SUMMARY REPORT

Inquiry into Motor Vehicle Fuel Prices

September 2001
INDEPENDENT COMPETITION AND REGULATORY COMMISSION

Summary Report

Inquiry into Motor Vehicle Fuel Prices

September 2001
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Public information about the Commission’s activities

A range of information about the role and current activities of the Commission, including copies of latest reports, can be found on the Commission’s web site at www.icrc.act.gov.au.

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## LIST OF ABBREVIATIONS

<table>
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<th>Term</th>
<th>Definition</th>
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<tr>
<td>ACCC</td>
<td>Australian Competition and Consumer Commission</td>
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<tr>
<td>ACT</td>
<td>Australian Capital Territory</td>
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<td>AIP</td>
<td>Australian Institute of Petroleum</td>
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<td>ALP</td>
<td>Australian Labor Party</td>
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<td>APADA</td>
<td>Australian Petroleum Agents and Distributors Association</td>
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<td>ATO</td>
<td>Australian Taxation Office</td>
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<td>GPOC</td>
<td>Tasmanian Government Prices Oversight Commission</td>
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<td>GST</td>
<td>goods and services tax</td>
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<td>ICRC</td>
<td>Independent Competition and Regulatory Commission</td>
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<td>IPI</td>
<td>import parity indicator</td>
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<td>LPG</td>
<td>liquefied petroleum gas, sometimes known as autogas</td>
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<td>LRP</td>
<td>lead replacement petrol</td>
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<td>MWP</td>
<td>maximum wholesale price</td>
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<td>NSW</td>
<td>New South Wales</td>
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<td>NT</td>
<td>Northern Territory</td>
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<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
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<td>OPEC</td>
<td>Organisation of the Petroleum Exporting Countries</td>
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<td>PULP</td>
<td>premium unleaded petrol</td>
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<td>SA</td>
<td>South Australia</td>
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<td>TGP</td>
<td>terminal gate price</td>
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<td>ULP</td>
<td>unleaded petrol</td>
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<td>Western Australia</td>
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INTRODUCTION

The inquiry was established against the background of fuel prices reaching record high levels, with petrol and diesel peaking over $1 per litre. Concern amongst ACT consumers led to the ACT Legislative Assembly recommending that the ACT Government issue a reference to the Independent Competition and Regulatory Commission (hereinafter called “the Commission”) for an investigation into the motor vehicle fuel industry and fuel prices. The Government issued the reference on 14 April 2001.

The Commission is required to report to the Government on the terms of the reference and to recommend possible courses of action. As the petroleum industry is not a regulated industry under the Independent Competition and Regulatory Commission Act 1997, it is not the Commission’s role to impose price controls or introduce a new regulatory framework.

Industry Structure

The four major players (hereinafter called “the majors”) in the Australian petroleum industry are Shell, BP, Mobil and Caltex. These four companies own all of Australia’s refinery capacity. The refineries are old and small by international standards, particularly compared with competing refineries in the Asia–Pacific region. Despite this, the domestic market is primarily supplied by fuel refined locally from local or imported crude. Local refineries have enough capacity to supply the total Australian market. However, of the total refined fuel supplied in Australia, a significant proportion is imported. Importing refined fuel rather than purchasing locally refined fuel is a strategy frequently used by the larger independent wholesalers and retailers.

The majors have a strong role not only in refining but also in the wholesale and retail market segments. Most service stations carry their brands: through direct operation of the majors’ own sites; by contracting agents to sell fuel through major-owned sites on a commission basis (commission agents); by contracting franchisees to operate major-owned sites; and through branding arrangements with independent owner-dealers. Retailers not carrying the majors brands include independent and supermarket chains, independent owner-dealers who purchase fuel in the wholesale market and some sites owned and/or operated by distributors (many of whom are wholly or partly owned by the oil majors). The multiplicity of fuel-supply arrangements and control of the various retail outlets leads the Commission to the view that competitive tension is at work within the market such that the majors cannot currently control prices.

In the ACT, fuel is supplied to service stations from terminals in Sydney and the ACT is thus part of the NSW industry structure. However, in terms of competitive pressures and prices, the ACT market is distinct from the Sydney market. Prices in the two markets are correlated but not tied. The ACT market also differs from other markets by having a higher proportion of sites carrying majors brands than the national average.
Fuel Prices

Retail fuel prices are made up of three components: taxation; international refined fuel prices; and a domestic marketing and retailing component. Taxation is the largest component of diesel and petrol prices, being typically around 50%. Most of the remainder is the international refined fuel price. In the ACT, the domestic industry component is typically less than 10% and includes all transport, retailing, wholesaling and marketing costs.

