GASOLINE PRICING IN AUSTRALIA

"Another Step in 30 Years of Failure to Appreciate the Industrial Dynamics of a Complex Question"

Submission to the Senate Economics Committee

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A. ABOUT THE AUTHOR.

Dr David Arelette –

- Holds the degrees of BSc (Chemistry), BEc (Operations Research), BBus (Accounting), Master of Business (Strategic Accounting) and PhD.

- PhD thesis – "Sources of Competitive Advantage in FMCG and Entrepreneurial Retail Markets using Porter End to End Value Chains" from the Australian Graduate School of Entrepreneurship at Swinburne University .

- Worked for Shell (1980 to 1990) in various marketing planning, retail marketing, retail sales, project management and HO business development roles in Australia and the UK,

- Worked for Coles Supermarkets (1990 to 1992) as Marketing Manager, Parent Brand

- Currently runs an entrepreneurial company with successful start ups in private healthcare (dental), private healthcare education and retail businesses in fragmented markets.

This submission is provided after many years of watching politicians of all parties make comments about the domestic supply and demand of oil products that are in error, are myths or falsehoods, are poorly informed or deliberate misrepresentations, or are just plain wrong.

B. SYNPOSIS.

The issues of gasoline pricing being investigated by the Senate Economics Committee cannot produce any worthwhile changes to the current situation.

This is not because of a lack of ability or a lack of will; it reflects that the current situation has evolved from 30 years of compounding populist policies that have degraded the domestic oil supply, manufacturing and marketing firms and their operating infrastructures.

This degradation has occurred in parallel with changes on the world scale operations of the oil majors such that Australia has now driven a strategic industry to almost the point where in the next decade, oil products including gasoline will imported and local product inventories will be so low that shortages will become a regular problem.

The road to Hell is both paved with good intentions and more critically starts with such a gentle downwards slope that few notice the change in direction. However, the largely arbitrary regulatory frameworks applied to the oil industry have been driven by populist politics and a near total denial of the industry dynamics of businesses that work on five, ten and fifteen year decision making cycles.

The current issue that needs to be addressed is more that correcting the decay in what is a strategic (both from a national interest and an economic perspective) industry that will need to happen on the same five, ten and fifteen year horizon.

Populist politics and dinner party Economics 101 as practiced by all political parties represented in the Senate are the enemies of the national interest in this case.

The science behind determining the date of the creation of the universe was done by working backwards by interpolating backwards the current evidence of the physics of the Big Bang theory. It is similarly possible to interpolate backwards to show the approximate time when the current skills and education crisis started through policy failures; in the future, your successors will be able to look backwards to see that the current time was when the strategic national oil industry was allowed to go into terminal and irreversible decline.

Around one third of gasoline is used in commercial and industrial applications. For on road use, about 35% is sold on company credit card systems to large business and an estimated 20% is sold to SMEs on accounts / personal charge and credit cards – so only 30% of all gasoline sold is purchased by everyday consumers. The capacity to change retail pricing regimes needs to seen in perspective.

C. WHY THIS INQUIRY CANNOT DELIVER A POSITIVE OUTCOME.

"For every complex question there is a simple answer and it is wrong"

W Edwards Deming quoted this from H L Menken in *Out of the Crisis* (MIT 1988 p 388) where he formulated the successful principles of driving productivity and quality through innovative and fact based thinking.

Considering the drivers of the price of gasoline in Australia today remains as complex a question as it has been since price discounting started in the 1970s – and to date, every attempt by Government and their Arm Chair Guru run Tribunals, Authorities and Commissions has made the competitive situation ever more unsustainable.

Indeed it has delivered Australia to a certain future of falling product security, lower service standards and higher than otherwise necessary prices to customers.

Why ?

The time scale of the oil industry is measured in 5 year increments as it takes at least that long to design and build a new refinery and 10 years to start receiving a return from the investment and 15 years to fully exploit the asset and 20 years to be in a position to see what to do next.

The regulatory time frame is measured in the 3 years between National elections and deducting the post election start up and pre-election preparation stages, Governments take actions with a few months of investigation with the hope of creating desirable outcomes within another few months. Quick wins in reduced prices can then be shown as good policy outcomes while the impact of poor decision making takes 5 to 10 or ever 15 years to come to their full impact.

Successive Governments and their implementation bodies have consistently failed to understand the Industry Dynamics of the oil and oil products industry, and have continually applied cursory Economics 101 standard thinking to the issues. So poor has this understanding been that one would suspect that their exposure to Economics 101 was as a result of going to the wrong lecture theatre when looking for the Politics 101 series on the Benefits of Marxist Theory applied to Nuclear Reactor Design.

