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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**

-- Hungary --

20 October 2008

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. Status of vertical relations related to retail gasoline outlets

1. Although increasing gasoline prices have frequently been the topic of policy discussion, no national laws or regulations requiring either explicit vertical separation of refineries from gasoline distributors or retailers, or some level of vertical unbundling exist nor have ever existed in Hungary. Therefore, retailers are not restricted in building or buying their own refinery capacity, although there have been no such market transactions in the past, so the market environment is quite stable from the point of view of vertical integration.

2. The upstream market of refining and wholesale of gasoline in Hungary is very concentrated and all market players are integrated further downwards in the retail sector. The leading player is the Hungarian oil company MOL, serving more than 80% of the Hungarian market from its Százhalombatta (Hungary) and Bratislava (Slovakia, bought in 2002) refineries. The main competitive constraint on MOL's behaviour comes from the Austrian oil company OMV, which owns big refinery capacity near the Hungarian border (Schwechat) but sells mainly to its own stations. Russian oil company Lukoil started to expand its downstream activity by buying gasoline stations from 2004, but having its closest refinery in Romania, it relies partly on MOL's wholesale supply as well. Other market players (PKN/Unipetrol and Agip) have negligible market shares (1-2%).

Table 1. Estimated market shares at the upstream level

MOL	80+%
OMV	10+%
Lukoil	Max 5%

3. The downstream market of gasoline retail is less concentrated than the upstream level, although more than two-third of the 1300 stations are controlled by four leading oil companies: MOL, OMV, Shell and Agip. Besides these main brands, two types of more serious competitors emerged in the recent years: the above-mentioned Lukoil with station acquisitions and hypermarkets opening new stations (with Tesco accounting for more than 80% of these). There also exist two types of competitive fringe: about 30 smaller networks selling branded gasoline from 2-10 stations each, and more than 100 "white" stations selling non-branded gasoline. To sum up, fully vertically integrated firms supply around half of the downstream market.

Table 2. Estimated market shares at the downstream level

MOL	30-35%
OMV	10-15%
Shell	10-15%
Agip	10-15%
Lukoil	5-7%
Hypermarkets	Around 5%
Small brands	10-15%
White pumps	10-15%

4. The majority of company-owned stations is operated by an external dealer in the so-called Co-Do model, where the company keeps the right to set station level retail prices.

5. The competition authority of Hungary (GVH) run antitrust investigations against MOL in 2000 and 2004 (case numbers Vj-2000/152 and Vj-2004/33) on whether MOL abuses its dominant position on the upstream market by setting excessively high wholesale prices for its downstream competitors. Although it was found in both cases that MOL was indeed in a dominant position, its pricing was not found to be excessive. There have been no antitrust (and to our knowledge, any other types of legal) actions taken

against retail wholesalers on price or service discrimination (which could be regarded as an abuse of dominance under Section 21 of the Hungarian Competition Act) or on resale price maintenance (which is covered by Section 11 of the Hungarian Competition Act). There have also been no acquisitions of wholesale capacities; therefore the issues of vertical relations and separation were not specifically investigated.

6. For recent years, we do not have explicit information on the existing vertical relations between gasoline refiners and retailers. As there have been no major changes or events on the market that would have made these kinds of investigations possible, the evolution of vertical contracts in the Hungarian gasoline sector was examined neither by academic researchers nor by the GVH.

7. The classical segments of the energy sector remained highly regulated even after the market opening. As the ongoing discussion on vertical separation in the electricity and gas sector has not come to an end yet, the current Hungarian legislation in these sectors does not reach beyond what is necessary according to EU laws. Therefore, Hungary's present laws and regulations do not require vertical separation between network and commercial activities in the economic sense of ownership unbundling; only legal separation and the unbundling of accounting. Currently every company active in the retail of electricity / gas is affiliated to firms that hold interests in generation / exploration as well, and so we cannot yet identify or compare the costs and benefits of vertical separation.

2. Costs and benefits of different vertical relations related to retail gasoline outlets

8. Vertical separation in the retail gasoline sector as such has not been the direct topic of policy discussion, therefore the potential benefits and costs were not compared. Some of these issues arose indirectly after the hostile takeover attempt of MOL launched by OMV in late 2007, which would have combined the two main gasoline suppliers of the Central European region.¹ Therefore, market power at the wholesale level and vertical issues were examined in a Phase II investigation by the European Commission in detail (case number M.4799). However, OMV abandoned the merger after receiving the Statement of Objections in August 2008, so there are no public results that emerged as a result of the merger investigation.

