Stop Making ¢ents?

Is the cents-per-gallon metric costing the c-store channel millions of dollars in fuel profits?

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Picture that 20-ounce bottled soda in your store cooler. So enticing on a hot day. The sweat of condensation dripping as you pull it off the shelf.

Now consider how you determine its value to your business. You price out the percentage of profit made on the sale of that individual soda by subcategory, brand or fluid-ounce basis. It's Business 101.

Now rethink the equation. What if you priced your profit based not on percentage margin but an arbitrary amount—say, 10 cents a bottle—and focused on making that same 10 cents all the time, every year, no matter the hard cost for that bottled soda?

Absurd? Well, think about your No. 1 destination—gasoline—and the cents-per-gallon metric that's the current industry norm.

Apples to oranges? Or just unquestioned habit founded on an anachronistic measure?

For as long as retailers can remember, the industry has measured gasoline and other fuels based on cents per gallon (CPG). It's a practice that resonates through internal spreadsheets and into NACS research for its annual State of the Industry Survey.

For the past several months, *CSP* has talked to leading industry executives and data specialists who are questioning the wisdom behind this age-old metric, and whether it's time to apply profit percentages to a category that generates 75% to 80% of our industry's total annual revenue.

In short, these critics say CPG pricing methods may be costing our channel millions of dollars in lost profits, preventing greater alignment between the forecourt and backcourt, and impeding construction of short- and long-term business projections.

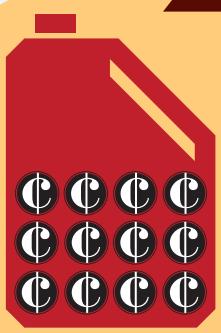
"I likened it to cigarettes and how [because of evolving] cigarette programs, the price of cigarettes goes up but the margin per pack is staying the same," says Jeff Miller, president of Miller Oil Co., Norfolk, Va. "There was a huge outcry in that margins were dropping like a rock. Now if a pack of cigarettes was always ['X' cents per pack], it

CPG vs. Margin Percentage

Making the switch in fuel metrics from cents per gallon (CPG) to a percentage margin is a mental leap of sorts. Not only are recalculations involved, but so are perceptions of what is satisfactory and what is not. Going from one to the other may mean looking at some figures one day and being completely satisfied, then looking at those same figures the next day and feeling defeated. Here's a quick look at how the two methods compare.

CPG

The CPG metric places an arbitrary, albeit historic, number—often 12 to 14—of physical pennies assigned to a gallon of gasoline, making that a financial goal. At the end of the day, retailers hope that what they pay for product and what they eventually sell it for brings in that amount.



VS.

Margin Percentage

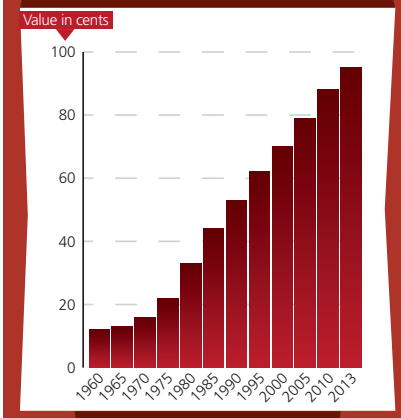
Using a percentage to calculate the return a retailer makes on fuel would mean the actual goal in terms of cents per gallon would change, based on what product was actually bought and sold for. If that goal percentage was set at a certain level, actual cents per gallon would move well past the historic 12- to 14-cent range.

**Source: NACS State of the Industry top quartile in-store gross margin percentage for 2012.*

Tracking Inflation Rates

One of the biggest arguments for moving to a percentage-based measure for fuel is the inability of the CPG metric to keep up with the rate of inflation. The annual inflation rate, which is also in flux, takes into account the overall rise or fall (in the case of deflation) of what goods and services cost, indicating how much more or less it may cost today for those same goods and services vs. in the past. The chart below shows how the value of 12 cents in 1960 has grown to almost a dollar today due to inflation.

The Value of 12 Cents Over Time



1.8%

Inflation rate for 2013

Source: U.S. Inflation Calculator, Coin News Media Group LLC

would be different … but that's not the way we do it."

Since discussion began in earnest with *CSP* editors, several prominent retailers have volunteered to voice their opinion on the matter, creating a chain of thought that may eventually spark change.

