

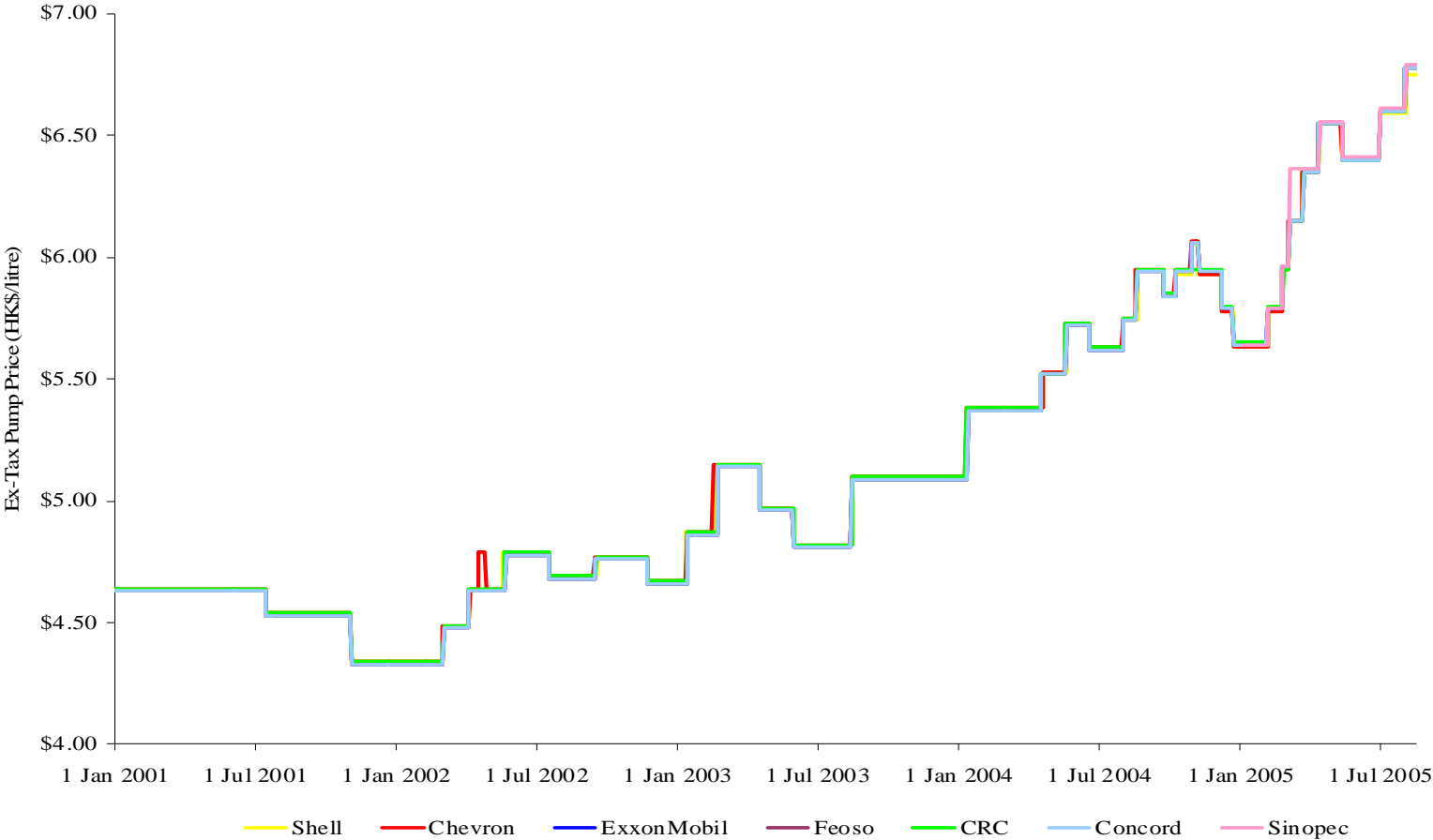
Study of the Hong Kong Auto-fuel Retail Market

