

CHAPTER 7

MULTI-SITE FRANCHISING AND THE SITES ACT

Terms of reference

7.1 Part (b) of the Committee's terms of reference requires it to consider the practice of multi-site franchising by oil companies and, in particular, whether this practice allows the companies to avoid restrictions placed on them by the *Petroleum Retail Marketing Sites Act 1980* (the Sites Act) and whether the Act should be strengthened.

7.2 This Chapter examines the Sites Act, the reasons for its enactment and whether these reasons are still valid. The Chapter then considers the issue of multi-site franchising, examining the factors that led to its introduction and whether multi-site operations are in keeping with the Act's objectives in relation to competition and the small business sector. The Chapter concludes with a discussion of the case for amending the Sites Act to limit the growth of multi-site franchising or strengthening the Act for some other purpose.

The Petroleum Retail Marketing Sites Act 1980

7.3 The Sites Act is one of two Acts¹ introduced to specifically regulate aspects of fuel retailing. The Act, enacted following a report by the Royal Commission on Petroleum, prohibits oil companies or related corporations from directly operating or controlling more than 5% of retail sites. The actual number of sites that may be directly operated is set by regulation.

7.4 The Act specifies tests to be used to determine if the principal company controls companies operating the sites. These tests are based on notions of corporate control similar to those under corporations law. They have regard to the control of the composition of boards of directors, voting rights, ownership of share capital, subsidiary relationships, powers over the appointment or removal of directors and receipt of payments in respect of sales.

7.5 Importantly, the existence of a franchise agreement relating to a particular site exempts the site from being considered as controlled by an oil company or related corporation.

7.6 As stated above, the Act was enacted following the release of the Royal Commission's report. That Commission made a number of findings about petrol prices and pricing practices, noting that 'motor spirit and other petroleum products are over-

1 The other being the *Petroleum Retail Marketing Franchise Act 1980*.

priced; both wholesale and retail margins are excessively high'.² However, when introducing the bill that became the Sites Act, the then Minister for Business and Consumer Affairs, Mr Garland, did not refer directly to petrol prices, but instead emphasised concerns about the continued viability of the small business sector and competition as the major reasons for the Act's introduction:

These bills...provide a means to assist the continuance of a viable, vigorous and competitive small business sector in the petroleum retail industry. They will lead to greater fairness and ensure that future rationalisation in the industry...will take place on a more equitable basis. At the same time, by encouraging diversity at the retail level, they will promote competition both in the long and short term.³

7.7 Minister Garland remarked on the noted 'increasing trend on the part of some oil companies to move away from marketing motor fuel through independent service station operators, in favour of direct selling'. The Minister told the House of Representatives that this trend had caused community concern about unfair competition and resulting long term anti-competitive effects resulting from vertical integration:

The Government believes that, in the particular and unique circumstances of this industry, the time has come to call a halt to vertical integration and to reduce it.⁴

7.8 One obvious method of limiting vertical integration, used in some United States jurisdictions, is to prohibit the oil majors from direct retailing, or "divorcement". The Government appears to have considered divorcement, but decided that this was not warranted. Instead, the Government decided that limiting each oil company's direct control to a maximum of 5 per cent of service station sites was a sufficient response.

7.9 The effectiveness of the Act as a method of limiting vertical integration, promoting competition and assisting small business has been questioned during this and previous inquiries. The advent of multi-site franchising in particular has been identified by opponents of the concept as one method by which the companies have allegedly increased vertical integration and circumvented the intent of the Act.⁵

7.10 However, the question arises as to whether the provisions of the Act are sufficient for it to meet its objectives and indeed whether those objectives are still relevant. Ultimately, if the Act can be shown to have been ineffective, or changes

2 House of Representatives, *Hansard* 16 Sept 1980 p.1309 (*The Marketing and Pricing of Petroleum Products in Australia*, Royal Commission on Petroleum, Fourth Report, 1976, p.2).

3 House of Representatives, *Hansard*, 9 September 1980, p. 1026-7.

4 House of Representatives, *Hansard*, 9 September 1980, p. 1025.

5 Numerous references. See for example Submission No. 30, MTAA, p. 46.

within the industry have made it less relevant to current circumstances, then decisions have to be made about the Act being retained and amended, or abandoned.

7.11 The Committee notes that the Government's position is that the Act should be abolished. However, the Committee was not required to consider this question and has restricted itself to evaluating the case for amendment.

7.12 In evidence and submissions, the MTAA argued strongly for the Sites Act to be retained and its scope extended to limit the influence of multi-site franchises. Mr Delaney of the MTAA told the Committee that in an unregulated market (ie if the Act were abolished, removing restrictions on direct company control), the companies would 'seek to secure total domination of the market'. The MTAA expressed the view that such a development would not be in the interests of either MTAA members or motorists.⁶ Mr Delaney maintained that the Sites Act, together with the *Petroleum Retail Marketing Franchise Act* 1980 (the Franchise Act) was put in place 'for the public interest' and that 'the public interest issues are still there and still very significant'.⁷

7.13 Equally, however, other submissions argued that there was no case for restricting multi-site franchising and that in fact, the Act should be abolished, as the Government proposed as part of its recent Oilcode initiative.

