reticulation system rests with the supplier even where the property owner fully amortised the cost of the installation.
 - 13.59.2. The LPG supplier signs an initial contract with the proprietor to install and operate the equipment at a shopping centre. Subsequent to this, the LPG supplier enters another contract with each tenant at the shopping centre for the supply of LPG. Given that the contracts between the supplier and the proprietor and those between the supplier and the tenants are entered at different times, the contracts tend to be staggered. The contractual period entered by the proprietor and the supplier generally differs from the stipulated period that the tenant and the supplier sign for. This means that if tenants' termination period is not aligned with that of the proprietor, they will be unable to switch suppliers.
 - 13.59.3. The Commission found evidence of some supply agreements including clauses under which wholesalers pay proprietors a monthly rental fee/ commission commensurate with the volume of LPG consumed by the tenants or based on a percentage of the invoiced amount. The argument provided by market participants was the payment is for rental space (the space where the bulk tanks are installed). The Commission found this might be construed to provide perverse incentives to proprietors to ensure the continued use of a certain wholesaler's LPG, inhibiting the ability of the shopping centre (or residential estate) to switch LPG suppliers even if the tenants were to identify a supplier with a competitive price. A separate rental agreement between mall owners and LPG wholesalers for the equipment should be considered.
- 13.60. The Commission found, the limited disclosure of these salient features of supply agreements creates an environment wherein end-users are unable to switch effortlessly at the end of a contractual period because the installed equipment is either not fully amortised or ownership of the equipment remains with the supplier (regardless full amortisation of the equipment).

Industry Feedback

- 13.61. The Commission put forth several remedies and invited the industry to provide feedback. One proposed remedy is a separation of agreements entered into between an end-user and an LPG supplier wherein the first agreement would pertain to the cost and usage of the installed LPG equipment, while the second agreement would pertain to the supply of LPG. Regarding the agreement pertaining to the cost and usage of LPG equipment, the Commission proposed that an end-user should be in a position to own the installed equipment after the costs have been fully amortised. Secondly, the Commission proposed the establishment of a dispute resolution mechanism (if parties do not agree on the commercial terms related to the sale of the equipment) to allow for the transfer of ownership of the LPG equipment between the incumbent supplier and the incoming LPG supplier. This dispute resolution mechanism would standardise the process followed if the LPG suppliers do not agree on the valuation of the equipment. The Commission also requested comments and proposals related to the equipment valuation methodologies with the relevant independent body/entity (either existing or new) that would facilitate the dispute resolution mechanism.
- 13.62. Regarding the Commission's proposal on the separation of the supply agreement from the equipment agreement, industry players were broadly in support of the Commission's proposal. Concerns were raised regarding health and safety risks and that ownership of equipment should not be ceded to end-users with less expertise in the handling safety aspects. Market participants stated that equipment should only be transferable to LPG suppliers. Further, market participants raised a concern regarding the lawfulness of the approach.²⁶⁹
- 13.63. Regarding the Commission's proposal for the establishment of a dispute resolution mechanism to ease the burdens associated with switching, market participants broadly supported this recommendation. There were major concerns in relation to the mechanism increasing the costs of LPG supply.
- 13.64. Regarding the Commission's request for further comments on the appropriate equipment valuation methodology that may be used in the event of any disputes between LPG suppliers, market participants were broadly in agreement with the replacement cost with due consideration of depreciation and any additional expenditure which may extend the useful life of the equipment.

²⁶⁹ The proposed recommendation is allegedly in contravention of Section 25(1) of the Constitution of the Republic of South Africa No. 108 of 1996 (as amended).

13.65. In terms of the Commission's request for further comments on the applicable independent dispute resolution body/entity, market participants proposed the major auditing firms, the Arbitration Foundation of South Africa, the Alternate Dispute Resolution Association of South Africa, NERSA, the South African Qualification and Certification Committee and the Association of Consulting Engineers.

Recommendations

13.66. The Commission recommends the following:

13.66.1. *Separating the LPG supply agreement from the LPG equipment agreement.* The parties to any supply agreement must separate the agreement in relation to the supply of LPG from that pertaining to the use of LPG equipment. The LPG equipment agreement must reflect the cost and usage of the installed LPG equipment, while the LPG supply agreement should reflect the cost of the supply of LPG. The agreement pertaining to the cost and usage of LPG equipment must provide for the end-user to own the installed equipment after the costs have been fully amortised; or, alternatively, it must be clear that the equipment is subject to a rental agreement. The contracts contemplated in this recommendation should, at a minimum, include the following terms:

13.66.1.1. By default, contracts between customers and wholesalers must contain provisions for transferring tanks, with a clear methodology for valuing the equipment.

13.66.1.2. Incoming suppliers must have a right, subject to a commercially agreeable arrangement, to buy the existing tank and piping equipment from the outgoing supplier. The incoming supplier must have two options: first, to negotiate with the incumbent for the transfer of the equipment; or, take over the equipment based on the existing terms between the customer and incumbent supplier. The outgoing supplier will have an obligation to sell the equipment at a price determined by applying the appropriate methodology.

13.66.1.3. Customers must be provided with information on how to switch in their contracts. This information must be clearly explained before they sign the contract, and both parties must sign a legal declaration to prove that this discussion took place. All future supply agreements must contain this

legal declaration and that it must be added as an addendum to supply agreements already in existence.

- 13.66.2. *Guidelines for the valuation methodology of LPG equipment.* In order to facilitate the transfer of LPG equipment and reduce any potential impediments in commercial negotiations relating to same, NERSA must develop and publish guidelines setting out the appropriate valuation methodology that market participants can use for the sale and transfer of bulk installation LPG equipment (e.g. bulk tanks, cylinder manifold and reticulation system). This is specifically in relation to those instances wherein a new LPG supplier seeks to purchase existing and previously used LPG equipment from the incumbent supplier for the purposes of supplying a bulk customer.
- 13.66.3. The mandate of NERSA must be expanded to include the resolution of disputes relating to the interpretation and application of the *valuation methodology of LPG equipment*. In the event of a dispute in the interpretation and application of the valuation methodology for the transfer of LPG equipment, such disputes should be referred to NERSA.