

# **The Downstream Petroleum Industry -- Supporting Australia's Prosperity**

**Dave Reeves**

**Chairman, Australian Institute of Petroleum**

Senators, Members, fellow board members, guests and staff of the Australian Institute of Petroleum.

It is a pleasure to be here today with the Friends of Mining and Resources to brief you on recent developments in the Australian Downstream Petroleum industry.

I am speaking in my capacity as Chairman of AIP, the industry body representing the four refiner/marketers operating in Australia, plus other associated companies.

John Tilley has already been introduced to you. Additionally I would like to introduce:

Glenn Henson – Director Refining, Australia and New Zealand, Mobil Oil  
Frank Topham – Government Affairs Manager, Caltex Australia  
Nathan Dickens – General Manager, Policy, AIP  
Nicky Reading – Program Manager, AIP

AIP has just released its latest report on the trends in industry performance to mid 2005. You all have copies of this report which contains extensive information about the Australian industry and the issues and challenges we are currently facing.

I encourage you to use this report as a key reference source in your dealings with the industry and in your consideration of relevant policy issues. Should you require more detailed information at any time, please contact John Tilley at AIP and he will arrange a briefing for you.

Today I will provide you with some brief highlights of our recent performance. This will provide background to the four key issues the industry is addressing in Australia. There are many more issues to cover but I'd like my remarks to be as brief as possible to allow time for your questions.

I should note up front that I will use the terms "we" and "the industry" interchangeably for convenience. While we come together for advocacy purposes, the member companies of the AIP are fierce competitors when we leave our roles as AIP board members.

## **First a brief overview of the industry**

There are 6 refineries on the east coast and 1 in Perth

Given the mix of crude oils needed to produce the products required in Australia, we import about 65% of our crude oil requirements from over 15 countries in Asia and the Middle East, and occasionally from West Africa.

Australian refineries currently produce about 77% of Australia's petroleum product requirements. The remainder is imported from a number of countries, with the majority coming from Singapore refineries.

Demand for petroleum products in Australia is growing at around 1.5-2% per year, although petrol demand was down a bit last year in response to the rapid price increase after the hurricanes in the US. Further work to 'de-bottleneck' Australian refineries will result in modest increases in domestic refinery output. However, we can expect product imports to remain at around 25-30% of consumption as we move into the next decade. That is – over

one in every four litres of transportation fuel – petrol, jet and diesel, will be coming to Australia by ship in the near future.

The highlights of the financial performance of the industry are set out in detail in our latest publication on pages 18-21.

Our assets are very substantial. These have grown in 2004 and 2005 as we have undertaken the largest investment at our refineries for over a decade – over \$2 billion.

This investment has taken place against a recent history of extremely poor returns for the industry between 2000 and 2003. These decisions were very hard to make given industry conditions at that time. Thankfully our return on assets has finally exceeded the long term bond rate, and the cash generated has allowed these investments without future pressure on company viability.

The total revenue flowing to governments from industry activities (including fuel excise collections) was \$16.5 billion.

**The Government's Cleaner Fuels Program** is the industry's major investment activity and covers installation of substantial new equipment at all refineries to enable the production of petrol and diesel with very low levels of benzene and sulfur, respectively.

The new fuels are prescribed in the Australian Fuel Standards and together with the introduction of new vehicle engine technology will substantially reduce motor vehicle emissions. The outcome will be a major reduction in the emissions of substances that contribute to urban air pollution.

In order to encourage the early production of these fuels ahead of the date they are required by legislation the Government has committed to introduce financial incentives. The incentive for early production of Euro 4 premium grade petrol with 50ppm sulfur has already been introduced. The incentive for Euro 5 diesel with 10ppm sulfur is expected to be introduced by the Government on 1 January 2007. In the absence of this incentive, it is unlikely that it will be economic to produce this super clean diesel in Australia prior to 2009.

The Cleaner Fuels program is part of an international move to improve urban air quality. In the Asian region, Australia is in the vanguard of countries taking action to introduce cleaner fuels. This slide is too small to read, but is reproduced in the report.

While this brings early environmental benefits, it also means that there are limited supplies of these fuels available from refineries across the region, and hence there is a price premium for these fuels. That price premium will fluctuate as the supply/demand balance for these unique products varies over time.

The Cleaner Fuels Program will bring about substantial environmental benefits. It will result in 50% reductions in most vehicle emissions by 2010, with these reductions increasing to around 80% by 2020, as more of the vehicle fleet can take full advantage of the cleaner fuels and cleaner engine technology. These changes will occur in emissions of particulates, and the key smog precursors.

In the case of hydrocarbons emissions, the majority of emission reduction will occur through other programs aimed at capturing emissions from fuel handling and refuelling activities.

I'm sure you will all be interested in what we have to say about **fuel prices**.

We have provided a fact sheet for you today on factors influencing fuel prices in Australia. This should provide answers to your questions.

