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Caltex Australia

Caltex submission to the House of Representatives Economics Committee inquiry into Australia's oil refinery industry

19 November 2012

House of Representatives Economics Committee inquiry into Australia's oil refinery industry

Part A Introduction

1. Caltex refinery review

Caltex welcomes the opportunity to provide input to the House of Representatives Economics Committee's inquiry into Australia's oil refinery industry.

In 2011-12, Caltex carried out an exhaustive review of its two refineries (in Kurnell, Sydney and Lytton, Brisbane). These refineries lost about $200 million (EBIT) in 2011, with the greater part of the loss arising from the Kurnell refinery. Like many manufacturing plants, Caltex's refineries face strong import competition and increasing costs.

Caltex has not been able to find an economically attractive way to make the Kurnell refinery sufficiently competitive in the Asian market. Caltex has therefore decided to close Kurnell's refining facilities in the second half of 2014 and convert the site to a major import and fuel storage terminal.

Caltex's Lytton refinery in Brisbane will continue operating as the company has identified a range of opportunities to improve performance, and a number of potential targeted incremental investment options, to drive sustained improvement.

Caltex is committed to addressing the impact on all those affected by this closure, including our employees, local communities and suppliers. There has been ongoing communication with stakeholders, and in particular with refinery employees, over the course of the review and since the decision was announced.

For Caltex customers, there will be a continued commitment to maintaining reliable supply of high quality products. Fuel prices are unrelated to whether or not Caltex operates a refinery.

Caltex believes the closure of the refinery, while driven mainly by factors beyond its control, will strengthen the ability of the company to become the outright leader in the supply of transport fuels across Australia. As a locally-managed, Australian-listed company, Caltex will be a long-term investor and employer in the Australian fuels market.

2. Caltex's business

Caltex is the leading fuel supplier in Australia, underpinned by a flexible and reliable supply chain. Caltex's vision is to be the outright leader in transport fuels across Australia.

Caltex is an ASX100 company, under Australian management. It has an Australian MD/CEO (Julian Segal) and Chairman (Elizabeth Bryan). There are more than 27,000 shareholders, including institutions, retail investors, employees, and Chevron Global Energy Inc. Caltex is the only oil refining, fuel and convenience marketing company listed on the Australian Securities Exchange.

About 3,500 people are employed nationally across the supply chain including refining, terminals, distribution, commercial and industrial sales, and fuel and convenience retailing. It has a retail venture covering exclusive supply of fuel to Woolworths and co-branding of sites owned by each company; it also has an extensive network of Caltex-branded franchised and independently-operated sites. There are about 1800 service stations supplied by Caltex nationally. Caltex is the wholesale supplier of about one third of all transport fuels (petrol, diesel, jet fuel) in Australia.

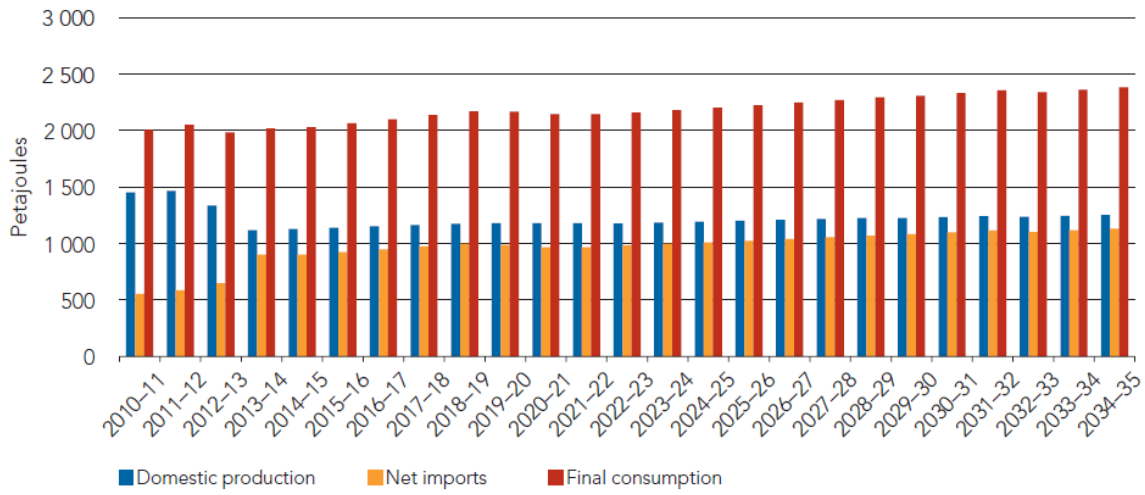
3. Australian fuels market

The Australian oil industry exists to supply quality fuels safely and reliably to customers. Suppliers currently balance the decisions between refinery production and imports based on the refining capacity available and the relative economics of refining versus importing the various products.

Over the next decade Caltex projects demand for petrol to decline but demand for diesel and jet fuel is projected to grow at around 4 per cent per annum. Petrol demand growth will be reduced, mainly due to substitution by diesel and increased fuel efficiency. Diesel demand is closely linked to economic growth and jet fuel to economic growth, international aircraft range and tourism. Strong growth in demand for diesel and jet fuel means that already sizeable imports will continue to grow as Australian refineries do not have the capacity to produce greater quantities of these fuels.

Australia currently (post the closure of the Clyde Refinery) imports approximately one third of its petroleum product requirements, as shown on the chart below. (Note: the chart incorrectly shows the Kurnell refinery closure affecting production in 2013-14, rather than 2014-15 onwards, as the refinery will close in second half 2014). Imports are projected to increase substantially by 2035 to about half of total requirements, assuming no further refinery closures. With the decline in production from domestic refineries and increasing demand, the industry must continue to meet petroleum demand efficiently from both domestic and imported sources.