Even with the best understanding of Industry Dynamics and a desire to deliver the best possible policies free from all party political bias and political points scoring, this Committee will fail.

It will fail because the last 30 years of government interference has eliminated the economic interest of the remaining oil companies in Australia to place further capital at risk of policies that destroy commercial outcomes and are implemented in such a short sighted way and are based on undergraduate level economic errors.

D. WHY HAS THE LAST 30 YEARS OF POLICY BEEN SO DESTRUCTIVE ?

In the 1960s, Shell used the rule of thumb that every new to industry (NTI) outlet represented an additional 20,000 gallons a month in sales – a case of build a service station and the demand will come.

To support this confident position, Shell had the additional land at their Pinkenba (Brisbane) terminal to build their third refinery in Australia as well as their pre-WWII refinery at Clyde and the then relatively new refinery at Geelong. With the discovery of crude reserves in Bass Straight, all domestic refineries were modified to stream this easy to use crude oil.

The industry wide discounting that started in the early 1970s (in Cents Off per Gallon) was not regulator initiated – it came from the competitive pressure that comes after the optimistic expansion of excess product chasing slower growing demand. But the industry had the freedom to chose where margins could be given away to move product and where margins could be secured without impacting on demand across the total production barrel.

The creation of the Prices Justification Tribunal was a political rather than an economic decision. If the logic had been economic like the wartime prices control mechanism then the industry would have had the opportunity to modify the margin losses and gains to achieve the same profit outcomes while meeting National policies.

The PJT "approval" process to recover a net $ amount of additional costs distorted the industry through higher prices being applied to products with lower competitive pressures – the price of heating oil to the snow fields was doubled one afternoon to recover additional costs on lubricating oils as there was no competitive alternate.

The arbitrary decision making delivered by the PJT made the industry look inwards for the profitability denied by the regulator. Service stations were closed (about 5,000 in 8 years), self serve replaced driveway service, new refineries were forgotten and existing ones structured to last an indefinite future and the smaller States were commercially abandoned with occasional representation from the larger offices.

The Sites Act and the Petroleum Retail Franchise Marketing Act gave dealers who could never had run their own business the power to unilaterally do as they pleased as terminating them was impossible. Super grade fuel was diluted with kerosene, service stations were less clean, actual service was rare, lower grade lubricating oils were passed off as premium grades, foreign fuel was sold as branded fuel. The better dealers who delivered what the customer was paying for were financially rewarded as the only way to bring the "crooks" into line which worked infrequently. The Prices Surveillance Authority continued the run of Arm Chair Guru regulators which continued to run down the economic imperative of investing to maintain future asset performance. The ACCC has done nothing to stop this decay.

There has not been a new refinery built in 50 years, 15000 service stations are gone, and the local oil businesses are now mere branch offices of Head Offices in Asia or the USA so even if competition was desired, there is no one here to make it happen.

E. THE INDUSTRIAL DYNAMICS OF THE CURRENT MARKETPLACE.

The current Inquiry is seeking to determine policies that can deliver lower gasoline prices both in Capital cities and regional areas.

Unfortunately the parallel political process requires Senators to provide 15 second quotes for media attention which reduces analysis and complex issues to trivial and invariably wrong grabs for radio and television use. This leads to economic one liners that are misleading, populist and more often than not, universal rubbish.

There is the view that if regulation is reduced, prices will rise. This is mixed with the view that if the oil companies are reduced to 2 or even 3 (from the current 4 majors) then prices must rise – this is dinner party Economics 101 and it is populist rubbish – it is based on the most trivial reading of the economics of the Robber Baron practices of the late 19th Century. While this simplistic one line grab suits the party in opposition to reducing regulation, it is plain wrong.

One example – the Mom and Pop Service Station This was possible at a time long ago when good margins covered average performers trading on low and uneconomic levels of trade. The current self serve outlet must do a minimum of 50,000 litres per pump per month to make a trading profit so having multiple outlets run by a single entity provides continuous staff for the 24 trading cycle and amortises the cost of the supply chain of purchasing, delivery and shelf management of the ancillary products. Belief in the viability of a Mom and Pop operation is admitting to having seen the tooth fairy.

Gasoline is perhaps 30% to 40% of the refined barrel – considering gasoline in isolation is easy to do but creates policies that are likely to be flawed and highly likely to make the total marketplace situation even worse.

