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THE COMPETITION TRIBUNAL

IN THE MATTER OF: An Application by the Director of Investigation and Research under the Competition Act.

-and-

IN THE MATTER OF: The Acquisition of Imperial Oil Limited of the Shares of Texaco Canada Inc.

BETWEEN:

THE DIRECTOR OF INVESTIGATION AND RESEARCH

Applicant

-and-

IMPERIAL OIL LIMITED

Respondent

-and-

ATLANTIC REFINING AND MARKETING EMPLOYEES ASSOCIATION AND ATLANTIC OILWORKERS, LOCAL 1

Intervenor

COMPETITION TRIBUNAL
TRIBUNAL DE LA CONCURRENCE
File No. / No. du dossier CT-89/3
Director v / et Imperial
Exhibit No / No. de la pièce 19-1
Filed on / Déposée le Oct 31/89; 10h54
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AFFIDAVIT

1. I, G. Campbell Watkins of the City of Calgary, in the Province of Alberta, Canada, MAKE OATH AND SAY AS FOLLOWS.

2. I am president of DataMetrics Limited, an economic consulting firm, and have been retained by the Atlantic Refining and Marketing Employees Association and Atlantic Oilworkers Union, Local 1 to provide my opinion on certain aspects of the effects of competition in the Atlantic region resulting from the merger of Imperial Oil with Texaco Canada Inc. The opinions expressed therein are true to the best of my knowledge, information and belief.

Professional Background

3. I hold the degrees of B.A. (Honours) and M.Phil from the University of Leeds, England and a Ph.D.from the University of Aberdeen.

Before joining DataMetrics in 1973, I was Director of Economic Studies for Gas Arctic Systems (1971-72), conducted regional and industrial economic research for the Royal Bank of Canada (1970-71) and was Chief Economist and Manager of Economics for the Alberta Energy Resources Conservation Board (1965-69).

Since 1973 I have also held the position as adjunct Professor of Economics at the University of Calgary. I am currently Vice President of Publications of the International Association for Energy Economics.

I have published many journal articles and papers mainly relating to energy economics and was editor of and contributor to four volumes of energy essays. I have testified extensively before various regulatory boards both provincial and federal, and before arbitration tribunals.

Introduction

4. The evidence given below is not based on original research undertaken by me. Time constraints precluded such activities. Instead, in the main I have assessed the various materials and information presented to these proceedings as best as I can.

5. My main focus is on what Professor Stanbury has in my view correctly identified as the key issue in the context of the proposed divestiture of Texaco's assets in Atlantic Canada, namely "...who purchases these assets and what they do with them after purchase" (Stanbury [1989, para. 32]).

The Eastern Passage Refinery

6. I adopt as a fundamental premise that the success of the proposed divestiture requires continued operation of the Eastern Passage refinery. Closure would entail 'independents' in the Atlantic distribution sector essentially relying on but one

refinery, Imperial's, for the supply of locally refined product. The economic feasibility of importing products would remain suspect unless local demands were sufficiently large in relation to cargo sizes, assuming independents enjoyed easy terminal access.[1] There are other reasons to suggest that the import option may not be especially attractive, as discussed later. In short, refinery closure would fly in the face of the Director's intention to at least avoid any erosion in the extant degree of competition in the Atlantic region (see Impact Statement, para. 21).

7. The economic viability of refinery operation will be materially assisted by preserving the integrated links with the terminalling and distribution, both wholesale and retail (Impact Statement, paras. 23 and 27). This feature of integration in the context of the Atlantic region is also noted by Stanbury (Stanbury [1989, para 32]). In other words, the Texaco assets preferably should be sold on a 'bundled' rather than 'unbundled' basis.

8. Another supposition is that the newcomer purchasing Texaco's assets should have the potential to emulate Texaco's competitive role in the Atlantic region, a role seen as vigorous and effective (see Grounds for Application, para. 52).

9. The Texaco refinery is small at some 20,000 bbl/day capacity - well below publicized economic optima.[2] It is also relatively old (built in 1963). Consequently, it is expensive to operate and faces extensive new investments over the next few years not only to maintain efficient operation but also to meet more stringent environmental regulations (see Prevost [1989, paras. 13 to 16]). The refinery, then, is more vulnerable to economic vicissitudes than larger more modern plants. And the ability to run continually at capacity is crucial.