Figure 8.6: Australia's refined product balance, 2010–11 to 2034–35 (PJ)



Source: BREE, internal, 2012.

Energy White Paper, page 128

Part B – Response to each term of reference

TOR 1. Identify the current international and domestic trends and pressures impacting on the competitiveness of Australia's domestic oil refineries.

1.1 Key points

- Competitive disadvantages for the Australian industry include economies of scale disadvantages, the strong Australian dollar, higher capital costs, significantly higher labour costs, dated technology and increasing environmental regulation. Competitive advantages are derived from location and product slate (a high proportion of high value-added products)
- The significant new refining capacity being commissioned in Asia is expanding regional petroleum product supply, while the increase in supply is decreasing refiner margins. With the market facing a protracted period of weak refiner margins, there are significant challenges for Australian refiners to be competitive against regional refiners and profitable in the Australian market.
- The decision to close Kurnell was due to a range of factors beyond the control of Caltex or its employees. These included:
    - Disadvantaged hardware and size relative to regional competitors
    - Changing customer demands
    - Higher crude costs increasing running costs (cost of fuel) and working capital (cost of holding crude inventory)
    - More West African crudes resulting in higher working capital (additional time on water) and freight cost
    - Australian cost of doing business (including capital and labour costs) is growing faster than regional pacesetters
    - Strong Australian dollar has reduced A$ margins**.**
- The net cash margin for Kurnell refinery is lower than for Lytton refinery. Other metrics were also benchmarked within the Solomon metrics which were found to be significantly uncompetitive – Caltex's refineries were ranked in the fourth quartile (ie least competitive) on most key metrics in a population of 70 refineries in the Asia Pacific region. A potentially affordable set of investments at Kurnell refinery was identified that, while profitable in themselves, would fail to lift the refinery out of the fourth quartile. To achieve sustainable, second-quartile net cash margin performance would be uneconomic for Caltex, in excess of $400 million upfront expenditure, and require high levels of ongoing capital investment.

1. 2 Challenges for the Australian oil refining industry

Like many other manufacturing industries in Australia, oil refining is under pressure from global forces and the resultant transformation of the Australian economy. According to the Australian Institute of Petroleum, the competitive disadvantages for the Australian industry include:

- economies of scale disadvantages
- the strong Australian dollar
- higher capital costs
- significantly higher labour costs
- increasing environmental regulation.

Competitive advantages are derived from location and product slate (a high proportion of high value-added products). However, over the last 20 years the Australian refining industry has struggled to achieve returns exceeding the long term bond rate and experienced losses in excess of $500 million in 2002 and 2008.

The most significant challenge for Australia's oil refining industry, along with much of the Australian business community, has been the prolonged high Australian dollar. As Australia is a net importer of

refined petroleum products, predominantly from Singapore, Australian petrol and diesel prices are based on import parity with Singapore benchmark prices.

As a result, the profitability of Australian refineries is adversely impacted by the fall in US$ refiner margins in the Asian region and the strength of the Australian dollar, which has risen to record levels since the float of the dollar in 1983. (The refiner margin is the difference between the cost of crude oil and the price of petroleum products, before the deduction of any costs.)

The competitiveness challenges for Australian refining are made more difficult by past and projected refinery capacity additions in Asia, which exceed demand growth. The resultant low refinery utilisation means that significant improvement in refiner margin (the difference between crude oil costs and product prices) is seen as unlikely in the next few years. The outlook is summarised in the following two charts.

Refining capacity additions projected to exceed demand growth (2013-2016)

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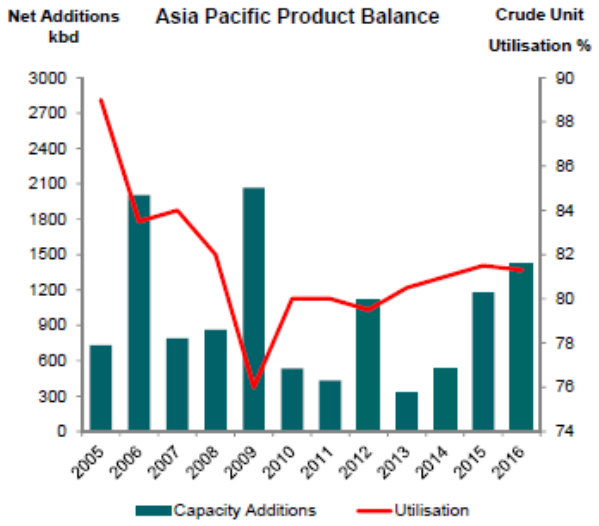
Asia Pacific Product Demand versus CDU Capacity Additions

- Regional product demand growth is projected to exceed capacity expansion in 2013/14, partly due to closures in Japan and Australia
- From 2015, capacity additions are projected to significantly exceed demand growth
- Although there is a possibility of delays in timing of projects, the refinery operating environment is expected to be challenging over the medium term and beyond

Source: FACTS Global Energy April 2012 Forecast, Caltex estimates
Capacity additions are net of forecast closures

Regional refining capacity additions to prevent utilisation improvement



Source: FACTS Global Energy April 2012 Forecast, Caltex estimates
Capacity additions are net of forecast closures

- Capacity additions in Asia-Pacific (particularly China) are expected to be significantly higher in 2012 compared to 2011.
- Refinery closures in Australia and Japan should partly offset new additions in 2013/14, before further growth in regional capacity from 2015
- FACTS 2012F Asian product demand growth +3.6%, up from the previous forecast of 2.7% (due to stronger Japanese fuel oil demand, rather than high value transport fuels).
- The longer term demand forecast to 2020 remains similar at about +2.2% per annum
- Refinery capacity expansion to 2016 should keep utilisation well below the peak recorded in the mid-2000's. Significant refiner margin improvement therefore deemed unlikely.