These operators are hoping to move the industry from CPG to the kind of percentage-based accounting used for just about every other area of the store. Formulating the basic core of a retailer's lifeblood: practical, comparable margins.

What's at stake going forward is an industry more in tune with its own decisions, the day-in, day-out choices that can turn a good year into a stellar one, or a make-or-break year into a make year.

But no one is expecting industrywide change overnight. Some challenges:

►**Collusion laws** put retailers on edge, keeping many guarded about discussing price in groups or behind closed doors.

►**Accounting technology** may need updating to help retailers with daily conversions.

►**Inertia** may exist within an industry so set in its ways that such a fundamental change is tantamount to reinventing the wheel.

"Fundamentally, we've been caught up in the CPG world that's out of the '50s or '60s; we've had a lot of inflation since the '50s, '60s and '70s," says Quinn Ricker, president and CEO of Ricker Oil Co., Anderson, Ind. "Ten cents in the '50s or '60s is not the same margin or profit as it is today. We need to look at this differently or we're going to hurt our industry overall."

Propelling this change in thinking is a fuel analytic company and the retailers that make up the company's newly formed Client Advisory Club. It includes retailers Ricker and Miller; Frank Gleeson, retail director of Dublin, Ireland-based Topaz Energy Group Ltd.; Ari Haseotes, president and chief operating officer of Framingham, Mass.-based Cumberland Farms Inc.; and Florham Park, N.J.-based KSS Fuels.

The Old Way

As far as retailers can tell, CPG emerged in a time when fuel was cheap and sold in a way that was isolated from anything else even remotely connected to running a retail store.

"It was fuel and repair for years," says Steve Montgomery, an industry veteran and president of b2b Solutions, Lake Forest, Ill. "When I got to Amoco, we measured everything in that per-gallon basis … and when gasoline and c-stores merged, [we said] with fuel, it'll be CPG, and we're going to measure everything else gross-profit percentages and dollars."

And for years it did work. Retailers such as Miller point out that for decades, gasoline nationwide hovered in the range of $1 to $2.

The biggest difference starting from the late 2000s is the dramatic increase in the price of gasoline at retail, now averaging from $3.50 to $4 a gallon, all the while with CPG goals still in the range of 12 to 14 cents.

The scenario is punishing retailers in many ways because it doesn't take into account increasing costs of labor, health care and, the worst of it, sharp increases in credit-card fees.

Miller brings up the routine example of buying loads of gasoline. Purchasing a load of 8,500 gallons in the past was, for example, $3 per gallon, with the retail price at $3.12. That load will cost $25,500 to bring in and give a retailer $1,020 for his time. But now the price is $4 a gallon per load and $4.12 on the street. That's $34,000, or $8,500 more in initial expense to bring in—way more than the $1,020 the retailer is making to sell it.

"Now you've got to go to the bank and hit your credit line," Miller says. "If you look at it over a period of years, as the price of gasoline has gone up, there's no reflection of the cost of living, the economy; everything you use goes up for whatever reason, yet we choose not to adjust our margin."

It's as if gas pricing has lived in its own bubble, ignoring the world around it.

Ricker concurs. "CPG is not inflation-adjusted; it's static," he says. "You hit 10 cents per gallon one year, you're up 10.1 cents per gallon the next year and think you're great—but that rate's not going to keep up with inflation."

According to Gleeson of Topaz Energy Group, operators across the pond are also feeling the inflation pinch when it comes to CPG—although there it's measured in cents or euros per liter.

"We're now in an upward market and will be for some time," he says. "Retailers need to get an adequate return and at least keep pace with inflation. The old way of cents per liter does not put us in a go-forward position. The old ways of doing business on fuel are gone."

Why the disconnect? The reasons go back to a commonly held belief of gasoline as a traffic builder and, in some cases, a loss leader. Much of the industry has spent years, and in some cases decades, weaning themselves off gasoline as its profit driver, turning instead to prospects such as foodservice to make margin, Montgomery says.

If a formula does exist, it ties back to retaining volume, he says. "What we're really talking about is the price on the street where you're at the mercy of your dumbest competitor," he says. "One of the [industry's] mantras for many years has been: Gallons are forever, margins come and go—meaning that fuel margins will go up and down, but do what you have to do to protect your gallons."

