Australian Institute of Petroleum

Submission to the

Review of *Trade Practices (Industry Codes – Oilcode) Regulations 2006*

20 May 2008

INTRODUCTION

About AIP

The Australian Institute of Petroleum (AIP) was established in 1976 as a non-profit making industry association. AIP's mission is to promote and assist in the development of a sustainable, internationally competitive petroleum products industry, operating efficiently, economically and safely, and in harmony with the environment and community standards.

AIP member companies play various roles in each segment of the fuel supply chain. They operate all of the petroleum refineries in Australia and handle a large proportion of the wholesale fuel market. However, AIP member companies directly operate and control only a relatively limited part of the retail market.

AIP is pleased to present this submission on behalf of the AIP's four core member companies:

BP Australia Pty Ltd
Caltex Australia Ltd
Mobil Oil Australia Pty Ltd
The Shell Company of Australia Ltd.

Contact Details

Should you have any questions in relation to this submission, or require additional information from AIP, the relevant contact details are outlined below.

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1. **Overview**

AIP and member companies strongly supported the repeal of the *Petroleum Retail Marketing Sites Act 1980* ("Sites Act") and the *Petroleum Retail Marketing Franchise Act 1980* ("Franchise Act") and accepted the introduction of the *Trade Practices (Industry Codes – Oilcode) Regulations 2006* ("Oilcode").

We did not believe at the time and still do not believe that there was a sufficient policy justification for introducing the Oilcode provisions because:

- The rights of small business were sufficiently guaranteed in contractual and legislative terms:
    - The Franchising Code of Conduct provides for protection for small business in many respects in excess of Oilcode provisions.
    - Small businesses have always been considered to be an integral and valued part of the Australian fuel retail and distribution system.
- Terminal Gate Prices were already being published by AIP member companies and formed the basis of many of the supply contracts in the industry.
    - The additional transparency mechanisms on invoices were considered unnecessary.
    - In WA and Victoria there are legislative requirements for the publication of TGPs
- Alternative dispute resolution mechanisms were available under the Franchising Code of Conduct and from other business mediation services.

The market reform package was the outcome of several phases of consultation and negotiation with interested parties over the past 11 years. Over that period, many compromises were made in order to find a workable solution for all parties.

A major concession was the introduction of a mandatory Oilcode under the *Trade Practices Act 1974* (the TPA). AIP member companies do not see the need for regulation that relates specifically to the oil industry, as no viable case has been made for treating the retail petroleum sector any differently to any other sector of the economy.

In the phase of consultation during 2005, a major concession from AIP member companies was the maintenance of tenure provisions for franchisees at 9 years when the original proposal was for 5 years tenure.

In addition, AIP members have seriously considered a number of proposals from independent service station representatives. For example, various formulations were considered to prohibit below cost selling in the Oilcode; none of the proposals were found to enhance competition or to be workable policy, and were withdrawn from the draft Oilcode regulation under discussion at that time.

As a result of these compromises, AIP believes that the issues that could be addressed in the market reform package were addressed.

Nonetheless, AIP and member companies supported the Oilcode package because of the following benefits:

- The repeal of the Sites and Franchise Acts has:
    - Removed legislation that was found by a number of government reviews (including by the ACCC) to be outdated and ineffective.
    - Removed compliance costs on the companies concerned which did not benefit the community as a whole.
    - Removed barriers to greater competition in the market so that consumers can benefit from more effective competition.
    - Allowed the four oil majors to compete with unregulated supermarket chains.

    - Improved international perceptions of Australia as an investment destination

- The introduction of the Oilcode has:
    - Enshrined greater price transparency at each stage of the supply chain in legislation.
    - Improved tenure for small business (commission agents) while maintaining the tenure of franchisees.

The retail petroleum market reform package has ensured that competition has continued to be vigorous, providing ongoing benefits to the consumer.

2. Meeting the Oilcode Objectives

AIP strongly argues that all the objectives of the Oilcode package have been met and there is no need for any further changes to the regulation.

Oilcode Objective One

"To establish standard contractual terms and conditions for wholesale supplier-fuel retailer re-selling agreements for both franchise and commission agency arrangements."

