CHAPTER 4

COMPETITION AND PETROL PRICES

Price effects of franchising

4.1 The ability of consumers to obtain petrol at competitive prices is linked directly to the wholesale price of fuel set by refiner/marketers and the control those refiner/marketers have over the market. If refiner/marketers control the pricing policies of a large number of service stations, and if they persistently charge high wholesale prices, then the ability of service station operators to compete against one another and offer cheap fuel to consumers is severely curtailed.

4.2 The author of the bill, Mr Fitzgibbon MP, argued that permitting franchisees to source up to 50 per cent of their fuel supplies from other than their franchisor would stimulate competition.[1] The rationale for this claim was that the major oil companies would have to compete to supply their franchisees and would be obliged to offer fuel on more competitive terms if they wished to retain their franchisees' custom for all fuel purchased.

4.3 The Motor Traders Association of Australia (MTAA) supported that view. The MTAA told the Committee that resellers tied 100 per cent to their supplier had to accept fuel at prices, and on payment terms, dictated by their franchisor oil company while in some cases knowing that their franchisor was supplying cheaper fuel to an independent competitor 'across the road'.[2] Franchisees, unable to negotiate in relation to the wholesale price, essentially are having their competitive position 'undermined by their business partner, their franchisor, selling fuel more cheaply to their competitors'.[3]

4.4 The MTAA submitted that it expected that if there were competition in wholesale pricing then the benefits of that competition would be passed on to consumers at the bowser.[4] Mr Michael Delaney, the MTAA's Executive Director, said that the inability of franchisees and other tied sellers to purchase competitively priced fuel was 'one of the most frustrating and bewildering aspects of petroleum retailing'. He saw the situation as 'totally inequitable' and expressed the view that until resellers could legally seek competitively priced fuel, the MTAA would remain concerned about the lack of competition in the wholesale market.[5]

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

2 Evidence, p. E2.

3 Evidence, p. E2.

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

5 Evidence, p. E2.

4.5 Mr Robert Harris, Chairman, Australian Service Station and Convenience Stores, gave evidence that some service stations were dependent on price support. Mr Harris said

> ... for the last three years … I have been purchasing my fuel for more than I retail it for, so my wholesale purchase price is 100 per cent of the time dearer than I am retailing it for. Therefore, I have to rely on price support to retail my fuel.[6]

4.6 Mr Harris questioned why this happened, concluding that because he was forced to rely on price support for extended periods, the companies used price support to control retail prices:

> If that happened once a month or six or seven times a year you would understand it, but 100 per cent of the time, to have the wholesale price higher than the retail price, it is there for a reason. It is there for control.[7]

4.7 The wholesale price of petrol, in relation to service stations such as that operated by Mr Harris, is always higher than the retail price. From an economic point of view this does not make sense.

4.8 There are two possible interpretations of price support. The first is that it is a genuine strategy to help franchisees survive in a very competitive market. The opposing view is that price support is a market control mechanism that allows franchisees to survive, despite being charged uncompetitive wholesale prices by their franchisors, and simultaneously gives the oil majors significant leverage over their franchisees to comply with the majors' directives on, for example, retail prices.

4.9 It is not possible to state conclusively that the oil majors are using the combination of high wholesale prices and price support to influence retail prices, but certainly the potential exists for the oil majors to do this.

4.10 It is the view of many within the industry, including the MTAA and Mr Harris of the SSA, that price support is used as a de facto retail price control mechanism. The recently tabled report of the WA Committee stated that price support 'schemes allow oil companies to manipulate prices at franchised sites'.[8]

4.11 Mr Harris himself stated that because of the price support system

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6 Evidence, p. E4.

7 Evidence, p. E4.

8 *Getting a Fair Deal for Western Australian Motorists*, Report of the Select Committee on Pricing of Petroleum Products, Western Australia Legislative Assembly, Perth, 2 October 2000.

> I do not call the shots. I am an independent businessperson but, when it comes to the retailing of my fuel, I am effectively under the control of the oil company regarding the price that I sell it for …[9]

4.12 Mr Harris' situation is doubtless not unique. If, as appears to be the case, the wholesale price of fuel is artificially inflated and refiner/marketers offer price support to service stations that follow their pricing dictates, then service stations must follow those dictates. Service stations which did not follow the dictates of the refiner/marketers would risk having price support withdrawn from them and therefore would face the hopeless task of trying to make a profit from fuel sold to them at the artificially high wholesale price. Their competitors who followed the dictates of the refiner/marketers would easily undercut their prices with the aid of price support. By the use of this strategy refiner/marketers have taken 'control'[10] of the retail pricing of fuel.