7.14 All supporters of multi-site franchising emphasised its operational advantages for companies, operators and consumers. They maintained that multi-site franchising does not constitute direct retailing by the oil companies and does not permit them to evade the Sites Act or exert undue influence over petrol prices. The Australian Institute of Petroleum (AIP) was strongly of the view that single and multi-site franchises should be subject to the same regulatory regime and that no change to current arrangements is warranted.

7.15 The AIP advised the Committee that all parts of the oil industry are currently experiencing 'unsustainable low profitability' and that the industry needs to restructure. It is a strong supporter of the Government's reform package, which included the mandatory Oilcode and abolition of the Sites and Franchise Acts. The AIP sees repeal of the Sites Act as an important part of this restructuring process:

The repeal of the Sites Act would have allowed the refiner-marketers to restructure their networks onto a viable and sustainable basis.⁸

7.16 The AIP is strongly of the view that the oil industry has changed substantially since the Sites Act was introduced, having undergone major structural change in all sectors - from refining through distribution, wholesaling and retailing - since that time.

6 Evidence, p. E2.

7 Evidence, p. E4.

8 Submission No.41, AIP, p. 19.

Multi-site franchising

7.17 Multi-site franchising is an extension of the single site franchise concept. Under this arrangement, a single operator or company controls the operations of several sites. In the case of the Shell Oil company, six multi-site franchisees now control the bulk of Shell's franchise network across the country.

7.18 Oil industry multi-site franchising had its origins in or about 1993. The Service Station Association (SSA) advised the Committee that Shell proposed the idea at a time when many small service station operators with low volume sites were encountering financial difficulties because of pressure on petrol margins.

7.19 Three of the four major oil companies either use or are establishing forms of multi-site franchising, although the model varies considerably between companies. BP Amoco has established 24 clusters covering 300 sites. Mobil operates a system known as Retail Area Franchise (RAF). Caltex does not use multi-site franchising because of the constraints placed on it by the ACCC when it merged with Ampol. Representatives from Caltex informed the Committee that it did not intend to go down that path.⁹

7.20 Shell has been a leading exponent of the practice and correspondingly, has attracted the most controversy in respect of its preference for this mode of operation. Across Australia, the company currently has six individual franchisees operating over 370 sites between them, as follows:

Franchise	Number of Sites	Number of Staff
Brumar VIC	59	400
Brumar SA	34	300
CARE Vic	54	500
Colchester NSW	59	720
Mistearl (Northshore) NSW	57	750
Novak WA	46	Not provided
Mistearl QLD	64	Not provided

7.21 Multi-site franchising is clearly Shell's preferred method of selling fuel. The company advised the Committee that it saw no future for single site franchisees in the longer term and that these would eventually all be absorbed within the multi-site network:

⁹ Hansard p E138. However, there is conflicting evidence from other sources on this point.

We have 185 single-site franchisees operating at the moment out of a franchise network of about 760. Most of those 10-year franchise agreements expire over the next two or three years. We would anticipate that, with the vast majority of those franchise agreements, we would not be entering into new single-site franchise agreements. The advantages of multi-site franchising are so compelling that we would think that, as those agreements expire, we would put them into a multi-site franchise arrangement.¹⁰

Rationale for multi-site franchising

7.22 The oil companies and the Australian Institute of Petroleum argue that they introduced multi-site franchising to improve efficiencies and reduce operational costs. According to AIP the advantages of multi-site franchising include:

- the ability to spread franchise skills resources better over the franchise network;
- cost-saving to the franchisor, through a decreased requirement for liaison activities, compared to working with a large number of individual franchisees;
- the ability for the franchisee to staff up specialists skills to service the multi-site franchise, thus improving the quality and competitiveness of the sites;
- the ability for the franchisee to fine tune a network. Sites in the multi-site franchise can be spread to meet particular local requirements, so that customer demands can be better serviced; and
- advantages for the franchisee in efficiency in administration costs, improved purchasing power and starting flexibility.¹¹

7.23 The Committee received evidence from a number of multi-site operators who also claimed a number of advantages for them and their staff from multi-site franchising. For example, Brumar Services listed the following:

- provision of training for staff in environmental and safety matters;
- provision of training in retailing methods;
- improved job security; and
- improved opportunities for career advancement.¹²

7.24 The oil majors claim that economic factors, particularly inadequate returns on investment, encouraged the adoption of the concept. BP advised the Committee that it was a relative latecomer to multi-site franchising and did not introduce it as a full scale concept until 1998. The company maintained that following its poor profit result

10 Evidence, p. E165.

11 Submission No.42, AIP, p. 16.

12 Submission No. 14, Brumar, p. 1-2.

of 1997 (\$2m from an asset base of \$500m) it had little choice but to seek efficiencies or leave the Australian market.