Response

AIP member companies are expected to provide individual submissions to the Oilcode review that will detail their compliance with the legislative requirements. Our understanding is that the Oilcode provisions have been implemented by all sections of the downstream petroleum sector. As with all legislative requirements, AIP member companies comply with all relevant legislation and our perception is that the information requirements legislated in the Oilcode have been fully implemented. The implementation process was greatly assisted by ACCC guidance notes and directions including a compliance checklist.

Oilcode Objective Two

"To introduce a nationally consistent approach to terminal gate pricing (TGP) and improved transparency in wholesale pricing and allow access for all customers, including small business, to petroleum products at TGP."

Response

AIP considers this objective has been met.

All AIP member companies fully comply with the legislation with regard to TGP.

TGP is a well accepted concept and provides an important price marker for the wholesale spot market prices. Nevertheless, most fuel distributors and retail operators prefer to enter into term contracts with fuel suppliers to guarantee supply availability in a fuel supply restriction (such as might arise from refinery outages where term contracts have priority over spot liftings at refinery terminals) and to provide site branding and access to fuel card operations.

AIP strongly argues that the current TGP arrangements under the Oilcode are appropriate and are meeting the objectives that were originally intended. AIP also reminds the review of the extensive discussions to consider transparency of individual buy prices in the Oilcode and the measures to address so called below cost selling. These proposed measures were considered unworkable and anti-competitive and were dropped from further consideration. AIP still maintains that any regulation of below cost selling and predatory pricing needs to be applied to industry as a whole through the general provisions of the Trade Practices Act.

For large volume contracts, highly competitive prices can be negotiated with suppliers. These negotiations take account of the value of large supply volumes in planning refinery and import operations, the value of regular uplift of product in pipelines and tankers that enables the maximum use to be made of delivery vehicles, and the risks that can be managed between supplier and customer in relation to future movements in petroleum product prices.

Calls for all wholesale sales of fuel to be at the published TGP would remove this level of competition at the wholesale level. Such a move would also be atypical in Australian business practice where volume discounts are a feature of wholesale and very large retail sales activities.

TGP in the Oilcode regulations was never intended to be a mechanism to ensure that all buy prices were known publicly. As we strongly argued at the time, it is perfectly legitimate for discounts from TGP to large customers to recognise economies of scale in the contract and logistical efficiencies.

AIP does not agree with the conclusions pertaining to the operation of the wholesale petrol market and efficacy of TGP contained in the ACCC Inquiry *Petrol Pricing and Australian Consumers*, December 2007. Some of the conclusions of Chapter 8 on p.126 are not based on any verifiable evidence and do not match the analysis contained in the chapter.

In particular, we do not believe that any evidence given at the inquiry supported the conclusion that "Australian refiners will seek to recover margin across every component of the IPP formula". Each component of the IPP formula is based on an internationally recognised marker price.

In the body of the report, there is clear evidence that two AIP members use TGP as a basis for their contracts and the other AIP members use the TGP methodology to establish wholesale reference prices. The purpose of the inclusion of TGP in the Oilcode regulation is to establish a transparent wholesale marker price. The fact there are a range of wholesale prices applying to wholesale customers does not undermine the transparency objectives of the TGP in the Oilcode regulation.

AIP does not support any changes to the TGP provisions because any formulations are likely to prove to be anti-competitive and unworkable. We further consider that TGP objectives of the Oilcode have been met and no further changes are necessary.

<u>Oilcode Objective Three</u>

"To establish an independent downstream petroleum Dispute Resolution Scheme (DRS) including the appointment of a Dispute Resolution Adviser (DRA) to provide the industry with a cost-effective alternative to taking action in courts."

<u>Response</u>

AIP understands that the DRA has received very few inquiries and even fewer active dispute resolution cases. AIP member companies will report their experience with the process.

AIP considers that the objective has been adequately met as the DRS is in place but notes that individual AIP members may have concerns about its operation. AIP also notes that aggrieved parties still have recourse to court action if they are dissatisfied with the DRA processes.