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[1] Sufficient volume throughput at terminals is critical to economic operation (see Appendix 2, "The Canadian Refinery Industry", para. 88). Note that the refinery's output of fuel oil is considerable (Prevost 1989, para 18); continued operation will assist in assuring uninterrupted supply for fuel oil users, including residences (Prevost 1989, para 33).

[2] For example, see Waverman and Watkins [1985, pp. 12,13]. However more sparsely populated regions do encourage smaller minimum economic sizes, given high product transportation costs.

10. It is true that the relatively high costs of the refinery operation and likely future investment expenditures would be reflected in the purchase price the refinery may attract. But even a favourable purchase price would not offset the inherent operational risk. The conclusion is that the prospective purchaser should be sufficiently well established that such risks could be absorbed in the normal course of events without jeopardizing the purchaser's ability to survive.

11. It is unusual for refinery output to match the quality and slate of products marketed within a region. Yet full utilization is the single most important factor in achieving low cost refinery production. Efficiency thus dictates the sale of 'refinery services'. Hence the role of product swaps, exchanges and trades between integrated (and non-integrated) firms.[3] The Eastern Passage Refinery is not an exception to this kind of activity. The Ultramar exchange absorbs about one third of its output. There are other agreements. And butane surplus to local requirements is disposed within Texaco's integrated network (Prevost [1989, para 23 to 26]).[4]

12. Continuation of the Ultramar arrangement in its present form would require a buyer to have a market presence in Quebec. Or the buyer could broker the volume to someone else - if a buyer could be found. Such a buyer could be in Quebec, eastern Ontario, Atlantic Canada or possibly in another area altogether.

13. The sorts of trading and exchange deals to achieve balanced operation of the refinery require the ability to make complex arrangements and a co-ordinated network. Majors and other strongly established firms have these capabilities. But independents can and do operate in this way - witness the activities of Turbo and Parkland (see Turbo, Annual Report, 1988, p. 11, and Parkland,

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[3] The market for refining services obviates the need for separate firms to merge in order to take advantage of scale economies. Most volumes traded are through reciprocal arrangements. These appear to contribute to efficiency as well as allowing lower concentration levels. For general discussion of exchanges and the like, see Jacobs, [1982].

[4] To the extent that exchanges and trade do not appear in statistical data on inter-provincial product movements, the degree of trade between refins may be understated.

Annual Report, 1988, p.5).

Possible Purchasers

14. It also follows that to the extent the refinery is a relatively marginal facility a prospective purchaser should offer significant assistance to the refinery's ongoing operations. There are several dimensions to this, including the ability to access suitable crude supplies, the wherewithal to conclude exchanges and dispose of products excess to local demand, access to a sufficient technical expertise and knowledge to assist in efficient operation of a small facility, plus financial backing.

15. There has been some suggestion that the Texaco assets go to an 'independent'(see Stanbury [1989, para. 33] and Impact Statement, para. 31). That term has been quite well defined in the context of marketing (see Grounds for Application, p. 4) but has not been discussed in the context of the refining sector, and suffers from some ambiguity. Perhaps it is best to isolate its meaning by citing what would not be considered an independent. Of course the majors are not independents. It is also doubtful the national oil companies (NOCs) of producing countries would be considered independents.

16. There has also been the suggestion that the Texaco assets might only be run by a major or regionally integrated oil company (see Memorandum of Law, p.7). A sufficiently well founded entity - an Ultramar or an Irving for instance - could perhaps fit the bill in terms of survivability (although of course Irving would raise the same concentration problems as Imperial). But certainly a relative neophyte would be especially vulnerable to potential shutdown.

