



How Do Retailers Get – and Sell – Gasoline?

Retail gasoline prices directly reflect wholesale prices. However, how – and when – retailers purchase wholesale gasoline can differ significantly, leading to varying gasoline prices and/or margins on the product sold.

Complexities in the wholesale market result in retailers having different cost structures, including whether they are branded or unbranded, have long-term contracts or buy on the spot market. In the case of tight supply periods and rising wholesale prices, even the time of day that the wholesale product was purchased can play a role in determining the retail price.

Retail Gasoline Supply

Retailers obtain gasoline supplies based on the nature of their relationship with their suppliers, and because there are several different ways that retailers can purchase gasoline, the cost structure and availability of gasoline may vary greatly from one retailer to another – even those operating under the same gasoline brand. There are three primary supply arrangements influencing a retailer's operations:

1. **Major Oil Owned and Operated:** Less than 5 percent of the 161,768 retail gasoline outlets in the United States are owned and operated by the major oil companies. (Less than 2 percent of the more than 114,000 U.S. convenience stores selling gasoline are owned and operated by major integrated oil companies.) These retail locations receive product directly from the corporation's refinery assets and their profit or loss is integrated into that of the corporation.
2. **Branded Independent Retailer:** 55 percent of retail gasoline facilities sell one of the top 20 brands of fuel, which includes major oil plus refiners like Valero, Sunoco and Alon), and virtually all of them (with the exception of the directly owned and operated facilities mentioned above) are operated by independent business owners who sign a supply contract and sell gasoline under a brand owned or controlled by a refining company. Not every contract is drafted equally, and various market conditions can influence the terms of the contract. Branded retailers pay a slight surcharge per gallon for using the refiner's brand, benefiting from the supplier's marketing and ensuring a more secure supply of product. Their refiner supplier establishes their wholesale costs. When supplies are constrained, these retailers are given a higher level of priority for accessing product, although access to supplies may be restricted.
3. **Unbranded Independent Retailer:** Approximately 45 percent of retail gasoline facilities are operated by independent business owners who do not sell gasoline under a brand owned or controlled by a refining company. These retailers purchase gasoline from the unbranded wholesale market, which is made up of gallons *not* dedicated to fulfill a refiner's contracts. These retailers do not pay a marketing surcharge like their branded competitors do;

consequently, unbranded gasoline is typically sold at all levels of trade for a lower price than branded gasoline. However, when supplies are constrained, these retailers have the lowest level of priority to access gasoline, often incur the largest wholesale price increases and may be completely denied access to product. Their wholesale costs are also established by the refiner supplier(s).

A company's supply contracts and size determine its options for obtaining gasoline. Branded independent retailers have one option for gasoline: the refiner that provides it with supply. Some larger unbranded independent retailers also may have contracts with a specific refiner, or even multiple refiners. Others may simply purchase product off the open market.

Most retailers are small businesses that obtain their gasoline at a terminal, also known as "the rack." Prices at the terminal are known as "spot" prices, and these typically experience the most price volatility.

For those purchasing fuel at the rack, there are two options for delivery. Some companies may elect to have gasoline delivered to their stores by a "jobber" who delivers fuel to their store – branded or unbranded – for a delivery fee. Other retailers have invested in their own fleets of trucks that go to a specific terminal – or terminals – to obtain gasoline. These companies may also serve as jobbers to other retailers.

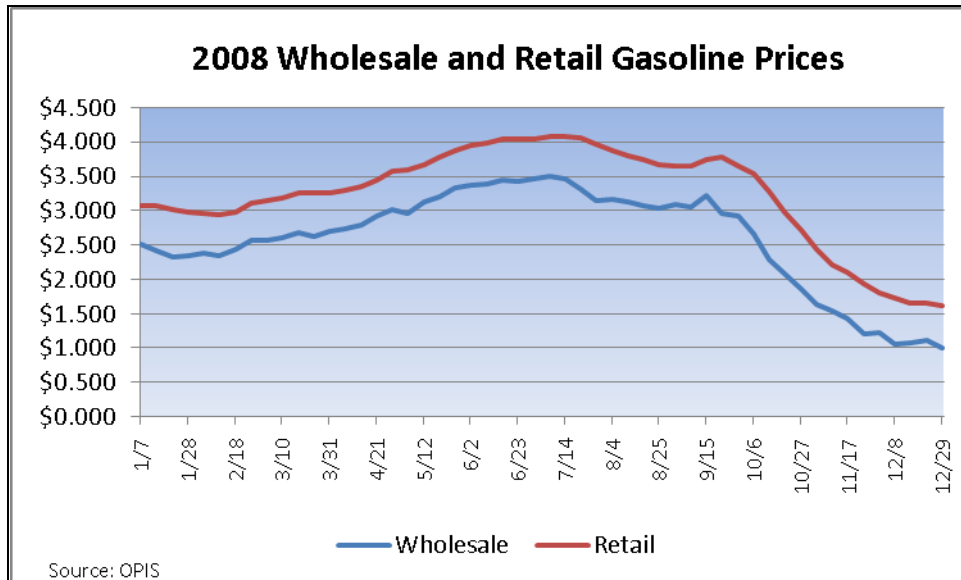
Some larger unbranded retailers may purchase gasoline futures, attempting to lock in specific prices for delivery on a specific date in the future. This type of purchase, commonly referred to as "hedging," helps these retailers manage their costs in anticipation of volatile wholesale prices.

