Coles Group Limited

Submission to the

Australian Competition & Consumer Commission
Inquiry into the price of unleaded petrol

July 2007

ACCC INQUIRY INTO ULP PRICES IN AUSTRALIA

Introduction

Coles Express is a fuel and convenience retailer, delivering one of the best value fuel offers in Australia through the provision of quality Shell fuels at competitive board prices as well as a base 4-cent per litre fuel discount off the pump price of fuel, and periodic promotions allowing customers to access discounts as high as 20 cents per litre (cpl).

Every month more than eight million Australians ‘vote with their feet’ and visit Coles Express to redeem their 4-cent per litre fuel discount and, in doing so, demonstrate the immense popularity of the Coles Group (Coles) fuel discount offer.

Coles Express was formed in 2003 following the development of an alliance between Coles and Shell. Under this alliance Shell supplies fuel products and Coles, under the banner of Coles Express, operates the fuel and convenience retail business independently of Shell.

Australian consumers have enthusiastically embraced shopper docket schemes. In excess of three million docket redemptions occur in the industry each week, and there are now well in excess of 100 fuel discount schemes operating in Australia, offered by retailers and other businesses both large and small.

We estimate that consumers across Australia are saving a significant amount off their fuel bills annually through the various shopper docket schemes thus helping to lower the cost of living for many Australian households.

Part A – The Current Structure of the Industry – Questions 13-19

Today, Coles Express operates 602 fuel and convenience stores Australia wide, equating to approximately 10% of the 6,500 service stations or fuel retail sites in Australia and a fifth of Australia’s retail fuel sales. Coles Express employs more than 5,000 people.

The 602 Coles Express sites are located in all states and territories as follows:

VIC	NSW	QLD	WA	SA	TAS	ACT	NT
151	187	112	66	44	16	15	11

Coles entered the fuel retailing market as a direct response to local retailer activity and the international trend of offering consumers fuel discounts for their supermarket food purchases. Prior to Coles Express entering the fuel retail market, fuel discounts were not as widely available.

Competitors at the retail level

Coles Express competes with all fuel retailers because it operates in most urban and regional markets nationally. Its key competitors are:

- the major oil companies such as Mobil, BP, Caltex and Caltex/Woolworths aligned sites;
- leading independent chains such as United, Gull, 7/11 and Matilda; and
- independents with comparable sites and convenience store offers, such as Metro and Fuel Zone.

Coles Express has one of the most extensive and efficient fuel networks in the country with more locations and higher average volumes than competitors. By international standards the Coles Express network is a highly efficient one driven by a strong brand, a strong customer proposition and low costs.

Convenience stores

Convenience stores revenues have always been important to Coles Express given low retail fuel margins. Commercial success depends on high fuel volumes being sold per site and providing customers with a compelling convenience store offer. Given the importance of our convenience store offer to profitability, we continue to improve and expand our convenience offer to customers. For example, we recently introduced everyday low prices on consumer staples, such as milk and bread in stores nationally.

Other fuel retailers have different models, some co-locating with other businesses on their sites such as fast food stores, mechanical services and car washes. These complementary businesses have become increasingly important for fuel retailers, as fuel alone does not deliver sufficient profit margins to ensure business success.

Rationalisation of sites

Coles Express has been in the retail fuel business for four years. In this time we have not observed a significant reduction in the number of sites overall. Oil company site numbers have remained much the same and independent chains are growing and competing aggressively. Poorly located sites with low volumes, no significant shop sales or other income and no compelling proposition for customers, may have declined in number but, according to industry analysts, have been doing so for decades. The decline in these types of sites supports the strong correlation between low fuel volumes and low profitability This is not surprising given the sector's gross margin of around 5%, the lowest profit margin sector in the Australian economy.

The Oilcode

It is too early to say what impact the *Oilcode* has had given that it only came into effect in early 2007. While there is scope for major oil company sites to become fully integrated with their refining businesses, we have not observed a significant impact on the retail market since the removal of the Sites Act and Franchise Act.