3. Structure of the Downstream Petroleum Industry

The structure of the service station industry has changed markedly since the introduction of the Sites and Franchise Acts. The dominant business model at that time was a petrol station with a mechanical repair workshop. Since that time the multi-product service site has become the dominant service station model. Under this model, service stations offer a range of products other than liquid fuels and rely on high volume fuel sales and significant convenience store sales for competitive advantage.

The competitive advantage of any individual site is determined by the package of goods and services being offered to consumers. The most obvious example is shopper dockets that have enabled supermarket chains to sell approximately 45% of the retail petrol and diesel in metropolitan Australia. Other important elements for consumers are the site location and access, the general condition of the site, and the extent of ancillary services, such as a convenience store.

All these developments mean the retail petroleum sector is competitive and dynamic. With the removal of constraints posed by the Sites and Franchise Acts there are no barriers to location or ownership models. Consumers are also benefiting from reduced prices and through better service.

In the case of AIP branded independents and independents not associated with AIP member companies, service station numbers have reduced, but not as a consequence of market reform. The main drivers for site closure continue to be general small business viability factors such as:

- Low fuel turnover and hence low profits from fuel sales (1 tanker per 2-3 weeks versus 1 per day and sometimes more tankers per day at metro sites).
- Lower convenience store turnover/sales over which to meet service station operating costs (ie limited diversity of income base).
- Viability/expansion constrained by aging capital - older businesses without capital backing for site upgrades (eg for new storage tanks, extra pumps, new forecourt, modern and expanded convenience store).
- Viability/expansion constrained by State/Territory government regulations and environmental expenditure requirements (eg to prevent leaks from underground storage tanks – most ‘at risk’ sites are in non-metropolitan areas where quality of groundwater may be a priority).
- Families not wishing to continue to operate their small business.
- Competition from more efficiently run businesses, and businesses offering a wider range of convenience store services.
- Too many service stations in the town.

Analysis by AIP suggests that the average customer base for a service station in metropolitan areas (based on numbers of residents in the vicinity of the service station) is around 4500. In non-metropolitan areas the average customer base per service station is around 2000 (based on numbers of residents in the vicinity of the service station), and in many towns the customer base is between a half and one third of this figure.

Outlined below is an explanation of the main types of service station operations:

- **Oil Company operated (sites may be owned or leased)**
  - Oil company supplies fuel to its own sites
  - Retail prices set by oil company
  - Convenience store options

- **Supermarket chain operated sites**
  - Term contract fuel supplies
  - Retail prices set by supermarket
  - Convenience store operations controlled by supermarket

- **Franchisee and Commission Agents**
  - Franchisee operated (declining in numbers)
  - Commission Agents (tenure extended in Oilcode)
  - Full marketing programme support by supplying oil company
  - Fuel supplies from franchisor
  - Retail prices set by franchisee (unless acting as a commission agent for fuel)
  - Convenience store options controlled by franchisee or CA

- **AIP Company Branded Independents**
  - Branded independents (major oil company brands) – still account for almost half the total number of service stations
  - May be operated by distributors or independent retailers (in some cases may be franchised by distributors or multi-site owners)
  - Subject to branding agreement with fuel supplier
  - Agreement may or may not include marketing programme support
  - Term fuel supplies
  - Retail prices set by independent operator
  - Convenience store options controlled by owner/operator

- **Non AIP company branded and other independents**
  - May be operated by distributors or independent retailers (in some cases may be franchised by distributors or multi-site owners)
  - Fuel may be obtained from more than one supplier
  - Retail prices set by independent operator
  - Convenience store options controlled by owner/operator

NOTE: Within this structure, <u>sites may be owned</u> by oil majors, supermarkets, franchisees/commission agents acting as investors, distributors, branded or non branded independent retailers, or unrelated investors. Sites may be operated by the owners or leased to other operators.

Service Station Numbers

AIP is still in the process of finalising the Service Station Survey for 2008 and results will be provided to DRET by the early July.

The majority of Australian service stations continue to be AIP member company branded independents. These sites are operated by small businesses with a fuel supply and branding contract with an AIP member company. Oil company owned and operated sites are less than 800 sites and an exact figure will be provided to DRET in the 2008 update of the Service Station Survey.

The following tables show some key trends in service station numbers.

