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COMPETITION COMMITTEE**

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Working Party No. 2 on Competition and Regulation

**ROUNDTABLE ON COMPETITION POLICY FOR VERTICAL RELATIONS IN GASOLINE
RETAILING**

-- Israel --

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The attached document is submitted to Working Party No. 2 of the Competition Committee FOR DISCUSSION under item III of the agenda at its forthcoming meeting on 20 October 2008.

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1. The Israeli gasoline market went through comprehensive reforms in the 1980's and 1990's. Since 1988 the market has been subject to considerable structural changes that included, *inter alia*, the privatization and divestiture of the national refineries and the opening of the wholesale market to new entrants.

2. This report summarizes the main features of the Israeli gasoline market while addressing the effects of vertical integration on competition in the market. It outlines the legal framework and highlights recent developments that followed the reform process in a market where the Israel Antitrust Authority (IAA) played a significant role.

3. The focus is on two major vertical relations in the Israeli gasoline market, namely, vertical relations between refineries and wholesale gasoline companies and vertical relations between wholesale gasoline companies and gasoline stations.

1. General overview of vertical relations in the gasoline sector

4. In general, vertical relations may offer many advantages and can contribute considerably to efficiency. This general rule may also apply in the gasoline market. In the wholesale-retail relations major wholesale firms may offer their experience and expertise in planning, construction and operation of stations, better financing opportunities, nationwide service for large scale consumers, reputation, and other efficiencies in aspects such as laboratory services, insurance, licensing and regulation, environment etc. A major wholesaler vertically integrated with gasoline stations can pre-commit to buying yearly quantities from the refinery in discount prices. Some of the discount may be passed to the stations and through them to the end consumers. In refinery-wholesale firm relations, vertical relations may offer certainty of committed quantities which has considerable impact on both parties. In the special case of vertical integration, a wide range of efficiencies is reached, including reduction of management, transaction and marketing costs. On the other hand, in markets with little competition, vertical relations may further hinder competition. In the retail market, vertical affiliations with major wholesalers might form an entry barrier at both local and state level. In particular, difficulties in selecting suitable locations for gasoline stations, especially in urban areas, and lengthy procedures and restrictions concerning environment, planning and licensing regulations make the accessibility of existing stations critical to new entrants. Vertical separation promotes gasoline stations' ability to constantly "shop around" for the best prices offered by wholesalers and to share some of the discount with consumers (assuming there is competition in the geographical level). The advantages and disadvantages of vertical relations in both sectors will be further discussed in the subsequent paragraphs.

2. The gasoline market in Israel

5. As mentioned above, the gasoline market in Israel went through a major reform over the last two decades. Hereunder is an outline of the main features of the Israeli gasoline market prior to the reform and following its completion:

3. Basic structural features of the gasoline market prior to the reform

6. Until 1988, the Israeli gasoline market was heavily regulated and lacked competition. There was only one, state owned, oil refinery which operated separate plants. The larger plant, which accounts for about 2/3 of the total refining capacity in Israel, operates in the northern part of Israel at Haifa industrial zone ("Haifa Oil Refinery" - "HOR"). A smaller plant, holding 1/3 of the total refining capacity in Israel, is located in Ashdod, in the southern part of Israel ("Ashdod Oil Refinery" - "AOR").

7. Gasoline has been sold in stations through three major wholesale companies- *Paz* (formerly a state owned company), *Delek* and *Sonol*, subject to quotas set by the government. Nearly all prices

(including wholesale price, station retail price, transport and storage prices etc.) were set by the government on a cost plus basis. The three major gasoline companies purchased distillates from the refineries and sold them to gasoline stations, most of which were owned, operated or otherwise controlled by the same gasoline wholesalers. Entrance to wholesale market was practically prevented.

8. In the refinery-wholesale aspect – a certain share of oil distillates supply was imported¹, while the main share was bought from local refineries. Import was based on "spot" deals and not on long term contracts, mainly because the major companies could purchase almost any needed quantity directly from the local refineries at (fixed) price of CIF Lavera, at the price of the distillates in Lavera harbour, which is the main trading harbour for oil distillates in the Mediterranean, including shipment costs. Import was therefore an effective alternative only where prices were lower.

