

## CHAPTER 2

### FRANCHISE AGREEMENTS AND TIED SUPPLY

#### Premise of the Bill

2.1 The current bill is based on the premise that ‘giving service station operators the opportunity to shop around for their fuel’<sup>1</sup> will reduce fuel prices, particularly in country areas. The bill presumes that current franchise arrangements which prevent franchisee service station operators from being able to ‘shop around’ are effectively denying cheap fuel to consumers.

2.2 The economics of fuel retailing is discussed in the next Chapter. This Chapter deals with the nature of franchise arrangements.

#### Structure of the industry

2.3 The structure of the petroleum industry in Australia has facilitated the development of current franchising arrangements. The industry is currently composed of the four oil refiner marketers - BP, Caltex, Mobil and Shell, a number of independent suppliers and about 8,200 service stations across Australia.

2.4 Mr Starkey of the Australian Institute of Petroleum (AIP), however, noted that the four refiner marketers own or lease less than 3,000 service station sites. Of these, about 2,500 are franchised and just over 300 are commission agency sites. Even allowing for some sites franchised by distributors with equity ties to the refiner marketers, about 3,000 sites are tied to the four refiner marketers. This is less than 40 per cent of the total number of service station sites.<sup>2</sup>

2.5 Owners of other service station sites have a much greater variety of choice in sourcing their fuel supplies on the basis that they want. They can have exclusive supply on a branded basis or they can source from a number of local sources on a non-branded basis or from imports. The franchise agreements that the bill seeks to regulate are not therefore relevant to many service station outlets.

2.6 The impact of the bill therefore will be confined to franchisees of the refiner-marketers. Other fuel marketers such as the independent chains and the supermarkets will not be affected.<sup>3</sup>

2.7 In the table below are figures supplied by the Australian Institute of Petroleum and the Motor Trades Association of Australia providing a breakdown of the types of

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1 First Reading Speech, House of Representatives Hansard, 30 August 1999, p. 9333.

2 Evidence, p. E200.

3 Submission No. 41, AIP, p. 8.

service stations. While reaching the same total, there was some difference in the break-up of the figures provided by the two organisations.

Type of Service Station	Number - AIP*	Number - MTAA*
Refiner-marketer owned / headleased		
Commission Agency	316	412
Franchise	2497	2497
Dealer-owned, supply contracted to refiner-marketer	936	936
Dealer-owned, or distributor owned, supplied by distributor		
Distributor or refiner-marketer	3920	3824
Independent distributor		
Independent Chains		
Eg, Gull, Liberty, etc.	479	479
Supermarkets	85	85
<b>TOTAL</b>	<b>8233</b>	<b>8233</b>

\*As at end of 1998. See AIP Submission No. 41, Attachment 1 and Correspondence from MTAA to the Committee dated 14 March 2000.

### Franchise Agreements

2.8 According to the *Petroleum Retail Marketing Franchise Act 1980*,<sup>4</sup> a franchise agreement is any agreement between entities, which are not related to each other in a corporate manner, that requires the franchisee to:

- use the identifying corporate symbols of the franchisor,
- use premises identified in the franchisee agreement for retailing motor fuel,
- sell motor fuel supplied by the franchisor, or
- sell motor fuel, with the agreement of the franchisor, of “another person (whether a party to the agreement or not)”.<sup>5</sup>

2.9 The term ‘tied supply’ is often used almost as a synonym for a franchise agreement, even though in reality tied supply is only one feature of franchise agreements and, indeed, can occur outside the context of franchise agreements. Tied supply is strictly speaking the situation where the franchisor (usually an oil company) has exclusive rights to supply fuel to a franchisee (a petrol retailer). In such arrangements the franchisee is indeed tied to the franchisor, yet clearly the Petroleum

4 *Petroleum Retail Marketing Franchise Act 1980* (Cwth), section 3.

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Retail Marketing Franchise Act provides for franchise agreements which do not tie franchisees to franchisors.

