

Financial performance of the major suppliers of domestic bulk LPG

Summary

1. This appendix describes the approach we have adopted to assess the financial performance of the domestic bulk LPG businesses of the major suppliers (BP, Calor, Flogas and Shell) in the UK for the period 1999 to 2004, and our conclusions.

Basis of analysis

2. Our analysis has focused on the major suppliers, who between them account for approximately 90 per cent of the domestic bulk LPG market in Great Britain and for all of the market in Northern Ireland.
3. Domestic bulk LPG is defined by the terms of reference of the inquiry rather than a clearly defined segment of the major suppliers' business. For the most part, the major suppliers' financial data relating to domestic bulk LPG are not shown separately in their financial reporting systems. The major suppliers have therefore allocated specific costs and apportioned common costs to the various segments.
4. In judging the weight we can attach to the financial data supplied by the major suppliers (set out in the annexes to this appendix), we have taken into account that the data have, in most cases, been prepared specifically for this exercise from the management accounts and has therefore not been subjected to a rigorous checking and audit process by the major suppliers or their auditors.
5. This appendix analyses profitability and, for this purpose, we have looked at annual averages: the actual revenue or cost per litre will have been higher or lower at points during the year. In addition, the financial data we have received have in general been provided as annual data.

Income

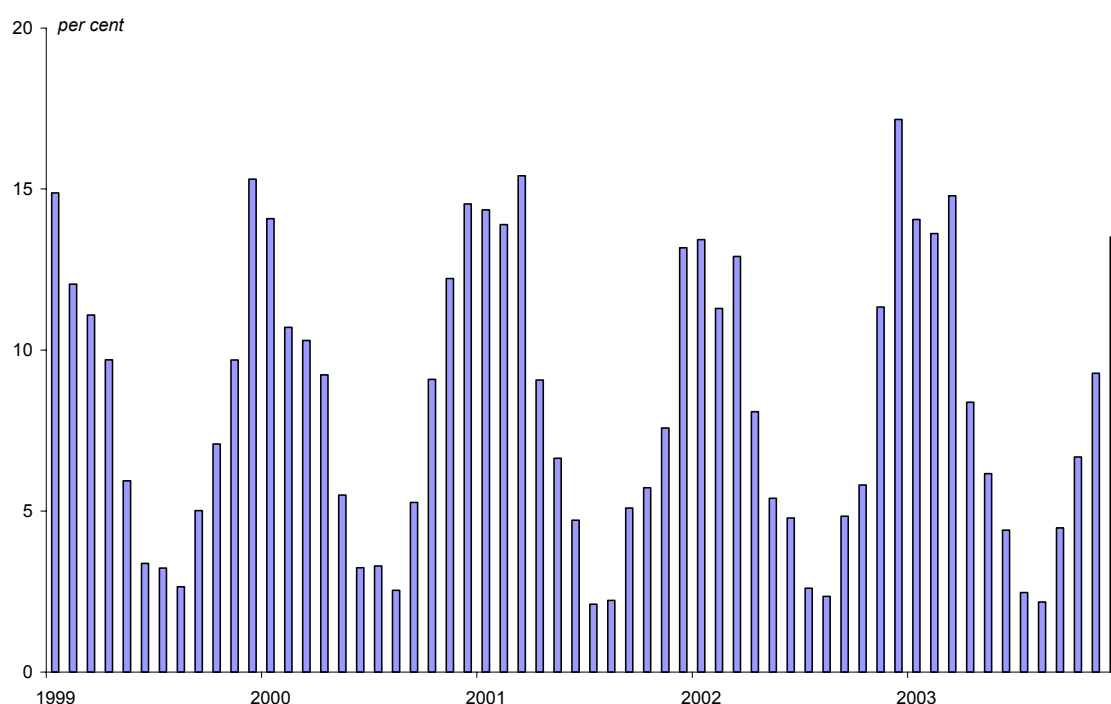
6. The sources of income for suppliers broadly consist of the following, although the major suppliers generally do not see these income streams as distinct businesses (some suppliers prefer the description 'tank activity' to 'metal business'):
 - (a) gas revenue; and
 - (b) metal income, including:
 - (i) charges for the installation of tanks at customer properties;
 - (ii) charges for the uplift (removal) of tanks from customer properties; and
 - (iii) a standing charge to cover emergency services and the maintenance and insurance of the tanks.
7. The majority of the major suppliers' revenue (over 90 per cent in aggregate) arises directly from the sale of LPG: the major suppliers view their businesses as fully

integrated and consider the revenue from their metal businesses to be ancillary to the supply of LPG.