- The rate of closure of service station sites has declined significantly over the last few years:
  - 2000 to 2004 452 sites closed per year
  - 2004 to 2007 143 sites closed per year

- There was a reduction in AIP member company branded sites that declined by 14.5 per cent between 2004 and 2007, but this was substantially offset by the significant increases in the numbers of supermarket chain sites and independent retailer sites.

- Overall, there was an estimated net reduction in service station numbers of 5.2% between 2004 and 2007.
    - of the sites converted to either independent sites or supermarket chain sites:
        - Supermarket chain sites increased by 28.0% between 2004 and 2007.
        - Independent service stations increased by 21.7% between 2004 and 2007.

- While not reported in the following tables the number of franchisees was 525 in 2008, down from 958 in 2004.

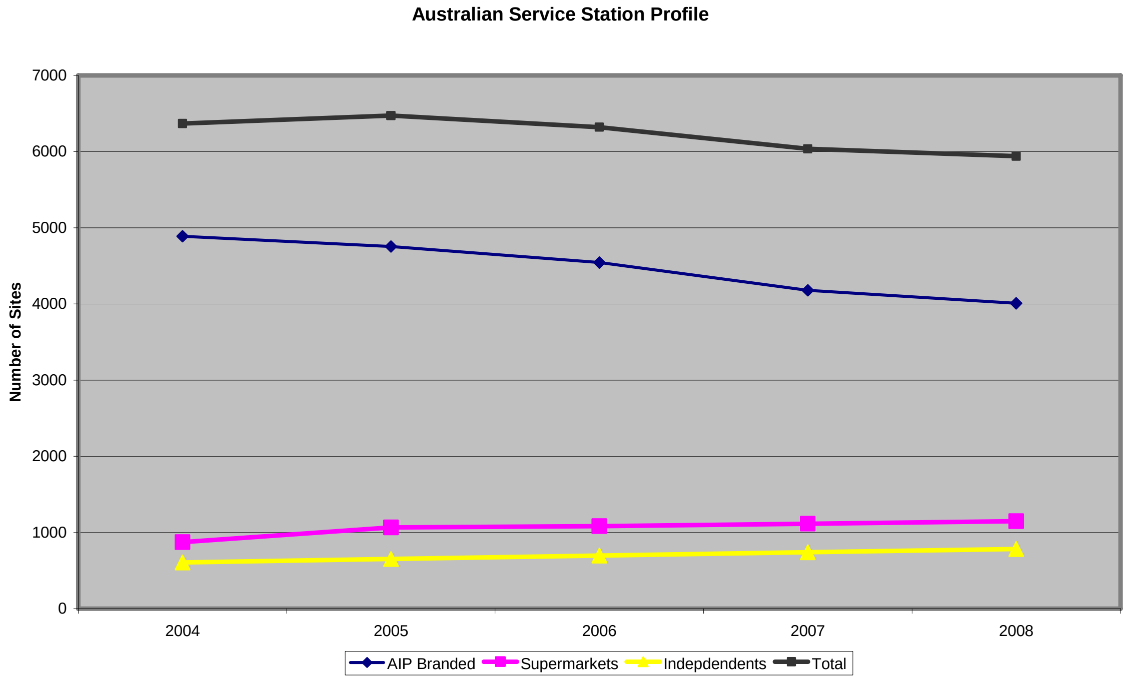
Changes in Service Station Numbers since 2000

	2000	2004	2007	2008
AIP Member Company Branded Sites	7362	4887	4180	
Supermarket Sites	156	872	1116	
Sub Total	7518	5759	5296	
Independents (non-AIP member service stations)	659	608		784
Total	8177	6367		

Changes in Service Station Numbers 2004-2007
The following table summarises the changes in service station numbers between 2004 and 2008 using estimates for data yet to be compiled.

	2004	2007	2008	Change 2004-07	% change 2004-07	Change 2007-08	% change 2007-08
AIP Member Company Branded Sites	4887	4180	4008(a)	-707	-14.5%	-172	-4.1%
Supermarket Sites	872	1116	1147(a)	244	+28.0%	31	+2.8%
Sub Total	5759	5296	5155(a)	-463	-8.0%	-141	-2.7%
Independents (non-AIP member service stations)	608	740(b)	784	132	+21.7%	44	+5.9%
Total	6367	6036	5939	-331	-5.2%	-97	-1.6%

(a) 2008 site data is an extrapolation from 2004 to 2007 data
(b) 2007 site data for independents is an interpolation from 2004 to 2008 data.



