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21st July 2006

The Secretary
Senate Economics Legislation Committee
Suite SG.64
Parliament House
CANBERRA ACT 2600

Dear Sir,

Inquiry into the Price of Petrol in Australia

Thank you for providing us with the opportunity to make a submission to this inquiry. We note the terms of reference, and have decided to confine our detailed comments to issues affecting service stations directly. Our submission makes general comments on Term of References (a) and (b) as other submissions will cover these aspects quite adequately.

Petrol Price Components

Typically, we see the components of the retail price of a litre of petrol being made up as follows:

	Acpl
Crude oil	62.7
Crude freight and insurance	4.0
Refiner margin	10.0
Excise	38.1
Oil company marketing and distribution	7.0
Distributor margin and freight	4.0
Service station margin	5.0
GST	13.1
Total	143.9

Many of these figures can vary significantly from day to day and reflect the free market competitiveness of the industry at all levels. All these margins are gross and are before expenses have been taken out.

Crude oil prices are affected by world market movements and movements in the A$ exchange rate. Oil company margins will vary depending upon the extent of discounting occurring at any one time and in any one geographical location. Similarly, service station margins will vary significantly from time to time and in line with the extent of discounting which varies from day to day.

Retail Petrol Prices

Petrol prices in Australia are market driven and generally deliver low cost petrol to Australian motorists when compared to other western nations. The Australian market in capital and regional cities is dominated by the weekly discount cycle which normally moves through a range of 12 to 14 cpl.

The basis for prices in Australia is import parity, based on the Singapore market. The oil companies base their terminal gate prices on import parity plus local premiums that reflect the relative competitiveness of the market area. For example, the TGP in Melbourne is the lowest in the county even though, with the exception of Adelaide and Hobart, it has the highest freight cost from Singapore. This "contradiction" occurs because Melbourne is the most competitive market area in Australia, due to the large numbers of independent service stations in that city. In fact, Melbourne is where independents first started up in Australia and broke the supply and distribution stranglehold hitherto enjoyed by the oil companies. Australian motorists directly benefited from the intense competition that followed and which spread around the country.

A majority of an oil company's petrol is sold through its own of franchised operated outlets. Franchisees are charged a "country reference price" which although based on import parity, is significantly higher than the TGP and represents the desired marketing and distribution margin that that oil company would like to maintain. The site then adds its margin, normally around 3 cpl for franchised sites. This is sometimes called "the natural margin" as opposed to "the supported margin". The retail price that results represents the top of the weekly cycle. The independents drive the retail price down as they lower their prices in an attempt to pick incremental volume. The oil companies are forced to follow to maintain their sales volumes and provide rebates to their franchisees to maintain the sites' fixed gross margin of around 3 cpl. When the bottom of the price cycle is reached, the oil companies temporarily withdraw from discounting and the whole process starts all over again.

For example, in Sydney in the week commencing 17th July 2006, the top of the cycle was about 145.9 cpl and the bottom of the cycle was about 132.9 cpl and the average TGP was about 132 cpl. The "reference price" that the oil companies charged their franchisees was about 142.9 cpl which represents the target wholesale price the oil companies would like to achieve all of the time.

This phenomenon is more marked in the cities than in regional Australia and is directly affected by the presence of independents in the market area. The

more independents, the more price based competition and the more pronounced is the discount cycle.

In rural areas where the competitive framework is less intense, the oil companies apply the same pricing philosophy and wait to see if the market moves down, requiring a response. If there is no market movement downwards, then the retail prices at the oil company sites will remain at the same level as the top of the cycle in the cities. The only difference is that the rural service stations don't experience the bottom of the cycle the way city service stations do.

Therefore, looking forward, without an effective presence of independent service stations in the cities, the weekly discount cycle will disappear and retail prices in the cities will be the same as those in rural areas.

The rate of service station closures has doubled since the supermarkets entered petrol retailing and there is a real risk that the number of independents remaining is close to falling below the critical mass necessary for them to be effective. That has already happened in many country cities where the supermarket/oil company presence has become so dominant and has captured so much of the market that pricing cutting by independents has become ineffective in increasing volume. As a result the independents have ceased discounting and now look for increased margin to provide adequate levels of profit. In these cases, the oil companies set the price and the independents follow, and discounting rarely happens. The structures in the capital cities are heading that way.