7.25 The company told the Committee that analysis showed its single site franchisees were unable to provide an efficient return because they lacked scale of operation and cost efficiencies compared to competitors.

7.26 All of the companies expressed support for the concept. Mobil for example advised the Committee that multi-site franchising evolved as 'a means to provide scale to the operator, reducing site costs and improving the overall performance of a group of sites'. Mobil said that it had developed its retail area franchising system in response to changing consumer needs, inadequate franchisee returns, inefficiencies in the industry and insufficient returns to the company.¹³

7.27 Other witnesses and submissions painted a different picture of multi-site franchising. The Motor Trades Association was strongly critical of multi-site franchising. They claimed that the concept is a contrivance on the part of the companies designed to 'circumvent the restrictions placed on them by the Sites Act in order to achieve their goal of greater control of the retail market and hence the retail price'.¹⁴ The Association claimed that multi-site franchising stifles competition at the expense of both the small business sector and the consumer. Opponents of multi-site franchising sought changes to the Sites Act to limit its growth and influence.

7.28 The MTAA argued strongly for amendments to the Sites Act in order to restrict multi-site franchising. The MTAA recommended that the Sites Act be amended to include multi-site franchises within the ambit of the Act. The Association also recommended that the Sites Act be amended 'so that any equity holding by the declared companies in any other company falls within the provision of the Sites Act relating to "related bodies corporate" and thus the operation of service stations operated by the related body corporate would be governed by the provisions of the Sites Act'.¹⁵

7.29 The Service Station Owners' Association (SSA) acknowledged that multi-site franchising has a number of operational advantages. However, the SSA also called for changes to the regulation of multi-site operations. Mr Hanlon, the CEO of the SSA, told the Committee that the view of his members was that they 'want to see that those multi-site franchising operations are at arms length from refiner-marketers'.¹⁶ The SSA also expressed concern about multi-site franchisees' market power and the consequent vulnerability of single site operators and independents:

13 Submission No. 10A, Mobil p. 5.

14 Submission No. 30, MTAA, p.14.

15 Submission No. 30, MTAA, p. 46.

16 Evidence, p. E24.

The major concern is that single site franchisees or independent dealers are vulnerable to extreme competition from multiple site operators having the ability to collectively vary the retail price at all their sites at will.¹⁷

7.30 The SSA advised the Committee that in its view, Shell's multi-site franchises in particular were now of a size 'never contemplated by the SSA and other Associations' and called for them to be limited in size 'in order for small operators of service stations, whether franchisees or independent of the major oil companies, to hold a competitive position in retailing'.¹⁸

7.31 The AIP and oil companies however oppose any restrictions on multi-site franchising. Mobil, for example, maintained that restricting multi-site franchising 'would do nothing to improve the industry, for any participants'. The company was of the view that restrictions would not address the fundamental issue that led to the development of multi-site franchising, namely the increasing unviability of single site operations. Mobil argued that restrictions would lead to the closure of some low volume sites with attendant employment losses:

Multi-site operation allows volume sites, which would be otherwise uneconomic, to continue trading as part of a larger business, based on spreading costs across a volume base. Without this sort of franchise, we would see many more small volume sites closing, with resulting job losses from the industry.¹⁹

7.32 In the following sections of the report, the Committee has considered multi-site franchising and how it relates to the Sites Act by examining the following key questions:

- the nature of the relationship between the oil companies and multi-site franchisees;
- the impact of multi-site franchising on competition;
- effects, if any, on prices; and
- effects of multi-site franchising on the small business sector.

7.33 The final issue that the Committee has considered is whether the Sites Act should be amended to restrict the operation of multi-site franchising. This is a complex issue, as the Committee had to consider whether any consumer or other public benefit would result, and if these amendments of themselves would be sufficient to make the Act function as intended by the Parliament.

17 Submission No. 34, SSA, executive summary.

18 Submission No. 34, SSA, p. 8.

19 Submission No. 10A, Mobil, p. 5.

Relationship between the oil companies and multi-site franchisees

7.34 As noted in paragraph 7.5, the existence of a franchise agreement in respect of a petrol retail site exempts the site from being considered as controlled by the parent oil company. Thus, multi-site franchises are not considered to be under oil company control.²⁰ However, both the rapid adoption of the concept by the oil companies and the apparent closeness of the relationship between franchisees and their franchisors have given rise to suspicions that they are effectively controlled by the companies and operate like commissioned agents.