4. Enhancement of competition in the wholesale gasoline market

9. In 1988, the government decided to open the gasoline market to new entrants. Consequently, new companies entered the market, introducing competition in the wholesale market. Today the three major wholesalers still control about 70% of the gasoline stations on a national scale, while the remaining 30% of the stations are affiliated with one of the new companies that were established after 1988². It is noteworthy that in certain geographic areas, some of which are densely populated, the share of stations controlled by the three incumbent wholesalers is still much higher than 70%. Effective competition at each geographic area is the main driving force which ensures that efficiencies which stem from vertical integration are passed on to consumers. In order to ensure continuity of geographical market competition, the Gasoline Sector - Enhancement of Competition Law (1998) sets a minimum distance between gasoline stations which are affiliated with the same company (1 km in urban roads and 10 km along inter-city roads). Any deviation from the standard set by the law is subject to IAA authorization. In such cases, the IAA examines the geographical competition in that area and approves the establishment of a new station only when it doesn't raise any competitive concerns.

10. The most prominent new entrant is *Dor-Alon* which is the product of a 1999 merger between two new entrants (Dor and Alon). *Dor-Alon* controls about 17% of the gasoline stations. The growth of *Dor-Alon* is important especially in light of the fact that one of the highest entry barriers to the petrol retail market is the establishment of new stations. On average, a period of seven years may be needed to establish a new gasoline station in Israel. At present, instead of three major wholesalers there are four major wholesalers (namely, Paz, Sonol, Delek and Dor-Alon), which control nearly 90% of the market. Under these circumstances, in November 2005, the IAA blocked a merger between Sonol and Dor-Alon. The economic assessment carried out by the IAA demonstrated that the merger would eliminate a substantial competitor and would increase the risk of coordinated effects in an oligopolistic market. The merger raised concerns in the geographic dimension and the parties did not present any efficiency gains that could justify the transaction. In light of the above, the merger was blocked. The merging parties have filed an appeal, which was approved by the Antitrust Tribunal on 9 April 2006, however, the ruling was reversed by the Supreme Court on 15 June 2006. The Supreme Court's ruling issued by Chief Justice Barak, Justice Procaccia and Justice Arbel upholds the IAA decision to block the merger, due to the importance of preserving competition among four players in the national fuel market. The detailed decision is based on reasoning that the merger in question should not be approved because of its adverse effect on competition, particularly in a small economy such as Israel.

¹ According to official statistics in the years 2000-2006 average import share was around 20% of the distillates sold in Israel.

² According to data of the Israel Ministry of National Infrastructures (May 2008).

5. Separation and privatization of the national oil refinery

11. The next stage of the reform included separation and privatization of refineries in Israel. In December 2004, following the 1988 reform, the Israeli government decided to split the national oil refinery company into two separate companies and privatize them in order to introduce competition in the refining market. In the planning of the separation and privatization process, the issue of vertical integration between oil refineries and gasoline wholesalers became imperative. In contrast to the traditional view concerning the gasoline market structure, the government has adopted a new policy that encourages refineries to enter the gasoline stations market, in order to enhance competition. According to government's decision, the separation process would mark the end of price supervision on the main distillates produced by the refineries.

12. As mentioned above, vertical integration between a refinery and a wholesale company may induce efficiencies. On the other hand, since there are only two refineries in Israel, wholesale competition may be injured in the event that only two wholesale firms are allowed to vertically integrate while others are not.

13. The government turned the issue to the IAA which serves as consultant to the government on competition matters. In an effort to find an optimal solution that minimizes the disadvantages of vertical integration while maximizes its advantages, the IAA recommended that the four major gasoline companies should not be allowed to bid for the larger refinery (HOR). As for the smaller refinery plant in Ashdod (AOR), the IAA found there was no need to prevent the four major companies from taking part in the bid.

6. IAA's conditions on AOR-Paz merger

14. In 2006, the smaller refinery (AOR) was auctioned and sold to *Paz*, the largest wholesaler, which operates about 26.5% of public gasoline stations in Israel. The IAA approved the merger subject to conditions which aimed at minimizing anti-competitive effects. One of the concerns was that *Paz* would consume most of the distillates produced in AOR, while practically excluding other wholesalers from buying distillates from AOR and raising their costs³. Considering the high entrance barriers which were noted earlier, the merger also raised a concern that *Paz* would largely expand in the retail market of gasoline stations which could lead to gradual exclusion of its rivals and harming competition in various geographic markets. The result might yield higher prices in the short run and creation of a duopoly of vertically integrated refineries-wholesalers-retailers in the long run. The IAA decided to approve the merger subject to conditions based on the fact that HOR which had excessive production capacity was not allowed to merge with one of the major gasoline companies. The fact that there is an effective and viable import alternative ensures that import infrastructures are available to all distillates consumers.