Part B - The extent of competition at the retail level – Questions 14-21

As the Committee would appreciate, retail petrol prices in Australia are determined largely by factors beyond the control of retailers themselves. These factors include:

- The **price of oil**, which is set internationally and oscillates on a daily basis in response to international political events and economic drivers of demand and supply. The price of oil over time is well documented and is the key determinant of petrol prices. Oil prices are currently at historically high levels.
- The value of the **Australian dollar** directly impacts the purchase price of oil (usually sold in $US per barrel) and therefore the price of products like petrol.
- **Government taxes**. Which form a substantial part of the retail board price for petrol. These include fuel excise of over 38 cpl plus 10% GST on the retail price. At today's prices this means consumers pay over 50 cents in tax on every litre of petrol.
- **Refiner margins** have reportedly increased in recent times (Coles Express only entered the retail market in 2003) which we understand reflects limitations to the refining capacity in Australia and internationally and the costs associated with the introduction of "*clean fuels*" requirements in 2006.
- Periodic **price support** provided to retailers by oil companies so as to increase or maintain their respective market shares of petrol volumes.
- The provision, or removal, of **government subsidies** eg removal of the Fuel Savings Grants Scheme operating in regional areas, the current Queensland Government subsidy and the recent removal of the Victorian Government subsidy.

Petrol retailing is a high volume, low margin business. Retail petrol prices are the outcome of a complex interplay of competitive and operational factors. These factors are peculiar to individual markets and sites. They start with the wholesale prices set by fuel distributors or refiners of oil - Shell, BP, Caltex and Mobil. Additional factors that impact the price paid by consumers are taxes, freight, operating costs, site rental, site throughputs, trading terms, promotions, legislative compliance obligations, investment, safety and maintenance needs, competitor initiatives, price support and of course, consumer demand.

The retail petrol industry is highly competitive. Petrol retailers of all sizes compete with each other for patronage by motorists seeking the lowest petrol price in the market. It is a market driven by transparent price signals with motorists keenly aware of even the smallest price differential – a price measured in tenths of a cent. Most fuel retailers invest in monolithic price boards at their sites in response to consumers' intense price awareness and scrutiny. Coles Express is currently rolling out electronic price boards to further enhance pricing information.

Average margins on retail fuel sales are extremely small, such that retailers' pre-cost share of the price of fuel is measured in single digit cents in the dollar, the lowest in the retail industry.

Differences in the retail price of petrol between cities and urban and regional markets

In regional Australia, retail fuel prices tend to be higher than metropolitan ones because of the smaller volumes sold in regional and remote locations. Due to the smaller volumes, higher fuel prices are necessary to cover the fixed costs of operating a service station in these locations. This differential is further exacerbated if, as is typically the case, the regional location has significantly lower shop sales.

For example, it is generally accepted in the industry that the larger urban fuel outlets require at least a 3-4cpl gross margin to cover fixed costs. This is before an allowance for a commercial profit is made and does not take account of other factors such as business risk and costs associated with remoteness (freight, maintenance, higher working capital and extreme seasonal conditions).

It is also true that stock turns in regional (lower volume) sites are lower and supply chains are longer hence movements in wholesale prices take longer to be passed through to customers.

Note: Further commentary on fuel price differences between cities and urban and regional markets are in Part C on page 8 - Geographic markets.

Non-price competition

Coles Express and its partner Shell have developed premium quality fuels such as V-Power to differentiate the retail offer. Price however, remains the key competitive measure at the retail level. Motorists value Coles Express to not only provide a competitive price but also quality Shell fuel products, which they trust and purchase on a regular basis.

Loyalty is another area where fuel retailers compete for custom. For example, shopper dockets are now used widely across the industry. Coles Express offers Fly Buys points to card members for fuel and convenience store purchases and card programs such as Shellcard, seek to win regular customer loyalty and patronage.

Other factors such as the convenience of the location, ease of access to the site the speed of service and the other retail offers are important considerations to motorists. Consequently, retailers have invested in prime site locations and point-of-sale technologies to improve service and provide complementary goods and services.

State Government Regulation on Retail Price Competition

Western Australia is the only state with significantly different regulations on retail prices. Our general observation of the WA market is that while intraday prices in certain areas of the state remain unchanged for the day it does not prevent price cycles, although they tend to be smaller in amplitude. We have observed that over the course of the last year retailers have been fined for discounting petrol to motorists at prices lower than they notified the WA PriceWatch regulator. It seems a bizarre situation to limit the ability of retailers to respond to their competitors by selling fuel to motorists at lower prices. WA motorists are arguably missing out on lower prices generated by vigorous intraday price competition that would otherwise be offered, as occurs in all other states.

Part C – The determination of prices at the retail level – Questions 21-33

As outlined in Part B, retail petrol prices in Australia are determined largely by factors beyond the control of fuel retailers themselves.

In this environment, the Coles Express pricing strategy across Australia is to present motorists with a consistently competitive offer by at least matching the board price of the lowest priced competitor as often as possible. Successful execution of this strategy provides consumers with confidence that whatever the retail price, they can be assured that Coles Express provides the best value. In addition, of course, Coles Express also offers a base 4cpl discount for those consumers who choose to shop and save at Coles, Bi-Lo, Kmart and Liquorland outlets, plus periodic promotional offers.