2.10 In reality, although the Petroleum Retail Marketing Franchise Act allows a franchisee, with the relevant franchisor's agreement, to source fuel from parties which are not even party to the franchise agreement, franchisors invariably draw up agreements requiring franchisors to source 100 per cent of their fuel from a single franchisor. The current commonly existing franchise arrangements are thus not entirely in keeping with the intent of the 1980 Petroleum Retail Marketing Franchise Act. The current bill seeks to redress this problem by introducing into franchise agreements the variety that was allowed for in the 1980 Act.

2.11 The current bill does not simply state that the definition of a franchise agreement is the same as that definition contained in the Petroleum Retail Marketing Franchise Act. Instead the current bill defines a franchise agreement as being an agreement where a franchisee:

- sells fuel under a plan devised by the franchisor, and
- uses the franchisor's identifying corporate symbols, and
- pays the franchisor fees, such as capital investment fees.<sup>6</sup>

2.12 Unless a franchise agreement contains all three of the above requirements, it is not a franchise agreement for the purposes of the current bill.

2.13 The definition of franchise agreement in the current bill is relatively narrow when compared with its 1980 predecessor. For example, an agreement allowing a franchisee to use the corporate logo of an oil major would be an agreement that would meet the definition of a franchise agreement in the 1980 Act. The same agreement would not be subject to the provisions of the current bill unless the agreement also required the franchisee to operate under a plan devised by the franchisor and pay fees to the franchisor. Thus the 1980 Act applies to branded independents, but the current bill would not.

2.14 The logical explanation for the current bill not simply adopting the definition of franchise agreement contained in the *Petroleum Retail Marketing Franchise Act 1980* is that the franchise agreements the current bill seeks to cover are not identical with, in fact only a subset of, the agreements covered by the 1980 Act.

2.15 Seemingly the current bill is aimed only at what are apparently regarded as restrictive franchise agreements. These agreements would be those which require franchisees to source 100 per cent of their fuel from their relevant franchisors. Essentially such agreements are those which are colloquially referred to a 'tied supply' arrangements.

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6 Fair Prices and Better Access for all (Petroleum) Bill 1999, section 4.

## **Nature of current franchise arrangements**

2.16 Current petroleum franchise agreements habitually exhibit the hallmarks of tied supply arrangements. Such agreements inhibit competition at the wholesale level of the industry by preventing franchisees from shopping around for a better deal if they are dissatisfied with the wholesale price the franchisor charges. This prohibition on alternative supply allows franchisors (the oil companies) to dictate terms of supply, constrained only by the provisions of the Trade Practices Act.

2.17 Supporters of the bill argue that partially breaking tied supply requirements, permitting franchisees to source up to 50 per cent of their fuel supplies from other than their franchisor, would stimulate competition. Theoretically, the companies would have to compete to supply franchisees and would be obliged to offer fuel on more competitive terms if they wished to retain the franchisee's custom for all fuel purchased. The Motor Traders Association of Australia (MTAA) argued that it expected that the benefits of competitive wholesale prices would be passed on to the consumer at the pump.<sup>7</sup>

2.18 The MTAA considers that 100 per cent tied supply is 'inequitable' as it prevents resellers from negotiating for cheaper fuel supplies and undermines their competitive position in the market.<sup>8</sup> Professor Fels of the ACCC concurred, stating that such ties 'are an impediment to competition'.<sup>9</sup>

2.19 The major oil companies and the AIP pointed out that in the majority of franchise arrangements, the franchisee purchases the right to operate the site and sell a specific fuel brand but the company retains ownership of the site, pumps, tanks and other infrastructure. The companies maintain that legislating to give franchisees the right to seek half their fuel from other sources amounts to an expropriation of property rights.

2.20 The property rights issue was significant in this inquiry and it, together with other legal issues centring on fuel quality guarantees, branding and product differentiation, are dealt with in Chapter 5.

## **Impact of the Bill on Franchise Agreements**

2.21 The AIP and the companies predicted that the bill would not achieve its objectives and would lead to wholesale changes within the industry, to the disadvantage of franchisees. The companies maintained that passage of the bill would result in the end of franchising, with a loss of opportunities<sup>10</sup> for small business participation in the industry.