Retail Gasoline Pricing Considerations

Retail motor fuel pricing is a complex relationship between wholesale costs and competitive market analysis.

Wholesale Costs

Wholesale gasoline is a commodity that is traded on the open market. As such, its price can change by the minute, which may influence the cost structure for a retailer. On average, retailers sell approximately 4,000 gallons of fuel each day and receive about three deliveries (approximately 9,000 gallons per delivery) each week. Higher volume retailers may receive multiple deliveries each day depending on their storage capacity. Considering the volatility of wholesale prices, the cost of each delivery can vary significantly even within a short time frame. The following chart plots the national average wholesale (not including taxes and freight) and retail price of regular unleaded gasoline week-to-week in 2008 as reported by the Oil Price Information Service (OPIS):



Competitive Considerations

While wholesale costs are a significant factor in retailer prices, the retail pricing decision also is heavily influenced by market conditions and local competition. Ultimately, movements in wholesale gasoline prices influence the cost structure of a retail facility, but competition for customers will dictate the store's profitability.

Consumer research, as reported in the 2008 gas price kit, reveals that price is the most important criteria when consumers select a gasoline retailer. Nearly one-third of consumers will go out of their way to save as little as three cents per gallon. Consequently, retailers must ensure their posted fuel prices are competitive within their market.

In 2007, motor fuel sales accounted for 70.8% of total sales in the convenience store industry, but contributed only 34.5% of pre-tax profit. Consequently, it is critical that posted fuel prices *at worst* do not deter in-store customers from visiting a particular retail location, for it is from these customers that convenience retailers generate most of their profits.

Convenience retailers establish a target retail price based on the wholesale costs of the fuel, operating costs associated with selling the fuel, and a desired profit margin. This target retail price is then adjusted in accordance with competitive pressures, as the retailer seeks to set a price on fuel that will maximize customer traffic inside the store and generate the greatest overall profitability for the location.

Fuel Profitability

As wholesale prices change daily, retailers are forced to constantly adjust their target retail price. However, because not every retailer receives deliveries at the same time nor incurs the same change in wholesale prices, competition does not always allow the retailer to immediately or completely adjust for changes in costs. This creates a volatile situation in which retail fuel profitability fluctuates continuously. Consequently, it is important for retailers to evaluate the profitability of their fuel operations over a period of time rather than at any one particular moment.

When wholesale prices are increasing, competition often prevents the retailer from passing the higher costs through to the consumer immediately, resulting in a lower retail markup and reducing the retailer's profitability. However, once wholesale prices stabilize or begin to decline, competition often enables retailers to maintain retail prices for a while, thereby increasing their markup and recovering the profits lost when wholesale prices were rising. Over time, the average retail markup remains relatively stable. For example, in 2008, national average retail prices ranged from a weekly low of \$1.622 to a weekly high of \$4.088, according to OPIS. Meanwhile, the national average retail markup varied from 4.8 cents per gallon to 53.4 cents. Over the course of the year, however, the average retailer markup was 18.0 cents.

Retail profitability, however, is much lower than the retail markup. From this 18.0 cents per gallon, retailers had to pay for equipment, associated operating expenses, and credit card fees (assessed on average at 2.5% of each transaction completed with a credit or debit card). The average breakeven is estimated at approximately 13 to 15 cents per gallon. Consequently, the retailer profitability for 2008 was 3 to 5 cents per gallon.

Replacement Costs

Complicating a retailer's ability to set competitive prices as wholesale prices move is the challenge of maintaining sufficient operating capital to cover the cost of the product that will replace the inventory being sold.