We observe a number of different pricing strategies employed by different operators. Those that do not rely on large volumes of fuel through their sites, such as 7/11, tend to lead prices down to attract customers to their convenience store offer. A business model more reliant on convenience store sales than fuel can use fuel as a loss leader and take advantage of the price cycle to generate in store foot traffic.

Most retailers in Australia use a high/low pricing strategy that involves offering discounts to the regular board price, facilitated by price support from oil companies. This discounting cycle has intensified over time as a result of increasingly vigorous price competition, putting downward pressure on fuel prices that must in turn be offset with higher prices when the cycle ends. Today the breadth of the cycle regularly spans over 10cpl.

Price Support and Discount cycles

Based on customer response, Coles Express believes that motorists have become so accustomed to regular discount cycles that they factor the cycle into their decisions about both where and when they buy fuel. As such, the majority of motorists take advantage of discounted prices during the cycle.

Retailers like Coles Express rely on averaging of their retail margins between the high and low points of the cycle.

It is our observation that fuel discounting cycles tend to vary in intensity and duration from location to location, depending on the concentration of competing sites in the local geographic market and the degree of price support provided by oil companies to retailers in these markets. Typically, petrol discounting cycles are more intense in metropolitan areas than regional areas because of higher volumes and closer proximity to a larger number of competitors.

Coles Express's experience of fuel sales across the price cycle is that over 50 per cent of fuel is sold below the average cycle price. The sector's slim margin coupled with intense competition and customer sensitivity to price movement leaves little room for error in managing the discount cycle.

Consequently, price support from the oil companies provides an important source of funds to help retailers manage their way through the discount cycle. Generally speaking, price support finances the cost of discounting by retailers who competitively match lower board prices in the expectation that higher prices will return and average their sell price to make a profit. This mechanism enables fuel retailers to compete with other market participants who set out to use fuel as a 'loss leader' to attract customers to their non fuel retail offer, such as the convenience store or food to go.

While Coles Express has only been a fuel retailer for four years and therefore has limited data on price cycle movements prior to 2003, we don't believe the fundamental pricing strategies employed by retailers have changed in recent times.

Mogas 95 & Retail Price Divergence

The key reason for the divergence in the two periods in question was that the normal discount price cycle was extended by up to two weeks. Prices remained at or near the bottom of the cycle longer due to local competitive pressures. While motorists enjoyed a longer period of lower prices, particularly in Sydney, the prices were not sustainable because retailers were losing money.

As indicated earlier, most fuel retailers, including Coles Express, rely on averaging profit margins over the typical weekly cycle.

It should be noted that Coles Express sets board prices based primarily on local retail competition – board prices are not directly driven by wholesale prices (although there is obviously a need to make a margin over the cycle) and have no direct reference to Singapore prices.

Geographic markets

Geographic markets generally fall into two categories, urban and regional.

In urban markets most of the major oil companies and independent fuel chains have sites, usually in close proximity to one another. In regional areas there are fewer chain operators present, because of lower population and traffic densities, but generally more independents or sole owner operators.

Urban sites benefit from higher concentrations of cars on the road. Typically urban sites sell substantially higher volumes of fuel compared to regional sites, often requiring tanker deliveries on a daily basis. Some regional sites require deliveries less than weekly, partly explaining why regional price cycles are less frequent and lower in amplitude, with fewer wholesale price variations being fed through to motorists.

As outlined in the previous Part B, the difference in urban and regional volume throughput explains why regional prices are higher than urban prices.

Part D – Current impediments to efficient petrol pricing and possible methods to address them

We don't believe there are any significant impediments to efficient petrol pricing at the retail level, other than in Western Australia.

Coles Express is a very efficient fuel retailer. We continue to monitor and contain our costs and improve efficiency. Profit margins are wafer thin. Coles Express endeavours to maximise volumes through its competitive board prices as well as the base 4cpl shopper docket discount and other 4 cents plus offers available from time to time. Additionally, Coles Express is working to increase sales and profitability of the convenience store.

It is our observation that petrol prices, as a product, and their reporting across the country are arguably the most transparent, watched and talked about price in the Australian marketplace. The transparency of these prices - via prominent price boards usually located on major roads, web sites and in the media - enables motorists to make informed choices about how much to pay and where to buy their fuel.

