

Articles/Archives

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Costco's Equation

Fast Company looks at how the big-box retailer can sell gas so cheaply

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In its July issue, *Fast Company* magazine looks at how the warehouse retailer does it. The article said Costco "simply matches its overall business model: Get rid of the frills, sell for cheap—and make up for thin margins with high volume."

Fuel retailers complain that Costco uses gasoline as a loss leader to get people into the store. While big oil companies are raking in record profits from production, refining, and distribution, the retail gas station business remains defined by razor-thin profit margins. More and more stations rely on ancillary convenience store sales. The unbranded Costco stations (are self-service only and do not take Visa or MasterCard, which levee fees that severely cut into a retailer's profitability.

Costco stations sell enough gasoline that they typically have to replenish storage tanks daily—three or four times faster than the average local station—yielding a far better return on capital, said the report.

The chain's fuel business now accounts for more than \$3 billion in revenues, about 5% of its \$62 billion total, the report added, and those fuel revenues are growing faster than the company as a whole. Last year, Costco opened 25 new fueling locations; so far this year, it has added another 21. Its goal is to include a station at every warehouse that it builds from now on, and to add them to as many existing stores as the law permits and real-estate space allows.

This expansion only exacerbates the squeeze traditional stations are feeling because of rising wholesale costs and escalating credit-card fees. Gross profits on retail gasoline fell to 14.7 cents per gallon at year-end 2006, versus 16.4 cents the year before, according to the report, citing the National Association of Convenience Stores (NACS). After accounting for credit-card fees, payroll, depreciation on the pumps and other costs, "most retailers were lucky to make a penny a gallon," NACS spokesperson Jeff Lenard told the magazine. "It's a game of chicken where retailers fight for consumers at the expense of margin. Right now, it's not uncommon to find retailers losing money on every gallon they sell."

In at least 11 states, laws prohibit stations from selling below cost, and there have been suits against Costco (and Wal-Mart). In a pending case in U.S. District Court for the Northern District of Alabama. The Pantry alleges that Costco sold

Mart). In a pending case in U.S. District Court for the Northern District of Alabama, The Pantry alleges that Costco sold gasoline “below cost” during 2006 and 2007 at its Huntsville location. “These illegal pricing practices have already damaged plaintiff’s business, and caused irreparable harm, and if these violations are allowed to continue, Costco will cause irreparable harm to plaintiff and other competitors,” according to the complaint. Costco has responded that it had “on occasion made some sales below cost...to meet the competition,” but otherwise denied the allegations.

Loss leaders have always been anathema to Costco’s corporate strategy, and the company swears it has not changed its tune at the pumps. “Our strategy is not any different than with anything that we sell,” Bob Nelson, Costco’s vice president of financial planning and investor relations, told *Fast Company*. “We’re willing to make less money than everybody else. But gas is not a loss leader, and we will never make it one.” But its fuel business serves the same function, the report said, driving more frequent visits to its warehouses.

Nelson is quick to point out that profit margins on gas are low even for Costco; while the chain’s overall gross margin is around 10%, its gasoline margins can dip as low as 1%. In fact, he said, making money selling gasoline is even tougher for Costco when prices are high and rising, because other retailers that replenish their tanks less frequently do not need to raise prices quickly to keep pace. Yet Costco’s costs rise almost immediately. Keeping its cost-per-gallon edge generates an immediate hit to profitability.



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