Movements in fuel prices reflect two types of fluctuations: long-term movements reflecting changes in international refined fuel prices, including the cost of crude oil; and short-term fluctuations generated in the domestic industry component of costs and reflecting competitive discounting of prices. High fuel prices in April to May 2001 appear to have been caused by international factors, namely a combination of high prices for refined fuel product in Singapore and a low Australian dollar. Price reductions from June to August 2001 have also been the result of fluctuations in these factors.

Fuel taxation and international refined fuel prices are outside the scope of the inquiry and were not investigated in depth.

Demand for fuel is generally felt to be highly price inelastic, such that for an X% price increase, demand will fall by less than X%. This is because there is no readily available substitute product. Thus, any reductions in demand must come from changes in consumer behaviour.

Efficiency of Price Levels

Excluding taxation and international issues, there is very little evidence that petrol and diesel price levels are inefficient at a national level. It is difficult to make a direct assessment of the efficiency of the various cost components of the local industry margin because data collected in the industry combine non-fuel costs and revenues with fuel costs and revenues. However, a number of factors suggest that the domestic industry portion of prices is efficient.

As the domestic component is a small proportion of fuel prices, any inefficiency or profiteering cannot raise prices by more than a few cents per litre. Further, international comparisons show that Australian tax-exclusive prices for petrol and diesel are among the lowest in the OECD. This cannot be fully explained by any general cheapness of goods and services in Australia, and therefore appears to reflect competitive factors driving our relatively efficient tax exclusive prices.

Competition in the refining, marketing and retailing sectors of the industry seems to be high, to the point that margins and profitability are low, possibly unsustainably so. This is causing ongoing rationalisation in the industry. This conclusion is supported by the fact that there are strong independent competitors to the oil majors at each level of the industry, the existence of price discounting cycles and low market entry costs. The discussion paper for the Australian Competition and Consumer Commission’s (ACCC) current inquiry into fuel price fluctuations
also shows that, aside from weekly cycles, fuel prices in the Sydney and Melbourne markets follow costs very closely.¹

**ARE FUEL PRICES HIGHER IN THE ACT?**

To examine this issue, the inquiry examined monthly average prices in the ACT, Sydney and Queanbeyan. Robust data for Queanbeyan were available only for unleaded petrol (ULP).

The differentials in monthly average prices between the ACT and Sydney are currently much lower than at the time of previous reports and show signs of decline over the period examined (mid-1998 to present). These differentials are around 1.6 cents/L for ULP, 0.5 cents/L for diesel and 2.5 cents/L for liquefied petroleum gas (LPG) and are fully explained by transport costs for petrol and diesel, and mostly explained by transport costs for LPG.

There was no long-term differential between the ACT and Queanbeyan monthly average prices for ULP until July 2001, following which prices in Queanbeyan were around 1 cents/L cheaper. This differential is fully explained by the Commonwealth Fuel Sales Grant Scheme, which treats most of the ACT as a metropolitan area but regards Queanbeyan as a non-metropolitan area with a resulting 1 cent/L Commonwealth subsidy.

The reduction in differentials since previous reports suggests that changes such as relaxed planning rules and the introduction of independent chains have been effective in making the ACT market more efficient and competitive.

**PRICE FLUCTUATIONS**

Only ULP price fluctuations were analysed, because of a lack of robust daily average diesel and LPG price data for the ACT. The short-term price fluctuations in the market appear to occur in fairly regular cycles that are around a week long. Rapid rises in price usually occur on Wednesdays and are particularly associated with public service paydays. There is mixed evidence on whether rises also tend to occur before public holidays.

Evidence suggests that these cycles are not caused by an attempt by oil companies to gain monopoly profits, but are instead caused by competitive price discounting cycles. Evidence for this is the low profitability of the industry and the fact that the troughs of the cycle often see fuel sold at or below wholesale cost. Further support of this view comes from the ACCC’s discussion paper for its inquiry into fuel price volatility, which concludes that discounting cycles are a likely cause of short-term price fluctuations in the Sydney and Melbourne markets.² In view of this, the correlation with public service paydays is most likely caused by retailers being unwilling to sell fuel at a loss over high demand periods and thus the payday acts as a trigger for discounting to end.

