



SHELL AUSTRALIA'S SUBMISSION

TO

**THE AUSTRALIAN COMPETITION AND CONSUMER (ACCC)
INQUIRY INTO THE PRICE OF UNLEADED PETROL**

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Introduction

This submission addresses issues relevant to Shell under the broad subjects, “Refining and importing”, “Wholesale and distribution” and “Retail”, which are set out in the Issues Paper published by the ACCC in June 2007. However, as Shell is essentially no longer a retailer, the submission makes limited comment on the retail market.

As an overarching comment, Shell believes that the Australian market for unleaded petrol is highly competitive as evidenced by:

- the fact that Australian fuel, both pre and post tax, is amongst the cheapest in the OECD countries;
- Shell’s profits before interest and tax in 2006 equate to 2.3 cents per litre of fuel and over the last five years have averaged around 1.8 cpl or 1.5% on a litre of petrol); and
- Shell’s investment of over \$1 billion in the Downstream business (refining, distribution and marketing) in Australia over the last 5 years is equivalent to what it has earned as profit before interest and tax in that period.

Refining and importing

Capacity

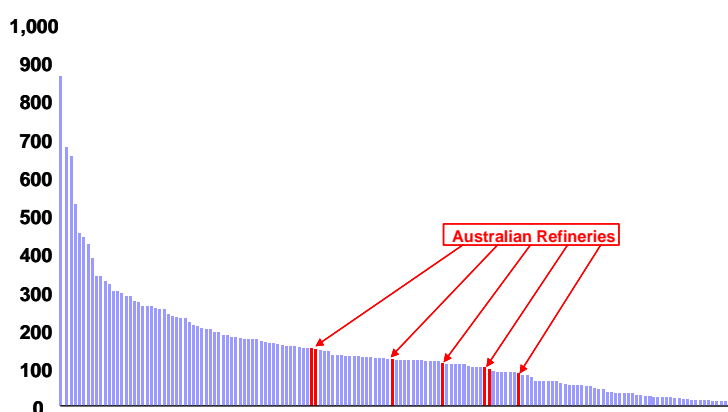
There are four integrated refiners/marketers operating refineries in Australia. These are: BP, Caltex, ExxonMobil and Shell. BP (QLD and WA), Caltex (NSW and QLD) and Shell (NSW and Vic) operate two refineries each and ExxonMobil (Vic) operates one. The total capacity of the seven refineries is 42 970 million litres per annum and they produce petrol, diesel, jet fuel, fuel oil, liquefied petroleum gas, lube oils, bitumen and other products.

Shell’s Geelong refinery in Victoria has a capacity of approx 110,000 bbl/d and Clyde Refinery in Parramatta, NSW has a capacity of approx 90,000 bbl/d. Between them, these refineries provide around 27% of Australia’s petroleum products.

Shell has no plans to increase this capacity, other than marginally through equipment upgrading.

The combined capacity of the seven refineries in Australia is less than the capacity of some individual refineries in the Asia–Pacific region. For example, the SK Corporation refinery in South Korea has an annual capacity of 47 415 million litres per annum. The graph below illustrates this point.

Asian Refineries (capacity in thousands of barrels per day)



Imports

In the first half of 2007, Shell's imports accounted for 12% of its total unleaded petrol volumes compared to 11% in 2006.

There are many terminals into which fuel can be imported into Australia. Shell imports fuel into a number of different locations, including independently owned terminals in Darwin and Sydney.

Storage

Shell's supply logistics are optimised around storage infrastructure. The location and scale of this infrastructure is ultimately determined by the market. Shell does not see any particular barriers to putting additional storage facilities in place other than market driven economics.

In recent years Australian fuel standards have been tightened to be largely in line with "Euro 3" specifications with one major exception. Under Euro 3 the amount of MTBE in petrol can be up to 15 per cent, whereas the Australian fuel standards allowed for 1 per cent. The hybrid nature of the Australian fuel standards makes it more difficult to obtain supply, as it is not readily available from many refineries in the region.

Despite this, there are several options in the international market for acquiring Australian specification fuel. In Shell's case, it sources its imports either from the Shell refinery in Singapore (Bukom) or trading with third parties. In 2006, for example, 44% of Shell's imported unleaded petrol came from trading with third parties.