The key messages on fuel pricing are

- We have internationally competitive prices in Australia
- International crude oil and petroleum product markets are influenced by a range of global and regional supply and demand issues
- International influences as well as domestic market competition and local factors influence fuel prices at the pump
- Australia benefits from fuel prices that are amongst the lowest in the OECD on a pre-tax and a post tax basis.

Since crude oil prices balance across the globe, this relatively low fuel price results from efficient cost structures and refinery operations, local competition, and the lower level of tax on fuel imposed by Australian government, versus Japan and the European nations.

Fuel prices in Australia closely track with prices for fuel in Singapore, with a differential reflecting shipping costs, foreign exchange impacts as well as the product quality premium as referred to earlier. You can then add local competitive forces, of course, since fuels are a global commodity. Singapore prices will respond to global market changes, as we saw with hurricane Katrina. We can expect further price volatility.

AIP member companies individually publish daily wholesale prices for the main fuels sold. Summary details are also published on the AIP website daily.

These wholesale or Terminal Gate Prices (TGP) are based on import parity prices using Singapore traded prices as the reference. John or other members of the AIP staff are available to help answer any questions you might have on the mechanics of the market.

At the retail level, you will all be familiar with the very strong levels of competition in metropolitan areas which leads to regular discounting cycles. The supermarket alliances have also introduced a further dimension of competition in these areas.

Outside the metro areas, there is the impact of higher transport costs, combined with the relatively low sales volumes for fuels and convenience store items which mean that higher retail prices are needed to maintain commercial viability of these businesses – the majority of which are small locally owned businesses.

**Fuel supply reliability** remains a top priority for the industry in 2006.

Some concerns have been raised that our growing level of petroleum product imports (ie now around 23%) will expose Australia to higher levels of supply risk. Those risks exist, but this industry has a remarkably successful history of supply reliability, and we see no reason for that to change.

Australia's access to product supplies from Asia has not been constrained even during the period immediately following Hurricane Katrina. In fact the increased volumes of imports from Singapore have meant that for several fuel importers the Australian grade fuels are now available on term contracts instead of just a spot basis. There are also more vessels bringing fuel to Australia which are now capable of being diverted to centres that might otherwise be faced with fuel shortages. The supply system is large and complex, yes, but also extremely efficient and reliable.

I mentioned earlier that the industry has begun to see improved earnings, largely because supply and demand have come into better balance. We expect demand across Asia to grow, and this means that even with refinery capacity additions, that balance will remain tight for the foreseeable future.

While Australian refineries are close to the major population centres, supply chains are very long by international standards.

Over the past 3 years, companies have invested substantial resources in improving their supply chain logistics to minimise potential disruptions to customers. We have introduced new supply monitoring arrangements, have revised stockholding policies and increased the levels of stocks, and have established better demand forecasting models.

AIP member companies have also worked extensively with Government agencies to improve supply planning for an emergency, and to ensure that fuel users understand the need to take action to manage the risks of a supply disruption on their activities.

**Fuel retail market reform** is essential if the downstream petroleum sector is to maintain and improve its efficiency in delivering competitively priced fuel to the widest range of Australians.

We are specifically seeking your support for the repeal of the Sites and Franchise Acts and introduction of the Oilcode as a regulation under the Trade Practices Act.

The Oilcode will

- Formalise transparency of wholesale fuel prices
- Preserve interests of franchisees and commission agents of the oil majors and of the independent retailers
- Establish an Adviser to resolve disputes related to the Oilcode.

Of the 6500 service stations across the country, the oil majors are currently restricted to owning/controlling the operations of about 5% of those sites.

This means the oil majors are very constrained in their ability to compete at the retail level. Each company's operations not associated with supermarkets are placed at a competitive disadvantage.

As I have emphasised in numerous meetings, the rights of franchisees are fully protected. Nor will market reform drive small businesspeople out of the industry in rural Australia. In fact it is more likely that market reform will enable the oil majors to provide a range of support services for smaller networks in rural Australia.

However, the Oilcode will not address issues related to market power and below cost selling; these are matters for the TPA and have been extensively considered and addressed as part of TPA reviews over the past 3 years.

In summary we believe retail market reform will

- Engender greater competition in metro and rural areas
- Increase the choice of business models and scale of other retail activities at service stations
- Enhance service options available to branded independents.
- Being free to compete in a changing market, on a level playing field, is the best way to assure a customer focused industry with competitive prices and a broad array of services.

**To summarise, our key messages are**

- We are making a massive investment in the Government's Cleaner Fuels Program which will help deliver very substantial reductions in vehicle emissions and major improvements in urban air quality
- Our fuel prices are amongst the cheapest among the OECD region, with Australian price movements driven by the impacts of international events on crude oil and product prices
- Fuel supply reliability in Australia is very high and the industry is continuing to improve supply chain logistics to further improve reliability
- Retail market reform in the sector is essential if the major players are to compete most effectively in the market and deliver the most cost-effective services to metropolitan and rural communities.

The overarching message is that this market is working well, is competitive and efficient and capital is flowing to address any constraints that exist.

Thank you for your attention. My colleagues and I will be happy to answer your questions on these and any other issues you wish to raise with us concerning the Downstream Petroleum industry.