Australian refineries face increased competition from large new refineries in the region. New refineries in India, China, Korea, Vietnam and Indonesia will seek to buy the crudes the industry has traditionally bought from the region, increasing demand and reducing available supply. The cost of crude oil has also increased and is likely to remain high. As some crude oil is consumed within refineries as fuel, and Australian refineries are less fuel-efficient than regional competitors, this creates a competitive cost disadvantage.

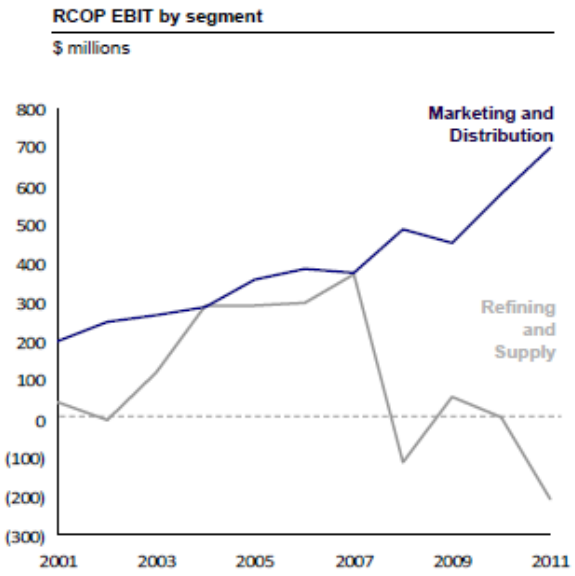
Caltex has recently seen a significant increase in crude oil sourced from West and North Africa. This incurs higher freight costs and higher working capital as buyers incur a liability to pay for the crude when it is loaded in Africa and a typical journey to Australia takes over a month. The higher price of crude increases this impact on the working capital requirement. Many regional competitors' supply chains are largely unaffected as they can process cheaper (and closer) Middle Eastern crude oils. Australian refineries are generally unable to process crudes sourced from the Middle East.

The significant new refining capacity being commissioned in Asia is expanding regional petroleum product supply, while the increase in supply is forecast to decrease refiner margins. With the market facing a protracted period of weak refiner margins, there are significant competitiveness and profitability challenges for Australian refiners.

1.3 Challenges for Caltex

In August 2011, Caltex announced that it was undertaking a refinery review with the purpose of determining the role its refineries play in the company's supply chain. Caltex's refineries lost about $200 million (EBIT) in 2011, with the greater part of the loss arising from the Kurnell refinery.[1] At the AGM in May 2012, Caltex announced that refining continued to lose money during the first quarter, with Kurnell contributing the majority of losses in 2011 and 2012 to date. Therefore, the review focused on Kurnell. Caltex further announced that the company's Brisbane-based refinery at Lytton is better suited to the product mix demanded by our customers and consequently a pathway is being explored to improve its operations and financial performance.

[1] Total Caltex earnings before interest and tax (EBIT) in 2011, on a replacement cost of sales basis, were $422 million. Of this total, the Marketing division EBIT was $697 million; the Refining & Supply division lost $208 million EBIT.



Caltex's refineries were built in the 1950s and 1960s and today they are disadvantaged in hardware and size relative to regional competitors. Competitor refineries in Asia, a number of which have been built over the past 10 -15 years are typically two to three times larger, resulting in lower costs per litre of production and more efficient and complex leading to increased flexibility to run cheaper crudes and produce high value products.

This, combined with the challenging business environment, including the ongoing strength of the Australian dollar, increased operating costs and a lower Caltex Refiner Margin, has meant that Caltex's refineries have been generating significant losses which, without intervention, are expected to continue into the future.

1.4 Specific factors reducing Caltex refinery profitability

- **Disadvantaged hardware and size relative to regional competitors** – Caltex's refineries were built in the 1950s and 1960s. Competitor refineries in Asia, a number of which have been built over the past 10 -15 years are typically two to three times larger, resulting in lower costs per litre of production and more complex leading to increased flexibility to run cheaper crudes and produce high value products.
- **Changing customer demands** – Demand growth in Australia is primarily in diesel and jet fuel. While overall growth for petrol is flat, customers are demanding more 95 and 98 octane premium petrol (PULP) at the expense of the base 91 octane ULP grade. Kurnell is configured to produce ULP as a major product, and has limited capacity to produce PULP. The Lytton refinery has greater capability to produce PULP.
- **Higher crude costs increasing running costs (cost of fuel) and working capital (cost of holding crude inventory)** – The cost of crude oil has increased and is likely to remain high. As some crude oil is consumed within the refinery as fuel, and our refineries are less fuel-efficient than competitors, this creates a competitive cost disadvantage.
- **More West African crudes resulting in higher working capital (additional time on water) and freight cost** – The declining availability of suitable Australian and Asian crude oils means Caltex must go much further to obtain the types of crude that it needs. This incurs higher freight costs and higher working capital as we incur a liability to pay for the crude when it is loaded in Africa and a typical journey to Australia takes over a month. The higher price of crude increases this impact on the working capital requirement. Many regional competitors' supply chains are largely unaffected as they can process cheaper (and closer) Middle Eastern crude oils.
- **Australian cost of doing business is growing faster than regional pacesetters** – The local resources boom has been increasing capital and labour costs.

- **Strong Australian dollar has reduced A$ margins** - The international oil market is based on US$, so import parity prices as expressed in A$, which are the basis of refinery product prices and revenues, have been reduced while operating costs in A$ are unaffected. This has squeezed net cash margins (the difference between revenues and cash costs).