RELATIONSHIP BETWEEN OIL MAJORS AND OTHER RETAILERS

The Commission heard the following major concerns from franchise and independent retailers:

- **Oil majors are controlling the market to ensure profit margins are unsustainably low for such retailers in order to drive competition from the market.** Material was provided to the Commission that demonstrated that margins were unsustainably low. However, this appears to be an industry-wide phenomenon as the oil majors are also experiencing low margins. There is no evidence that the oil majors are controlling retail prices.

- **Oil majors are setting the retail prices of the independents and franchisees they supply.** This is illegal if proven. Evidence provided to the Commission suggests that the oil majors do have a strong influence over the retail prices of their franchisees and branded independents but are not fixing them in a legal sense. Further, the Commission has no evidence that the majors set retail prices across the market as a whole. Rather, the evidence supports the view that the competitive market is driving prices.

- **Wholesale prices provided by the oil majors are not transparent and franchisees and independents are unsure why these prices change the way they do.** Because of this lack of transparency, various retailers can be discriminated against in the price they are offered and this issue may need to be addressed.

SOCIAL AND ENVIRONMENTAL ISSUES

Changes in motor vehicle fuel prices can have environmental and social impacts. Thus, there may be a need for policy activity. However, because of the importance of fuel as an input to production of other goods and services, manipulating fuel prices as a policy tool could have a widespread adverse impact on other industries. The Commission is of the view that the ACT should not attempt, for environmental or social policy purposes, to set fuel prices independently of other States. From an individual Territory perspective, targeted social or environmental policies are more likely to be appropriate in these circumstances.

ACTION BY OTHER JURISDICTIONS

In 1999 the Federal Government attempted to deregulate the industry by replacing controls over franchise agreements and the number of sites the oil majors are allowed to operate directly (the Petroleum Retail Marketing Franchise and Sites Acts 1980) with an enforceable industry code of conduct. This process of deregulation was not completed because the industry failed to agree on a code of conduct. There are, however, three activities currently under way at the Commonwealth level that may directly influence the future price paid for motor vehicle fuels. These are:

- an inquiry into fuel taxation which was established in March 2001 and is due to be completed in early 2002;
- an ACCC inquiry into fuel-price fluctuations for which a discussion paper has been released that examines a number of the options outlined at “Policy Options” below; and
- the reintroduction into Parliament by the Opposition of a Bill seeking to introduce a 50/50 supply rule, as discussed at “Policy Options” below.
Other States are undertaking the following actions:

- The WA Government is introducing a range of controls including a 24-hour price rule, a maximum wholesale price scheme, a 50/50 supply rule and a retail price cap. These are discussed at “Policy Options” below.
- The SA Parliament is holding an inquiry into options for fuel industry regulation.
- Victoria has recently mandated terminal gate prices as outlined at “Policy Options” below.
- NSW is not currently considering any action but has previously made price sign boards mandatory and has commissioned reports into the option of community fuel purchasing cooperatives as a means of accessing cheaper fuel.
- Tasmania has an ongoing fuel-price monitoring scheme in place.
- Queensland is considering a range of options but has not yet reached a decision.

**POLICY OPTIONS**

The following options have been introduced in, or are being considered by, other jurisdictions.

**24-Hour Rule**

24-hour price setting was introduced in WA on 2 January 2001. The theory behind 24-hour price setting is that consumers want certainty in prices. It requires retailers to report the intended price for the next day to the Department of Consumer and Employment Protection each afternoon. They must then sell fuel at that notified price for the whole of the next day. This is supported by a FuelWatch service that provides the notified price information to consumers over the Internet or by telephone.

The major benefit is that consumers have price certainty and improved access to pricing information. However, the scheme also has a number of problems:

- It may impact more heavily on independent retailers, as their marketing strategy is often to ensure they are always the cheapest in the market. The 24-hour price rule stops them from adjusting their prices and thus on days where they incorrectly predict their competitors’ prices, they will not be the cheapest in the market.
- Average prices may increase because market participants will be less willing to discount prices knowing that their ability to increase prices again is reduced. Further, their risk is increased (for example they may incorrectly anticipate the market and have to sell fuel at prices well below those quoted by other service stations) and they may seek higher profit to cover this risk. A potential balancing factor is that competition may increase as a result of improved public information arising from the easy availability of pricing information through FuelWatch.
**Maximum Movement Rule**

This approach involves limiting the daily maximum price adjustment to remove the large one-day changes in price. It would provide consumers with some price certainty and is much less restrictive than some other options. As such, it is less likely to drive up average prices. However, it may:

- restrict the industry’s willingness to discount prices as they could fear being trapped at a loss-making price level;
- not stop the increase of prices at the end of a discount cycle, just slow it; and
- have a high regulatory cost for Government and the industry.

