

Caltex Oil Hong Kong Limited
Submission on Retail Pricing of Petroleum Products

As a major marketer of petroleum products in Hong Kong, Caltex has always been a socially responsible oil company which follows closely the ups and downs of import prices of oil products. Caltex fully supports the free market economic system of Hong Kong and is an advocate of free and fair competition in the industry. In view of the recent discussions on retail pricing issues of petroleum products, we would like to take this opportunity to clarify and explain on our pricing policy with regard to crude oil prices, unleaded gasoline and diesel prices, and liquefied petroleum gas prices.

1. Crude Oil

People often have a misconception in the relationship between crude oil prices and refined oil products prices. The wrong perception is that if crude oil prices drop, the prices of other oil products have to drop at the same rate also. This is incorrect as oil products such as unleaded gas and diesel are refined oil products. Although they used crude oil as material, they have undergone a series of refinery processes which produced different refinery products with different uses and values. It is therefore irrelevant to assume that crude oil and its refined products will reduce prices at the same rate.

To illustrate this more clearly, we can take as example the case Consumer Council referred to in its letter to Caltex dated November 6, 1998. The letter stated that “from October 1997 to July 1998, the price of Arab crude oil price dropped from US\$19.20 per barrel to US\$11.85---a drop of US\$7 per barrel, or 38%. It would be expected that average Hong Kong import prices would follow closely any increases or decreases in the price of crude oil”. If we draw a comparison between the crude oil unit (barrel) and the retail unit (liter), we will see that every US\$1 price change per barrel is equivalent to approximately HK\$0.05 price change per liter. Given this, it is totally irrelevant to apply the same rate for crude oil and pump price changes. It is true to say, however, that Caltex has followed closely any increases or decreases in crude oil price changes as a reference for its pump price adjustments.

2. Unleaded Gasoline (ULG) and Diesel

The pump prices of ULG and diesel are made up of various factors, with consumption tax being the major component. In fact, more than half of the price collected is paid as consumption tax to the government through oil companies. In Table 1 below, we can see that approximately 60% of the pump price paid by motorists for ULG is public revenue, as is 35% of the diesel price. Therefore, it is incorrect to compare the percentage of price drop among pump prices, crude oil prices and import prices, as the pump price is made

up of various costs and a large portion of it just go directly from the oil company to the government.

Table 1. Proportion of Consumption Tax in Pump Price (per liter)

	Automotive Diesel	Unleaded Gasoline	Leaded Gasoline
Pump Price	\$5.69	\$10.04	\$10.69
Motorist Fuel Tax	\$2.00	\$6.06	\$6.82
Tax Component	35%	60%	64%

According to the Consumer Council letter mentioned in section 1, average import prices for ULG and diesel from the period of October 1997 to July 1998, obtained from the Census and Statistics Department, are as follows:

Table 2. Average Import Prices (per liter)

Product	Oct 97	July 98	Price change
Unleaded Gasoline	HK\$1.30	HK\$1.06	- HK\$0.24
Diesel	HK\$1.19	HK\$0.79	- HK\$0.40

On the other hand, the price changes in Caltex for the same period are as follows:

Table 3. Caltex’s Pump Price Changes

Product	Price Change from Oct 97 - July 98
Unleaded Gasoline	- HK\$0.20
Diesel	- HK\$0.33

As shown in tables 2 and 3, our decrease in price is actually very near to the government statistics. This indicates that our prices follow the general trend of import prices and we will keep the price at a reasonable low level so that our customers can benefit most.

Please keep in mind that apart from following the trend of import prices and reduce our pump price, we also face increasing operating costs and have to offer sales promotion discounts to our customers due to fierce competition in the industry. All these factors added extra burdens to Caltex and the reduction in import prices is easily offset.

2.1 Operating Costs

The operating costs of ULG and diesel are constantly on the rise. Of all the operating costs Caltex has to bear, we would like to draw your special attention to the huge investment we paid to the government in 1997--the lease renewal payment.