1.5 Refinery competitiveness

The Solomon Benchmarking Survey collects comprehensive performance related data on refineries globally, including about 70 in the Asia-Pacific region. The most recent survey data is for 2010. On the basis of net cash margin (ie revenues minus cash costs), Caltex's refineries are in the fourth (least profitable) quartile in the Asia-Pacific region. The net cash margin for Kurnell refinery is lower than for Lytton refinery. Other metrics were also benchmarked within the Solomon metrics which were found to be significantly uncompetitive, including operating costs, utilities, costs of labour, capital costs, taxes and environmental costs etc – Caltex's refineries were ranked in the fourth quartile (ie least competitive) on most key metrics.

Across a broad range of Solomon metrics including energy, maintenance and personnel-related costs, the Lytton and Kurnell refineries were at the wrong end of the cost curve. It would be unrealistic to expect GOC-1 (i.e. smaller refineries such as Australia) to be top quartile of competitiveness in the region as in some of these metrics scale is important. However, the top performing GOC-1 refineries are ranked in the top half of all Asia/Pacific refineries on the majority of metrics, so it is possible for a well-run smaller refinery in the Asia-Pacific region to find a niche operation that makes solid returns. The key question is whether Caltex's refineries could be one of these.

Extensive analysis was undertaken of investment options at both refineries, with the following outcomes.

- A set of investments at Kurnell refinery was identified that, while profitable in themselves, would fail to lift the refinery out of the fourth quartile. Such a position would not be sustainable in a highly competitive industry, so the investment would not be made. To achieve sustainable, second-quartile performance would be uneconomic for Caltex, in excess of $400 million upfront expenditure, and high levels of ongoing capital investment.
- A potentially affordable set of investments at Lytton refinery was identified that are profitable and, together with operational and reliability improvements, could make the refinery more competitive. These investments need to be further investigated before a final investment decision is made. Further changes need to be implemented to close the gap to second quartile performance of similar sized refineries.

Despite the exhaustive examination of a wide range of alternatives, the company was unable to develop a compelling case to maintain the Kurnell refining operation. Unfortunately the configuration and scale of the Kurnell refinery is such that without substantial investment, which would not be economic, it still could not become competitive with newer, larger scale plants in the region.

The outcome of the review was the decision to close the Kurnell refinery in the second half of 2014 with the existing storage and associated facilities then being converted to a major transport fuel import facility. The review further determined that the Lytton refinery is better suited to the product mix demanded by its customers and consequently a pathway is being explored to improve its operations.

TOR 2. Investigate the impact of declining refinery capacity in Australia on the economy. This should include analysis of:

(a) current supply chains and their effectiveness in meeting Australia's liquid fuel requirements;

2.a.1. Key points

- Australia will become more reliant on imports of crude oil and refined petroleum product over time. However, as outlined in the Energy White Paper, this trend does not reduce our liquid fuel security.
- Australia can access diverse and well-established supply chains, so any reduction in refining capacity will be offset by sourcing refined product via import facilities.
- Current supply chains are highly effective in meeting liquid fuel requirements, so there will be no decrease in supply reliability adversely affecting fuel using industries or private consumers
- With a reduction in local oil refining capacity, there is a need for good terminal and other infrastructure to ensure supply reliability. This will be provided efficiently by the private sector, as there is a commercial driver to maintain reliable supply to the market. Caltex is well progressed with its planned investments at Kurnell to ensure supply reliability. The company has two development applications in progress which are recognised as State significant developments. The first is a development to upgrade the dedicated Kurnell port and berthing facilities to enable larger ships to import product for the NSW market. The second is the development to convert the refinery into a terminal to ensure that there is adequate tankage for imported fuels.

2.a.2 Supply reliability – Energy White Paper and NESA

The 2011 NESA was an input to the Energy White Paper. The Executive Summary states:

> *Liquid fuel energy security remains largely unchanged from 2009 and is assessed as high trending to moderate in the long term, as Australia has continued access to highly adequate and reliable supplies of liquid fuels at price levels that are manageable within the broader economy.*
>
> *However, the moderate assessment in the long term recognises that the continued rise in Australia's imports of petroleum products will place greater reliance on international supply chains and the consequential need for investment in adequate import and storage infrastructure.*
>
> *The assessment also recognises a likely trend of high crude oil prices driven by increasing global demand and an increased reliance on more expensive sources of supply; the significant global investment challenge required to meet rising demand; and the continued risks of geopolitical uncertainty in key oil-producing countries.*

The NESA modelled the resilience of liquid fuels to supply shocks (a common argument for local refining capability) and concluded, "The modelling demonstrated that the global market and international supply chain could provide Australia with adequate and reliable supplies, albeit at higher prices".

The detailed NESA analysis reinforces the emphasis on international supply chains rather than domestic production of petroleum products. For example:

> *The liquid fuel industry has consistently performed well in meeting consumer demand with minimal disruptions to supply. This is due to continued access to well-functioning markets which have helped create robust and flexible supply chains with a high degree of diversity of supply – a key component of risk management. Domestically produced crude oil, LPG, biofuels and refined products supplied by Australian refineries are well integrated with crude oil and refined products sourced from a wide variety of international suppliers. Highly diversified supply has combined with pro-active supply chain management to mitigate the*

> *effects on reliability of short-term events such as refinery outages, shipping delays or unexpected spikes in demand. (Page 22)*
>
> *While the domestic refining industry is expected to continue to be an important component of a well-diversified domestic supply chain in the medium term, increased competition from large-scale Asian refineries will continue to pose a risk of further rationalisation in the domestic refinery sector. However, access to regional markets for refined products is expected to provide ample supply to meet any domestic refinery shortfall. (Page 24)*

Similarly, growing oil imports are not seen as a threat:

> *Increased reliance on imports does not automatically mean a decline in Australia's energy security. Australia is already well integrated into the global market for liquid fuels and pays global prices for oil. Australia is therefore subject to the price risks associated with this global market irrespective of our level of imports. (Page 17)*

These assessments are supported by a report commissioned by the Government from ACIL Tasman, *Liquid Fuels Vulnerability Assessment, October 2011*.