15. The conditions which were imposed on the merger concerned various activities in which *Paz* group was involved, including IAA's supervision over *Paz's* expansion in the gasoline station market, especially in Jerusalem and Tel-Aviv, where it operates (either through ownership or contractual ties with the stations) a particularly large share of public gasoline stations. The conditions also prohibited *Paz* from establishing new stations in these cities without prior approval of the IAA. In order to maintain competition

³ Another concern was associated with the liquefied petroleum gas (LPG) marketing segment, in which *Paz* operates through its subsidiary, *Pazgas* Ltd. In this case, the competitive concern was that *Pazgas* would take advantage of the vertical integration between *Paz* and Ashdod Refineries to eliminate competition in this segment. The fact that LPG is scarce in many months of the year was taken into consideration. Subsequently, the IAA imposed a corporate separation condition on *Pazgas* and Ashdod Refineries and instructed the latter not to discriminate other companies that market LPG. In addition, the IAA does not allow Ashdod Refineries to increase the quantity of LPG allocated to *Pazgas*, in order to assure that the competition in the LPG market is not distorted.

in geographic areas, the merged company was not allowed to affiliate with stations located in vicinity to other *Paz*-connected stations (one kilometer within urban areas and 10 kilometers along inter-city roads).

16. In addition, *Paz* was restricted to a 33% market share with respect to operation of public gasoline station. Crossing the above threshold by affiliating with a public gasoline station would be subject to IAA's approval. *Paz-AOR* were not allowed to hold infrastructures that are essential to import of distillates and were prohibited from engaging in long term contracts with HOR, unless approved by the IAA.

7. IAA's role in HOR tender

17. The larger refinery (HOR) was later sold through the stock market to the Israel Company Ltd., which was not engaged in either retail or wholesale supply of gasoline. In privatizing state owned companies, that play an important role in the Israeli economy, it is necessary to secure future national interests under any new ownership. Israeli law authorizes the Prime Minister and Minister of Finance to issue an Essential Interests Decree to secure these interests, amongst them, promotion of competition. Essential Interests Decrees were issued as part of the privatization process of both refineries. The AOR decree is of special interest to the current discussion.

18. Following the IAA initiative, the 2007 Essential Interest Decree concerning HOR included severe limitations on the identity of the ownership of HOR, practically preventing vertical integration between HOR and (amongst others) the major wholesale companies having nation-wide presence. The HOR decree also limited the firm's ability to affiliate with more than 20% of the public gasoline stations in Israel, unless specifically authorized by the Ministers, considering the state of competition in the market.

19. The Essential Interests Decree's order minimized the threat that HOR would drive the wholesale companies, which used to be its customers and became its potential rivals, out of the market. Since mergers with a major wholesaler were prohibited, the only effective ways by which HOR can expand are by purchasing small companies or establishing new gasoline stations. Since the largest among the non-major companies holds only about 3.5% of the gasoline stations, and since establishing a new station is a lengthy and complicated process, it is unlikely that HOR would be able to expand to a degree that would allow it to profitably exclude wholesalers and create a duopoly of vertically integrated companies in a foreseeable future.

20. In order to maintain competition in geographic areas, HOR was not allowed to affiliate with stations located in certain vicinity to stations that are affiliated with *Paz* (1 kilometer in urban areas and 10 kilometers along inter-city roads).

21. Current market conditions are such that HOR is dependent on its customers and bound by downstream competition between its customers and *Paz-AOR*, as well as by import. As such it has very limited ability to raise prices.

22. One of the conditions in the approval of both mergers in the refining market was the complete structural separation between the two refineries operating in Israel. The rationale behind this condition was that the two refineries have just been split from a single entity. In order to promote effective competition between them, full separation is needed at least in the beginning of the process. Considering the extremely high entry barriers in establishing a new refinery, it was very important to prevent any risk of collusion between the two plants.

23. In this aspect it was important to prohibit the refineries from reaching a "swap" arrangement according to which AOR will supply gasoline in the center-south parts of the country and HOR will supply in the north, since such an arrangement would result in geographic market division between the two competing refineries.

8. Vertical relations between wholesale firms and gasoline retailers

24. One of the main characteristics of the gasoline retail market is vertical affiliations (whether proprietary or contractual) between retailers and major gasoline wholesalers which have been holding a substantial share of the activity in the market for decades.