7.35 The multi-site franchisees strenuously denied suggestions that they are controlled by the companies. The response of Mr Bruce Holland of Brumar was typical:

On the issue of Shell control, Shell does not, and will not in the future, whilst I own them, control the Brumar companies. I am not and never have been an employee of Shell. Shell has no equity or voting rights in my company. The relationship between my company and Shell is a franchise relationship. There are no blind trusts or other such vehicles.²¹

7.36 Mr Holland quoted from a letter from his banker, the ANZ group, which made clear the arms length nature of the relationship between Shell and his company:

We must emphasise that all ANZ lending to Brumar has been assessed for approval by the ANZ as a separate credit risk to Shell or related Shell companies. This is because Brumar is not owned by Shell or a Shell group company and has independent company directors (not Shell employees). Brumar's loans are guaranteed by the directors of that company.²²

7.37 While some of those who gave evidence questioned the nature of the financial relationship between Brumar (and, for that matter, other multi-site operators) and the franchising companies, the multi-site operators do not appear to infringe the legal requirements of the Sites Act. However, while the multi-site operators can demonstrate that they are not controlled by the companies to the extent that would infringe the control provisions of the Sites Act, the companies are nonetheless in a strong position to influence them, particularly in respect of the level at which they set petrol retail prices. For example, in Chapter 3, the Committee highlighted the use of price support as a means of influencing retail prices. The potential to exert influence through other means brings into question the efficacy of the control tests in the Sites Act.

7.38 The MTAA argues that the Sites Act control provisions are inadequate and that the companies can exert effective control while meeting the control tests specified

20 Unless they are operating some of their sites on a commissioned agency basis.

21 Evidence, p. E97.

22 Evidence, p. E97.

under the Act. The Association pointed out that for example, a company requires considerably less than 50 per cent equity in order to exert effective control over another company. The Association maintained that the controlling company's influence would be increased if the franchisee's operations were financially dependant upon that company:

This would particularly be the case if the company were reliant on the oil major's support to say guarantee bank loans or overdrafts, provide letters of comfort to creditors or in circumstances where the cash flow of a company may depend to some extent on the oil major - for example where significant amounts of price support are paid to the company by an oil major, or where the oil major extends credit terms for the wholesale purchase of fuel.²³

7.39 The Association advised the Committee that current Australian Accounting Standards set a more realistic standard for determining effective control. The Association drew the Committee's attention to AASB 1016 which lists factors which might contribute to the existence of significant influence:

- the investor's voting power in the investee;
- representation on the investee's board of directors or equivalent governing body;
- dependence on technical information;
- economic dependency, including material transactions between investor and investee;
- interchange of managerial personnel;
- participation in decisions on the distribution or retention of the investee's profits;
- participation, in other ways, in policy-making decisions of the investee.²⁴

7.40 The MTAA argued that if the Australian Accounting Standards were applied to other oil industry operators (including multi-site franchises, but also including distributor arrangements, which the MTAA also considers to be mechanisms for bypassing the Sites Act), they would be considered as controlled or significantly influenced by the companies. Accordingly, they would be treated in the same way as directly operated sites for the purposes of the Sites Act.

7.41 The Association concluded that the companies have successfully structured their arrangements to work around the Sites Act control provisions in order to ensure their outlets fall outside the ambit of the Act. They recommended amendments to the control provisions in order to restore 'the integrity of the Act'.²⁵

23 Submission No.30, MTAA, p.17.

24 See Accounting Standard AASB 1016 paragraph 9.1.6

25 Submission No.30, MTAA, p.17.

7.42 The MTAA's arguments about the weaknesses of the Sites Act are persuasive. The Committee notes that the Australian Competition and Consumer Commission (ACCC) also concluded that it was doubtful whether the Sites Act constrains the oil majors from greater involvement in the retail sector and that it has not been effective in preventing vertical integration:

It may be that there could be some transitional arrangements in relation to the repeal of the sites act; we have been a longstanding advocate for its eventual removal. We do not think it is particularly effective in reducing vertical integration by the oil majors, given that franchisees are tied 100 per cent, for product, to their franchisor.²⁶

7.43 The evidence of the Managing Director of Brumar, Mr Holland, was also noteworthy. Mr Holland affirmed the closeness of his relationship with his franchisor. He also went on to list a number of significant advantages that accrue to him as a result of this close relationship. These included:

- access to new products;
- access to Fly Buys scheme;
- access to Shellcard; and
- agreement by the franchisor to underpin profit to a minimum level.²⁷

7.44 Mr Holland's comments highlight the nature of the partnership that he enjoys with his franchisor, but they also serve to illustrate the nature of the economic dependence or interdependence that exists in the relationship. It is difficult to escape the conclusion that while multi-site operators may not be controlled by franchisors, they are certainly in a position to be strongly influenced. However, it is questionable if the situation is any different in respect of single site operators who may be similarly influenced.

7.45 The logical conclusion is that the oil companies are in a position to use multi-site franchising as a means of exerting significant influence in the retail petrol market. As such, the concept has provided a means for the companies to increase vertical integration. The effects of this increased vertical integration on competition are examined in the following section of the report.