The paralyzing fear is of losing gallons and customers to a lower-cost competitor. It's an ingrained, fatalistic mindset in that retailers feel they have no control over margins because of street competition, and that volumes are more valuable than profitability.

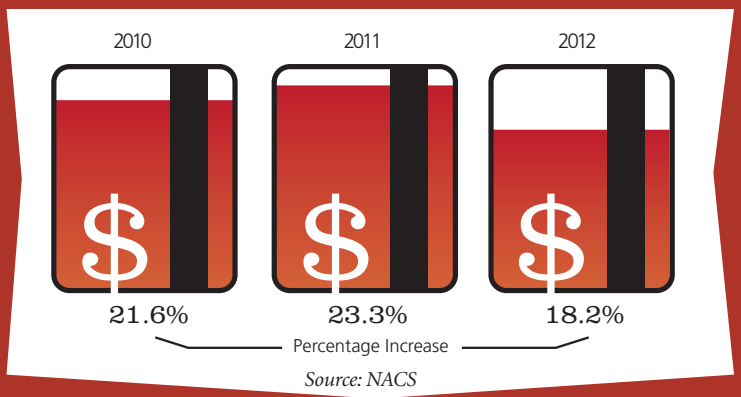
Add to that the pressure coming from the oil companies to protect ratable (essentially branded) fuel. Major oil historically needed to protect the volumes contracted that tie back to what they produce at their refinery. So again, it's a mindset tied to volumes and ultimately gallons sold—not profit opportunities.

Those days, however, are basically gone.

"Until two years ago, the major oil

Credit, Debit Card Fee Increases

While CPG values may stay the same, the cost of doing business has certainly risen. Here's the percentage increase in credit- and debit-card fees in just the past three years.



Source: NACS

$11.2 billion

What the industry paid in credit- and debit-card fees in 2012

companies were running the show," Miller says, referring to how most of Big Oil in recent years has turned over its retail operations to the distributor class of trade. "This is how the major oil companies were doing it, so if that's the way the jobbers and dealers were talking about it, that's what you did."

So today, with the transition complete, retailers are now in the driver's seat, operating without the deep pockets of a major oil company to rely on when fuel margins are squeezed.

"More and more of what we see of big oil networks is that they're becoming more of an independent or chain business," Gleeson says, pointing out that such retailers need healthy profit margins to continue doing business—and if they lack proper margins, have to leverage assets for credit in order to afford gas costs. "They don't have the ability to go up supply chain."

And with jobbers and dealers less tied to major-oil dictums, Miller poses the question of what a now more retail-focused segment thinks.

State Government Sees the Difference

Even state government—not typically thought of as fiscally forward-thinking—has understood the flaws of CPG accounting, according to Jeff Miller, president of Miller Oil Co., Norfolk, Va. He says his own state just this year repealed its old CPG-based excise tax and replaced it with a percentage-based calculation.

17.5 cents vs. 3.5%

The old CPG-at-the-pump rate vs. the new formula tied to wholesale gasoline for calculating excise taxes in the state of Virginia.

Source: Virginia Department of Motor Vehicles

Refining Measurements

So if the industry were to move to a margin-percentage based perspective on gasoline, what would that scenario bring?

For one, a greater understanding of the overall numbers, says Mark Hawtin, senior vice president of strategy and business development for KSS Fuels.

Appreciating the effect of a price increase in one part of the business means putting every aspect of that business under the same metric. "We want to put all the core categories on the same footing," he says. "If we want to trend fountain drinks vs. foodservice, we can, but coffee to fuel? There's no easy way to make a direct comparison."

> "Ten cents in the '50s is **not the same margin or profit** as it is today."

Put simply, can we bring the forecourt and backcourt in alignment to weigh how pricing in one affects the other?

The CPG vs. margin percentage debate has been growing among KSS advisory group members for many months, especially among members who wanted to better integrate their ongoing analysis of fuel with their inside sales, Hawtin says.

"[It has] to do with revenue," Hawtin says. "When we think margin rate and margin contribution, it's difficult because [fuel and inside sales] are judged on a completely different basis."

Comparing apples to apples has its advantages, Hawtin says, one being as a way to decide where to commit limited resources. "A retailer has restricted space to stock offerings," he says. "They're limited by the size of the store and the space available. So it's a key parameter. From which category do I get the greatest margin contribution, and are [those products] getting their fair share of space in my stores?"