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7 Submission No 30, MTAA, pp. 42-43.

8 Evidence p. E2.

9 Evidence, p. E174.

10 Submission No. 38, BP, p. 6.

2.22 The MTAA expressed the view that the provisions of the bill would not lead to many of their members actually using the provisions to source fuel from alternate suppliers. Rather, the Association considered that the legislation would provide franchisees with leverage in their negotiations over price with the companies.

2.23 The MTAA told the Committee that regardless, the introduction of the 50 per cent provisions would have significant effects on the petrol market:

While franchisees may not choose to secure fuel from alternative sources, the legal right to do so at any time of their choosing (subject to giving notice to their franchisor) will mean that they are in a position to negotiate competitive wholesale prices with both these alternate suppliers and their franchisors.<sup>11</sup>

2.24 The Service Station Association, while sympathetic to the aim of the bill and generally sharing the MTAA view, was less enthusiastic than the MTAA, casting doubt on its efficacy. In its submission the SSA expressed concern that individual franchisees may lack sufficient buying power to obtain competitive prices from alternative sources. They also considered that the possibility of contamination of fuel by using alternative supplies posed risks. Most importantly, they did not think that many of their members would take up the rights the bill would give because of a fear that the companies would withdraw price support on which they depended.<sup>12</sup>

2.25 Professor Fels expressed a similar view of the impact of the bill. He suggested that the partial breaking of tied supply arrangements could enable other refiner marketers and independent wholesalers access, thereby increasing the intensity of competition in the wholesale fuel market. But he considered that it may have only a limited impact on the level of competition in the wholesale fuel market as branded franchisees 'account for only around 30 percent of all retail service stations sites'.<sup>13</sup>

2.26 Not only will many service stations not be affected by the provisions of the current bill but some areas will also not be affected for the simple reason that the distribution of service stations with franchise agreements that would be covered under the bill are not evenly distributed.

2.27 According to information supplied to the Committee by the Australian Institute of Petroleum (AIP), franchisees operate an estimated 2,700 of the 8,233 sites in Australia at the end of 1998 and the bulk of these franchised sites are in metropolitan areas.<sup>14</sup>

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11 Submission No. 30, MTAA, p. 42-3.

12 Submission No. 34, SSA, pp. 1-2.

13 Evidence, p. E194.

14 Submission No. 41, AIP, p. 6.

2.28 Some service stations in country areas are controlled by the oil majors through arrangements that are not categorised as franchisees, but the number of such service stations is small. Mobil told the Committee that of the 5,400 petrol resellers in country Australia, Mobil distributors owned and controlled 227 sites through commission agencies or distributor operations, a mere 4 per cent of the total.<sup>15</sup>

2.29 Similarly, Mr Topham of Caltex indicated that Caltex has only 80 company owned franchise sites in country Australia out of a total of about 800 Caltex franchised sites.<sup>16</sup> In its submission Shell noted that ‘most of the country outlets supplied by Shell are not owned by Shell’.<sup>17</sup>

2.30 Independent and supermarket chains generally are agency operation or directly operated by company staff. The bill will have no impact on these service stations as, in the main, the operator either is the fuel supplier or does not purchase the fuel retailed at the site.

2.31 The bulk of country petrol stations are operated either under distributor arrangements or by owner operators. The bill would not extend to sites supplied by distributors although it may apply in the relatively small number of cases where dealers are franchised by a distributor. The bill will therefore have limited impact in non-metropolitan areas.

### **Recommendation**

**The scope of the bill could be expanded by changing the bill’s definition of a franchise agreement. The Committee recommends that the bill’s proponent give consideration to this matter, possibly amending the current bill so that it simply adopts the definition of a franchise agreement that is contained in the *Petroleum Retail Marketing Franchise Act 1980*.**

2.32 A further barrier to competition in country areas, raised by several witnesses, related to the entry of independents into country markets. This is discussed in more detail in the following Chapter.

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15 Submission No. 10A, Mobil, pp. 2-3.

16 Evidence p. E135.

17 Submission No. 45, Shell, p.15.