Coles Express's approach to pricing is to at least match the board price of the lowest priced competitor, as often as possible. If our pricing is out of the market by more than a fraction of a cent, our site driveways are empty of motorists within minutes.

As a consequence Coles Express monitors board prices at our sites, and those of our competitors, every 15 minutes. This is achieved using Informed Sources (***Informedsources.com.au***) data that covers more than 90 per cent of sites nationally, enabling all retailers to make informed and timely price changes, which ensures intense price competition.

Price matching or parallelism

The uniformity with which board prices change in particular geographic markets is a distinguishing characteristic of fuel price cycles. This uniformity in price changes is a consequence of vigorous price competition for a homogenous product between fuel retailers and availability of information to make rapid changes, with each retailer in particular geographic markets trying to match or better the others' prices. Fuel retailers are all too aware that if they fail to respond to a competitor's lower price point, then motorists (having little brand or site loyalty) will simply purchase their fuel at a nearby retailer with cheaper prices and they will lose their custom.

The ACCC, in its evidence to a Senate *Inquiry Into Petrol Prices* in July 2006[1] said:

"…price matching or parallelism…. relates to the fact that petrol is generally a similar product with minimum brand loyalty, which means that competition is based primarily on price. Retailers cannot afford to set prices that are higher than prevailing market prices for too long or they risk losing market share".

The ACCC went on to conclude:

"So it is not surprising that retail petrol prices cluster around an average".

We are not aware of any price collusion at the retail level and, by any measure, retail fuel prices, while volatile, are subject to this strong countervailing consumer *price matching* effect. Retailers who set prices higher than prevailing market prices can and do lose customers. The WA market is a good example of this happening when retailers, in error, set their price uncompetitively high and are unable to adjust it for 24 hours. It is also why parallel pricing is so evident elsewhere – if retailers do not match the lowest price offered, motorists can easily drive to an alternative supplier with a lower price.

Imported fuel

Coles Express has an exclusive fuel supply contract with Shell. We understand that Shell uses a combination of local and imported fuel/oil to refine the Shell fuel Coles Express sells. We do not have visibility of, and cannot comment on, the level of competition at the wholesale or distribution levels.

Competition

Motorists have a significant number of fuel retailers from which to choose. These include the major international oil company chains as well as numerous independent chains and smaller owner operators.

The majority of motorists see unleaded petrol (ULP) as a homogenous product and have little brand loyalty if the price is not right. All other things

[1] Evidence to Senate Economics Legislation Committee July 2006 page 101

being equal, motorists chose a site that is convenient, has good service and provides quality fuel. Competitive board prices, the right mix of fuels, convenience and service determines retail success.

Few informed observers of the retail fuel market would argue that there is an absence of intense competitive rivalry between retail brands. This is evidenced by consumer willingness to switch between brands (or the same brand in different locations) based on product prices that are measured by these customers in tenths of a cent.

This behaviour and intense rivalry has led to ever decreasing margins at the retail level where gross profit is less than 5% (five cents in the dollar) and net profit margins are less than 1%. Such margins have, over the last 30 years, led to the closure of low volume or poorly located sites and the expansion and placement of larger sites with convenience stores on major roads and intersections - seeking to increase economies of scale to maintain profitability.

Regulation

While there are many regulations relating to safety and the environment, the only significant retail regulations on prices are in Western Australia. These regulations prohibit intraday price discounting or changing of retail fuel prices for 24-hour periods of time. Our experience of this level of regulation in WA, is that it tends to reduce intraday price volatility and competition between fuel retailers.

Most fuel retailers earn less than one cent in the dollar net profit on each litre of petrol sold – a very small proportion of the retail fuel price. This compares to over 50cpl collected in taxes. By way of illustration, Coles Express's 2006 audited earnings before interest and tax (EBIT) was $30 million.

Conclusion

The fuel retail industry is intensely competitive and will continue to explore ways of improving productivity through higher volumes and lower costs.

Coles Express is proud of its record in providing a competitive fuel offer to Australian motorists, and seeks to offer competitive prices in every geographical region in which it operates. Coles Express also offers motorists the opportunity to save a further 4 cents or more per litre if they choose to shop at Coles supermarkets, Kmart or Liquorland stores. Offers such as this are helping reduce the price of petrol for Australian motorists and we aim to continue developing innovative offers in the marketplace for them. Customers taking advantage of our low grocery prices and the Coles Express shopper docket scheme are reducing their household expenses and the effective price of petrol.

In conclusion, oil prices are the key determinant of petrol prices and these are determined largely by factors beyond the control of retailers or governments.

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