4.13 As Mr McKenzie of Shell said, the oil majors control the wholesale price. [11] By setting the wholesale price at an artificially high level the oil majors are, in theory, able to manipulate the retail price through selective price support. An artificially high wholesale price combined with price support provides the oil majors with the ability to heavily influence the retail price of petrol.

4.14 The Committee received other evidence confirming the statements of Mr Harris. The Motor Trade Association of Western Australian, for example, submitted that:

> … franchisees always pay the highest price for fuel and are then supported through complex price rebate/support systems. They rely totally on these handouts from the oil companies and are now being forced to exist on ever reducing margins[12].

ACCC concerns about tied supply arrangements

4.15 Professor Alan Fels, Chairman of the ACCC, reminded the Committee that the ACCC, and before it the Trade Practices Commission (TPC), has for some time regarded tied supply franchise agreements as impeding competition in the retailing of fuel. Indeed, the genesis of the Fitzgibbon Bill proposal appears to lie with a 1975 initiative of the TPC.

4.16 Professor Fels explained that in 1975, the TPC had rejected 100 per cent tied supply arrangements. The Commission had formulated the 50 percent rule as a compromise position, 'giving something to the landlord and allowing franchisees to act as independents for 50 per cent of their fuel purchases'. However, no retailer was

9 Evidence, p. E4.

10 Evidence, p. E4.

11 Evidence, p. E160.

12 Submission No. 37, MTAWA, p. 1.

able to exercise their rights because of 'the Laidley agreement, franchisees or lessees' fear of retaliation from the oil majors, the oil majors' ownership of storage tanks and pumps, and the cost of separating brands'.[13]

4.17 Professor Fels noted that the 50 per cent rule came under challenge in 1988 and on legal advice, the Commission decided against attempting to enforce the rule because of concerns about:

- difficulties regarding evidence in mounting a case sufficient to convince a court that these exclusive arrangements would substantially lessen competition; and,
- a risk of common law passing off proceedings, if the petrol supplied by the retailer was of a different brand to that shown on the bowser.

4.18 The oil majors resumed their practice of 100 per cent tied arrangements with their branded resellers in 1988.[14]

4.19 The ACCC's 1996 inquiry into the petrol industry again concluded that 100 per cent ties were an impediment to competition.[15] Professor Fels told the Committee that the ACCC 'remains of that view'[16] and that the Commission would be concerned about any development that severely retarded contestability of the wholesale and retail markets for petroleum products in Australia.[17]

4.20 Professor Fels told the Committee that the current bill 'certainly has some merits' in that it could encourage competition in the retailing of petrol. The bill, however, was not a panacea for all the ills of the petroleum industry.[18]

Perspective of the Australian Institute of Petroleum (AIP) and the oil majors on competition and prices

4.21 The AIP and the four oil companies presented the Committee with a quite different perspective to that put forward by the MTAA and other supporters of the bill. They argued that strong competition exists at the wholesale level of the industry and they defended their pricing policies for franchisees arguing that there are sound reasons why they insist on tied supply. The following section of this Chapter deals with these matters.

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13 Evidence, p. E194. The Laidley Agreement was an agreement drawn up in 1980 between the Transport Workers' Union (TWU) and the oil majors. The Agreement restricted access to oil terminals to tankers driven by members of the TWU (Peter McGauran MP, Minister for Science and Technology, Press Release, 11 December 1996). The Laidley Agreement is no longer operative.

14 Submission No. 52, ACCC, p. 2.

15 Evidence, p. E174 and Submission No. 52, ACCC, p. 2.

16 Evidence, p. E174.

17 ACCC responses to questions on notice, 28 April 2000, p. 5.

18 Evidence, p. E175.

Extent of wholesale competition

4.22 Mr Topham of Caltex told the Committee that the competition envisaged by the Fitzgibbon Bill already exists. He contended that:

> … the ability to obtain competitively priced supply is already in place and underpinned by both contracts and the Trade Practices Act, particularly in relation to the new unconscionable conduct provisions.[19]

4.23 The Australian Institute of Petroleum (AIP) rejected the view that there is a lack of competition at the wholesale level, contending instead that that there is a highly competitive wholesale and retail market:[20]