Implications of Oilcode Introduction

Predictions of mass site closures, particularly in rural sectors and the commercial demise of the independent sector have not been realised. As AIP argued at the time, we expect the general trend of closures in the service station sector to continue because of the changes to business models and the impact of small business drivers.

Retail Pricing and the Role of Different Entities

Retail prices are set in around 90-95% of cases by people other than the oil majors. While the oil majors and some importers are responsible for setting the wholesale fuel prices, retail prices and hence retail margins are set at the vast majority of sites by the site operator. It should be noted that:

- Numerous pricing inquiries have confirmed that the wholesale fuel prices closely follow the marker prices in Singapore, adjusted for freight and insurance costs and the US$/A$ exchange rate.
- Considerable information is available to retail customers about comparative fuel prices at a local area level (including newspapers, TV, internet sites of fuel retailers, motoring organisations, government agencies and private data monitoring companies).

Fuel Quality Management

Each of the oil majors operating in Australia guarantees the quality of the fuel purchased from service stations carrying that company's brand. For this reason, there are strict controls on sourcing fuel supplies only from an authorised distributor of that brand's fuel. The quality of the fuel will have been closely monitored and checked from the time it was produced at a refinery and fed into the distribution system.

All fuel sold between the oil majors goes through rigorous checks for quality assurance.

For brand management and fuel quality assurance reasons and to avoid misleading consumers it is not acceptable for individual AIP branded service station operators to seek fuel supplies from other than approved distributors. This situation is no different from the arrangements that are rigorously applied in many other branded product wholesale and retail operations (eg fast food, beverages).

The maintenance of clear fuel supply accountability is even more important under the Australian Government's Cleaner Fuels Program that imposes legal compliance implications on fuel suppliers. As Australian fuel suppliers guarantee their fuel quality the supply of off-spec fuel to a retailer by a third party can have significant negative financial and reputation implications for the fuel supplier.

Retail Price Discounting and Shopper-Dockets

Strong competition at the retail level in Australia has ensured that fuel prices have remained amongst the lowest across the OECD countries. With the advent of the supermarket alliances, customer loyalty programs in the form of supermarket shopper dockets redeemable as discounts on fuel have become a significant feature of fuel retailing in Australia. Advice from the supermarket chains indicates that up to 4 million shopper dockets are now being utilised each week. Consumer surveys indicate that up to 75% of motorists are using shopper dockets.

The ACCC has considered over 800 shopper docket schemes and has confirmed that they increase retail price competition in the sector and provide a significant benefit to consumers.

Such schemes are considered by some opponents of market reform as examples of abuse of market power and below cost selling. The 2007 ACCC report on petrol pricing has drawn a clear distinction between below cost selling and the sale of competitively priced fuel that is above the cost price of that fuel.

AIP member companies strongly believe that these allegations are matters for consideration under the general provisions of the Trade Practices Act, not under the Oilcode. Successive governments has extensively considered this issue as part of TPA reviews over the past 5 years and has announced further relevant changes to the TPA. There is no case for treating the fuel retailing industry any differently to other sectors of the Australian economy.

Role of Independent Service Station Operators (including supermarket chains) in Driving Competition in the Retail Market

Independent operators have a strong presence in the fuel retail market and AIP member companies do not expect this situation to change. However, in recent times we have seen independents playing a far less significant role in driving price competition in Australia.

From the mid 1990s to mid 2003 there were significant volumes of fuel available from refiners in Australia and in Asia at discounted prices, reflecting the excess production at refineries, and the availability of lower quality fuel from some Asian refineries. These factors were the basis on which much of the fuel discounting reputation of some independents was built.

However, there are no longer easy options for price discounting through access to cheap surplus fuel supplies. Rapidly growing demand in Asia has absorbed much of this excess production, and growing domestic demand and the mothballing of the Port Stanvac refinery in Adelaide has significantly increased Australia's net imports of fuel. This situation was further exacerbated with the introduction of more stringent fuel quality standards in Australia to enable the introduction of new vehicle technology needed to reduce motor vehicle emissions and to improve urban air quality.

