Australian Institute of Petroleum

Submission to the

Inquiry into the Provisions of the Petroleum Retail Legislation Repeal Bill 2006

Federal Parliament

(Senate Economics Legislation Committee)

13 April 2006

The Australian Institute of Petroleum (AIP) is pleased to present this submission on behalf of the AIP's four core member companies:

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

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 operate and control only a limited part of the retail fuel market.

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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Overview

The AIP member companies fully support the Government's Downstream Petroleum Reform Package, including

- the *Petroleum Retail Legislation Repeal Bill 2006*, and
- the *Trade Practices (Industry Codes – Oilcode) Regulations 2006.*

The Australian Government has announced that it intends to repeal both the Petroleum Retail Marketing Sites Act 1980 and the Petroleum Retail Marketing Franchise Act 1980. The repeal of these Acts is to be accompanied by the introduction of a mandatory Oilcode under the *Trade Practices Act 1974* (TPA). The Oilcode provides for:

- regulation of fuel re-selling agreements;
- a national terminal gate pricing (TGP) regime;
- price transparency and documentation measures; and
- a dispute resolution process.

AIP sees many <u>benefits</u> from these reforms:

- repeal will remove barriers to greater competition in the market and consumers will benefit from more effective competition
- the Acts limit the ability of the four oil majors to compete with unregulated supermarket chains
- there will be greater price transparency at each stage of the supply chain
- small business (commission agents) will gain improved tenure, while the tenure of franchisees will be maintained
- both Acts have been found by a number of government reviews (including by the ACCC) to be outdated and ineffective
- the Acts currently place compliance costs on the companies concerned without benefit to the community as a whole
- international perceptions of Australia as an investment destination will be improved

The retail petroleum market reform package will ensure that competition continues to be vigorous, providing ongoing benefits to the consumer. Independent rural and regional service station operators, in particular, will continue to be able to take advantage of local market knowledge and will generally have lower overheads than major service station networks.

In considering the implications of the Market Reform Package, particularly the significant benefits to competition and consumers, it is important to understand the key features and structural characteristics of the fuel market in Australia. This also provides relevant context to the assessment of the myths surrounding market reform.

The downstream petroleum retail sector has undergone significant changes in the last ten years in almost every aspect of its operations — but particularly in relation to industry structure.

The convergence of fuel retailing and convenience store shopping has advanced through the supermarket alliances that have emerged since 2003 between Shell and Coles Myer and between Caltex and Woolworths.

The supermarket alliances now handle almost 50 per cent of petrol sales in metropolitan areas. There have been very strong consumer responses to the supermarket shopper docket discounts and according to the ACCC there are now over 100 shopper docket fuel discount schemes in place.

Other key factors that have influenced the structure and operation of the Australian fuel market that are discussed in more detail in this submission are

- Changes in service station numbers since 2000
- Flexible business practices
- Terminal gate prices
- Retail price discounting and shopper-dockets
- Role of independent service station operators in driving competition in the retail market
- Long term role of oil majors and supermarket alliances in fuel retailing

Opponents of the repeal of these Acts— especially some representatives of the branded and non-branded independent sector — have argued that there will be a reduction in competition within the market and the oil majors, particularly through supermarket alliances, will establish a dominant presence in the retail sector. AIP member companies strongly disagree with these purported outcomes of the Reform Package.

In particular, opponents argue 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.
- ***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 and no discounting should be allowed.***
  This proposal would damage competition at both the wholesale and retail levels because discounting is a primary method for capturing additional volume – 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 strategies of AIP member companies or trends in industry structure and it should be noted that, even under the restrictions of the existing Act, only one company has taken full advantage of the operational limits allowed.

- ***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 from franchisees.***
  Oil Company franchise agreements will 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 allow for termination in the event of market reform. Even if they did, the legislation would make such clauses void. Neither the Franchise Act nor individual franchise agreements create 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 franchisee’s 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 6650 in 2004. Site numbers may reduce 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 will 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 have no tenure protection whatsoever under the current legislation.
- ***Rural areas will see mass closures of sites as sites migrate to regional centres***
  There is no basis for this assertion. Any rationalisation of rural sites that may occur will be a result of the broad competitive dynamics of the industry and is unrelated to market reform.

Structure of the Downstream Petroleum Industry

The structure of the service station industry has changed markedly since the implementation 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 model that offers a range of products other than liquid fuels and relies on high volumes for competitive advantage.

In this context, the competitive advantage of any individual site is determined by the package that is being offered to consumers. The most obvious example is shopper dockets that have allowed supermarket alliances to retail approx 50% of petrol and diesel sold in metropolitan Australia. Other important elements for consumers are the site location and access, the general condition of the site such as facilities and the extent of ancillary services such as a convenience store.

All these developments indicate the retail petroleum sector is a competitive and dynamic activity that could see further competition if new business models are not constrained by regulation. Ultimately the consumer will benefit from greater levels of competition either through reduced prices or through better service.

Changes in Service Station Numbers since 2000

The following table summarises the changes in service station numbers in recent years.