A gasoline retailer typically seeks to establish a retail price based on the cost of replacing the gasoline currently at the retail location – not the cost of that product itself. Basing prices on “replacement costs” is especially critical when wholesale prices fluctuate frequently. A retailer must generate sufficient cash from its current retail sales to purchase its next delivery of gasoline; otherwise, the retailer would be constantly using debt to finance wholesale gasoline purchases.

This was a significant problem during the first half of 2008, as retailers exhausted their credit lines to pay for more expensive fuel deliveries during the run-up to \$4.00-plus gasoline. Many were forced to close their stores because they could not generate sufficient revenues from fuel sales to purchase the next delivery. This was particularly true with one-store operators. As a result, for only the third time in the past 15 years, the number of convenience stores selling gasoline *decreased* in 2008.

With pricing influenced by replacement costs, there can be consumer misperceptions when gasoline prices rise, as some consumers observe prices changing at a retail location even though the station did not receive a new shipment of gasoline. However, the store may be responding to a notice from its supplier that explains how much the next shipment will cost. But even these decisions to respond to anticipated changes in wholesale costs are strongly influenced by competitive pressures and, often, a retailer is unable to adjust retail prices to match the change in wholesale costs. When prices retreat, market competition again influences a retailer's pricing decisions. During these periods, consumer interest in prices wanes and they usually don't notice that prices dropped even though a new shipment has not arrived.

Why Can Prices Vary in a Given Market Area?

Because of consumer price sensitivity, retailers know the importance of setting their price to be as competitive as possible in a market area. If their retail price is significantly higher – for whatever the reason – retailers lose not just the gas sale, but any chance of capturing the additional in-store sale.

But, the fact remains that costs can vary in a market area, and that the retailer with the highest retail price may not be making the most money per gallon. Depending on the terms of supply arrangements, operating expenses and other factors, the store with the highest price in a market might actually realize less profit per gallon than the competition. There are usually several factors that could contribute, and some or all of them could be at work in a given area:

- **Taxes:** State taxes can vary wildly in a given metropolitan market area. For example, gasoline taxes in New York state average 59.7 cents per gallon, while in neighboring New Jersey, taxes average 32.9 cents per gallon. A number of municipalities across the country also assess local taxes on fuel, and these could vary by city or county. Competition does not recognize political boundaries, so the impact of varying tax policies on individual retailers can be quite different – a competitor operating in a higher taxed jurisdiction is at a disadvantage compared to the retailer in a lower taxed area.
- **Proximity to Product:** Distribution costs affect the retail price of gas. In some cases, being a few dozen miles further away from a terminal can have a significant impact on costs. While most metropolitan areas are located near several wholesale terminals, retailers in more rural areas may be forced to drive more than 100 miles to obtain supplies.
- **Fuel Requirements:** Fuel requirements vary by region, state and even county. In general, the more densely populated areas of the country are required to sell a different blend of fuel in the summer months. This fuel costs more to produce, and supply challenges during the spring transaction can create added costs to the process.
- **Business Costs:** Rent is a considerable expense for retailers in some areas. Highly desirable locations cost more to operate. For example, there are less than 50 gas stations on the island of Manhattan because retailers find it difficult to make sufficient income selling gas on costly real estate. Across the country, factors include whether the site is owned or leased, when the property was bought or leased and the terms of this contract. These all can play a role in the costs required to sell fuel.
- **Market Conditions:** Some high-volume retailers may get new deliveries multiple times a day, but even average retailers get new deliveries several times a week. When wholesale prices are fluctuate rapidly, the day – or even the time of day – that fuel is delivered can significantly impact the cost. Today it is not uncommon to see wholesale prices move 10 cents or more in a given day.
- **Brand:** A branded retailer typically pays a premium for fuel from a branded supplier in exchange for marketing support, supply guarantees, imaging assistance and other benefits, including the value of the brand, which is still important to many customers. However, when supplies are tight, these retailers may see lower wholesale costs. In extreme cases, there is a “market inversion,” where branded retailers are selling fuel for a price less than unbranded retailers can find it on the spot market. Other factors that could impact the branded retailers’ costs are the terms of the contract, and market conditions at the time the contract was signed. Finally, there are situations where the branded supplier offers discounts to retailers in highly

competitive areas, and these discounts may not be available to a retailer selling the same brand a short distance away where competition is less severe.

- **Pricing Strategy:** Ultimately, retailers examine how they want to go to market. The vast majority adjust their markup on gas depending upon current market conditions, settling for a lower markup when prices rise in return for the potential to make up for the lost margin when prices fall. A smaller percentage of retailers seek to have consistent, predictable margins throughout the year. When prices are rising, they may have a price higher than the competition; when prices fall, the reverse is true.