

# Cost Plus vs. Retail Minus:
# Separating Fact from Fiction

# Selecting the best plan

For many fleet managers, attempting to curtail fuel costs feels like bailing out the Titanic. Retail gasoline prices have been on an upward trajectory in recent years, and higher prices seem to be here to stay. Given this environment, it's no wonder that discount-oriented pricing plans, such as cost plus, have thrived; in tough times, everyone chases a bargain.

But the old maxim still holds: If a deal looks too good to be true, it usually is.

In today's volatile market, fleet managers must do more to protect their bottom line than chase lower fuel prices. They must think critically about what's best for their business, which means finding a pricing plan that offers transparency and comprehensive station coverage—in addition to discounts at the pump.

In this paper we contrast two popular pricing scenarios, cost plus and retail minus, and assess how fleet managers fare under each, including:

- How retail margins factor into pump prices;
- How cost plus vs. retail minus pricing plans fare under real world conditions;
- Why a pricing plan's transparency and flexibility can matter as much as, even more than day-to-day low prices;
- Why in most real-world scenarios, retail minus remains the best pricing option

# Parsing Prices at the Pump: An Introduction to Retail Margins

Before we can assess the pros and cons of cost-plus or retail-minus, we must first understand how retail gasoline prices are calculated.

The price one sees at the pump is a combination of several individual factors, dictated primarily by the cost of crude oil. Other significant contributors include refinery costs and federal/state gas taxes:

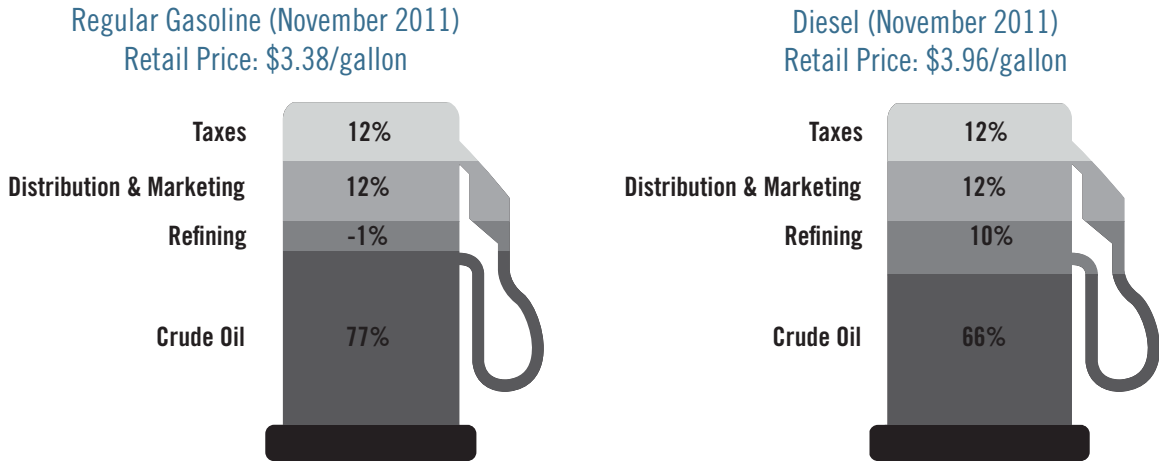



*Fig 1: Breakdown of average U.S. retail gasoline and diesel fuel prices in November 2011*
*Source: Energy Information Agency*[1]

Station managers also add some retail margin to their fuel price to cover all other expenses of doing business, including the cost to transport fuel from terminal to station, franchise fees, rents, wages, utilities, equipment, maintenance, permits, licenses, insurances, advertising, and so on. According to the National Association of Convenience Stores[2], it costs a retailer about 12 Cents Per Gallon (CPG) on average to sell one gallon of gas – a figure that creeps ever higher as rack prices also continue to rise. This figure does not account for a station's profit on its fuel, but ultimately, that tends to be minimal, amounting to only a few cents per gallon:

## Table 1: Historical average margins and profits for U.S. fuel stations

| | DEC 2011 | 2011 | 2010 | 2009 | 2008 |
|---|---|---|---|---|---|
| Average U.S. Retail Margins | $0.213 | $0.194 | $0.170 | $0.135 | $0.186 |
| Average Profit* | $0.093 | $0.074 | $0.050 | $0.015 | $0.060 |

**Assuming a $0.12 breakeven price*
*Source: WEX, EIA*[3]

[1]Energy Information Agency, "Gasoline and Diesel Fuel Update: Jan 3, 2011" Available at http://www.eia.gov/petroleum/gasdiesel/
[2]National Association of Convenience Stores Annual Fuels Report 2011 http://www.nacsonline.com/NACS/Resources/campaigns/GasPrices_2011/Documents/GasPriceKit2011.pdf
[3]WEX data, and Energy Information Agency, 2011

Retail margins, and thus prices, fluctuate daily, swinging significantly from region to region and brand to brand. Seasonal demand, weather emergencies, regulatory pressure, local competition, and, of course, volatility in the oil market can all push margins higher or lower. Some days or weeks, retail margins may climb as high as 25 CPG; other times, they may shrink to 2 or 3 CPG. One recent WEX survey of fueling stations in Phoenix, AZ revealed that within one five-mile radius, retailer margins varied by as much as 22 CPG -- for just one day.