In 1997, with Hong Kong's hand over to the Chinese government, the leases of 12 of our service stations terminated at the same time. Those 12 stations are at: Kai Tak, Kwun Tong, Tai Po Road, Tai Hang Tung, Po Kong Village, Kowloon Bay, Tai Po Market, Mui Woo, Fo Tan, Yuen Chau Kok, Tsuen Wan and Clear Water Bay. To continue our business, a single sum of HK\$700 million was paid up front as lease renewal to the government. If we calculate this sum against the assumed interest rate of 7% and our average monthly throughput in liters, for every liter of oil, we have to pay an extra sum of over HK\$0.20 as interest and the renewal payment itself. This enormous cost was paid at our own expense rather than passed on to the customers by charging higher pump prices. Please be reminded that the leases have to be renewed in another 21 years.

We also have to pay about HK\$1 per liter as rent of short term tenancy for certain service stations to the government, as well as the rising operating costs incurred from depreciation and amortization, maintenance, utilities, and human resources etc. For details, please refer to annex 1.

2.2 Competition in the Oil Industry

Competition in the oil industry in Hong Kong is fierce given that there are only a few oil companies in this geographically small market, and every competitor is fighting for more market shares. Although we do not usually offer discounts on the pump price of our products, we often provide other sales promotion offers to our customers. Quite a large proportion of our customers of motor fuels benefit from lower actual pump prices, taking into consideration various price reducers such as discounts offered to fleet drivers, promotional giveaways, free credit terms, and card benefits to different market segments. For example, with every purchase of HK\$200 at our service stations now, customers can use a cash coupon valued at HK\$12 and enjoy a discount from the grand total immediately, which is equivalent to HK\$0.60 per liter off the pump price. Please note that due to intense competition, this same offer has increased from a \$5 discount a year ago to a \$12 discount now.

Retail sales are only one segment in Caltex's portfolio of businesses. We also supply all kinds of oil products in bulk for our industrial and commercial customers, utility companies, the government, international airlines and shipping lines. Competitive discounts and various value-added services are often offered to them in view of the fierce competition in the industry.

Competitive forces in the industry have resulted in remarkably responsible and steady oil prices in Hong Kong over time. In the year 1997, the retail price of auto fuels has actually decreased by 6.7% (government tax excluded). Similarly, our annual price increase from 1990 to 1998 is also lower than that of other commodities such as housing, transport and clothing. For more details, please refer to annex 2 and 3.

3. Liquefied Petroleum Gas (LPG)

Our LPG list price of HK\$8.35 per kilogram has remained unchanged for two years now. Despite the ever-increasing operating costs and inflation, we have not raised the price since our last price adjustment in November 1996.

Like ULG and diesel, the LPG list price is composed of various necessary costs apart from the LPG import price. These include commission to dealers, cylinder plant filling, cylinder reconditioning and replacement expenses, delivery costs and fixed costs. The LPG import price represents just a small portion (about 25%) of our list price, so it alone may not be a decisive factor in adjusting our price.

So even though LPG import price has dropped from the average price of HK\$1.75/kg in 1997 to HK\$1.13/kg in 1998 (Jan to December {projected}), this will not necessarily lead to a price adjustment. Due to expense increase of other composing factors, this HK\$0.62 decrease in import price from 1997 to 1998 has been offset, as detailed below:

3.1 Commission increase for dealers

Over the past few years, the LPG cylinder consumption has been declining quite significantly, at about 5% a year. Since LPG dealers are facing more and more intense competition in the market, Caltex implemented a new incentive program in August 1997 to support them. An addition of HK\$0.17 is paid as our dealer's commission per kilogram to alleviate their operating cost so that our dealers can survive and provide the required standard of service to our customers.

3.2 Increased investment and operating costs due to new safety requirements

In response to the new regulatory requirements on LPG cylinder wagon parking, three new cylinder wagon parking sites were built at Tuen Mun, Kwai Tsing and Pokfulam at the oil companies' expense. These parking sites not only generated construction costs but extra operating costs as well, which add up to approximately HK\$0.1/kg more.

3.3 Inflation

As mentioned, we have not adjusted our LPG list price for two years, despite the average inflation rate of 5.8% in 1997 and 4.1% from January to September, 1998 (figures obtained from Census and Statistics Department). For 1997, we were actually bearing an additional operating cost of HK\$0.383/kg due to the inflation.

3.4 Investment on Infrastructure

To maintain the standard of LPG infrastructure at our terminal, a substantial investment has to be made to ensure a continuous and reliable supply of LPG to our customers and to strengthen our operation safety. Therefore, investment expenses such as LPG filling plant upgrade and LPG cylinder replacements are composing factors of the list price also.