	2000	2004	Change
AIP Member Branded Service Stations:			
Company operated	296	316	20
Franchises	2019	958	-1061
Supermarket	156	872	716
Other - AIP branded independ. & other related brands	5047	3895	-1152
Total	**7518**	**6041**	-1477
Non-AIP Member Service Stations:	659	608	-51
TOTAL ALL SERVICE STATIONS	**8177**	**6649**	-1528

It should be noted that the majority of the service stations shown as declining in the franchisee category actually joined the supermarket alliance groups. The change is reflected in the substantial increase in the number of sites in this latter category.
Some opponents have asserted that the reform package will result in the closure of a large number of service stations across Australia. AIP rejects this contention.

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

- Low fuel turnover and hence low profits from fuel sales (1 tanker per 2-3 weeks vs 1 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 govt 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 is a priority)
- Families not wishing to continue to operate their small business
- Competition from more efficiently run businesses, and businesses offering 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.

The basic economics of operating a service station have clearly changed significantly since the petroleum retail legislation was introduced in 1980. Opposition to the reform package will not change this situation.

Flexible Business Practices

Claims have been made that vertical integration of oil company operations have an extremely negative impact on competition in the retail sector. The ACCC and most economic theories have recognised that vertical integration per se is not a negative market characteristic. What is important, as acknowledged by the ACCC, is the level of competition between integrated businesses. As most government reviews of fuel pricing have concluded, the Australian fuel market is highly competitive.

The following table summarises the actual operating arrangements across the industry.

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

- **Oil Company operated (sites may be owned or leased) (316 in 2004)**
  - Numbers restricted by the Sites Act
  - Tied fuel supplies
  - Retail prices set by oil company
  - Convenience store options

- **Supermarket alliances (872 in 2004)**
  - No mandated restrictions on operations
  - Tied fuel supplies
  - Retail prices set by supermarket
  - Convenience store options controlled by supermarket

- **Franchisee and Commission Agents (958 in 2004)**
  - Franchisee operated (declining in numbers)
  - Commission Agents (limited tenure if not franchised but guaranteed returns)
  - Full marketing programme support by supplying oil company
  - Tied fuel supplies
  - Retail prices generally set by franchisee
  - Convenience store options controlled by franchisee or CA

- **AIP Company Branded Independents (3895 in 2004)**
  - Branded independents (major oil company brands) – 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
  - Tied fuel supplies
  - Retail prices set by independent operator
  - Convenience store options controlled by owner/operator

- **Non AIP company branded and other independents (608 est in 2004)**
  - May be operated by distributors or independent retailers (in some cases may be franchised by distributors or multi-site owners)
  - Fuel supplies not tied to single oil major
  - 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/CAs 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.

Two key factors are highlighted in this summary.

<u>Retail prices</u> 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).

<u>Fuel supplies</u> to service stations carrying the brand of an AIP member company are tied to fuel supplied by that oil major. 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 that 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 the same rigorous checks for quality assurance.

For brand management and fuel quality assurance reasons it is not acceptable for individual 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 situation is even more important under the Australian Government's cleaner fuels agenda, where the supply of off-spec fuel by a retailer can have severe implications for vehicle operability. As Australian fuel suppliers guarantee their fuel quality the supply of off-spec fuel to a retailer by a third party can have negative financial and reputation implications for the fuel supplier.

Terminal Gate Prices

Fuel prices are amongst the most transparent prices of all commodities sold in Australia. Extensive information is provided by a range of organisations about the factors influencing fuel prices at the international and local levels. In addition, details of average local prices and service station specific prices across the country are readily available.

The Oilcode will require the publication of terminal gate prices for all fuels sold on a 'spot' basis to approved customers with a tanker of 30-35,000 litre capacity that meets strict safety requirements. AIP member companies already publish these prices, but this is not the case for other fuel suppliers.

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) term contracts have priority over spot liftings at refinery terminals) and to provide site branding and access to fuel card operations. 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.

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 100 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. 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. There is no case for treating the fuel retailing industry any differently to other sectors of the Australian economy, and the Government has extensively considered this aspect as part of TPA reviews over the past 3 years

Role of Independent Service Station Operators in Driving Competition in the Retail Market

Independents 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 these refineries, and the availability of lower quality fuel from some Asian refineries. These factors were the basis on which much of the current fuel discounting reputation of the 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 demand and the mothballing of the Port Stanvac refinery in Adelaide has turned Australia into a net importer of fuel. This situation was further tightened 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.

A Northern Territory fuel pricing inquiry indicated 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.

It seems somewhat incongruous that independent representatives can simultaneously argue that independents drive price competition while making accusations about unfair competition from the supermarket alliances.

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

Opponents of the Reform Package claim that the Package will 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 only grow substantially if reform is stifled.

Market reform will enable all four oil majors to compete on an equal basis, without artificial constraints on choice of retail business model. This will enable networks to be established that are commercially viable in size and hence enable the networks to optimise the economies of scale that exist in fuel retailing and convenience store operations. Once established these networks will be the platforms from which service options can be offered to a wide range of branded sites across Australia.

The ability to modify business structures as required will enable more effective competition with the service stations controlled by the supermarket alliances. Progressive improvement in the quality of service stations in rural and regional areas can also be expected (ie the quality and range of services can be better targeted to meet current community needs)