"Buy/sells"

In states where Shell operates a refinery, Shell sells fuel at a wholesale level to other refiner/marketers. In states where Shell does not have a refinery Shell either buys fuel at a wholesale level from other companies that do have refineries there, and/or transports fuel from Shell's Australian refineries or imports from the international market. In Queensland for instance, Shell typically imports directly into its North Queensland terminals (mainly from its Singapore refinery) but buys fuel for the Brisbane market from a refiner in that state.

In instances where Shell is buying or selling fuel, Shell negotiates a contract with the buyer or seller, based on an import parity price, using a suitable regional benchmark, plus Australian quality premia, freight and wharfage. In most cases, fuel is supplied into the buyer's terminal, and the buyer is responsible for the costs and operation of terminalling and consequently for setting their own terminal gate price.

Whilst from Shell's perspective, buy/sell negotiations are aimed at securing the lowest cost of supply, it is ultimately the market, not the buy/sell price, which determines the wholesale or terminal gate price. Australian refined petroleum product prices follow international prices because the Australian petrol market is an integral part of the highly efficient global petrol market.

There is an enormous challenge for Australian refinery operations to remain cost competitive, for otherwise they will not survive against the alternative of imports. These same market forces ensure that there are adequate fuel supplies in Australia by minimising any product export incentives that would arise if prices in Australia were set below international prices.

Prices in the Australian petroleum product market, like prices for many other products sold in the Australian market, are therefore based on the price of imported alternative supply (Import Parity Pricing), rather than on cost plus or bottom-up pricing of manufacture in Australia. One of the main benefits from the competitive pressures created by an open market like this, is that over time it tends to provide lower prices to consumers compared to prices established,

for example, by a cost plus formula (with an appropriate allowance for a reasonable return on capital).

Wholesale and distribution

Terminal Gate Price

Shell structures its wholesale fuel sales across Australia around a terminal gate price (TGP). Terminal gate pricing is presently a legislated requirement in Victoria and Western Australia and is a requirement under the Oilcode, which is part of the Federal Government's petroleum market reform package. The TGP is based on import parity pricing and includes a Singapore fuel price benchmark, ocean freight, wharfage charges, insurance, a premium for Australian quality product, a terminal margin to cover costs of infrastructure, excise tax (38.14 cpl) and GST (10%).

Singapore benchmark

Australia uses a Singapore benchmark for unleaded petrol because Singapore is the leading refining, exporting and trading hub in the Asia Pacific region. The Platts organisation collects extensive data on trading through the Singapore hub and publishes daily prices (a high and low) for various grades of commonly traded fuel.

“MOPS95” (the mean of Platts Singapore price quote for spot sales of Premium Unleaded Petrol – 95 Octane) is the common benchmark for commercially traded Australian-grade unleaded petrol. The quality of this benchmark fuel most closely reflects Australian fuel standards, although the quality of Australian fuel standards currently exceeds this benchmark. Any movement to another marker would require an adjustment for Australian quality premia and would likely have a minimal impact on overall pricing and volatility.

Because of the higher Australian fuel quality standards, the actual purchase prices, which Shell and other companies will pay for imports of unleaded petrol into Australia will exceed the marker prices quoted by Platts.

Ocean freight

The benchmark freight cost used is the Worldscale quote for the journey from Singapore to the relevant discharge port, eg: Singapore to Sydney. Worldscale is an internationally recognised non-profit organisation whose members include leading international tanker broker firms (for more information see www.worldscale.co.uk). Worldscale quotes are recognised and used internationally as a basis for negotiating oil industry freight costs.