17. To remain competitive the refinery is reported to require upgrading over the next five years costing $50 million. Additional expenditures to meet environmental conditions could arise.[5] Also

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[5] Parra [1989] refers to 30 to 40 percent of refinery investments in the next decade being directed towards meeting environmental specifications. The Globe and Mail reports industry spokesmen as saying "...cleaner burning gasoline would cost the (refinery) industry billions of dollars...", (see Globe and Mail, Sept. 20, 1989, p.B4).

a $50 million line-of-credit is required to secure daily operation (Prevost [1989, para 13]). And operation of the marine terminal requires financial support to pay for cargoes shortly after delivery to storage, while the timing between order and delivery can increase risks (see Appendix 2, op. cit., para 63).[6]

18. Prospective capital expenditures on the Eastern Passage refinery are of sufficient size that any purchaser should enjoy a strong financial position. External financing can be difficult to obtain because of the extent of specialized knowledge needed in petroleum refining. However, independents such as Turbo have demonstrated the ability to raise capital for refinery expenditures, although here Turbo's balance sheet has been assisted by some unusual financial features including interest free loans from Federal and Provincial governments (see Turbo Annual Report, 1988, p.4).[7]

19. In light of this discussion, an independent as a prospective producer requires certain qualities. If a suitable independent does not emerge as a contender, then the remaining possibilities are a major (for example Shell, Mobil, Chevron) or an NOC (for example Petroleos de Venezuela S.A. or Kuwait Petroleum Corporation). Of late, NOCs have had a penchant to integrate downstream.

Imports of Products and Crude

20. The prospective divestiture has also been seen as an opportunity for the importation of products for Atlantic based independents.[8] This opportunity may be contingent on continued refinery operation. But it is also affected by conditions in international product markets. There is a supposition (see

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[6] Note that these costs are not incurred by refineries relying on pipeline access, such as prairie plants, including Turbo and Parkland.

[7] Turbo and Parkland have been (rightly) cited as examples of independents expanding into refining; see Impact Statement, para 72.

[8] Texaco's terminal at Dartmouth has been seen as facilitating competition by independents by importation of low priced offshore products (see Backgrounder, p.9).

Appendix 2, op. cit., para. 23) that surplus world refinery capacity will continue to provide generous product availability.

21. However, there is contrary evidence that much of the effective surplus refinery capacity has been absorbed and that stronger product markets are emerging. Utilization rates for conversion facilities have approached maximum levels. This reflects both increased demand for petroleum products worldwide (especially transportation fuels) and higher octane requirements with growing sales of unleaded gasoline.[9] Consequently refining margins have improved substantially (see Petroleum Economist, September 1989, pp. 271-275). What this implies is that the product import option will become less attractive vis-a-vis having access to local refinery capacity, that the economics of catalytic refining will improve, and that tighter product markets will emphasize the role of companies with the ability to facilitate product imports if required.

22. Other factors affecting the availability of suitable product imports are gasoline quality standards (see Appendix 2, op. cit., para 56) and the need to blend imported product with domestic supplies (or to accept a cost penalty).

23. What of the availability of crude? Again, markets here have been adjusting. Demand growth - if sustained - will encroach on installed productive capacity and move levels of OPEC production to a more comfortable zone where there is less pressure to exceed OPEC quotas. At the same time the resurrection of integration - this time between NOCs and refiners either by acquisition or arrangment - will entail more tying up of crude supplies and de-emphasize the role of spot trading. The implication again is that facilitating crude supply generally will be easier for companies of wide ranging scope.[10]

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[9] Also Parra [1989] cites the emergence of refinery bottlenecks in the United States and the need for new conversion capacity.

[10] Crude acquisition by the Eastern Passage Refinery has been assisted by market information from Texaco in Toronto (Prevost [1989, para. 10]. Note that crude supplies are readily available to independent Prairie refineries by virtue of Alberta and Saskatchewan nomination procedures.

Competition in the Atlantic Market

24. The absence of independents in the Atlantic Region, whose presence often provides the 'cutting edge' of competition, might be viewed as imposed by the acting of the major players involved. However, it also seems that the minor role of independents in this market is no mere accident. Policies of the Nova Scotia and PEI governments on gasoline pricing and distribution, the entrenchment of branded service station networks, and relatively thin, spatially spread markets have constrained the scope for independents which typically thrive on low prices and high volumes (Appendix 2, op. cit., para. 95 and Grounds for Application, para. 28). Thus the structural features of the Atlantic market have contributed to the type of operations that have emerged, quite apart from any question of market power exerted by incumbents.