8. Revenues, and hence profits, are highly seasonal (see Figure 1): peak revenues can be up to eight times the lowest monthly revenue. We were told that the main drivers of revenues include:
 - (a) the weather, which has both a seasonal effect, whereby demand is higher during the winter months, and an overall effect, whereby warmer years experience lower demand, while cold periods increase customer demand;
 - (b) underlying movements in the price of oil-related products such as naphtha; and
 - (c) demand for LPG from other sources such as agriculture and chemical feedstock.

FIGURE 1

Aggregate monthly revenue



Source: CC analysis of data provided by the major suppliers.

Note: Revenue figures shown represent the average monthly revenue as a percentage of that year's total aggregate revenue (ie all the months in any calendar year total 100 per cent).

9. This seasonality requires a significant amount of working capital as well as the capacity to 'gear up' in the winter.

Costs

10. Set out in Figure 2 is a schematic representation of the various costs leading to the major suppliers' EBIT (earnings before interest and tax) shown as a percentage of total revenue. While the figure represents the UK generally, the data shown is

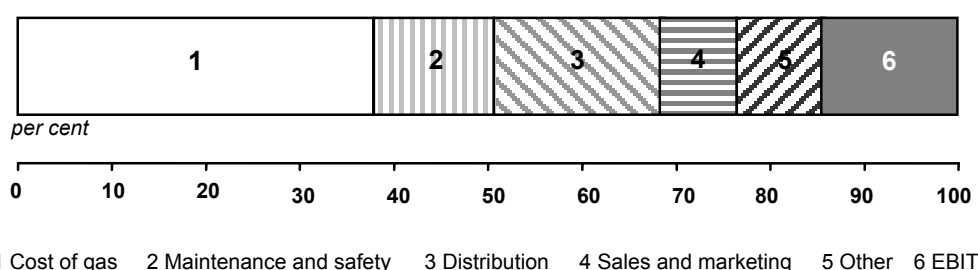
actually based on an aggregate of the information we are using for the major suppliers in GB in 2004.¹ These costs can broadly be grouped into:

- (a) cost of the LPG (including any gains or losses arising from hedging operations);
- (b) distribution of the LPG;
- (c) maintenance and safety;
- (d) sales and marketing; and
- (e) other.

11. Costs arising from the metal business are not always passed on in full as charges to the customers.

FIGURE 2

Split of 2004 aggregate total revenue



Source: CC analysis of data provided by the major suppliers.

Note: Figures are aggregates of all the major suppliers in GB. All data has been annualized to 31 December 2004 (where 2004 data is not available, the split has been taken to be the same as 2003).

12. In aggregate, the major suppliers spend around 40 per cent of their total revenue on the cost of LPG, although this cost of LPG as a percentage of total revenues varies slightly from year to year, and also between the major suppliers (more detail is provided in the annexes to this appendix).
13. The major suppliers spent over 10 per cent on average of their total revenue in 2004 on maintenance and safety.

Cost allocation

14. As stated earlier, the scope of the reference relates to only part of the major suppliers' businesses, and as this generally does not correspond directly to existing segmental reporting it has been necessary for the major suppliers to 'recreate', inter alia, a domestic bulk profit and loss account. For this purpose, the major suppliers have allocated specific costs and apportioned common costs to the various segments.

- (a) All of the major suppliers have been able to separately identify domestic bulk LPG revenues and have not needed to allocate or apportion such revenues.

¹Based upon information received earlier in this inquiry for 2003, we believe this figure is representative for the UK as a whole.