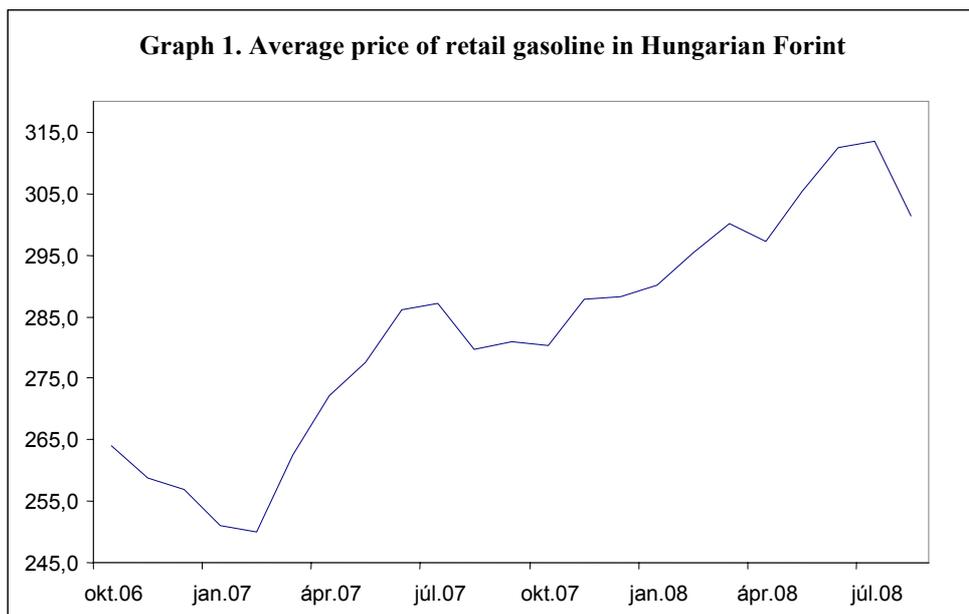
9. Although there were no shocks that may have affected vertical integration in Hungary, we are able to use a large panel database covering a significant share of gasoline stations in order to compare the prices and services offered by companies with different levels of vertical integration. Our database contains price data for a selected day (Friday) in 88 consecutive weeks between October 2006 and August 2008 for almost 90% of Hungarian petrol stations.² In this document, we merely present some of the simplest stylized facts that might shed some light on the effect of vertical integration on gasoline retail prices and services offered.

2.1 Pricing

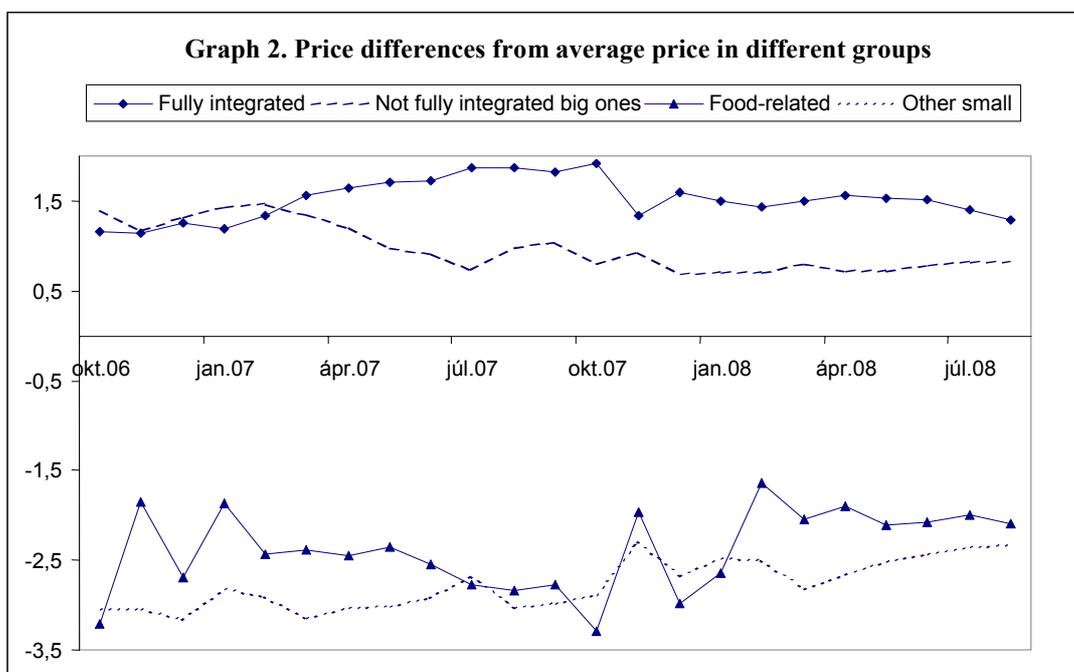
10. Similarly to other OECD countries, average retail prices have risen significantly in Hungary following the crude oil price increases in 2007, as the diagram below also demonstrates. The increase was 16% over 2007, and a further 8% in the first half of 2008.