The impact of multi-site franchising on competition

7.46 Potentially, competition can take place at a number of levels within the oil industry. At one level, the oil companies and other industry players such as the supermarkets and independents compete with each other for market share. At the next level, competition can theoretically occur between the individual service station

26 Evidence, p. E226.

27 See for example Evidence p. E97.

operators themselves, regardless of brand, if they are sufficiently independent of their franchising company and can access competitively priced wholesale fuel. The MTAA's view is that the latter is to be preferred:

Diversity at retail means having many small operators in the market; it does not mean a market that is dominated by an oligopoly (as are so many other sectors of the economy) comprising highly vertically integrated multinational oil companies.²⁸

....

A large number of small operators competing against each other for market share (that is volume throughput) will assist in ensuring that competition in the retail sector. Arrangements such as multi-site franchising (of whatever mode) lessen the extent to which small retailers will have influence and indeed involvement in the petroleum industry... Competition at the retail level cannot be assured if the majority of sites are controlled either overtly or covertly by the four refiners, who are also the wholesalers.²⁹

7.47 The MTAA argues that such competition was intended by the Parliament when the Sites Act was originally passed.

7.48 The MTAA has long voiced its opposition to the multi-site franchise concept, expressing concern that multi-site franchises are potentially anti-competitive. The MTAA maintains that the arrangement offers the companies a method of limiting competition:

A franchisee controlling perhaps 30 or more sites, which are geographically concentrated, is not going to compete with itself.³⁰

7.49 There is some evidence to suggest that multi-site franchising serves to limit competition between dealers trading under the same brand name, ensuring that it only occurs between brands. In support of this proposition, the MTAA quoted Mr Derek Black of Mistearl (Northshore), a Shell multi-site franchise:

The multiple site franchise is the current trend in the industry because of the efficiencies in costs and processes. You are not in competition with the same brand down the street, you're actually in partnership.³¹

7.50 However, while competition may be inter-brand only, this does not result in uniformity of pricing across all sites controlled by the multi-site operator. Rather, pricing decisions for each site will be made in accordance with local factors such as prices set by local competitors.

28 Submission No. 30, MTAA, p.14.

29 Submission No. 30, MTAA, p.16.

30 MTAA submission to 1996 ACCC Inquiry into the Petroleum Products Declaration.

31 Service Station Australia magazine, October/November 1999 edition, quoted in MTAA submission p26.

7.51 But would encouraging greater diversity of ownership by limiting the size of multi-site franchise operations or eliminating them necessarily produce greater competition? The arguments put forward by the SSA and the MTAA hinge on the assumption that having many small operators within a market improves competition. Indeed this is the basis for the MTAA's position.

7.52 Intuitively, the MTAA's argument appears reasonable. However, the behaviour of the retail petrol market suggests that the situation is more complex and that the problem of many small independent business operators will only result in improved competition in particular circumstances.

Competition and diversity

7.53 Fundamentally, the primary motivation of all participants in an industry is to maximise profits. Petrol retailers' profits may be maximised by charging the highest margin the market will bear and/or increasing turnover.

7.54 Commonly, retailers sacrifice margins if they can significantly increase volume and this appears to be the prevailing strategy preferred by the oil companies. There are sound economic reasons for this. However, not all retailers conform. For example, Mr Ian Mackenzie of Shell provided the Committee with information about the margins charged by its dealers which showed that there are some franchisees who prefer to pursue the high margin-low turnover strategy:

You will see a small spike at the end of the metropolitan where there are a small number of franchisees in the Sydney market electing to adopt a high price, low volume strategy. From Shell's perspective, we would prefer that they not do that. Firstly, it is damaging to our brand and, secondly, most of our income is based on turnover. It is turnover based royalties and fuel margin. We would much prefer that they price more competitively in the market.³²

7.55 There is also evidence that where volumes cannot be significantly increased by reducing prices, service station operators have no option but to maintain the highest possible margin. The ACCC's discussion of country petrol prices in its 1996 report on the petroleum products declaration is relevant:

In many of the larger country centres, retailers tend to adopt a 'live and let live' strategy...avoiding price competition to drive rivals out and maintaining relatively high prices to cover the high costs of inefficient structures...There was evidence that in some rural towns and cities, high gross retail margins attracted entry and the consequent loss of average volume was reflected in even higher gross retail margins to maintain profitability of incumbents.³³

32 Evidence, p E160.

33 Correspondence from ACCC, 28 April 2000, answer extracted from Inquiry into the Petroleum Products Declaration, August 1996.

7.56 Other commentators have observed that some retailers in country areas exploit their market position and increase prices. For example the recently tabled inquiry into petrol prices in Western Australia observed that:

No adequate explanation has been given during this Committee's hearings for the significantly higher prices paid by motorists in many regional centres. Nor were apparently high margins in some regional areas satisfactorily explained. It is clear that the current pricing and marketing mechanisms have failed the country areas of the State. The only reasonable conclusion that can be drawn is that some industry participants in country WA are exploiting the limited degrees of competition.³⁴

7.57 There is nothing particularly surprising in this behaviour which represents a rational response to prevailing market conditions. Small business operators are driven by the same economic principles as large players. It would be economically naive to suggest that the presence of many players will guarantee competition or lower petrol prices. What is important is the presence of economic conditions conducive to competition: sufficient volume of sales to make active competition on price viable, and participants in the market who wish to increase their market share.