The NESA included an oil shock as part of its analysis. The hypothetical shock scenario analysed for the liquid fuel sector was a temporary interruption to the supply of oil products from a major regional oil trading and refining hub. Specifically, the scenario involved interruption of shipping of oil to, and oil products from, Singapore for about 30 days. After allowing for the time it takes to ship crude oil to Singapore, refine crude oil, store and blend sufficient oil products, break up cargos, and ship crude oil and refined products to Australia, the interruption of supply from Singapore to Australia could last for 45 to 60 days.

> *In general, analysis of a shutdown in Singapore for a period of 30 days indicated that while there would be a short-term rise in petroleum product prices, there would nevertheless be sufficient availability of petroleum products to support economic activity. This undercuts the common argument that a domestic refining industry is necessary to avoid unacceptable impacts from international supply disruptions.*

2.a.3 Supply reliability - Caltex

Caltex has a strong reputation for safe and reliable supply to all its customers. In fact, the industry has proven itself extremely adept at maintaining reliability of this supply and this will continue into the future. Australia can access diverse and well-established supply chains, so any reduction in refining capacity will be offset by sourcing refined product via import facilities. The Energy White Paper contemplates the maintenance of market supply and makes the case that supply reliability will be maintained.

> *The decline in Australia's domestic refining capacity (following announcements of the Clyde and Kurnell refinery closures) is not considered to impair Australia's liquid fuel security. The closures will occur over 18 months, and will be complemented by an expansion of import terminal capacity to ensure that market supply is maintained. Substituting imports of crude oil for imports of refined fuel at this scale does not pose any additional risk to market security. (Energy White Paper, Page 50)*

With a reduction in local oil refining capacity, there is a need for good terminal infrastructure to ensure supply reliability. This will be provided by the private sector, as there is a commercial driver to maintain reliable supply to the market. The private sector has historically responded to make these investments, as can be seen in Caltex's significant investments in new terminal infrastructure in locations such as Adelaide, Port Hedland, Gladstone, Mackay.

> *Australia's refineries are in key geographical locations and have access to existing distribution infrastructure (pipelines or roads) to meet market demand. Therefore, any future refinery closure decisions are expected in most cases to be accompanied by decisions to convert the refineries to import terminals, maintaining these supply connections. (Energy White Paper, Page 127)*

Caltex is also well progressed with its planned investments at Kurnell to ensure supply reliability. The company has two development applications in progress which as recognised as State Significant Developments. The first is a development to upgrade the dedicated Kurnell wharf and berth facilities

to enable larger ships to import product for the NSW market. The second is the development to convert the refinery into a terminal to ensure that there is adequate tankage for imported fuels.

Governments play a limited role in supply reliability, and should focus on avoiding barriers and setting in place frameworks to support investment in ports, pipelines and tankage. During normal market operations, private enterprise is best placed to manage supply to market. Governments will play a greater role in times of challenges to national security, for instance times of conflict, and should only then intervene in the market.

> *As demand increases, it will be important for the Australian and state and territory governments to maintain an attractive investment environment through efficient, timely and consistent national planning, approval and regulatory processes. This will support future investment in import fuel terminals, storage facilities and distribution infrastructure. (Energy White Paper, Page 127)*

(b) import price outcomes for consumers from the current arrangements;

2.b.1 Key points

- The prices of products from Australian refineries reflect international prices, through the mechanism of the import parity price. As a consequence, declining refinery capacity has no impact on import prices, hence no impact on the cost basis for Australian wholesale or retail prices
- The import parity price (IPP) benchmark is the fundamental basis for wholesale prices and is largely driven by the cost of refined unleaded petrol plus other costs associated with importing petrol to Australia.
- The key characteristic of the relationship observed between wholesale prices and the IPP and Terminal Gate Price (TGP) is also evident in the relationship between wholesale prices and retail prices. Retail prices are determined by a number of factors, including local competition, but track movements in wholesale prices closely.

2.b,2 Australian consumer prices reflect international prices

The prices of products from Australian refineries reflect international prices, through the mechanism of the import parity price. As a consequence, declining refinery capacity has no impact on product import prices, hence no impact on the product cost basis for Australian wholesale or retail prices.

> *The closure of existing Australian refineries is unlikely to have any major impact on consumer fuel prices, as import parity pricing is the basis for wholesale and retail fuel pricing in Australia. (Energy White Paper, Page 126)*

The relationship between consumer prices and import prices and related issues have been examined in great detail by the Australian Competition and Consumer Commission in a series of reports in recent years.

The ACCC report Monitoring of the Australian petroleum industry December 2011 makes the following key points (Chapter 8, p.125):

- *The import parity price (IPP) benchmark is the fundamental basis for wholesale prices and is largely driven by the cost of refined unleaded petrol plus other costs associated with importing petrol to Australia.*
- *Over the four years to June 2011 the notional IPP has been shown to closely reflect the actual costs of importing.*
- *Throughout 2010–11, movements in wholesale prices have continued to reflect movements in the IPP, which, in turn is driven by movements in the cost of refined unleaded petrol.*

Chapter 8 of the ACCC report discusses these points in some detail and key extracts are provided below. (Note that this is a condensed extract and some text has been omitted without affecting accuracy).