**50/50 Supply Rule**

So called 50/50 supply rules seek to allow retailers such as franchisees (and in some cases branded independents) who are contractually tied to one major, to purchase up to 50% of their fuel from a different wholesaler. Proponents argue the following benefits:

- Competition at the wholesale level will increase because many more retailers will be able to buy fuel directly through the wholesale market.
- Competition in the retail market will increase because franchisees and branded independents will not be so dependent on the wholesale price set by their major, and will thus have more freedom when setting retail prices.

Those against a 50/50 rule cite the following problems:

- It would unfairly breach the property rights of franchisors to have their own fuel sold through their sites and could cause them serious financial losses where existing franchise contracts had a low entry price that was subsidised by expected profit on sales of fuel.
- A franchisee could purchase poor quality or adulterated fuel and consumers purchasing that fuel would blame the major when it was found to be inferior. Consumers would in effect be misled into believing they were buying a certain brand of fuel when in fact they are possibly buying a mixture.
- Franchising would cease as a result of these difficulties which would drive many small business people out of the market.

**Informing Consumers About Price Cycles**

This involves educating consumers about how the price discounting cycle works, with the aim of increasing their ability to take advantage of the peaks and troughs in prices to reduce their fuel costs. The major advantage is that it requires no interference in the market. The major disadvantage is that irregularity in price fluctuations may lead to consumers becoming frustrated when the price does not move as predicted.

**Terminal Gate Pricing**

The Victorian Petroleum Products *(Terminal Gate Pricing) Act 2000* came into effect on 1 August 2001 and mandated terminal gate pricing in Victoria. This requires:

- declared suppliers to publicly advertise a terminal gate price (TGP) for declared products, and to provide product at that price;
- the TGP to be calculated according to a particular methodology, which is a build-up of landed international product price, plus excise, terminal operating margin and GST;
• contracts to identify the TGP plus the price of additional services such as freight, less discounts and rebates; and
• invoices to identify the TGP plus the price of additional services such as freight, less discounts and rebates.

It is argued that this approach will increase transparency and improve the functioning of the wholesale market as previously only three oil majors made a TGP publicly available and the advertised TGPs did not apply to many purchasers. However, the results are unlikely to be a dramatic reduction in price or reduction in market fluctuations and, as such, consumers are unlikely to see terminal gate pricing legislation creating immediate benefits for them. It would also be difficult to implement in the ACT which has no fuel terminals; fuel is delivered directly from terminals in Sydney. Unlike a wholesale price cap, terminal gate price legislation does not specify a particular formula or price level.

**Price Caps**

A number of options revolve around the capping of wholesale and/or retail prices. The main difficulty with price capping is setting the cap level. On the basis of the Commission’s findings that the local industry component of fuel costs is already efficient, setting a price cap below the market price will lead to the cessation of supply or falling profitability for wholesales and retailers in the domestic market. Falling profitability will lead to further restructuring in the industry and, in the long run, to a run-down in investment. Eventually, this may lead to a poor safety record, environmental damage, higher wholesale costs and eventually a withdrawal of players from the market. If the price cap is set too high, it will either be useless, as prices will be below the cap anyway, or it will provide a “benchmark” for companies to aim at, causing prices to rise to the cap.

**Reintroducing the former Commonwealth regime**

The Commonwealth capped wholesale fuel prices until 1998. In addition to the general administrative and arbitrary cost allocation problems with caps, the previous Commonwealth scheme had flaws such as allowing oil majors to evade the cap by selling through their local, unregulated distributors. Also, it was used for political purposes, for example by manipulating the transport cost component in some regional areas to reduce fuel prices. The cap system was abandoned with the support of the ACCC, as it was considered largely ineffective.