To make accurate and informed decisions on the domestic oil industry, members of the Senate Economics Committee need to invest perhaps three months of full time study of the industry dynamics involved today and how the last 30 years of decision making by each of the 9 oil majors of 1980 has reduced the industry to where it is today. Anything less is a tourist visit being passed off as having lived like a local.

The current marketplace is a true reflection of the imperatives for survival of the remaining oil majors taken in response to 30 years of arbitrary and ill conceived attempts to deliver populist outcomes for voters. Continuing these approaches will leave the Nation with fewer and fewer efficient refineries (and eventually none), fewer retail outlets and put the Nation at the mercy of products sources from overseas refineries and the international shipping supply chain.

F. DEBUNKING THE ECONOMICS 101 MYTHS ABOUT OIL PRICES

The popular SBS television show "Mythbusters" takes a science and fact based empirical analysis of popular urban myths. You need to do the same.

- The Oil Companies Hide Designs of More Efficient Gasoline Engines.

This assumes that oil companies are in the oil product sales business. Not true. They are in the invest to make money business. Selling 50% less gasoline but collecting more from licensing the patent to build the engine delivers profits now while selling fuel delivers possible profits later. This is a no brainer.

- Prices will rise if we allow oil companies any freedom.

Name one instance since 1970 where the desire for market share driven by excess refinery capacity has been sidetracked to allow for prices to rise on a long term basis when raw material costs have been otherwise stable.

This thinking is Arm Chair Guru rubbish. If Australia is converted to a Socialist centrally Planned System, oil product prices can fall in both Capitals and regional areas, variations can be eliminated immediately and all options of collusive price fixing will be gone forever. And eventually the Nation will collapse just as the USSR did.

- The CEOs of the oil companies tell us everything is working well.

Shell told me that my employers were guests in Australia and we should always behave as a guest which was a very sensible way to operate long term and I always followed these principles.

This means - We would obey the laws, show real respect to the Government and never tell the Government when they were wrong, stupid, economically shooting themselves in both feet or all three at the same time. It was better to live to fight another day through going back to the office and adjusting (downwards) all of the asset maintenance and new capacity investment programs to sustain profits, and copy the Government at that time with their populist approaches by selling any necessary additional operating expenses as "new investment".

Myths are never challenged particularly when that myth underpins a populist and vote catching view. Price manipulation and osmotic price fixing come about as a survival mechanism to regulators and their policies that destroy value and destroy ROI from investments made in response to earlier Government promises that are capriciously broken to feed populist policies and vote grabbing needs.

No sane oil major would ever trust any Government assurances after the last 30 years of commercial ambush regulations – Australia is now a price taker in oil products when we could have been a price maker if decision makers and regulators have had been given unchallenged guru status.

G. WHAT SHOULD YOU DO NOW ?

- Stop looking for the magic bullet – there is not one available.

It's time to be honest with the Nation. Car drivers have benefited from 35 years of aggressive gasoline discounting – at say 4 cents a litre over 12 billion litres per annum that is $17 billion saved. The bad news is that the party is over.

In this spirit of honesty with the Nation, tell them that $5 Billion of their money was thrown down the drain to introduce unleaded gasoline to save the residents of Sydney from supposed lead poising when perhaps 70% of the Sydney homes are painted with lead rich paint. It was a con job but it was the NSW Government that ripped you off.

- Eliminate the Sites and PRMF Acts this afternoon.

These add cost, reduce product quality, kills customer service - all for no gain.

- Show the Ethanol Rent Seekers out the door.

Ethanol is a low power product that still creates the same, possibly worse levels of pollution (through chemicals used on the food product are transferred with the core compounds). Investigate the option to make ethanol into more complex Ethers that deliver current gasoline levels of power, will not dissolve water from fuel tanks to rust engines and will be immediately acceptable and credible to car owners.

- Decide if the Nation needs secure access to strategic products such as clean aviation turbine fuel for the F18 wing, widely dispersed supplies of turbine fuels for naval vessels and premium gasoline for the Abrams M1 tank group.

Create a Button car plan for the remaining oil majors. Admit that all the Governments of the last 30 years have really buggered the domestic oil industry and that the father of them all was the Fraser PRMF Act.

Decide which two oil majors have the capacity to survive (probably Shell and BP) and invest public money in new world scale refineries (repayable through future sales), provide incentives to hold inventories and use the competition from internal and external supply chains as the only source of price regulation.

Ignore the arrival of Grocers into fuel retailing – they sell whatever builds foot traffic of household expenditures and whatever delivers a margin better than their long run average of 3%. They have no appreciation of the industry dynamics at play and will remain or retreat based on profitability as they have zero strategic interest in the industry and its products.

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