- (b) Costs within the major suppliers' LPG businesses have been allocated to the domestic bulk LPG sector based on a number of drivers, for example the number of deliveries made or the number of tonnes of LPG sold.
15. For each of the major suppliers, we reviewed the costs allocated between LPG business lines (domestic bulk, cylinders, commercial and others) both from the top down (ie considering the businesses in aggregate) and in detail from the bottom up (ie considering individual cost lines) and made a number of adjustments (which are described in more detail in the individual company sections of this appendix).
 16. The allocation rationale used by each supplier (for example the split of LPG delivery costs between commercial, cylinder and domestic bulk) is not necessarily the same, reflecting differing business models: precise comparisons of the suppliers are therefore not necessarily meaningful.
 17. The key adjustments which we have made to align the data include:
 - (a) the exclusion of exceptional or one-off items; and
 - (b) the exclusion of balance sheet goodwill and the associated amortization charges in the profit and loss accounts.

Effect of vertical integration

18. We have considered whether the vertically-integrated suppliers (BP, Shell) have different unit operating costs to those suppliers which are not vertically integrated. From the annual average costs given for each major supplier (shown in the annexes to this appendix), we believe that the price differentials are not significant.
19. We found that the major suppliers which are vertically-integrated [✂].

Economies of scale

20. We have considered whether among the major suppliers, any suppliers have significantly different unit operating costs and, in particular, whether the size of a supplier has an impact on the level of its unit operating costs.
21. The major suppliers have explained that efficiencies can be gained through having a dense network rather than absolute size—thus a smaller national supplier may be able to achieve greater economies and lower unit operating costs than a larger, but less dense, national supplier. [✂]

Approach to the assessment of profitability

22. We have used return on capital employed (ROCE) as the key measure of profitability in this industry. Our guidelines state that 'in the context of a market reference, the CC will normally consider profit levels, usually in terms of rates of return on capital in the market concerned, as a further indicator of competitive conditions'.²
 - (a) We have used earnings before tax and interest payable, adjusted to exclude exceptional or one-off items (such as the costs of this inquiry).

²CC3, *Market Investigation References: Competition Commission Guidelines*, 2003, paragraph 3.82.

(b) We have calculated the capital employed using assets valued at their net book value (NBV).

23. In addition, as part of our overall analysis, we also considered the EBIT margins, gross profit margins, and returns on net assets of the major suppliers (these are set out in the annexes to this appendix). We found that the ROCEs we calculated for each of the major suppliers were consistent with their other financial data.
24. In our analysis, we have valued the major suppliers' asset bases at historic NBVs. Some of the major suppliers have suggested we should use a higher valuation, for example that tanks should be valued at the replacement cost of a new tank. The major suppliers have made general comments but, with one exception (described more fully at paragraph 55), have not provided concrete suggestions with numbers. We did however consider the alternative methodology proposed by one of the suppliers (see paragraph 55).
25. We have used a weighted average cost of capital (WACC) figures as the comparator. This is discussed in detail in Appendix K.

The major suppliers

BP

26. BP's UK domestic bulk LPG operations form a small part of BP plc's total UK operations. BP told us that its domestic bulk LPG business has grown organically and through acquisitions (including the businesses of North East Farmers, Border Gas and Mobil Gas) and so has goodwill in its balance sheet. Table 1 gives summary financial information for BP.

TABLE 1 Summary financial information for BP

	Year ended 31 December						
	1998	1999	2000	2001	2002	2003	2004
Tonnes							
Gas revenue							
Average revenue (ppl)							
Cost of product							
Average cost (ppl)							
Net gas margin							
Metal income							
Operating costs							
Operating profit							
Other costs							
EBIT							
Capital employed							
Gross profit margin							
EBIT margin on total revenue							
ROCE							

Source: CC analysis of financial information provided by BP.

Notes: See Annex 1.

27. [X]

28. [REDACTED]

29. [REDACTED]

30. [REDACTED]

(a) [REDACTED]

(b) [REDACTED]

31. We assess that BP has achieved ROCEs of between [REDACTED] and [REDACTED] per cent since 2001. These are [REDACTED] the WACC that we estimate as appropriate for the supply of domestic bulk LPG (see Appendix K). The return it has achieved since 2001 is [REDACTED] a mid-point estimate WACC of 10 per cent.

Calor

32. Calor is the largest supplier of domestic bulk LPG in the UK by 2004 tonnage, having grown organically from its original LPG cylinder operation. Table 2 gives summary financial information for Calor.