Within this environment, however, we can identify three categories of margin markets —low, mid, and high:

- Low margin markets tend to be found in oil-producing states, such as those in the Gulf Coast, where fuel does not need to travel far to reach stations. Retail margins here average about 4-8 CPG.
- In high margin markets, such as in California or Hawaii, gas must travel farther from terminals to reach fueling stations, meaning lessees must pay their dealers higher prices for fuel. These costs are passed along to customers. Stations in these areas might impose margins of upwards of 25 CPG.
- Mid-margin markets, such as those in many parts of the Northeast, fall somewhere between these two extremes.

## Pricing Options: Cost Plus and Retail Minus

Two fleet pricing structures dominate today's market: retail minus and cost plus. Under a retail minus pricing plan, fleet drivers pay the actual posted pump price; often fuel card providers will offer some additional rebate amount, negotiable on the size of the fleet, the volume of fuel purchased monthly, etc.:

**Retail Minus $$ = (Station Rack Price + State/Federal Taxes + Transportation Cost + Margin) - Rebate**

Fleets using cost-plus pricing, however, do not pay retail. Instead, they pay a rack price based on an Oil Price Information Service (OPIS)[4] index of average nationwide rack prices, or a specific local rack price. On top of this is added some fixed fee set independently of a station's pump price (e.g., in a Cost+10 plan, a driver would pay a fee of 10 CPG). Thus, cost plus pricing can be calculated as:

**Cost Plus $$ = (OPIS-Based Rack Price + State/Federal Taxes + Transportation Cost) + Cost Plus Fee**

For example, say a retailer sets a $3.50/gallon pump price, with margins of 15 CPG. Under a retail minus plan, a driver would pay pump price $3.50, minus whatever his or her rebate was (a few cents to the gallon, usually):

**Retail Minus $$ =($3.35 + $0.15) – (rebate) = $3.50 – (rebate)**

A fleet driver locked into a Cost+10 plan, however, would buy the same fuel for $3.45/gallon, or $0.05/gallon less than the published pump price, assuming that the station's rack price matched the average OPIS rack price:

**Cost Plus $$ = ($3.35) + $0.10 = $3.45**

[4]OPIS is a research service tracking more than 50,000 rack prices for petroleum products around the world, including heating oil, gasoline, diesel fuel and kerosene.

Cost plus appeals to fleet owners because of its consistency: Regardless of how much rack prices may fluctuate within a given season or region, drivers will pay one consistent margin, no matter what.

The rub, of course, is that this pricing can cut both ways. If for the same pump price the retailer's margins instead drop to 5 CPG, then all else held equal, a fleet driver under the Cost+10 plan would end up paying 5 cents above pump price, or $3.55/gallon. (The retail minus driver would, again, simply pay pump price minus any additional rebates.)

**Retail Minus $$ =($3.45 + $0.05) – (rebate) = $3.50 – (rebate)**

**Cost Plus $$ = ($3.45) + $0.10 = $3.55**

## Cost Plus versus Retail Minus In The Real World

For which margin markets does retail minus offer a better pricing option than cost plus, and vice versa? To determine that, let's run some real-world scenarios:

- Low-margin market (Alabama)
- Mid-margin market (Kentucky)
- High-margin market (California)
- Across multiple-margin markets

We can draw several conclusions from these examples:

**1)** In high margin markets, cost plus pricing can sometimes save fleet owners more money than retail minus.

**2)** In low margin markets, or across markets that span multiple margins, retail minus saves more money than cost plus.

**3)** In mid-margin markets, drivers pay roughly the same for fuel under cost plus as they would retail minus, but retail minus still delivers slightly more savings, given the additional rebates available.