> *The wholesale sector of the petroleum industry is much like the wholesale sector operating in other industries. The main role of the wholesale sector is to distribute product from the point of production to the point of retail sale.*
>
> *The four refiner-marketers along with a number of the larger independent wholesalers such as United, Neumann, Gull and Liberty trade the majority of the volume flowing through the sector. Petrol enters the wholesale sector through two main sources:*
>
> *• domestic refinery production, by the refiner-marketers*
>
> *• petrol cargo imports, by both refiner-marketers and independent wholesalers.*
>
> *Petrol also moves in and around the downstream industry through buy–sell transactions among the refiner-marketers. These transactions take place around Australia and allow refiner-marketers to purchase large volumes of petrol in locations where they do not operate a refinery. Buy–sell transactions also provide an opportunity for operators of a local refinery to supply other refiner-marketers who do not have a refining presence in that location.*

Wholesale prices are largely based on the costs of acquiring petrol. In Australia, the costs of acquiring petrol are most commonly observed by the costs faced by refiner-marketers or independent wholesalers to import petrol.

As the Australian market must import petrol in order to satisfy its total demand, the cost of importing petrol provides the basis for which wholesale and retail prices are determined. If the price of locally refined petrol supplies were too high, wholesalers could choose to source petrol through imports at a more competitive price.

Refiner-marketers utilise a notional cost of importing as the basis for setting wholesale and retail prices. This cost, known as the import parity price (IPP), represents the cost of importing petroleum into Australia and is a key pricing benchmark. IPP is used as the basis for pricing throughout the industry, including for price setting under buy–sell arrangements.

The base product price used for the pricing of regular unleaded petrol (RULP) in Australia is the Platts Singapore quote for refined unleaded petrol of 95 RON (Mogas 95). Mogas 95 is an international price subject to supply and demand factors on the global market. It is clear that Mogas 95 is not only the largest component of IPP, but is also the key driver of changes in the IPP and exerts an overwhelming influence on the IPP.

In general, the IPP appears to have moved in line with actual import costs, despite occasions where the observed import costs have deviated slightly from IPP in the short-term. Overall, over the four years to June 2011 the difference between IPP and observed imports costs has been, on average, less than 1 cpl.

Often the most efficient method of accessing local supplies where a refiner-marketer does not operate a refinery is to purchase it from a local refiner-marketer. Refiner-marketers buy and sell refined petrol with each other through buy–sell arrangements. Refiner-marketers facilitate this buying and selling of petrol through six-monthly agreements outlining the volumes they intend to buy and sell in each location.

The price at which petrol is traded under buy–sell arrangements also impacts on wholesale prices. Generally, prices at which buy–sell transactions take place are based on IPP. If prices were substantially higher than IPP, a refiner-marketer could choose to import petrol at the lower cost of importing.

Concerns had been raised in the 2007 ACCC petrol inquiry report about the exclusive nature of buy–sell agreements, as independent wholesalers are not privy to such arrangements. The ACCC's 2009 petrol monitoring report found that while arrangements may have had the potential to lessen competition, there was insufficient evidence to support a conclusion that the arrangements contravened the Trade Practices Act 1974 (since replaced by the Competition and Consumer Act 2010). Since 2009, further evidence has shown that buy–sell prices and IPP have tracked each other very closely, indicating that prices at which buy–sell transactions take place are competitive with the notional costs of importing. Over the four years to June 2011 buy–sell prices (exclusive of taxes) have tracked closely with the IPP.

Terminal gate prices (TGPs) are spot prices at which petrol can be bought on demand from a refinery or terminal. As most wholesale transactions occur under contract (or other negotiations) few transactions actually occur at the terminal gate, and at the specific TGP. TGPs are, however, a useful indicator for analysing movements in average wholesale prices.

Comparing IPP with TGP and actual wholesale prices paid throughout the market provides an indication of the extent to which wholesale prices reflect notional import costs. The key characteristic of the relationship observed between wholesale prices and the IPP and TGP is also evident in the relationship between wholesale prices and retail prices. Retail prices track movements in wholesale prices closely. The additional premium of retail prices over wholesale prices represents a combination of costs incurred at the retail level as well as a margin.

Chapter 9 supports the observation on retail prices above. It states that "movements in Australian retail petrol prices are primarily determined by movements in the international price of refined petrol (Singapore Mogas 95 Unleaded) and the AUD–USD exchange rate."

(c) direct and indirect employment impacts;

2.c.1 Key points

- While refinery closures inevitably reduce employment in the sector, the avoidance of losses in refining frees up capital for more productive use within the economy, boosting employment overall; in addition, Australia has a shortage of skilled labour broadly of the type released by refinery closures, so it is expected labour will be redeployed overall into more productive uses
- The total number of workers affected by the closure of the Kurnell refinery is about 700 – approximately 430 Caltex employees and about 300 contractors.
- Caltex is committed to supporting its people with the highest level of care, attention and respect. The company will continue to work closely with its Kurnell refinery people to discuss their individual needs

2.c.2 Employment impact of Kurnell refinery closure in 2014

The total number of workers affected by the closure of the Kurnell refinery is about 700 – approximately 430 Caltex employees and about 300 contractors. Less than 100 workers will be employed at the terminal once closure of the Kurnell refinery is completed in the second half of 2014. There are about 700 employees and contractors at the Lytton refinery.

Caltex is committed to supporting its people with the highest level of care, attention and respect. The company will continue to work closely with its Kurnell refinery people to discuss their individual needs – whether that is retention, redeployment and retraining, or outlining generous redundancy entitlements.

The company has developed a “Stay, Focus & Develop” program during the period leading to final conversion, enabling achievement of safe and reliable operations while demonstrating a high level of care for employees. This program incorporates transitional support through generous redundancy benefits, outplacement support services, vocational training allowances, health and wellbeing programs and services, and industry retraining.

To date, employees have had access to:

- Individual redundancy estimates for each employee
- Superannuation sessions with AMP
- Lunchtime wellbeing sessions run by the Employee Assistance Program (EAP) provider
- Novated lease information sessions
- Employee survey to gauge interest in support services desired
- Vocational training and development allowance (22 approved applications as at 31/10/12)

The following events are confirmed and will be held in the near future:

- Introduction to outplacement information sessions
- Applying for internal jobs – hints and tips for preparation
- EAP information sessions for managers and employees
- Chevron WA roadshow

Outplacement services will commence in 2013 including:

- Resume writing
- Understanding the job market (local, NSW, interstate, overseas)
- Interview skills training
- Networking techniques
- Small business program
- Retirement planning.