TABLE 2 Summary financial information for Calor

	Year ended 31 December						
	1998	1999	2000	2001	2002	2003	2004
Tonnes							
Gas revenue							
Average revenue (ppl)							
Cost of product							
Average cost (ppl)							
Net gas margin							
Metal income							
Operating costs							
Operating profit							
Other costs							
EBIT							
Capital employed							
Gross profit margin							
EBIT margin on total revenue							
ROCE							

Source: CC analysis of financial information provided by Calor.

Notes: See Annex 2.

33. [REDACTED]

34. [REDACTED]

35. [REDACTED]

36. [REDACTED]

(a) [REDACTED]

(b) [REDACTED]

37. [REDACTED]

(a) [REDACTED]

(b) [REDACTED]

(c) [REDACTED]

(d) [REDACTED]

(e) [REDACTED]

TABLE 3 [REDACTED]

[REDACTED]

Source: [REDACTED]

38. [REDACTED]

39. As set out in Table 3, Calor has achieved ROCEs of between [REDACTED] per cent since 2001. These are [REDACTED] the WACC which we estimate in Appendix K as appropriate for the supply of domestic bulk LPG. The return it has achieved since 2001 [REDACTED] is [REDACTED] a mid-point estimate WACC of 10 per cent, and over the six-year period averages [REDACTED] a mid-point estimate WACC. [REDACTED]

Flogas

40. In November 2002, Flogas acquired the nationwide LPG business of British Gas from Centrica plc. This business now represents the bulk of Flogas' enlarged domestic bulk LPG operations. Table 4 gives summary financial information for Flogas.

TABLE 4 Summary financial information for Flogas

	Year ended 31 March						
	1999	2000	2001	2002	2003	2004	2005
Tonnes							
Gas revenue							
Average revenue (ppl)							
Cost of product							
Average cost (ppl)							
Net gas margin							
Metal income							
Operating costs							
Operating profit							
Other costs							
EBIT							
Capital employed							
Gross profit margin							
EBIT margin on total revenue							
ROCE							

Source: CC analysis of financial information provided by Flogas.

Note: See Annex 3.

41. [REDACTED]

42. [REDACTED]

43. The financial data shown in this appendix include an adjustment provided by Flogas to include the assets acquired from Centrica at the book value as stated in Centrica's books, and restate the profit and loss account accordingly. [REDACTED]

44. We have considered only the last two years to be indicative of Flogas' returns, due to the fundamental change [REDACTED] in Flogas' business on the acquisition of the BG business in 2002. [REDACTED]

45. Flogas has achieved ROCEs of [REDACTED] per cent in the years ended 31 March 2004 and 2005. These are [REDACTED] the WACC which we estimate in Appendix K as appropriate for the supply of domestic bulk LPG. The return it has achieved in these two years is [REDACTED] a mid-point estimate WACC of 10 per cent.

Shell

46. Shell's UK domestic bulk LPG business grew out of its cylinder operations through a number of acquisitions and represents a small part of its total UK operations. In 2000 Shell divested its cylinder business and some of its small bulk LPG to British Gas (at the same time receiving some other non-domestic bulk business from British Gas). On account of this change, Shell was only able to provide data for 2001 onwards. Table 5 gives summary financial information for Shell.

TABLE 5 Summary financial information for Shell

	Year ended 31 December			
	2001	2002	2003	2004
Tonnes				
Gas revenue				
Average revenue (ppl)				
Cost of product				
Average cost (ppl)				
Net gas margin				
Metal income				
Operating costs			✂	
Operating profit				
Other costs				
EBIT				
Capital employed				
Gross profit margin				
EBIT margin on total revenue				
ROCE				

Source: CC analysis of financial information provided by Shell.

Note: See Annex 4.

47. [✂]

48. [✂]

(a) [✂]

(b) [✂]

(c) [✂]

49. [✂]

50. Shell has achieved ROCEs of between [✂] since 2001. These are [✂] the WACC which we estimate in Appendix K as appropriate for the supply of domestic bulk LPG. The return it has achieved since 2001 is [✂] a mid-point estimate WACC of 10 per cent.

Northern Ireland

51. The two major suppliers (Calor NI and Flogas NI) which operate in Northern Ireland are run as separate entities and have provided separate information. The Northern Ireland market is less than [✂] per cent of the size of the British market by tonnes of domestic bulk LPG sold.

