Petrol Prices: Fair or Not?

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If petrol becomes more expensive, prices go up. Is this surprising?

THERE has been a lot of recent media coverage regarding petrol price rises. The Melbourne *Herald Sun* banner headline of 6 August 1999 declared 'Petrol fury'. A headline in the *Sydney Morning Herald* pronounced 'Motorists urged to dob in petrol cheats'. Nothing seems to stir the community to anger quite like a jump in petrol prices, except maybe hikes in bank fees and charges.

For decades, oil companies have been on the receiving end of bad publicity and miserable press coverage. Some of this is more than justified.

It all started with the original evil oil company that captured a virtual monopoly over the American oil refining industry, the Standard Oil Company, headed by John D. Rockefeller. The Standard Oil Company was eventually broken up by court order after legal action was initiated by antitrust authorities in the United States. Indeed, three out of the four oil refining companies in Australia today can trace back at least some part of their lineage to the Standard Oil Company.

Oil companies have developed a tense relationship with antitrust authorities throughout most of the world. Australia is no exception. The Australian Competition and Consumer Commission, and its predecessor, the Trade Practices Commission, have litigated numerous cases in the oil industry, with mixed success, for breaches of the *Trade Practices Act*, in particular price-fixing and resale price maintenance.

Are claims that petrol prices are too high correct? Do popular stereotypes—that oil companies are ripping off the public through petrol price rises—ring true? Do the oil companies behave like a cartel?

Petrol prices in Australia at the time of writing are hovering between 70 and 80 cents a litre in most of the capital cities and are often much higher in country areas.

The largest component in the price of petrol at the bowser is tax. Commonwealth excise on unleaded petrol is currently just over 43 cents a litre. Around 8.2 cents of this goes back to State and Territory governments, some of which use it to subsidize and reduce the cost of petrol by some amount. In Victoria, for example, 1.1 cents is returned to motorists in the form of lower petrol prices; in Queensland the entire amount is used to reduce the price.

Another major component in the price of petrol is the cost of crude oil. Crude oil is the main ingredient in the oil refining process from which all petroleum-based products are made. Although Australia does produce and export some crude oil of its own, more than 50 per cent of the crude oil used in Australian refineries comes from overseas. This makes Australian petrol prices heavily dependent on the international price of crude oil. The price of crude oil is generally denoted in barrels, which are equal to roughly 159 litres.

The price of Malaysian Tapis crude oil, the benchmark crude oil in the Asian region, has risen from US$10.95 a barrel last December, to US$11.50 a barrel in February, to about US$21.65 a barrel in mid-August. Other varieties of crude oil have had similar price rises during this year. The main reason for this price rise is the production cuts in crude oil made by the Organization of Petroleum Exporting Countries (OPEC), which have consequently pushed up the world price of crude oil.

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Converting crude oil prices from barrels into litres and US dollars into Australian currency indicates a crude oil price of 10.6 cents a litre in December, 11.1 cents in February, rising to 20.9 cents in mid-August.

After allowing for taxation and the price of crude oil, the rest of the retail price of petrol has to cover refinery production costs, the cost of distribution and transportation to the retail market, advertising and marketing, the cost of operating service stations as well as any overhead administration costs. After taxes and the price of crude oil are taken into account, it does not leave much to cover these other expenses.

High profitability within an industry has sometimes been used by economists as an indicator of market and/or monopoly power. According to a survey conducted by Ernst & Young on behalf of the Australian Institute of Petroleum, profitability for the domestic refining and marketing companies has been less than spectacular. It found that the net underlying return on shareholders' funds was only 5.3 per cent in 1997, as compared to the average yield on 10-year Treasury bonds during 1997 of 6.9 per cent.

Treasury bonds are used as a proxy for a (relatively) risk-free investment vehicle as compared to other investment opportunities because they are issued by the Australian Government. During 1997, the domestic refiners would have been better off investing in Treasury bonds than risking their money by investing in their Australian refining and marketing operations.

So what have the critics been accusing the major oil companies of?

Recent media criticism of high petrol prices and the oil companies has been spearheaded by the New South Wales Minister for Consumer Affairs, Mr John Watkins. Mr Watkins has called on the Australian Competition and Consumer Commission to investigate what he has described as 'outrageously high' petrol prices in regional NSW, declaring that 'It's the major oil companies that do have a lot to answer for'. Mr Watkins has been blaming 'greedy' oil companies for recent petrol price hikes and the failure of the Federal Government's moves towards deregulation of the retail industry.

If Mr Watkins had managed to get himself a copy of the ACCC's 1996 report on the retail petrol market (*Inquiry into the Petroleum Products Declaration*) he might have discovered some of the answers. Aside from higher transport costs, the ACCC identified a number of other reasons for petrol prices being much higher in the country than in the city.