7.58 The companies and multi-site franchise operators maintain that there is strong competition within the market. If this is true, it suggests that the presence of small individual operators is not as essential to competition as some would suggest. Indeed, current thinking on vertical integration confirms this line of reasoning.

Vertical integration – anti competitive?

7.59 In correspondence to the Committee, the Department of Industry, Science and Resources drew the Committee's attention to a number of international studies that had considered the issue of vertical integration. These included a Green paper on vertical restraints in EU competition policy, released in January 1997; and a study of Vertical Restraints and Competition Policy for the UK Office of Fair Trading, released in December 1996. While neither paper can be considered as definitive, both point to a shift in economic thinking about whether vertical integration necessarily inhibits competition or is against the public interest.

7.60 According to the Department, the EU Green Paper noted that vertical restraints (agreements between producers and distributors) are no longer regarded prima facie as either suspicious or pro-competitive. Instead, economists rely on analysis of market structure rather than making generalised statements. The paper concluded that the fiercer the competition between brands, the more likely it is that beneficial effects of vertical integration (eg efficiencies of scale, integrated marketing) will outweigh any anti-competitive effects. DISR then noted that there appears to be strong inter-brand competition in the Australian petroleum market.

34 Select Committee on Pricing of Petroleum Products, *Getting a Fair Deal for Western Australian Motorists*, Report, 12 October 2000, pp. 49-50.

7.61 In the case of the UK study, the Department noted that the paper concluded that vertical integration did not appear to have adverse consequences for the public interest, largely because of strong inter brand competition. Again, DISR argued that the Australian market has similar characteristics.

7.62 Ironically, the MTAA also drew the EU Green paper to the Committee's attention. However, the MTAA's conclusions were quite different to those of the Department. The Association pointed out that the effects on competition and society of vertical restraints are not ignored by competition regulatory authorities in other countries. It drew the Committee's attention to Article 81(1) of the Treaty of Rome which prohibits agreements that restrict competition.

7.63 The MTAA described how in certain circumstances, (eg where efficiency gains outweigh disadvantages from the loss of competition) exemptions may be granted from this provision. However, such exemptions may be withdrawn in certain circumstances including where 'the supplier without any objectively valid reason... applies less favourable prices or conditions of sale to resellers bound by an exclusive purchasing obligation as compared with other resellers at the same level of distribution'. The regulation does not allow the supplier to impose any obligation on the reseller with respect to the resale price or special sales efforts.

7.64 The MTAA argued that there is in Australia 'no competition between the oil majors at the wholesale level and they presently engage in devices to reduce inter-brand competition'. The Association said that vertical arrangements included 'restrictive contracts, exclusive supply agreements and multi-site franchising arrangements', all of which are features of the Australian petrol market.³⁵

7.65 The point of the MTAA's argument appears to be that vertical integration is not ignored by overseas competition authorities who impose conditions on vertically integrated organisations and deem some practices unacceptable. The Association is apparently implying that some of the practices of vertically integrated oil companies in this country might well be restricted in other jurisdictions. While understanding the essence of the Association's argument, the Committee notes that the ACCC is well aware of this issue and vertical integration's potential for adversely affecting competition.

ACCC views on vertical integration and multi-site franchising

7.66 The ACCC takes a neutral view of vertical integration, looking for actual evidence of a lack of competition rather than relying on a doctrinal view that vertical integration is intrinsically anti-competitive.

7.67 Nonetheless, the ACCC acknowledges potential anti-competitive effects that could arise from wider adoption of multi-site franchising:

35 Submission No. 30, MTAA, p. 20

On multi-site franchising, we gave some consideration to that in our 1996 report. We saw some possible gains in efficiency but we had some reservations about the effects on competition, particularly in slightly smaller places. In a big capital city, we were less concerned. In a smaller place, if there was multi-site franchising and it ended up with just three or four people controlling an area because they each had quite a few multi-site franchises, we would be concerned if the whole industry adopted multi-site franchising.³⁶

7.68 While acknowledging the potential for anti-competitive effects in multi-site franchising, the ACCC noted that to date, '... no price effects have been observed from the effects of multi-site franchises'. The ACCC does not appear to regard multi-site franchising as a greater threat to competition than single site franchises, noting that the oil companies can exert considerable leverage over either form of franchising:

At present, though franchise agreements, the oil majors have extensive control over the operation of franchisees. It is difficult to identify any significant additional control which can be obtained through multi-site franchising.³⁷

7.69 The ACCC also notes that its concerns about the potential anti-competitive effects of multi-site franchising could be largely eliminated if two conditions were satisfied:

- the Commission's concerns about the horizontal arrangements between the oil majors could be overcome; and
- there was more effective competition from imports.