52. Prices for domestic bulk LPG in Northern Ireland are lower than in Great Britain, and the average ROCEs of the two suppliers in Northern Ireland are lower than in Great Britain and [✂] our estimated WACC. [✂]

53. These major suppliers suggested a number of reasons for the differences between Northern Ireland and Great Britain, including: lower annual consumption per household; extra freight costs associated with importing LPG to Northern Ireland; a

higher proportion of smaller tank size for customers in Northern Ireland; and lower average earnings per capita in Northern Ireland.

ROCE

54. This section is a summary of the ROCE calculations in the preceding sections. Included in the ROCE figures set out in Table 6 are those adjustments which we have accepted and which are described in the preceding company specific sections. [redacted]

TABLE 6 ROCE of the four major suppliers in GB (nominal)

	1999	2000	2001	2002	2003	2004
ROCE						
Calor						
Flogas						
Shell						
BP						

per cent

Source: CC analysis of information supplied by major suppliers.

Note: [redacted]

Depreciated replacement cost basis

55. [redacted] provided us with additional analysis of its financial information in which it had revalued all of its tanks on a depreciated replacement cost basis in each of the years we are considering: [redacted] believed that its balance sheet, based on historical cost accounting, understated the true position. This was done by assessing the value paid in 1998 for new tanks, and increasing the entire tank population in 1998 to this average price. In each year following this, all of the tanks were revalued to the average price paid for tanks in that year. The accumulated depreciation was also increased by the same proportion: as though the tanks had been bought at this new price and then depreciated as before.
56. The holding gain (or loss) resulting from revaluing the tanks was then posted to the profit and loss account for the period to which it related. In addition, there was an increased depreciation charge in each year to reflect the increase in the value of the asset base and the capital employed figure was also increased.
57. The correct comparator for these results is a real WACC of approximately 8 per cent (which we estimate in Appendix K as appropriate for the supply of domestic bulk LPG): as tanks make up the majority of the suppliers' asset bases, if they increase in value in line with inflation, the resulting returns approximate a real return.
58. In order to reduce the volatility in the ROCE resulting from this calculation, we have also shown it with the holding gains spread evenly across the period. The results of this exercise [redacted] are shown in Table 7. As can be seen in the table, if this methodology were accepted, [redacted], the return on capital in 2002 would be [redacted].

TABLE 7 [REDACTED] ROCE with holding gains

	Year ended 31 December						per cent
	1999	2000	2001	2002	2003	2004	Average
ROCE (historical cost)							
ROCE with revalued assets							
ROCE with revalued assets (averaged holding gain)							

Source: CC analysis of information supplied by [REDACTED].

59. [REDACTED]

(a) [REDACTED]

(b) [REDACTED]

(c) [REDACTED]

(d) [REDACTED]

60. [REDACTED]

61. [REDACTED]

Conclusions

62. We have found that:

(a) since 2001, BP achieved returns on its capital employed [REDACTED];

(b) since 2001, Calor achieved returns on its capital employed [REDACTED];

(c) [REDACTED] Flogas has made returns on its capital employed [REDACTED];

(d) Shell has made returns on its capital employed in 2003 and 2004 [REDACTED]. Shell's returns prior to 2003 were [REDACTED]; and

(e) the ROCEs achieved by the major suppliers in Northern Ireland are lower than for Great Britain [REDACTED].

BP key financial data

	<i>Year ended 31 December</i>						
	1998	1999	2000	2001	2002	2003	2004
<i>Profit and loss—domestic bulk</i>							
Number of tanks							
Tonnes							
Gas revenue							
Revenue growth (%)							
Average revenue (ppl)							
Cost of product							
Average cost (ppl)							
Net gas margin							
Metal income							
Operating costs							
Operating profit							
Other costs*†							
EBIT*†							
EBIT growth (%)							
Interest							
PBT							
PBT growth (%)							
Tax‡							
Net income							
Net income growth (%)							
<i>Balance sheet</i>							
Net assets†							
Capital employed†							
<i>Profitability</i>							
Gross profit margin							
EBIT margin on total revenue							
ROCE*†§							
Return on net assets†							

Source: CC analysis of information provided by BP.