The ACCC found that there were far too many service stations selling low volumes of petrol, requiring much higher retail margins than required in the cities just to remain viable. In other words, too many retail outlets chasing a limited amount of business.

It also found that there was a general lack of competition in country retail petrol markets, with retailers much preferring to accommodate the opposition rather than compete against it. The ACCC did not, however, absolve the oil companies from blame altogether, finding that there was some evidence to suggest that oil companies extracted higher fees and royalty payments from country service station franchisees.

The President of the NRMA, the largest motoring organization in the country, Mr Nick Whitlam, has called on the ACCC to launch an inquiry into petrol prices. There have been 40 inquiries into the oil industry since the 1970s. During the 1990s, there have been five State and Territory-based inquiries, as well as two Federal inquiries. No other industry could claim this level of scrutiny and examination.

Never one to miss a media opportunity, the Chairman of the ACCC, Professor Allan Fels, has also weighed in on the issue. He was questioned on the ABC's *7.30 Report* about price boards at service stations and how this allows the major oil companies to find out their rivals' price. In responding to a question on whether this amounted to illegal tacit price collusion, Professor Fels replied: 'On the whole, we have thought that means of signalling to one another is just inside the law, just safe, but it's fairly close.'

When making this observation, Professor Fels obviously forgot about recommendation 9 from the ACCC's 1996 report that states: 'The State and Territory Governments give consideration to the mandatory display of price boards at service stations.' What was suggested as a good idea by the ACCC in 1996 to promote competition has undergone a transformation to tacit price collusion by 1999.

The Federal Labor Opposition has been blaming the Government's deregulation package for recent petrol price rises. Shadow Assistant Treasurer Kelvin Thompson said that the reason for recent price rises was 'the Government's abandonment of wholesale price maximums and price monitoring by the ACCC in August last year.'

Up until August last year, petrol prices had been subject to some form of price regulation since the beginning of the Second World War. The most recent manifestation of this was the maximum endorsed wholesale price which was set daily by the ACCC. It was based on the imported price of petrol from Singapore, the closest major refining centre to Australia.

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The former Industry Commission (now Productivity Commission) in its 1994 report into petroleum products recommended that the maximum endorsed wholesale price should be scrapped. It found that it was not a constraint on pricing in metropolitan areas, noting that it may even have acted as a target price at the end of a discount cycle. Even the ACCC in its 1996 report recommended that petrol price controls should be removed.

Given recent increases in the international price of crude oil, it is extremely doubtful that continued price regulation would have done anything to prevent recent petrol price rises, contrary to Mr Thompson's assertion.

Another cause of complaint amongst motorists in the capital cities is the massive price fluctuations that are observed. The ACCC in its 1996 report found that:

> it appears that petrol price cycles in some capital cities are generally linked to weekly fluctuations in demand, continuing excess product at refineries, the threat of or land of imports, the presence of independent chains and competition for sale share.

The ACCC also hinted at possible motives on the part of the major oil companies of predatory pricing (pricing below cost in order to drive your opposition out of business). This all sounds pretty much like a normal competitive market process, however, with the forces of supply and demand ultimately determining prices at the end of the day.

In its report, the ACCC concluded that:

> Retail price levels in Australia appear relatively low by international standards, despite the high concentration of companies and the relatively low level of demand, and apparently profitability is not excessive.

The major oil companies are also subject to legislation that restricts the number of retail outlets that they can directly own and operate—the *Petroleum Marketing Retail Sites Act 1980 (Sites Act)*. The Fraser Government introduced this legislation in order to counter the perceived evils of vertical integration within the industry. This has forced the major oil companies to franchise out most of their retail network. This restriction, imposed on the commercial freedom of the major oil companies, is unprecedented in Australia.

This means that at most retail service stations, the major oil companies have no direct control over the pump price of petrol and any attempt to do so would risk possible breaches of the *Trade Practices Act*.

The major oil companies claim that the *Sites Act* has hampered their attempts at service station site rationalization. They claim that this has led to many service stations remaining in business with low sales volumes and requiring higher retail margins to survive, consequently pushing up the price of petrol to consumers.

The current Federal Government has accepted this argument and is attempting to repeal the *Sites Act*. This is being thwarted, however, by opposition from the Labor Party and minor parties in the Senate.

All this adds up to the fact that the major oil companies in Australia are not quite the villains and rip-off merchants that they are often portrayed to be by politicians and the media. With the lethal combination of the media and politicians on the warpath over petrol prices at the moment, the latest 'regulatory solution' to the ongoing problem of high petrol prices cannot be too far away. Maybe it is about time we had a little less regulation in the petrol industry. This is a novel solution that could actually make the price at the bowser far more palatable.

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