25. Integration and high concentration is a prominent characteristic of the petroleum industry (Appendix 2, op. cit., para. 20). The reasons for the prevalence of vertical integration have been well documented (for example, see Jacobs [1982]). Integration can offer cost savings over the alternative of market transactions. Vertically integrated firms typically have high capacity utilization rates, and there is evidence that financing costs tend to be lower (Jacobs, op cit).[11] These advantages become especially important in the case of smaller operations of less than optimal size. Of itself, vertical integration cannot create monopoly profits - this requires horizontal collusion and entry barriers.

26. If the Texaco assets were taken over by a major or another strongly integrated entity there is the expectation that competition could erode. The Director has sugggested that vertical integration can "facilitate interdependent stability among refiner-marketers" (Impact Statement, para 7). Vertical integration is seen as anti-competitive because "it affords greater opportunity

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[11] There is reference to the virtues of vertical integration in planning output and investment in Appendix 2, op cit, para 101. Stanbury discusses the economic forces behind vertical integration (Stanbury [1989, para 11]).

for horizontal interdependent behaviour among refiners by making it easier for each party to monitor the behaviour of its rivals". (Grounds for Application, para 17).[12] While the potential for anti-competitive effects obviously arises if the Texaco Assets were acquired by a major, it is important to avoid dogmatism. The over-riding objective, as argued beforehand, is to ensure the refinery is maintained in operation.[13] If the best bet here were sale to a major or other entity not considered an independent, then satisfaction of that objective should prevail. Texaco Canada was a major and the Director of Investigation and Research (see Grounds for Application, para 52) has acknowledged its role as a competitive force.

27. Professor Stanbury has argued that sale of the Assets to an independent would have the "...highest liklihood of increasing the intensity of competition in the region" (Stanbury, [1989, para. 33]). He also argues that the new entrant would not have to rely on Imperial for product supply, could either operate the refinery or import product, would be more likely to supply new entrants[14], would enjoy a viable chain of retail stations,[15] and would be free to reduce prices (ibid).

28. I agree with Professor Stanbury that the greatest competitive impetus might come from takeover by a sufficiently well established 'independent', other things equal. However, other things are not likely to be equal. The combination of the peculiar characteristics of the Atlantic market and the quite vulnerable economics of the refinery in question suggest that continued operation may best be assured by sale to a company with a wide scope of operations.

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[12] Stanbury also discusses the way integration facilitates co-ordination between parties (Stanbury [1989, para 11]).

[13] The Director refers to the purchaser preferably being one who is likely to ensure "... the continued operation of the Eastern Passage Refinery as a viable concern..." (Draft Consent Order, para. 14).

[14] Although Irving is not a good example.

[15] However, the retention by Imperial of several service stations, including high volume operations, does curtail the impact of divestiture on the retail sector (see Prevost [1989, para. 38]).

29. The burden of this Affidavit is to emphasize that it would not be prudent to restrict the ambit of possible purchasers to independents on the seeming grounds of maximizing competitive impact. I do not wish to suggest that an independent per se could not run with the ball. What I do suggest is that sale to a large integrated firm might do more to sustain competition in the long run by better ensuring continued operation of the refinery. And after all majors and other large companies do engage in rivalry. Thus purchase by a major or a large firm need not have strong adverse impacts on competition.

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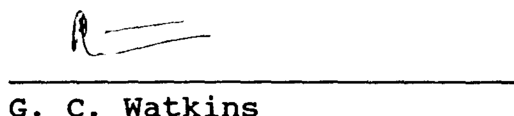
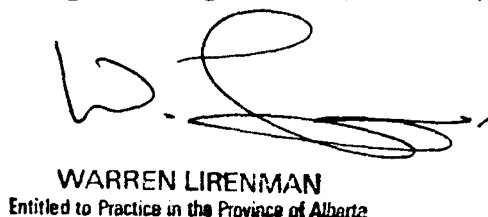
I make this affidavit pursuant to Rule 42(1) of the Competition Tribunal Rules.

SWORN before me at the)
City of Calgary, in the)
Province of Alberta, this)
29th day of September, 1989.)



G. C. Watkins



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