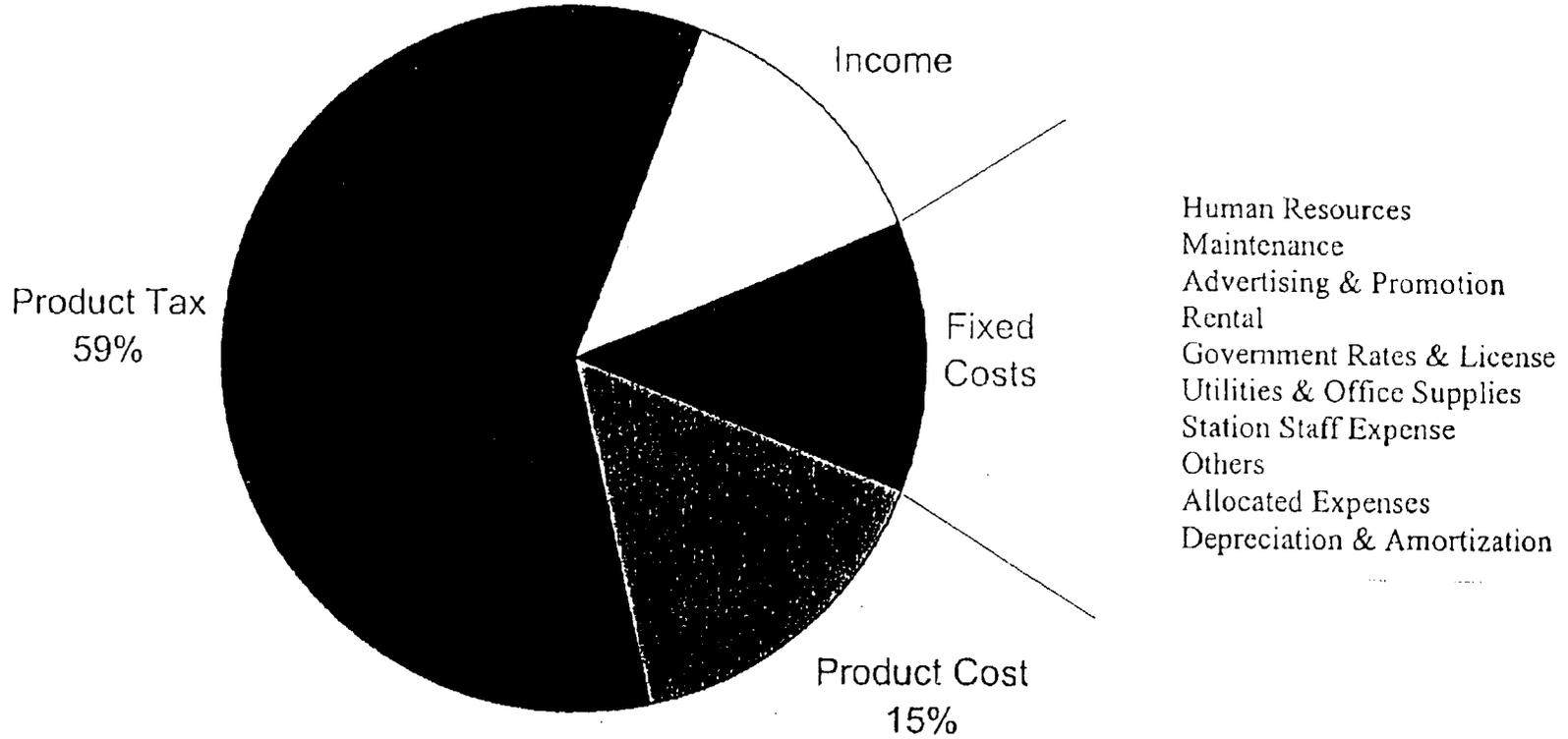
In view of the above increase in operating costs, we still adhere to the price set in 1996 instead of increase our price to offset the extra expenses. Since we have not adjusted our price and the costs are ever increasing, the price difference caused by reduction in LPG import price has been offset entirely. For your information, the LPG import price from July this year onwards has gone up by 84%, but we still have not adjusted our price upwards. As of today, the cost benefit of lower product cost to offset the increased operating cost is no longer valid. The escalating product cost of LPG is back to the level of October 1997.