25. A common variation of vertical relations in the market is exclusivity contracts between gasoline stations and major wholesaler. Another substantial form of vertical relation has always been direct ownership or possession of the land by the wholesaler itself. It seems that in the last decade, this form of complete vertical integration between wholesalers and stations is becoming common. A third form of vertical relations is operation contracts by which the owner of a station grants the operation of the station, including the sale of gasoline to the wholesaler, in return to fixed sum and share of revenues.

9. Long term exclusivity contracts and their effect on competition

26. One of the main obstacles to the development of competition in the gasoline retail market in the post-reform period was the abundance of long term exclusivity contracts between major wholesale firms and station operators, many of which were directly owned by major wholesale firms. According to those agreements the operator was obliged to buy and distribute gasoline and oils exclusively from the wholesaler with which the agreement was made. The average period of exclusivity was extremely long and usually reached 50 – 100 years. In many cases the contracts included the right of the wholesaler to set not only the wholesale price but also the station retail price. It should be noted that the major wholesalers acknowledged that retail price setting is void and did not attempt to enforce those provisions.

27. In many cases the major wholesalers engaged with private land owners in contracts under which the wholesaler planned, financed and constructed the station and in return received an exclusivity right for a very long period, with or without land rights. In other cases, exclusivity contracts were made between a major wholesaler and an already operational station.

10. Exclusivity contracts in gasoline stations operated by disabled army veterans

28. Throughout the years, state involvement in the market was intensive enough to allow the creation of a settlement between state officials and major wholesalers concerning professional rehabilitation of disabled army veterans. According to the settlement, veterans that were found eligible by a committee of the Ministry of Defence were signed for a rehabilitation program which provided them with a license to operate gasoline stations on state owned land. The location of the station was selected by the wholesaler and was allocated without a public auction. Planning, licensing financing and construction of the station were left to the wholesaler. Both the wholesalers and the veterans received certain inter-dependent property rights in the land. Operation contracts, signed between the veteran and the gasoline wholesaler, always included purchase exclusivity provisions of for the full duration of the property rights held by both parties (usually 49 years with an option to another 49 years term).

11. IAA decision with respect to exclusivity contracts in the retail gasoline market

29. In 1993 the IAA General Director was first to take action in order to provide new gasoline wholesalers with access to existing stations and thus reduce entry barriers to the market. According with its powers, the General Director stated that exclusivity contracts in the retail gasoline market were restrictive practices that were harmful to competition. The General Director stated that station owners were not free to choose a wholesaler in a free market since it was found that the exclusivity contracts bound the majority of stations in Israel. Moreover, it was found that the great majority of the non-exclusive stations (i.e. stations which are not bound in exclusivity contracts with any major gasoline wholesaler) were owned by incumbent wholesalers making them also inaccessible to potential wholesale competitors. It was decided

that the General Director's decision would come into force only after the judicial review process would be concluded.

30. In 1995 a settlement was reached between the General Director and two of the three major gasoline firms: *Paz* and *Sonol*. According to the settlement, the General Director revised the abovementioned decision by excluding contracts referring to stations where the gasoline wholesaler held land rights, amongst them, "army veteran rehabilitation program" stations. The revised decision emphasized the importance of releasing a considerable amount of stations from the exclusivity they were subject to. Exclusivity contracts that were excluded from the decision were still considered by the General Director as restrictive practice. The General Director described the considerable legal and commercial difficulties concerning this type of contractual relationship, where the firm has invested considerable resources in construction of the station and held land rights that were intertwined with the operator's right. The revised decision did not prohibit any private party from bringing private legal suits to challenge the validity of specific exclusivity contracts. The two major gasoline wholesalers, on their behalf, agreed to release dozens of stations that were bound by such exclusivity contracts. The release of these stations, as well as the later release of stations by the third major firm, *Delek*, is believed to mark the beginning a state-scale competition in the market.

31. As part of the settlement with *Paz* and *Sonol*, a flexible standard for permitted exclusivity periods was set by the General Director. According to the settlement a standard of 14 years of exclusivity was set for stations that were constructed and completely financed by the major firm. A standard of 7 years of exclusivity was set for stations that were renovated and financed by the gasoline firm up to a certain level. The default exclusivity period for stations that were not financed by the firm was set on 3 years. In addition, the duration of exclusivity contracts between released stations and their ex-suppliers was set on 1 year only. The abovementioned standards were later changed by the Antitrust Tribunal in the case of *Delek*.