¹ As these two companies are the only integrated players who would be able to engage in quantity swapping, their hostility against each other makes these agreements unlikely.

² The source of our data is a public homepage used for daily gasoline price comparisons: www.holtankoljak.hu (Where To Tank?), run by a private company. We selected Friday as this was the day with the most observations, and price changes are usually made on Wednesdays.



11. However, if we take a look at company-level average prices, there are some noticeable differences in pricing between the firms with different profiles, which are quite stable over the observed period of two years. Vertically integrated firms (MOL, OMV) are on average the most expensive ones followed by stations owned by large but not fully integrated firms (Shell, Agip), but all four are able to charge a significantly higher price than average. Stations connected to hypermarkets charge a significantly smaller price than average, while the prices of small brands and at white pumps are even lower. The graph below shows how the average price of these groups differs from the overall average price in the observed period.



12. Although we cannot observe the exact contractual vertical relationship between these different groups and their wholesalers (which should mostly be MOL), we can use these groups as proxies for different level of vertical integration.³ Note that the observed price differences are statistically significant, but they are not necessarily significant from an economic point of view: a 5 HUF price difference, which is not very common, represents just 2.5% of the average price.

13. One might argue that vertical integration is not necessarily the main factor behind higher prices: downstream market power (approximated by market share) can also be a price-driver, since vertically integrated companies are usually larger. In our case, however, we can partially separate these two explanations, as the second largest integrated player OMV is roughly of the same size as the large non-integrated suppliers, and OMV's pricing seems to follow the other vertically integrated firm's pricing more closely than Shell's or Agip's do.

14. The effect of full vertical integration can be also estimated by simple panel regression analysis, in which we can control for local demand characteristics for each station and for common shocks in time (changes in the wholesale price) as well.⁴ Our results indicate that fully integrated retail stations charge a price that is about 2.5 HUF higher on average than that of non-integrated companies – this difference is statistically significant, although it constitutes only about 1% of the average price.

15. There has been one antitrust case (Vj-168/2004) in which the GVH investigated whether some stations connected to hypermarkets were offering prices below costs, but found no evidence on this matter. The parties claimed that low wages and the significant economies of scale arising from their other selling activities (so common costs of infrastructure and operation are distributed over a lot of transactions) allow them to set these prices, making the gasoline branch profitable.

2.2 Services

16. In line with some other countries' experience, the focus of services offered by retail stations in Hungary has shifted from automobile repair services to a model with snack and other food sales, complemented by the sale of newspapers, gifts, etc. There remain only a few petrol stations where automobile repair services are still provided.

17. In our database, some of these services are recorded, such as: restaurant, ATM, sale of highway vignette, sale of medicinal products, Internet services. The following table gives information about the penetration of these services at various petrol stations.

Table 3. Estimated market shares at the downstream level

	Restaurant	ATM	Vignette	Medicine	Internet
<i>Average for all stations</i>	26,1%	6,3%	38,2%	1,0%	4,6%
Average for fully integrated stations	27,5%	7,2%	45,6%	2,3%	7,5%
Average for non-integrated stations ⁵	29,8%	6,2%	39,7%	0,3%	3,0%
Average of Agip & Shell	35,7%	9,1%	48,6%	0,4%	5,1%

³ This method might also be justified by the fact that price differences between these groups are smaller than differences within the group.

⁴ For each station we observe the so-called statistical municipality it resides in (this is a statistically defined area where the inhabitants do most of their shopping activities, so it can be used as a proxy for the local market), and therefore local demand characteristics (population, average income) can be controlled.

⁵ Without white pumps.

18. We can see that the penetration of all these services (except for that of restaurants) is higher at the petrol stations operated by integrated companies than at stations operated by non- integrated ones – however, the differences are not striking.⁶ Again, a part of these differences may be explained by size effects, so it might be more fruitful to compare the integrated companies to networks of similar size, Agip and Shell, whose stations offer these services with considerably larger likelihood (except for medicines). Based on these stylized facts, we cannot state that the fully integrated companies have any advantage in the provision of these additional services.

⁶ These differences in penetration are again statistically significant.