Admittedly, the balance of margin and space to sales is a complex one. Some lower-margin categories, such as cigarettes, may drive sales and higher market-basket rings. Yet many are space eaters with both subpar margins and sales.

Still, Hawtin's fundamental question has relevance. And when applied to the fuel island, the question centers on: Are we getting the best margin we can? And of course, fuel is a set investment, Hawtin admits. To be in the fuel business at all, a retailer must make a commitment to equipment, canopies and lot space to accommodate that traffic.

So it's not just looking at it as a percentage of gross margin, but also looking at fuel as a category and managing it that way, Ricker says.

His company is an example of a historic jobbership (albeit also a c-store-focused one) taking over the retail that was once controlled by a major oil.

"I'll be honest—we weren't a fuel-focused company," he says. "When we bought BP's [stores here] … we bought

"As the price of gasoline has gone up, there's no reflection of the cost of living, the economy … **yet we choose not to adjust our margin."**

the Indianapolis market, and suddenly we were selling a lot of fuel. Once we picked up all those gallons, it became a really big deal, and we had to be as good on fuel as we were inside the store. It's really changed for us over time with all these oil company divestments and the volumes that we have now."

If the industry switches from CPG, Ricker is confident fuel margin percentages will become inflation adjusted and, ultimately, market adjusted.

"It's going to give you a more accurate picture of that category than looking at the static metric we've used for 40 to 50 years," he says.

And that means thinking about fuel in classic category-management terms.

"It's so important that our retail fuel pricing person reports directly to me; we talk virtually every hour about fuel," Ricker says. "Fuel is on my mind all the time."

The problem comes in the down times, Ricker explains. "When the economy was doing well, our area was growing. … You didn't have to be as creative and cute when it came to fuel," he says. "Now, if you're going to do well or even sustain your fuel volumes, you have to get very thoughtful about how you do so. We've put more efforts into fuel in the last year than we put into anything from a marketing perspective."

Will Change Mean Higher Prices at the Pump?

While the impetus to go from a CPG-based metric to a percentage margin is all about properly recouping operational costs and making profit, it may not necessarily mean higher prices at the pump.

Street competition would be the public's best friend, says Steve Montgomery, president of b2b Solutions, Lake Forest, Ill. "I don't see everyone saying, 'I'm going to make 8% whether [gas is] $2 or $4 a gallon' anytime soon," he says. "It's about the price on the street, where you're at the mercy of your dumbest competitor."

Others agree. Jeff Miller, president of Miller Oil Co., Norfolk, Va., says if the entire industry moved to percent margin on gasoline, it would be invisible to motorists on the street. Competition aside, price-collusion laws keep retailers from actually talking about how they came to their street postings, so a veil always exists between retailers. And for any successful operator, pricing is a continuous balancing act.

"It's like selling fountain drinks for 79 cents a cup," Miller says. "Some people may do it because a competitor is doing it, but if you're not managing inventory or marketing [your product], then all you're doing is losing money."

Even if pricing remains relatively unchanged, retailers such as Quinn Ricker, president and CEO of Ricker Oil Co., Anderson, Ind., believe the switch to margin-based decision making will still result in better profits at the all-important pump.

"My guess is we'd probably make some different decisions [on pricing]," says Ricker. "Day-in, day-out I don't think a lot would change, but we'd be making a few different decisions than we would from looking at CPG. Small changes in fuel equal very big gross profit dollars. Tenths of a percent make hundreds of thousands in profits—or lack of profits."

Bringing About Change

While retailers have different ideas about what change will mean, many believe pulling the industry away from CPG starts with NACS. Because of collusion laws and natural competition, retailers cannot compare fuel numbers (CPG or margin percentages) with each other and must rely on outside sources, such as NACS, Nielsen or even publications such as *CSP*, to understand how their numbers stack up to the industry standard.

"There needs to be a coordinated effort to look at this," says Ricker. "NACS needs to take a leadership role, particularly in the SOI forum. When we're going over our store numbers, we should not just be posting CPG up there—we should be posting the margin percentage."

While the NACS State of the Industry Survey has in recent years published profit margin in terms of percentage of revenue, retailers interviewed believe more could be done to better understand the category in terms of margin percentages.