(d) any relevant information on the impact of the closure of Australian refineries, including on downstream activities.

2.d.1 Key points

- There may be some impacts on downstream companies using Caltex feedstocks but it is up to those companies to provide this advice.
- Caltex met with local community groups and residents through the refinery review. Caltex has also committed to ensuring the Kurnell community is fully informed and engaged throughout the closure and conversion process.
- There will be some impact on other businesses from the Kurnell refinery closure, including large and small contractors, suppliers and customers.

2.d.2 Community consultation

Caltex has been meeting with local community groups and residents through the refinery review and continues to meet regularly with neighbours to provide updates about current operations and the conversion. Caltex has committed to ensuring the Kurnell community is fully informed and engaged throughout the process, and to date has held community meetings and distributed newsletters.

One element of this engagement is the development of the Environmental Impact Statements for the Development Applications for the marine and land-based works. The approval process including environmental assessments and public exhibition for comment is within the jurisdiction of the NSW Department of Planning & Infrastructure, and Caltex is working closely with the government and interested parties.

2.d.3 Impact on other businesses

The known impact on businesses upstream and downstream once Caltex refining ceases at Kurnell includes:

- Lyondell Basell will be impacted and Caltex understands that they may close, but the decision is for Lyondell Basell, not Caltex, and the timing is unclear.
- We anticipate that HCE may also close, which is a much smaller operation.
- Site contractors (PSN etc.) will also be no longer required (at least in the same numbers).
- There will be a material reduction in capital investment post-closure (although not all work currently takes place at the Kurnell site), while major plant turnarounds will also cease. Capital works utilise a range of skills such as engineers, designers, tradespeople, fabrication shops, etc. Turnarounds generally utilise a short term transient workforce.
- There is also a wider impact on smaller businesses as both suppliers and customers. There are about 470 suppliers to the Kurnell refinery. In the three months March to May 2012, the total value of spend on suppliers was about $50 million (excluding crude oil). Of this total, about a half was paid to NSW suppliers and about one quarter to Victorian suppliers; about $3 million was for suppliers from the Sutherland Shire. Payments under $100,000 were made to about 400 of the suppliers but we do not have information currently on how many of these were small businesses.

TOR 3. Identify any potential issues for Australia's energy security from possible further closures of oil refinery capacity, noting the findings of the National Energy Security Assessment (December 2011).

3.1 Key points

- Over 80 per cent of our crude oil and other refinery feedstock is already imported. To suggest that recent refinery closures imperils our energy security is to miss the point that most of the crude oil previously refined in the domestic market already comes from overseas.
- Caltex agrees with the findings of the 2012 Energy White Paper about structural changes occurring in Australia's liquid fuel supply market. Australia will become more reliant on imports of crude oil and refined petroleum product over time. However, as outlined in the paper, this trend does not reduce our liquid fuel security.
- Caltex analysis undertaken as part of its refinery review supports the view that adequate petroleum products are available in the region in the event of Australian refinery closures

3.2 Refinery restructuring will not affect liquid fuel security

Caltex agrees with the points made by Minister for Resources, Energy and Tourism on 8 November 2012 when launching the Energy White Paper. An extract from the minister's speech follows:

> *Our refining industry is re-structuring, faced with economic pressure from new Asian mega-refineries. The announced closure of the Clyde and Kurnell refineries will see domestic refining capacity decline by about 28 per cent in 2014 from 2012 levels. From that time Australian refineries will supply only around half of our refined fuel needs.*
>
> *But it is important to recognise that over 80 per cent of our crude oil and other refinery feedstock is already imported … To suggest that recent refinery closures imperils our energy security is to miss the point that most of the crude oil previously refined in the domestic market already comes from overseas.*
>
> *Domestic oil production is expected to further decline over the next decade in the absence of new discoveries. This decline, coupled with continued growth in demand for fuel, means Australia will have a growing reliance on imports of crude oil and refined product. And regardless of our refinery capacity, Australia will continue to pay world market prices for oil.*

Our ongoing liquid fuel security will be supported through the introduction of equivalent importing capacity from well-established international supply chains and ready access to regional fuel supplies."

3.3 Energy security – Energy White Paper

Caltex agrees with the findings of the 2012 Energy White Paper about structural changes occurring in Australia's liquid fuel supply market. Australia will become more reliant on imports of crude oil and refined petroleum product over time. However, as outlined in the paper, this trend does not reduce our liquid fuel security. Caltex agrees that the cornerstone of the government's energy policy framework should be the delivery of Australia's energy needs through competitive and well-regulated markets that are operating in the long-term interests of consumers and the nation.

> *Australia's refining industry is undergoing structural change in response to strong competitive pressure from larger and newer Asian refineries, which continue to lower the break-even benchmark that its refineries compete against. The domestic pressure of high local costs, coupled with a high exchange rate, is expected to keep Australian refineries under pressure for some time.*
>
> *Structural change in this highly capital and infrastructure-linked industry tends to follow a very orderly transition over a long timeframe, so that the market can respond accordingly to ensure that supply security is maintained and supplier market shares are preserved. In order to continue to meet market demand, refinery closures are very unlikely to occur until alternative supply capacity has been secured. This is the case with the recent announcements by Shell and Caltex. (Energy White Paper, Page 125)*

Asia is increasingly becoming the global refining and trade centre, with significant refining and storage capacity, highly complex and export-oriented refinery operations, and proximity to major trade routes. Significant net additions to Asia–Pacific export refining capacity are forecast to come online, including more refined fuels from India that meet Australian standards. This will maintain a surplus in regional refining capacity through to 2020.