> This competition takes place between oil companies, between oil companies and importers, between refiner-marketers and independent marketers, between distributors, and between service stations. Petroleum product suppliers – refiner-marketers, independent suppliers, and distributors – compete vigorously to gain rights to supply owner-dealer service stations.[21]

4.24 The AIP advised that the companies were in competition not only with each other but against foreign refineries as well:

> Ultimately, the Australian refining marketing industry has to compete with product that is available for import in huge quantities from the South-East Asian market. There is absolutely no doubt they are under tremendous pressure. They compete vigorously for market share. If they don't, they lose business and the refineries will close. [22]

4.25 The AIP also supported its contention that competition within the industry is vigorous by drawing the Committee's attention to the low level of Australian petrol prices compared to those overseas. The AIP told the Committee that the International Energy Agency's quarterly analysis of petrol prices in OECD countries has consistently shown Australia's pre-tax prices to be amongst the lowest in the world, including those of the U.S.A.[23]

4.26 The AIP also drew the Committee's attention to the ACCC's findings of November 1999 following an investigation of the relationship between Australian petrol price movements in relation to changes in international oil prices. The ACCC found that:

- average capital cities' unleaded petrol prices increased about 1.8 cents per litre *less* than international prices;

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19 Evidence, p. E136.

20 Submission No. 41, AIP, pp. 8-9.

21 Submission No. 41, AIP, p. 9.

22 Evidence, p. E16.

23 Submission No. 41, AIP, p. 9.

- average country prices increased by 3.7 cents per litre *less* than the rise in international prices; and

- the city-country price differential had decreased by 1.9 cents per litre over the period. [24]

4.27 Like the AIP, Shell also submitted that the petroleum industry market is intensely competitive arguing that 'the characteristics of an uncompetitive market such as high prices, excessive profits, barriers to entry, and inefficiency, clearly are not present'.[25]

4.28 Representatives of Mobil Oil Australia told the Committee that the competition the oil majors face in the Australian market is in fact unfair. Mobil's retail sales manager, Mr Buchan, pointed out that the independents and new entrants like supermarkets were free of the regulatory restrictions placed on the established companies by the Sites Act and the Franchise Act. He said that this unfair competition had impacted severely on franchisees and companies alike:

> Mobil, for instance, owned or leased 649 sites at the end of 1997. Today we have 510. All 139 closed sites were operated by franchisees, and they are now gone. Whilst we are closing sites, independents and supermarkets are building them, either in their own company operations or in their own form of unregulated franchising. That tells you something about the total imbalance in the playing field—an imbalance that hurts franchisees as much as it does us.[26]

4.29 The Committee sought Professor Fel's opinion about the state of competition in the oil industry. He responded that in parts, particularly in the major capital cities, it is 'quite competitive'. He thought that the industry is less competitive in other parts of the country, particularly in rural areas, but he implied that a number of factors were at work in these areas:

> The industry is not so competitive in many rural parts of Australia. That is, of course, one of the key reasons for the high prices in rural areas. It is all mixed up with some other factors, such as the small volumes and so on, but it is also separately because of the lack of competition going right through. It is not just retailing, but that interacts with the distribution of petrol out in the bush, and then it goes back and affects refining competition to sell to distributors and so on. So everyone is kind of ganging up on rural areas.[27]

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24 Submission No. 41, AIP, p. 9.

25 Submission No. 45, Shell, p. 5.

26 Evidence, p. E145.

27 Evidence, p. E186.

Pricing practices and franchisees

4.30 The Australian Institute of Petroleum and the companies strongly defended their pricing practices in respect of franchisees. They freely admitted that the wholesale fuel list price for franchisees is higher than it is for independents, but argued that they charge the franchisees a fair price and that arguments to the contrary are based on misconceptions and misunderstandings.

4.31 BP's explanation of its pricing policy was typical of those given by the other companies. BP pointed out that when the company sells fuel to another company such as an independent, it does not have to meet any other costs and accordingly charges the independent less. However, when the company supplies fuel to a franchisee, it charges a higher price to reflect the company's investment in the site and brand.

4.32 BP stated that its investment in a service station can amount to several million dollars and it seeks to recover its investment mainly from its fuel margin, that is, the price it sells product to the franchisee. So effectively, when a franchisee purchases wholesale fuel, they pay for more than the base price refined product, they also pay for infrastructure, support advertising and a range of other services.