In response to that sentiment, NACS spokesperson Jeff Lenard points out that the survey "includes both calculations so that the data is actionable regardless of how retailers calculate break-even."

The survey still stands as "the most comprehensive benchmarking tool in the industry," though it continues to improve, Lenard says. "Over the past 40 years, it has significantly evolved from a one-page sheet of top-line industry data to near 200 pages of benchmarking data," he says.

Dave Carpenter, president and CEO of JD Carpenter Cos. Inc., Urbandale, Iowa, and current chairman of NACS, moves the discussion back to the central issue, agreeing the inveterate CPG model is undercutting fuel's peak performance potential.

"We don't keep up with cost increases and rate of inflation and dramatic price swings," he says. "As price goes up, everyone wins but the retailer. As price goes up, either traders or large fund or oil companies win. We lose."

When it comes to changing how NACS reports fuel at forums such as the State of the Industry Summit, Carpenter says discussions have been ongoing, with more NACS members expressing interest in fuel-margin percentages in recent years than in the past.

With this kind of vested interest, it would seem a natural move for NACS to lead the way in tracking fuel margin—but such a move is not without complications. As a neutral party, NACS can be a forum for open discussion while moderating concerns regarding price fixing and collusion.

> "Every year when [fuel] **cost rises, the true margin goes down**. It's a **death spiral.**"

"We just need to give serious thought on how we report," Carpenter says. "As NACS, we have to be careful with sensitive topics like gas pricing, but it is incumbent on us in how we report gas."

It's a legal tightrope, certainly, but one to consider as energy around the topic grows. Though no real moves have been made internally, Carpenter says NACS has had serious talks about how to better relate fuel statistics at its annual summit. Among the considerations include how to obtain the numbers from its retailer sources and then report them in ways that tie back to other categories, as well as separating laid-in costs such as credit-card and transportation fees.

"For me personally, it is an important thing," Carpenter says. "[With CPG], we've just done it for so long. It's crazy to think people [still operate] that way. Gas is three to four times more costly than in the past."

Overcoming Hurdles

Still, no one believes change can happen overnight, even with NACS' help. Ricker says he's already "dialed in to look at CPG."

But he considers himself ahead of other retailers in that at least he realizes the importance of considering change. "We need to start including both of those figures so we can make the natural migration toward metrics that makes more sense long term," he says.

Ricker also sees a hiccup with technology. Companies such as KSS need to build this data into their software because the more sophisticated operators are all using some kind of computer programs to run their retail strategies for fuel, he says.

"The software companies need to be able to provide the business intelligence and the viewing capability of looking at both CPG and margin percentage," he says. "Long term, you could probably migrate to just margin percentages, but in that migration process you're going to have to have both.

"But we don't even have gross margin percentage in the software right now," he continues. "The software companies that do retail fuel pricing have to move the ball forward. The first to market on this is going to have a big advantage."

Carpenter also believes an industrywide metric change would require changes to existing software, pointing out that such a change is "no easy task, but from a general reporting standpoint, there are ways we can figure it out."

Of course, retailers are also facing that same legal tightrope that NACS has to consider when sharing fuel-margin percentages. Once software adapts to track fuel margin percentages, it might be very easy for a retailer to make the shift from CPG to margin percentage, but very complicated to really put those percentages into perspective without violating collusion laws.

"It's very delicate," says Miller of Miller Oil. "It's one thing for me to ask [another retailer's] opinion; it's a whole different story for us to talk about our gross margins and how to figure them."

There is another challenge that transcends the world of retailers and possible collusion: the supplier.

"[Suppliers will] still sell in cents of scheduled price less rebate in cent per liter, not percentage," Gleason says. "So you've got to be … aware of how you buy and how you sell. How it's priced [when buying] may be in cents but how you mark up [your fuel] needs to be based in percentage to make sure you're recovering [what you need to]."

Despite the hurdles of software limitations, collusion laws and suppliers remaining in the CPG universe, retailers such as Gleeson push for change.

"Retailers operating with fuel need to make retailer returns," he says. "As retailers we need to be able to reinvest in our assets. We can only achieve that by actually having money."

Miller agrees: "Every year, when [fuel] cost rises, the true margin goes down. It's a death spiral." ■