The Northern Territory fuel pricing inquiry in 2006 concluded that while the opening of a service station by one of the larger independent chains was likely to create local price competition, the presence of the smaller chains or single site independent operators was not likely to generate price competition due to the basic economics of fuel retailing in Australia, particularly outside metropolitan areas.

Longer Term Role of Oil Majors and Supermarket Chains in Fuel Retailing

Opponents of the Reform Package claimed that the Package would over time result in a fuel retail duopoly in Australia, based on the supermarket fuel operations. AIP member companies believe the market share of supermarkets will grow substantially if market reform and hence competition is stifled.

Market reform has enabled all four oil majors to compete on an equitable basis, without artificial constraints on choice of retail business model. This has enabled networks to be established that are commercially viable in size and hence able to optimise the economies of scale that exist in fuel retailing and convenience store operations.

Progressive improvement in the quality of service stations in rural and regional areas is also occurring with the quality and range of services targeted to meet current community needs.

Continuing Myths about Market Reform and the Oilcode

Opponents of the repeal of the Acts - especially some representatives of the branded and non-branded independent sector – have continued to argue that there will be a reduction in competition within the market, and that the oil majors, particularly through supermarket chains, will establish a dominant presence in the retail sector.

In particular, opponents have argued that:

- ***Shopper docket discounts are a form of below cost selling which is alleged to be predatory pricing.***
  These schemes have been thoroughly investigated and upheld by the ACCC on the basis that lower prices benefit consumers.
- ***Small independent service station operators are unable to purchase fuel at the same price as the supermarket chains.***
  Supermarket chains are purchasing billions of litres annually from oil companies and can therefore negotiate lower prices than single service stations or small chains. On the issue of access to supply, any person with the appropriate health and safety clearances can purchase 35000 litres from an AIP member company terminal at its terminal gate price (TGP).
- ***The TGP price should be set at a flat rate for all with no discounting of wholesale prices allowed.***
  This proposal would damage competition at both the wholesale and retail levels. Discounting is a primary method for retailers to build market share, and to increase sales revenue and overall service station profitability. Consumers directly benefit from such competitive pressures.
- ***Repeal of the Sites Act will result in direct ownership and operation of sites which are currently run by branded independents.***
  This claim does not reflect the demonstrated strategies of AIP member companies or trends in industry structure.
  Repeal of the Franchise Act will undermine the preservation of property rights for existing franchisees.
  The mandatory Oilcode provides for franchisees to retain tenure for nine years. The Oilcode preserves tenure for existing franchisees.
- ***Repeal of the Sites and Franchise Acts will result in the loss of valuable property rights for franchisees.***
  Oil Company franchise agreements remain on foot for the terms under which they were originally signed, including those signed under the provisions of the Franchise

Act. No oil company franchise agreements were terminated as a consequence of market reform. Neither the Franchise Act nor individual franchise agreements created any 'residual' property rights for franchisees at the expiry of the franchise agreements.

- ***Market reform will lead to the closure of thousands of service stations and will see franchisees' livelihoods taken from them.***
  The service station industry is driven by competitive dynamics that have seen the number of sites fall from 20,000 in 1970 to 6036 in 2007. Site numbers may reduce further as a result of the continuing competitive forces in the industry but not specifically because of market reform. The Oilcode provides significant further protection compared to most industries that operate in a more deregulated environment. Franchisees continue with at least the tenure they originally signed up for. Oilcode continues to provide for 9 years tenure for new franchisees. Oilcode provides for 5 years tenure for commission agents who previously had no tenure protection whatsoever under the legislation. These provisions apply not only to franchisees and commission agents of the oil majors, but also to those service station operators in similar relationships with distributors and the operators of independent chains.
- ***Rural areas will see mass closures of sites as sites migrate to regional centres***
  There is no basis for this assertion and this has not been the case for the past 12 months. Any rationalisation of rural sites that has occurred has been the result of the broad competitive dynamics of the industry and is unrelated to market reform.