In fact, LPG is still the cheapest and most competitive domestic fuel for cooking and water heating in Hong Kong when compared to electricity and town gas. Besides, LPG suppliers and dealers have to compete strongly among themselves, whereas the other two fuel companies are monopolies. It is not uncommon that LPG cylinders are sold at an unit price lower than the list price in certain districts.



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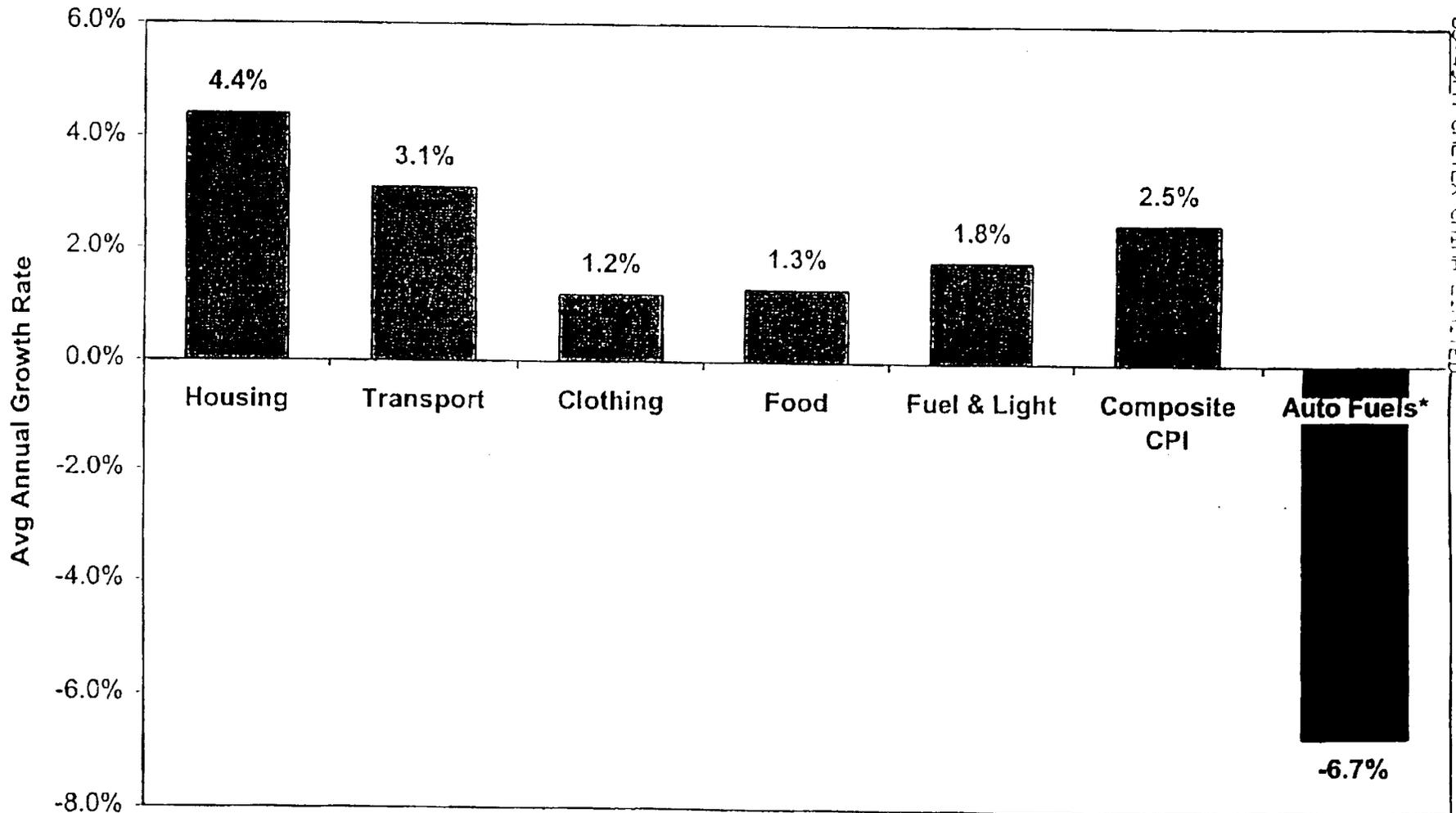
CALTEX OIL HONG KONG - RETAIL SEGMENT COST & PROFIT COMPONENTS (YTD OCT 98)





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1997-1998 ANNUAL PRICE INCREASES IN HONG KONG