Impacts on prices

7.70 While the debate about multi-site franchising is characterised by claim and counter-claim about the impact of multi-site franchising on competition and consequently prices, it is very difficult to produce convincing evidence as to whether the practice produces any measurable effect on prices. Indeed, the Committee saw no convincing evidence either way during the inquiry.

7.71 The operators of the multi-site franchises argue that the effect of their presence is positive for the consumer, that is, the efficiencies they are able to achieve reduce prices. The multi-site franchise operators also dismiss suggestions that because they are able to set prices over a wide area, they are able to exert significant influence to increase prices. This is because of the presence of competitors in the market.

7.72 Mr Holland of Brumar claimed that the level of competition in the industry is intense. He made the point that his service stations are geographically dispersed and in

36 Evidence, p. E188.

37 ACCC, Inquiry into the Petroleum Products Declaration, August 1996, p.38.

competition with 'hundreds of other service stations' and that 'any operator that seeks to maintain prices significantly above those of competitors will go out backwards'.³⁸

7.73 While not disputing the logic of Mr Holland's argument, in the Committee's view, Mr Holland nonetheless understates the extent of his influence. The ability to dictate prices of all branded outlets for a particular company in a state, when combined with modern communication systems, undoubtably gives persons in his position a considerable degree of power. By controlling all outlets, he is also in a position to ensure that the only competition is between brands, rather than between individual outlets.

Effects on small business

7.74 As noted in paragraph 7.7 above, a major objective of the Sites Act (and the accompanying Franchise Act) was to allow the small business sector to compete more effectively in a market that was becoming increasingly dominated by large business interests.

7.75 One of the peak organisations that represents small businesses in the petrol retailing sector is the Service Station Owners' Association (SSA). The Association's evidence indicated that when multi-site franchising started, rather than being seen as a threat to small business, it was a welcome development allowing many who wished to leave the industry to do so. At the time, many smaller operators were trading unprofitably because of declining margins and low volumes.

7.76 The SSA told the Committee that in the case of the Shell network, the company made generous offers to single site operators that many were happy to accept.³⁹ The Association noted that the initiative was a 'reasonable response' to the unviable situation of many single site franchisees.

7.77 However, the SSA now holds reservations about the possible effects of very large multi-site franchise operations on other industry participants. In particular the Association expressed concern about the ability of small operators to compete against the very large multi-site franchise operators. Representatives told the Committee that the Shell multi-site franchise operations in particular had grown to a size that was 'never contemplated' by the SSA and expressed a 'preference' for a limit to be imposed on the size of multi-site franchises.⁴⁰

7.78 The Motor Trades Association of WA expressed its concern about multi-site franchising in much stronger terms. The Association sees multi-site franchises as

38 Submission No. 14, Brumar, p. 2.

39 See Submission No. 34, SSA, p. 6. This situation contrasts with some of the evidence received at public hearings which indicates a somewhat more aggressive approach in recent years in respect of some operators who were possibly more financially viable and who wished to continue as single site franchisees.

40 Submission No. 34, SSA, p. 8.

having a severely detrimental effect on single site franchisees and accordingly, on competition within the industry:

The major oil companies have effectively removed small business from the retail fuel market through multi-site franchising and other complicated expensive corporate structures that seek to circumvent their obligations to the Sites Act. In removing the main independent small business operators the oil companies have removed the competition created by many small business operators competing in a given area.⁴¹

7.79 Aside from the potential effects on competition of removing many single site franchisees from the industry, it became increasingly clear during the inquiry that the MTAA was also concerned about the effects on its members of the expansion of multi-site franchising.

7.80 Much of the early growth of multi-site franchising, particularly within the Shell network, was apparently facilitated by operators who wished to leave the industry. A further group, noting the company's determination to switch operations to multi-site franchising and recognising that they had no future once their leases expired, accepted inducements to terminate their agreements early. While many unprofitable operators were happy to leave the industry, many others, presumably those who had been trading profitably, are reluctant to relinquish their franchises and wish to stay in the industry. Mr Ron Bowden, a single site Shell franchisee, reflected this position:

Despite the injustices and inequities that have taken place, the Shell single site franchisees that remain have a tremendous will to stay in the business, to be part of the vital small business economy and to contribute to the future of this industry. We believe that we can bring a balance to competition and service that is comparable to any vertically integrated business model put forward, for we truly represent small, but efficient, business.⁴²

7.81 The companies have been unmoved by the views of their single site operators and generally, the industry trend is away from the single site model. Some of those who are being or have been forced out of the industry consider that they have not been treated fairly. However, it is clear that the companies are acting within the letter of the law in respect of the non-renewal of franchise agreements.

7.82 The Franchise Act determines the circumstances under which franchisors may decline to renew franchise contracts. Under the provisions of the Franchise Act, franchisees enjoy a considerable degree of protection. For the first nine years of a franchise agreement, the circumstances under which franchisors can decline to renew a franchise are relatively difficult to satisfy and represent a considerable obstacle to

41 Submission No. 37,MTAWA, p. 3.

42 Evidence, p .E52.

capricious action. However, after that period, there is no requirement under the Act for the franchisor to renew the franchise.