Margins, however, are not implemented in a vacuum. Distributors in consistently high margin markets are often less inclined to support cost plus pricing, because, as illustrated in the previous section, cost plus erodes their bottom line. Indeed, fuel stations in lower margin markets are the ones far more likely to adopt cost plus plans, when there's the chance of protecting, even improving upon, their set retail margins:

Table 2: Coverage of Retail Minus and Cost Plus Plans by Margin Market

| MARKET | MARGIN* | # STATIONS COVERED BY RETAIL MINUS | # STATIONS COVERED BY COST PLUS | % PROPORTION OF COST PLUS SITES TO RETAIL MINUS SITES |
|---|---|---|---|---|
| High Margin | 20.4 | 16,998 | 1,714 | 10.1% |
| Mid Margin | 11.9 | 71,874 | 10,197 | 14.2% |
| Low Margin | 1.7 | 22,501 | 4,237 | 18.8% |

** Where margins are the weighted average for each market category, including ten states each*
*Source: WEX, Inc.*

This does fleet managers little good, of course, as their bottom line depends on exactly the opposite scenario. Thus the acceptance network for a given fuel card is critical (see "Adequate Coverage" below).

That said, one critical result from our analysis should not be overlooked: In mid-margin markets, there is little to no difference between cost plus and retail minus pricing. Some weeks, one pricing scheme will be a better deal; in others, it won't be. Over time, the two will balance out, assuming—and this is key—that the cost-plus provider actually adjusts its pricing to reflect market conditions more favorable to the fleet owner.

In reality, however, cost-plus providers are for-profit firms, and when margins are low, they benefit from shifting in their favor the index prices upon which they base their pricing. There is little accountability to the fleet manager for how that index price is set or the methodology of if and how it may be changed. The retail price, however, is transparent: The pump price is and always will be the pump price.

Thus, for a fleet manager operating vehicles across many regions, the math begins to change in favor of retail minus. That's also why fleet managers should not select pricing schemes based on at-the-pump cost alone, lest they always be chasing yesterday's prices. Other factors matter too.

## Transparency: The Golden Goose

In some ways, pricing transparency is even more critical to fleet managers than day-to-day low fuel costs. Especially in today's volatile markets and increasingly complicated regulatory environment, managers need a pricing structure that allows for self-reporting and easy auditability.

Retail minus plans are inherently transparent: The pump price is the pump price, no matter what. But cost plus plans can be trickier to understand.

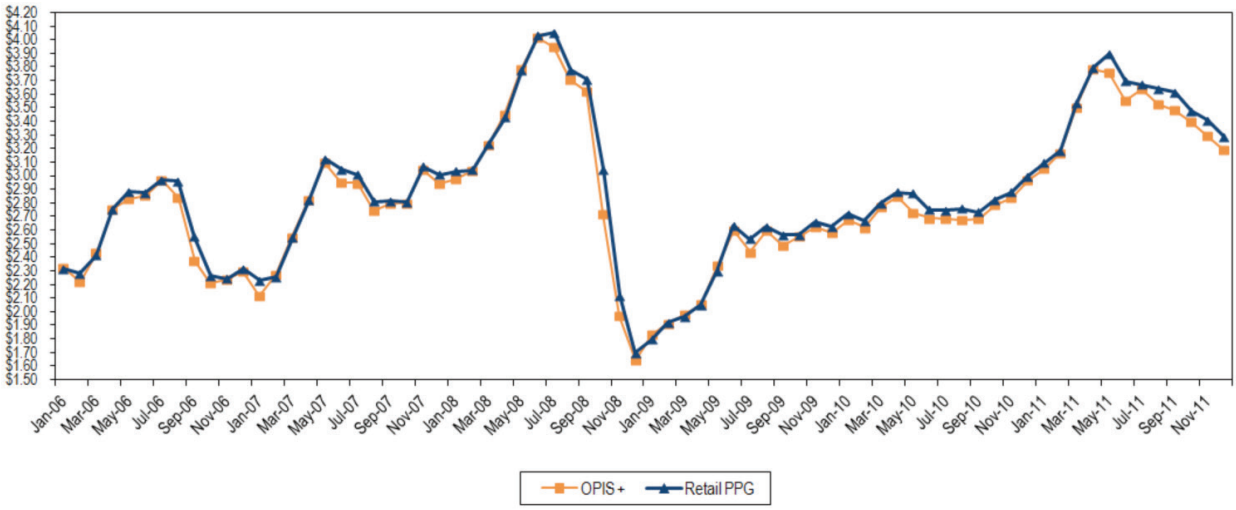
As explained earlier, cost plus bases its pricing not on a station by station basis, but on a benchmark of averaged OPIS rack prices. The expense of accessing OPIS data services – upwards of tens of thousands of dollars per year -- creates a firewall between the fleet company and its pricing provider. Fleet managers seeking to audit their books often have no choice but to depend on their cost plus providers to supply OPIS index data—and how these indexes are selected, calculated and rebalanced isn't always made clear. Are these the most accurate indexes? Or only the most convenient? The fleet manager has no way of knowing. Thus, managers are unable to benchmark or verify their invoices with any real confidence, and should their pricing providers decide to change which index they use, fleet managers get little accountability or sway in the process.