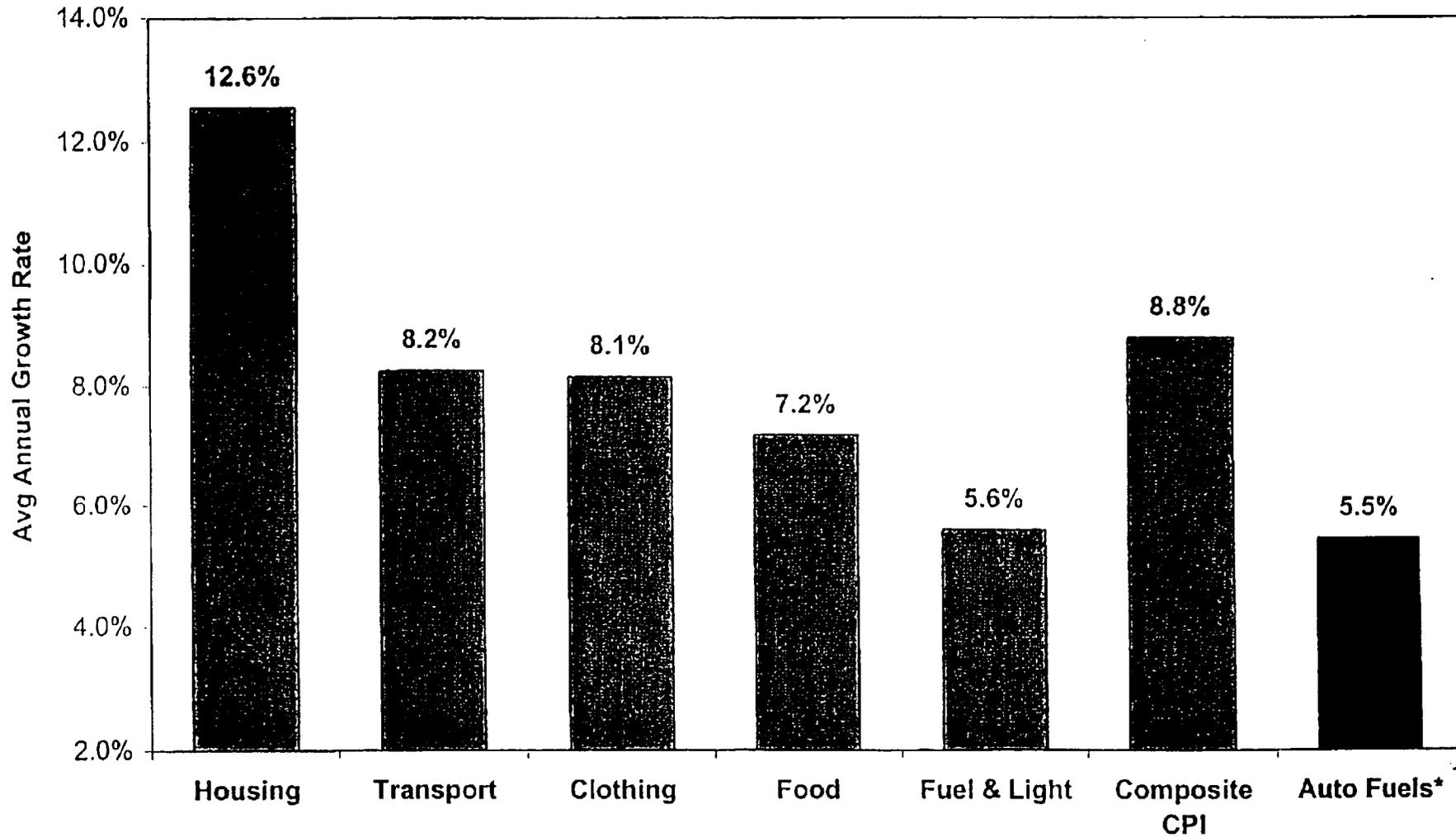
* Retail Automotive Fuels with Tax Component Excluded

Source: Hong Kong Monthly Digest of Statistics, Census and Statistics Department (Sep97 - Sep 98)



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1990-1998 ANNUAL PRICE INCREASES IN HONG KONG



* Retail Automotive Fuels with Tax Component Excluded

Source: Hong Kong Monthly Digest of Statistics, Census and Statistics Department (1990 - Sep 98)