Service Station Margins

As stated above, service station margins vary significantly in line with the extent of discounting and are also affected by the type of tenancy. A significant number of service stations in Australia are oil company owned and operated and hence the service station margin is bundled up with that company's marketing and distribution margin. The same applies for commission agency sites where the company owning the site also owns the petrol and sets the price. In some cases, the revenue to the agent operating the site is by way of a fixed sum, and in other cases by a cpl payment on fuel sold. In the latter case, margins of around 2 cpl are quite common as the operator does not have to finance the fuel underground.

Many other sites are operated by oil company franchisees. In almost all these cases, the gross margin is set by the oil company and is commonly around 3 cpl and is a fixed amount, irrespective of the retail price, which is often also determined by the oil company.

Finally, independents buy their petrol either directly from an oil company or from a wholesaler. In these cases, the price they pay is based on prevailing terminal gate prices, plus a premium depending upon the buyer's individual circumstances. The independent operator will then set his/her retail prices

normally in line with prevailing market prices which can vary significantly from one day to the next. At the top of a discount cycle (when sales levels are quite low), an independent can make as much as 11 cpl and at the bottom of the cycle (when sales levels are quite high) as little as 1.5 cpl. On a volume weighted average basis, independent operators gross margins will therefore be around 5 cpl.

The above scenario applies for capital and large regional cites. In rural areas, gross margins are higher, but on lower levels of fuel sales so the net profit results are not dissimilar.

Service Station Costs

In last twenty years or so, service station operators have increased the amount of non-fuel commercial activities they engage in so that now, unlike in the past, there are no service stations that just sell petrol and nothing else.

The following table sets out the cost components of operating a fuel sales only service station and highlights the contribution that non-fuel commercial activities make to service station profitability and therefore to lower petrol prices in Australia.

The data presented below are based on a hypothetical independent service station in an Australian capital city selling 300,000 litres of fuel per month and operating for 16 hours per day, 7 days per week. These figures are fairly typical of the average city service station. Wages are based on the prevailing Vehicle Industry Repair, Services and Rental Award 2002.

Costs per month	$	cpl
Wages and on costs	11,630	3.9
Operating expenses	2,890	1.0
Fuel losses and drive-offs	1,800	0.6
Utilities and phone	1,700	0.6
Credit card merchant service fees	3,500	1.2
Finance costs on $2.1m capital	17,500	5.8
	39,020	13.0

Given that the average gross margin is around 5 cpl, this table shows the extent to which the non-fuel commercial activities are contributing to the profitability of service stations. It also demonstrates that service station operators' entrepreneurial activities are saving Australian motorists over 8 cpl on the cost of fuel.

When the SSA carried out this exercise in 2002, this cost, on the same basis, was around 7 cpl, indicating the extent of the decline in service station profitability in recent years. Over the same period, petrol gross margins have decreased under intense competition and below cost selling by the supermarkets.

Competitor Activity

The SSA has noticed a distinct change in the complexion of the retail industry since the supermarkets entered the industry. This event has coincided with the emergence of a shortage of refining capacity in the Asia Pacific region and resulting higher refiner margins and a significant reduction in refining capacity in Australia, largely caused by Exxon Mobil. Australia, once self sufficient, now imports about 25 per cent of its white products needs and the position is likely to persist with no new refining capacity being planned. The four oil companies import virtually all this shortfall and hence there is no necessity for Australian refiners to sell locally refined product "at the margin" because all refinery production is totally consumed through oil company and supermarket outlets. Therefore there is little competition at the wholesale level, unlike the situation up to four year ago when independently imported petrol was generating intense competition from Australian refiners.

The concentration of market power towards the oil companies and the supermarkets has been accelerated by the supermarkets' use of shopper dockets. Supermarkets now account for roughly 50 per cent of all petrol sold in Australia. The situation for many independents and some oil company franchisees is becoming perilous.

There is widespread belief that new refining capacity will come on stream in the Asia Pacific region from 2008 onwards, which will relieve the supply situation and put downwards pressure on refiner margins. It therefore follows that oil company profitability will decline when that happens and independents will have strengthened buying power and increased competitiveness.

It is the SSA's view that the oil companies and supermarkets are taking advantage of the current favourable climate to establish clear dominance in the retail market so that when 2008 comes around, the independent sector will be too small to be able to drive the market into deep discounting. In this way, the oil companies will be able to maintain current profit levels in the face of diminishing refiner margins. Australian motorists will lose the benefit of the current competitive market if that is allowed to happen.

Yours faithfully,

Ron Bowden
Chief Executive Officer