This opacity works to a cost plus provider's advantage, as it allows for the provider to sneak in hidden "transportation fees" to help maintain a profit line. This transportation fee, which is negotiated between the station owner and the cost plus provider, is arbitrarily calculated, and its presence is not always spelled out to the fleet manager whose drivers purchase fuel at that station. Fleet managers must audit their fuel bills carefully each month to find these fees, which can change without advance notice.

What's more, it is implemented at the station's discretion: A given fleet manager may expect a Cost+10 price, but when it comes time for drivers to purchase fuel, the at-the-pump price may be significantly inflated by this fee. It's a false bargain most comparable to retail outlet stores, which sell goods specially-manufactured for the outlet and artificially raise their prices, only to then knock them down again with deep 50%, 60% or 75% off discounts.

Transportation fees are an additional reason why in mid-margin markets, a significant difference between retail and cost plus pricing schemes cannot be observed:

Fig 2: Five years' worth of Cost plus+10 vs. Retail prices, assuming a constant transportation fee of $0.015




*Source: WEX, Inc.*

Cost plus requires the fleet manager to place significant trust in the provider to set fair index pricing. And when not all the information is immediately obvious, it can be difficult to determine whether the index benefits the fleet manager, or just the suppliers. While with a retail minus plan, what you see is what you get, one can never be sure of the same under a cost plus plan, as no inexpensive means exists for a fleet operator to verify pricing.

## Adequate Coverage Frees Up Drivers To Make Good Decisions

When it comes to station coverage, it's obvious that more choice is better. A fuel plan with broad acceptance is critical, because then fuel consumers may choose the retailer best for them at the time of purchase.

Retail minus provides that choice, since drivers simply pay pump price, then receive a discount negotiable through their fuel card provider. For example, one major provider, WEX, Inc., has an acceptance network that totals more than 180,000 locations, inclusive of 54,000 diesel fuel stations.

Fig 3: Fuel and service brands supported by WEX, which has acceptance at 90% of US retail fuel locations, and offers retail minus plans.




Card acceptance is subject to independent owner/operator participation and subject to change without notice.

*Source: WEX, Inc.*

In contrast, only about 30,000 U.S. stations currently support cost plus pricing plans. This cuts the fleet manager in two ways. First, with a limited network to choose from, drivers may be forced to drive out of their way to locate accepted stations. As little as one extraneous mile per month per driver can result in significant margin erosion across a large-scale fleet.

Second, a smaller network inherently inhibits a driver's ability to comparison shop. If a nearby out-of-network station offers a much lower fuel price, a driver does not have the agency to patronize that station, since they may only purchase fuel from accepted retailers. Therefore, with a captive customer base, cost plus station owners essentially have less incentive to price their fuel competitively against the local market, leading to higher pump prices overall.

Retail minus plans, by nature of how they are structured, give drivers the freedom and flexibility to react to local changes and secure the best price possible. Competition provides choice.

## What Questions Should You Ask When Considering Cost Plus?

**1)** Are my vehicles in primarily low, mid, or high margin markets, or a combination?

**2)** Does the acceptance network cover where my fleet travels?

**3)** How is the index price generated?

**4)** Can I easily audit my statement?

**5)** Can I tell how my prices compare to retail prices? How about the low cost providers along my drivers route?

**6)** Are hidden transportation fees eroding my savings?

# Getting The Best Deal

All else held equal, fleet managers need the most cost-effective pricing option to reel in fuel costs. But finding that solution isn't simply a matter of selecting whichever plan offers the largest day-to-day discount.

As we've seen, in certain limited scenarios, cost plus pricing offers fleet managers more savings over retail minus plans, but these scenarios tend to be mostly hypothetical. In real-world market conditions, retail minus often offers the better deal.

But fleet managers must also consider other criteria in making their selection, including pricing transparency and station coverage. Here again retail minus is the clear winner, providing the fleet manager not only the flexibility for self-reporting and easy auditability, but a nearly universal acceptance network and greater ability for drivers to comparison shop along routes.

Nobody likes to pay high gas prices. But fleet managers shouldn't chase false bargains around the hull of a sinking ship either. To secure the right pricing plan, managers must remain vigilant, asking tough questions and auditing their fleet bills as needed, because once the numbers are tallied, it's surprising how quickly so-called "bargains" can erode. Often, the right pricing plan for a fleet is the one with a clear paper trail, which was the one upfront about its costs all along.

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