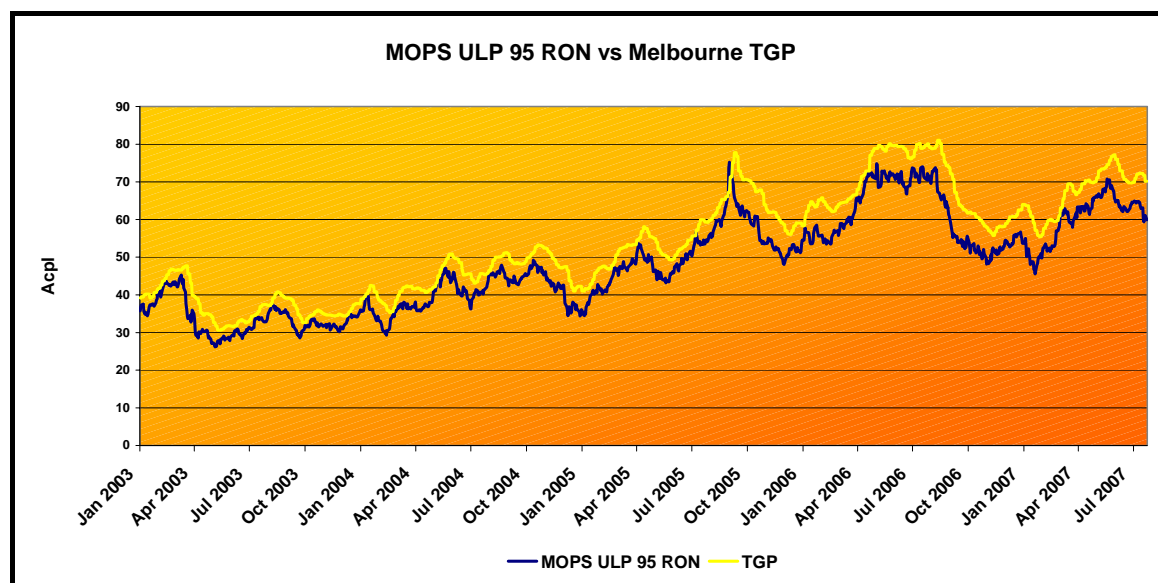
Until recently, the specific index used was based on the quoted Singapore to Japan voyage for a 30,000 tonne vessel. Although a number of Singapore to Australia quotes were available, the market was too thin to provide a reliable and stable price, hence the use of a Singapore to Japan reference as it represented a comparable voyage and a more robust market.

Since the beginning of 2007, Shell believes that the market for freight from Singapore to Australia had increased sufficiently to warrant using a Singapore – Australia quote as the basis for its ocean freight calculations.

Quality premium for Australian petrol

The quality premium for Australian petrol is a result of Australia's legislated fuel quality specifications. A good example is the limit of under 1% benzene in petrol, which is more stringent than in the majority of countries in the Asian region, and requires expensive refinery investment to produce. Australian quality price premia reflect real price differentials, payable for imports of Australian quality fuels, over standard benchmark prices.

The graph below shows MOPS ULP 95 RON (Unleaded Petrol with a Research Octane Number 95) compared to the TGP in Melbourne (before excise and GST). The TGP here incorporates a rolling 7-day average price on the MOPS benchmark and exchange rates.



The graph shows that:

- the TGP follows the benchmark very closely and has risen significantly in the last two to three years;
- Margins are compressed when prices are rising and expanded when prices are falling. This is due to the 1-2 week lag on rolling averages prices.
- The gap between TGP and MOPS 95 has increased in recent years due to increases in freight charges and quality premia differential.

TGP tracks the international benchmark closely but not exactly, because Shell uses a rolling 7 day average of the daily average regional product indicator (MOPS) as the basis for TGP, which is set only twice a week. Thus, changes in international prices can take 3-4 days to begin to have an impact on the TGP, with the “full” impact taking 1-2 weeks.

The anomaly in TGP tracking import parity and international benchmarks is when there is a public holiday, either in Singapore or in Australia. When there is a public holiday in Singapore, there is no published MOPS benchmark price for the day. On a given 7-day rolling average, this has the effect of making Shell's TGP lower than it might have been if the market is rising and higher than it might have been if the market is falling.

When there is a public holiday in a particular state in Australia on a Monday, the TGP is published on the Wednesday instead of the Tuesday. The TGP calculation is based on the same formula – that is, it uses the previous 7 days rolling average.

Wholesale market

At the wholesale level, Shell sells fuel to commercial customers, Shell branded and non-branded retailers and other non-Shell branded wholesalers. The arrangements with these

customers are based on TGP and may incorporate additional charges for delivery, brand and credit. Due to strong competition and low/no barriers to changing suppliers, some customers are offered discounts to attract or maintain their business. The discount level will be largely driven by the volume that the customer is contracting to purchase.