Conclusions on effects on small business

7.83 The conclusion that the expansion of multi-site franchising has largely been at the expense of single-site small business operators is inescapable. From that perspective, it is very clear that the Sites Act has failed in this regard.

7.84 However, the issue of whether this decline in small business participation in the industry has affected competition within the industry and resulted in higher prices is debateable. It is significant that the ACCC does not apparently regard multi-site franchising as being more subject to company influence than single site franchisees.

Other alleged evasions of the Sites Act

7.85 As required by the terms of reference, the Committee concentrated on multi-site franchising and how it operates in respect of the Sites Act. However, several witnesses also drew the Committee's attention to other methods allegedly used by the oil companies to evade the intent of the Sites Act and increase their influence over the retail petrol market.

7.86 Witnesses identified the companies' use of equity holdings in distributors and third party retailers as further methods of securing effective control over sites. The MTAA told the Committee that the Mobil oil company appears to have used this arrangement particularly successfully.

7.87 Evidence given to the Committee by the Tasmanian Automobile Chamber of Commerce and a number of Tasmanian ex-franchisees indicated that Mobil had pursued this strategy ruthlessly and at the expense of its former franchisees. The ex-franchisees told the Committee that Mobil had originally intended to expand multi-site franchising in Tasmania but later reneged on verbal agreements and insisted that the ex-franchisees accept commissioned agent arrangements.⁴³

7.88 The ex-franchisees alleged that the company had engaged in unethical and possibly unconscionable conduct in its dealings with its ex franchisees, several of whom now obviously bear the company considerable ill will. Allegations were made that the company had failed to declare the commissioned agency sites and had breached the Sites Act.

7.89 The MTAA advised the Committee that Mobil has now passed control over the disputed sites to its Tasmanian distributor, Norvac, effectively dispossessing the

43 See for example the evidence of Mr Martin Arnold, Mobil ex franchisee, Evidence, p. 236, Ms Ann Gregson, Mobil ex franchisee, Evidence, p. 242.

previous franchisees. As such, the sites no longer have to be declared under the Sites Act.⁴⁴

7.90 The Committee sought further information about this matter from the Department of Industry Science and Resources who advised that Mobil had not exceeded its quota but had breached the Act by filing incorrect returns.⁴⁵

7.91 In the Committee's view, Mobil appears to have pursued its strategy of transferring control to its distributor with little regard for the previous relationships established with franchisees. If the evidence presented by the ex-franchisees is accepted then Mobil's behaviour can only be described as ruthless and bordering on unethical. Nonetheless, apart from breaching its obligations to report accurately under the Sites Act, the company was apparently within its rights as determined under the Franchise Act in respect of its actions.

7.92 However, this is largely beside the point. What is relevant is that Mobil apparently wished to increase its commercial returns from its Tasmanian sites and to achieve this end, ultimately transferred its former franchise arrangements to a distributor arrangement in which it held substantial equity.

7.93 The Committee notes that a large proportion of service stations in Australia are operated under distributor arrangements and are therefore not within the scope of the Sites Act unless the oil company's equity in the distributor exceeds 50 per cent.

Conclusions and recommendations

7.94 The evidence that the Sites Act has failed to limit the growth of vertical integration and to protect the competitive position of small business is incontrovertible. It is clear that the Act is largely ineffective.

7.95 There is a lack of convincing evidence that the growth of vertical integration to date has inhibited competition. The Committee notes that the ACCC also has found that multi-site franchising has not apparently affected competition. However, the Committee also notes the ACCC's reservations about the potential for anti-competitive effects (see para 7.67) and shares the ACCC's concerns in this regard.

7.96 While there is support from several sources in the evidence that multi-site franchising provides efficiencies in petrol retailing, there is also a strong argument that these operations are potentially anti-competitive. This is particularly the case where a single multi-site franchisee can control almost all stations of a particular brand in each state, as is the case with Shell.

7.97 Consolidation of single franchisees into multi-site franchises will inevitably lead to an industry where there are fewer businesses competing for market share. The

44 Correspondence from MTAA to Committee, 18 May 2000.

45 Evidence, p. E261.

oil companies and DISR do not appear to regard this as a particular problem, maintaining that there is sufficient competition between brands. Nonetheless, the potential for diminishing competition is real and accordingly the Committee believes it would be prudent to take action in order to preserve and enhance competition.

7.98 The Committee therefore recommends that the Government amend the Sites Act so that no more than ten sites may fall under the control of any individual MSF operator.

7.99 This recommendation of itself will not be sufficient to strengthen the Act. The Committee notes the evidence that smaller and single site franchisees are also subject to considerable franchisor influence through other means such as price support. The issue of what constitutes effective control therefore must be addressed.

7.100 The Committee recommends that the Government examine the adequacy of provisions relating to 'related bodies corporate' with a view to bringing the definitions in the Act into line with Australian Accounting Standards.

**Senator Shayne Murphy
Chair**