4.33 Several of the other companies submitted similar evidence. Caltex for example took issue with the basic premise of the bill, which the company identified as allowing franchisees to buy fuel as if they were independents. The company pointed out that there is a fundamental difference in the financial structure between independents and franchisees: independents own their own land, building and equipment, franchisees do not. The company argued that it does not receive sufficient revenue from non-fuel income and fuel royalties to cover capital and operating costs associated with franchised sites and therefore 'a substantial part of the return to Caltex…must be recovered from the wholesale price of fuel'. Caltex, in common with the AIP and other companies concluded that as a result, it is not reasonable for franchisees to purchase wholesale fuel as if they were independents.[28]

4.34 Representing Shell, Mr Ian McKenzie also drew a distinction between franchise operations and other varieties of operation. He told the Committee that in respect of franchisees, there is 'a much higher degree of interdependency'. Mr McKenzie's view was that franchisees receive a range of benefits from the relationship that the company does not extend to other outlets including 'price support, profit support, the premises for the franchisee to operate in, the Shellcard, marketing support …. Those things are not available to the owner-dealers or independent chains'.[29]

4.35 Several of the companies also went to some lengths to explain the nature of franchising from their perspective, emphasising that they see a franchise arrangement

28 Submission No.44, Caltex, p. 9.

29 Evidence, p. E166.

as a close partnership with the parent company, which is established for mutual benefit and quite different from any relationship with an independent reseller. They stressed that the price to franchisees could not be uncompetitive because it would not be in the company's interests for the franchisee to operate unprofitably. Mr Frank Topham of Caltex explained:

> We own and franchise many hundreds of sites and we have a great interest in ensuring that these sites make a fair return on our investment. There is a mutual interest with franchisees in the success of the franchise.[30]

4.36 Company representatives also disputed the assertion that price support was indicative of an uncompetitive price to franchisees. For example, Mr Topham of Caltex argued that the focus on the list price rather than the net wholesale price gave a misleading impression:

> The inquiry has heard far too much obfuscation on this issue of pricing. It has been told repeatedly that franchisees did not receive a competitive price. But when you delve further, witnesses almost always mean that the invoice price, which is the list price, is not competitive. This is beside the point. The price support system is there to provide a competitive wholesale price. The focus needs to be on the net wholesale price, not the invoice price.[31]

4.37 In their explanation of pricing arrangements for franchisees, the major oil companies advised that they recover a portion of their costs through the higher wholesale price charged. Without exclusive supply, this link could be broken and the companies could only be assured of recovering their costs through the fifty percent of sales that are guaranteed to them. This argument was summarised in the Caltex submission:

> A substantial part of the return to Caltex…must be obtained from the wholesale price of fuel…The Bill would fundamentally change this financial structure as Caltex would not be able to obtain any return on site investment or operating costs through the wholesale price for at least half the volume…[32]

Impact of the Bill on the industry

4.38 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. The MTAA told the Committee that, despite this, 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

30 Evidence, p. E136.

31 Evidence, p. E136.

32 Submission No. 44, Caltex, p. 9.

> to their franchisor) will mean that they are in a position to negotiate competitive wholesale prices with both these alternate suppliers and their franchisors. …
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> In order to secure the level of supply to franchised dealers that franchisors presently enjoy, it is an economic reality that the major companies will have to be prepared to negotiate, and not dictate, wholesale prices to their dealers.[33]

4.39 Mr Keith Pynt, President, Service Station Association (SSA), gave evidence that the bill should be enacted in an effort to 'allow the franchisees and the independents to have a competitive price' for fuel. Mr Pynt was, however, dubious as to the actual benefits of the bill because he believed that many franchisees would not take up the rights the bill offered them for fear that the oil companies would withdraw price support and so send them 'broke very quickly'.[34]

4.40 BP claimed that the bill if passed could result in higher petrol prices. They said that this was because the bill could provoke the withdrawal of one or more majors from the Australian market, resulting in less competition and consequently, higher prices to the consumer.[35]

4.41 Caltex representatives confirmed the view, common among the oil majors, that the bill would result in a poor outcome for franchisees. Caltex, like other oil majors, also stated that price support would end:

> The Bill will be bad for franchisees because it would force the end of franchising as we know it. There will be no more price support. Franchisees would be in a similar position to independents and their pricing risk would be greatly increased. Few franchisees would want this. In fact, we have heard considerable evidence that franchisees would like commission agency for fuel as an option, which reduces their pricing risk. A number of franchisees want to retain the status quo on pricing structures as well.[36]

4.42 Mr Ian McKenzie of Shell explained why Shell would not enter into any new franchise arrangements if the bill passed:

> … if the franchisee had the legal right, having entered into a 10-year franchise agreement which gave him access to all these benefits, then to say, 'Now I'm going to go and buy half my fuel from somewhere else,' we would be absolutely crazy to enter into such an agreement in the first place. We are simply not going to provide all these benefits when the only way we earn income from the franchise relationship is through a turnover based royalty and through a wholesale fuel margin. If the franchisee can then go

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

34 Evidence, p. E32.

35 Submission No. 38, BP, p. 7.

36 Evidence, p. E135.

> and take half his business elsewhere, we are simply not going to provide the sort of benefits we provide under a franchise package.[37]

4.43 Others indicated that franchise fees would rise if the bill passed and tied supply ceased, as the companies would seek to recoup their losses through increased fees. Mr Frilay of BP suggested that as such, the legislation could be self defeating for franchisees as the savings they might achieve would be offset by the increases.[38]

4.44 The Committee sought to quantify the amount by which site fees could be expected to rise. Mr Starkey, Executive Director of the AIP, informed the Committee that one oil company, which he declined to name, had already done some work on increasing fees and had calculated that its current profits would remain unchanged if, for example, it raised each service station site rent by about $88,000 per annum, an increase 'in excess of 70 or 80 per cent'.[39] If legislation for an access regime were enacted, then the sort of rises in service station rents foreshadowed by Mr Starkey could be limited. This matter is discussed further in the next Chapter.

4.45 The ACCC, although it indicated support for the principles behind the bill, was equivocal about its assessment of the bill's impact. Professor Fels told the Committee that the bill might only marginally improve the lot of franchisees:

> I think one of the effects of a fifty-fifty rule would be that it would put a little more pressure on the oil companies to give a good deal to their franchisees and then the franchisees would not all be running off to get supplies from other sources. I do not think a fifty-fifty rule is a miracle cure for the problems of the industry, but it would marginally change a few things. It would marginally put some pressure on the oil companies to look after franchisees better. It is conceivable there could be some marginal effects on investments. That is possible. It is also possible that it could, in a few instances, go the other way. They may feel that they have to invest a little more in some of these sites for the sake of their relationship with the franchisee.[40]

4.46 Professor Fels indicated that he considered the partial breaking of tied supply arrangements would increase competition in the wholesale petrol market, unlocking a proportion of the existing captured market share of the refiner marketers, making it contestable to other refiner marketers as well as to independent wholesalers. However, he cautioned that the effect might be limited because branded franchisees of the refiner marketers account for only around 30 per cent of all retail service station sites in Australia.[41]

37 Evidence, p. E166.

38 Evidence, p. E127.

39 Evidence, p. E203.

40 Evidence, p. E183.

41 Evidence, p. E194.

4.47 The Department of Industry Science and Resources (DISR) was also unenthusiastic about the bill's likely effects. DISR concluded that rather than guaranteeing the individual service station's future in a deregulated market, the bill might contribute to its demise.[42]

4.48 To illustrate this point, Mr Brugger of DISR suggested that the ability to shop around for petrol would make an individual site, franchised by an oil major, less attractive to its franchisor because there would be less guaranteed flow-through of the franchisor's product at that site. Mr Brugger suggested that if the oil majors believe that they will not be able to maintain the same level of turn-over under the arrangements introduced by the current bill then they will choose 'different business structures' that inhibit franchisees from shopping around for petroleum. It was therefore the view of DISR that 'the ability to shop around for petrol is likely to act as a disincentive to the oil companies to continue [current] business structures'.[43]

4.49 Mr Starkey indicated to the Committee that it was conceivable that one 'different business structure' that the oil majors might adopt would be one in which they sought to maintain their profit margins.[44] Currently the fees that an oil company charges its franchisees, plus the return its receives from selling fuel to the franchisees, together make up the receipts the oil company receives from service station sites. In the event that the bill reduced fuel prices then the oil majors could maintain their receipts by increasing the fees they charge their franchisees.

4.50 The massive service station site rent increases outlined by Mr Starkey[45] easily could have the effect of deterring franchisees from taking advantage of the provisions of the bill. In effect the major oil companies could thwart the intent of the bill.

4.51 Legal issues also may impede the bill and these are discussed in the next Chapter.

42 DISR, correspondence to Committee, 5 September 2000, Attachment A, p.2.

43 Evidence, pp. E266-267.

44 Evidence, p. E203.

45 Evidence, p. E203.