*[€]
†[€]
‡[€]
§[€]

Note: [€]

Calor key financial data

	<i>Year ended 31 December</i>						
	1998	1999	2000	2001	2002	2003	2004
<i>Profit and loss—domestic bulk</i>							
Number of tanks							
Tonnes							
Gas revenue							
Revenue growth (%)							
Average revenue (ppl)							
Cost of product							
Average cost (ppl)							
Net gas margin							
Metal income							
Operating costs							
Operating profit							
Other costs*							
EBIT*							
EBIT growth (%)				✂			
Interest							
PBT							
PBT growth (%)							
Tax							
Net income							
Net income growth (%)							
<i>Balance sheet</i>							
Net assets							
Capital employed							
<i>Profitability</i>							
Gross profit margin							
EBIT margin on total revenue							
ROCE†							
Return on net assets							

Source: CC analysis of information provided by Calor.

*[]

†[]

Note: []

Flogas key financial data

	Year ended 31 March						
	1999	2000	2001	2002	2003	2004*	2005
<i>Profit and loss—domestic bulk</i>							
Number of tanks							
Tonnes							
Gas revenue							
Revenue growth (%)							
Average revenue (ppl)							
Cost of product							
Average cost (ppl)							
Net gas margin							
Metal income							
Operating costs							
Operating profit							
Other costs†							
EBIT†							
EBIT growth (%)				✂			
Interest							
PBT							
PBT growth (%)							
Tax‡							
Net income							
Net income growth (%)							
<i>Balance sheet</i>							
Net assets†							
Capital employed†§							
<i>Profitability</i>							
Gross profit margin							
EBIT margin on total revenue							
ROCE†§							
Return on net assets‡							

Source: CC analysis of information provided by Flogas.

*[€]
†[€]
‡[€]
§[€]

Shell key financial data

	Year ended 31 December			
	2001*	2002*	2003	2004
<i>Profit and loss—domestic bulk</i>				
Number of tanks†				
Tonnes				
Gas revenue				
Revenue growth (%)				
Average revenue (ppl)				
Cost of product				
Average cost per litre (ppl)				
Net gas margin				
Metal income				
Operating costs				
Operating profit				
Other costs				
EBIT				
EBIT growth (%)		✂		
Interest				
PBT				
PBT growth (%)				
Tax				
Net income				
Net income growth (%)				
<i>Balance sheet</i>				
Net assets‡				
Capital employed‡				
<i>Profitability</i>				
Gross profit margin				
EBIT margin on total revenue				
ROCE§				
Return on net assets				

Source: CC analysis of information provided by Shell.

*[€]
†[€]
‡[€]
§[€]

Calor NI key financial data

	<i>Year ended 31 December</i>				
	1999	2000	2001	2002	2003
<i>Profit and loss—domestic bulk</i>					
Number of tanks					
Tonnes					
Gas revenue					
Revenue growth (%)					
Average revenue (ppl)					
Cost of product					
Average cost (ppl)					
Net gas margin					
Metal income					
Operating costs					
Operating profit					
Other costs					
EBIT					
EBIT growth (%)			✂		
PBT					
Tax*					
Net income					
Net income growth (%)					
<i>Balance sheet</i>					
Net assets					
Capital employed					
<i>Profitability</i>					
Gross profit margin					
EBIT margin (on total revenue)					
ROCE					
Return on net assets					

Source: CC analysis of information provided by Calor NI.

*[✂]

Flogas NI key financial data

	<i>Year ended 31 March</i>				
	2000	2001	2002	2003	2004
<i>Profit and loss—domestic bulk</i>					
Number of tanks					
Tonnes					
Gas revenue					
Revenue growth (%)					
Average revenue (ppl)					
Cost of product					
Average cost (ppl)					
Net gas margin					
Metal income					
Operating costs					
Operating profit					
Other costs					
EBIT					
EBIT growth (%)			✂		
PBT					
Tax*					
Net income					
Net income growth (%)					
<i>Balance sheet</i>					
Net assets					
Capital employed					
<i>Profitability</i>					
Gross profit margin					
EBIT margin (on total revenue)					
ROCE					
Return on net assets					

Source: CC analysis of information provided by Flogas NI.

*[✂]