A domestic refining presence provides Australia with a limited ability to process domestically produced crude in-country, and a degree of supply flexibility and reliability. While there is the prospect of some further reduction in Australia's refining capacity, the underlying competitiveness of most Australian operations, along with the strategic advantages that some in-country refining presence offers, suggests that the prospect of a severely reduced or no refining capacity in Australia over the next decade is very remote.

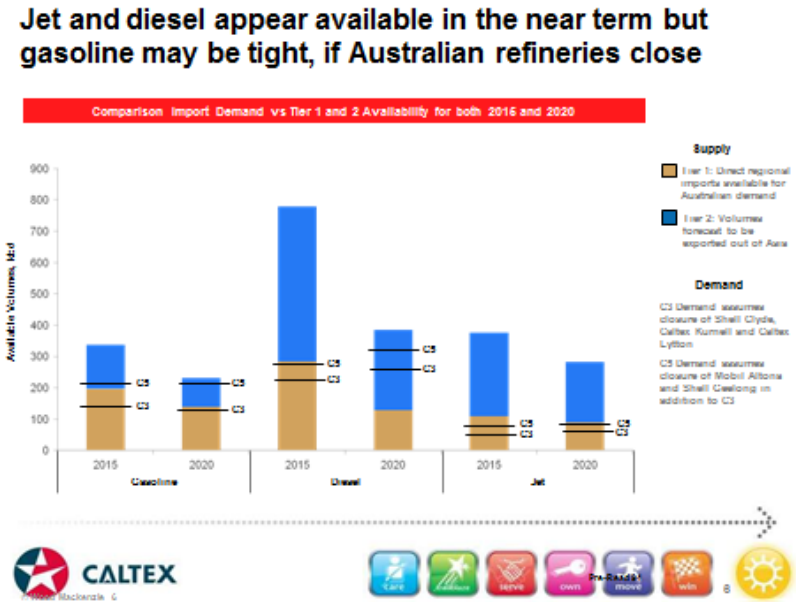
However, the extent to which a domestic refining presence is considered critical from a security perspective must also be considered in conjunction with the cost of maintaining such capacity, supply flexibility, and the security benefits of global trade. Global trade provides energy security through the diversity of source countries, multiple import points and ample terminal infrastructure at major demand centres. (Energy White Paper, Page 126)

Caltex supports the conclusion of the 2012 Energy White Paper that the rationalisation of Australia's refining industry does not reduce our liquid fuel security, as discussed above. The company also undertook extensive analysis (through consultants Wood Mackenzie) while determining the outcome of its refinery review and concluded that there was adequate regional supply of liquid fuels, and a sophisticated supply chain, to ensure ongoing supply to service Australia's market.

3.4 Caltex analysis of petroleum product supply and demand

The following chart summarises the Wood Mackenzie work. Two demand scenarios are shown labelled C3 (three refinery closures) and C5 (five refinery closures). The specific scenarios are described on the charts but are generic – they could represent any three or five Australian refinery closures within the order of accuracy of the study.

The supply scenarios for 2015 and 2020 for petrol, diesel and jet fuel are shown by the brown and blue bars. The brown bar represents currently available supply; the blue bar represents supply currently leaving the region because that could be diverted back into regional supply. The charts show there is ample supply available in 2015 of petrol, diesel and jet fuel. Supply in 2020 appears to be more limited relative to demand for petrol and diesel, although sufficient. However, this is misleading as the analysis assumes only currently announced refinery projects; new refineries will almost certainly be announced to cover the 2020 timeframe, resulting in greater net supply than shown.



4. Consider the implication of refinery closures on the associated workforce, including age profile, alternative employment opportunities and labour force mobility

4.1 Key points

- The total number of workers affected by the closure of the Kurnell refinery is about 700 – approximately 430 Caltex employees and about 300 contractors. Less than 100 workers will be employed at the terminal once closure of the Kurnell refinery is completed in the second half of 2014. There are about 700 employees and contractors at the Lytton refinery
- An extensive program is being implemented to support .affected workers in relation to redundancy, redeployment and retraining options.

4.2 Transitional support for Kurnell refining employees

Redundancy benefits

A generous redundancy formula applies for all Refining employees in Caltex, with a maximum payout for those with 22+ years of service, which is 40% of the impacted population. A minimum redundancy benefit will apply to all impacted employees, regardless of their tenure.

Vocational training allowance

All current Kurnell Refining employees will be offered up to $8,000 to spend on a training and development activity of their choice in any vocational capacity. Reasonable time off will be provided to facilitate attendance. Payments will be made by reimbursement upon successful completion.

Outplacement support services

A highly regarded professional outplacement services organisation will provide assistance and guidance in resume preparation, job search and interview skills development.

Access will also be provided to independent financial, taxation and superannuation advice, advice on establishing a self- employed enterprise, and /or guidance concerning retirement.

Those aged 45 or above will be eligible for an enhanced level of coverage to these services.

Health and well being

Various health and well- being programs and services will be provided including Employee Assistance Program counselling services for employees and their family members.

Industry retraining

There will be a two year period of ongoing operation of the refinery before closure and conversion to a terminal. This provides those employees who are not retiring a two year window in which to prepare for their next role, perhaps in another industry in their local area, or via relocation to more active employment industries and regions, such as upstream oil and gas operations in Western Australia or Queensland.

Caltex will seek to assist Kurnell Refinery employees to undertake structured training by registered training organisations to equip and certify those employees to make transition to future career roles in higher demand industries.

Caltex will invite local and interstate companies to participate in ‘career fairs’ hosted onsite for Kurnell employees.

Continuity of death and disability insurance

Retrenched employees who are members of the CalSuper (superannuation) plan will have an option to maintain death and disability insurance at a reduced rate without additional medical review.