**WA maximum wholesale price (MWP) scheme**

The MWP is calculated daily for each declared terminal using a formula set by the WA Government. Spot sales of fuel above the MWP are not allowed at those terminals. The aim is to increase competition by allowing non-contract or above-contract fuel purchasers to buy at a transparent and competitive price. While the scheme has been in place since 12 April 2001, it is understood that few if any spot sales of fuel have yet occurred and, as such, no benefits of the scheme are yet apparent. However, proponents of the scheme argue that in the long term, the capped wholesale price will become the benchmark for new contracts, leading to a decrease in fuel prices.
Those against the MWP cite the following problems:

- The formula used to calculate the MWP is flawed and thus sets prices that are too low. This is the reason there have been no spot fuel sales. This is an example of the general failings of price caps discussed above.
- For an ACT-only MWP, spot sales may be shifted to NSW to avoid the MWP.

**Retail price caps**

Regulation to allow the WA Government to cap retail fuel prices has yet to come into force but is expected to be implemented shortly. However, it is unlikely to be used in the short term as it is seen as a last resort measure to force down prices in some regional areas.

When the retail price cap is set below normal market prices, it will benefit consumers at the cost of discouraging sellers. As with all price caps, any benefit derived by consumers in these circumstances may be offset by time spent queuing and finding a service station that is selling if shortages occur. Further, such a cap would likely impact most heavily on small owner-dealers and franchisees as they are less able to withstand short-term losses when the cap is set too low. The result could be a market solely supplied by the majors.

**Conclusion**

The Commission is of the view that none of these new regulatory actions, if introduced only in the ACT, would have long-term net benefits for ACT consumers. As the domestic industry component of the fuel market appears to be efficient and is relatively small by comparison to the total retail price of fuel, there is little scope for prices to be reduced by regulatory action that focuses upon the domestic industry component. Removal of the short-term price fluctuations caused by competitive price cycles risks reducing competition and thus raising average prices.

Policies that are directed at capping the wholesale price must be able to demonstrate that such an approach produces a better outcome than simply using the Singapore equivalent refined fuel price. In any such comparison, the cost of applying and managing the cap needs to be considered because, based on past experience in Australia, such costs appear to have outweighed any consumer benefit.

At this stage it is too early to form a definitive view as to whether the market interventions being undertaken in other jurisdictions are benefiting local consumers. Early signs indicate they are not. There is also a grave risk that unilateral action in the ACT could conflict with decisions taken at a national level as a result of the current ACCC inquiry into reducing fuel price fluctuations.

Having examined all the available evidence, the Commission has concluded that the most appropriate response by the ACT Government at this time would be to continue to support competitive reforms of the fuel industry and initiate action to provide consumers with better fuel pricing information. Such a public information strategy could allow consumers to optimise their fuel purchasing decisions throughout fuel price discounting cycles. The Commission recommends that the ACT Government should support further regulation of the industry only where it can be shown that it would contribute to the long-term competitive pricing of fuel in the ACT and would be implemented and operated in a way that is consistent across all jurisdictions.
RECOMMENDATIONS

Recommendation 1: That the ACT Government make representations to the Commonwealth to ensure all service stations in the ACT region are treated equitably in their ability to access the Fuel Sales Grant Scheme.

Recommendation 2: That the ACT Government consider reducing the requirement for a person who purchases a service station as a going concern to operate it as a service station for five years.

Recommendation 3: That the ACT Government request the Commission to monitor ACT/Sydney and ACT/Queanbeyan fuel price differentials.

Recommendation 4: That the ACT Government support the introduction of a national temperature correction regime and, following the introduction of such a regime, ensure that ACT legislation is harmonised with the national approach.

Recommendation 5: That the ACT Government not introduce any new fuel pricing regulation before the conclusion of the current ACCC inquiry into price variability. Following the ACCC inquiry, the ACT should take a regulatory approach that is consistent with any national regulatory action. In particular, fuel regulatory policies that differ from those in surrounding NSW should be avoided.

Recommendation 6: That the ACT Government implement a public information strategy that informs the public about the discounting cycle and regularly provides information on the movement of fuel prices.

Recommendation 7: That the ACT Government work with other jurisdictions on improving the transparency of wholesale pricing of fuel, for example through the introduction of an initiative to release terminal gate pricing information that includes the terminals that supply the ACT.

Recommendation 8: That the ACT Legislative Assembly repeal the fuel price setting provisions of the ACT Fair Trading (Fuel Prices) Act 1993 as these have been superseded by the powers contained in the legislation establishing the Commission.
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<td>G Lynes</td>
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<td>Michael Delaney, Motor Trades Association of Australia</td>
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