32. *Delek*, the third major wholesaler in the gasoline market did not enter the settlement with the General Director until after Supreme Court decision in the *Caspi* case which did not allow the firm to enter the settlement prior to releasing stations.

33. In 1998, a settlement was reached between the General Director and *Delek*, which was similar to the previous settlement, reached with the other major firms. Due to changes in the Antitrust Law, this settlement was brought before the Antitrust Tribunal, which conducted a thorough examination of the exclusivity contracts⁴. The Tribunal's decision was formally restricted to exclusivity contracts that did not include land rights. The Tribunal reviewed the standard exclusivity periods set by the General Director in 1995. In its ruling, only some of the standards set by the General Director were approved. The Tribunal adopted the general standard of three years exclusivity in stations where no financial investment was made by the wholesaler but rejected the notion that the standard exclusivity period should reflect the scope of wholesaler's investment in the station. The Tribunal found that exclusivity enhances efficiencies in the gasoline retail market: it promotes stability and long term planning, offer better use of the majors' scale advantages and expertise in spotting commercially beneficial locations for the station, planning, regulation and construction of the station. Vertical relations formed by exclusivity can save transaction and financing costs and can further serve efficient risk allocation and encourage investment in construction of new stations. On the other hand, vertical relations reached through long term exclusivity create competitive concerns, such as blocking distribution channels, increasing entrance barriers to the market and preserving the low degree of competition in the market. The Tribunal stressed that easier financing through gasoline wholesaler and investment return should not justify long term exclusivity. Considering the advantages and disadvantages of vertical relations based on exclusivity, the Tribunal set the following standard exclusivity

⁴ Antitrust Case no. 469/98 *In re Delek*.

periods: already existing/operating station - three years; released station – one year; new station (finance and construction) – six years.

12. Exclusivity & land rights

34. Despite the fact that the revised General Director's decision and Tribunal's decision in the *Delek* case did not relate to stations where the firm had property rights in the stations, cases challenging the legality of such contracts were brought before civil courts since the early 1990's. Over a decade of legal debates, the courts did not reach a uniform opinion concerning such contracts. Appeals on contradicting decisions of the first instances are pending in the Supreme Court. In September 2008 the Attorney General, provided the State's position on the issue. Based on IAA opinion, the Attorney General stated that the land rights held by the wholesalers were artificial and could not justify long term exclusivity contracts as they are restrictive practices. The Attorney General based its opinion on the Tribunal's and General Director's finding that such contracts significantly harmed competition in the market.

13. Divestiture of Pi Gilloth Petroleum storage facilities and its acquisition by *Delek*

35. Pi Gilloth Petroleum Terminals & Pipelines Ltd. was the major storage facility for petroleum distillates in Israel, and had been owned by the major gasoline companies (Paz, Sonol and Delek) in conjunction with the State of Israel, through what the IAA perceived as an unauthorized restrictive arrangement that inhibited competition in the gasoline station segment. In 2004, the General Director initiated government negotiations with Pi Gilloth, involving the Ministries of Energy, Finance and Justice, in order to reach an agreement regarding a plan for the company's privatization and breaking-up. The IAA and Pi Gilloth ultimately reached an agreement that was later submitted for the Antitrust Tribunal's Approval as a consent decree under § 50B of the Law. The agreement, which was subsequently approved by the Tribunal, incorporated a privatization agreement and a creditors' settlement⁵. In August 2007, the Pi Gilloth facilities were successfully divested, to Delek, the Israel Fuel Corporation. This transaction was evaluated as a merger, and approved by the General Director under strict conditions that are expected to enhance competition and prevent market foreclosure⁶. The conditions prohibit Delek from discriminating or refusing to supply storage services to its competitors and impose on Delek a duty to apply for IAA approval in case it wishes to purchase or operate additional infrastructures to import, store or distribute distillates.

⁵ *Re: Delek the Israel Fuel Corp. Ltd. – Paz Oil Co. Ltd. – Sonol Israel Ltd. – Sonepco Straight Corp. Bank - Pi Gilloth Petroleum Terminals & Pipelines Ltd.* (Consent Decree), 2005 Antitrust 5000094.

⁶ *Re: Delek the Israel Fuel Corp. - Pi Gilloth Petroleum Terminals & Pipelines Ltd.* (Approval of Merger with Conditions), 2007 Antitrust 5000620.