Legislation on terminal gate pricing introduced in Victoria and Western Australia has improved the transparency of the price for buyers but, in Shell's view, has not impacted on competition.

Shell does not believe there are any particular barriers to wholesaling or distributing fuel in Australia, other than having the capital to purchase the necessary distribution equipment, such as trucks.

Retail

In the late 1990's and early part of this decade, the petroleum retail business in Australia was becoming increasingly competitive. Shell's strategy in general was to move towards fewer, bigger retail sites to spread the fixed costs of each site over more fuel sales – this was prior to the large scale entry of supermarkets into petrol retailing.

In 2003, Shell began its alliance with the Coles Group (then Coles Myer) and as a consequence, Shell is essentially no longer a petroleum fuel retailer.

Today, Shell branded sites fall into two categories:

- Dealer owned sites; and
- Coles Express sites.

In addition Shell operates a very small number of sites as part of its commercial vehicle refueling network, which sell primarily diesel fuel and are located mainly in regional areas to service large fleets traveling throughout Australia.

The following gives more detail about each arrangement.

Alliance with Coles Express.

Shell supplies fuel on a delivered basis and grants branding rights to around 600 Coles Express and Shell branded sites, predominantly in metropolitan and large regional centers. Coles Express operates the service stations, including the convenience stores and car washes. Coles Express independently sets the retail price for all fuels at these sites.

Shell sells to Coles Express on a pricing mechanism that incorporates TGP, plus other charges, for example branding and delivery.

Shell's Coles Express alliance sites constitute around 9% of the total service stations in Australia. Shell's fuel sales to Coles Express represent around 24% of total Australian retail fuel sales for on-road use, including LPG.

Dealer owned sites:

There are around 350 dealer owned and operated, Shell branded sites across Australia. Shell supplies fuel and grants branding rights and provides the option to have the fuel delivered to the site. Pricing to these customers is on a TGP basis plus a fee for branding rights and credit charges and where applicable delivery charges. Shell also makes the Shell Card facility for purchasing fuel on credit available to the site.

The dealer owner operates the service station and any associated facilities. The dealer owner sets the retail price for all fuels at these sites.

Commercial Vehicle Refueling Outlets.

The CVRO network is a small national network dedicated to the Commercial Road Transport sector. The sites are primarily designed and positioned to cater to the refueling needs of heavy goods vehicles, with the majority in regional areas. There are approx 41 CVRO's, in Shell's national network. They sell a total of 80 million litres per annum, 85% of which is diesel. These sites are predominantly Shell owned and 24 are attached to facilities that either were, or still are, functioning as Shell depots. Shell sets the pump prices at these sites.

Other retailers and wholesalers

Shell also sells fuel to other retailers and wholesalers, who are not Shell branded. These customers buy fuel based on Terminal Gate Price, plus costs for any other services such as delivery.

There is significant competition in the petrol retail market relating to factors other than the pump price, including discount vouchers, service station location, trading hours and convenience shops.

Oilcode

In March 2007 the Federal Government introduced a mandatory Oilcode, following the repeal of the Sites and Franchise Acts. Shell welcomed this development as it resulted in a small reduction in the amount of administration required under the old Acts, removed barriers to more effective competition and increased pricing transparency. However, the change has had little effect on Shell's business, as the old Acts had limited impact on Shell's primary business models (outlined above).

Shell observations on price cycles

Shell's observations internationally indicate that there are very few other markets where retail prices cycle in a way similar to that which exists in Australia. The following are the few examples:

- Germany - 2 cycles per week. Amplitude of 4 Euro cents or 3%. The market tends to move down 0.5 Euro cents, twice a day and then restore to previous levels
- Austria - Weekly cycle. Amplitude of 4 Euro cents or 3%.
- Canada - Multi day part cycle. 8-10 price changes per day. 5-8 cents per day. High at night (post commute) down during the following 24 hours.

In Shell's view, the retail price cycles in Australia are driven by the relatively high proportions of fixed costs throughout the supply chain leading to a requirement to maintain volume throughputs at high levels. When that circumstance is blended with the absolute transparency of retail price boards and the customer sensitivity to very small pricing differentials, price cycles occur which create an intensely competitive market, to the ultimate benefit of consumers.