**Presentation to Legislative Council
Panel on Economic Services**

24 April 2006

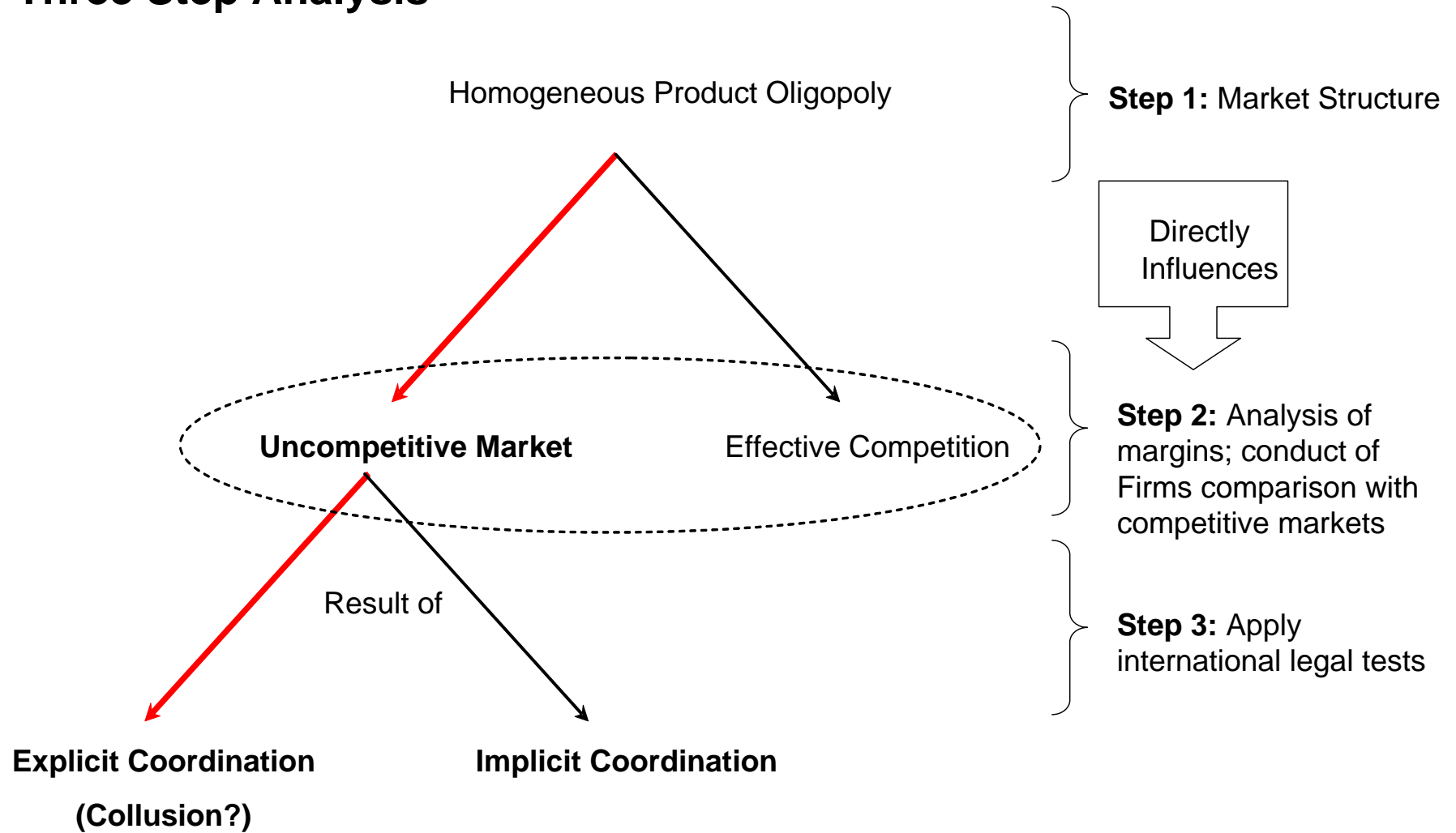
Conduct of Firms: Prices move in Parallel

- Public perception that prices move in parallel is **correct**:



What do Parallel Prices Mean?

Three Step Analysis



Characteristics of the Hong Kong Market

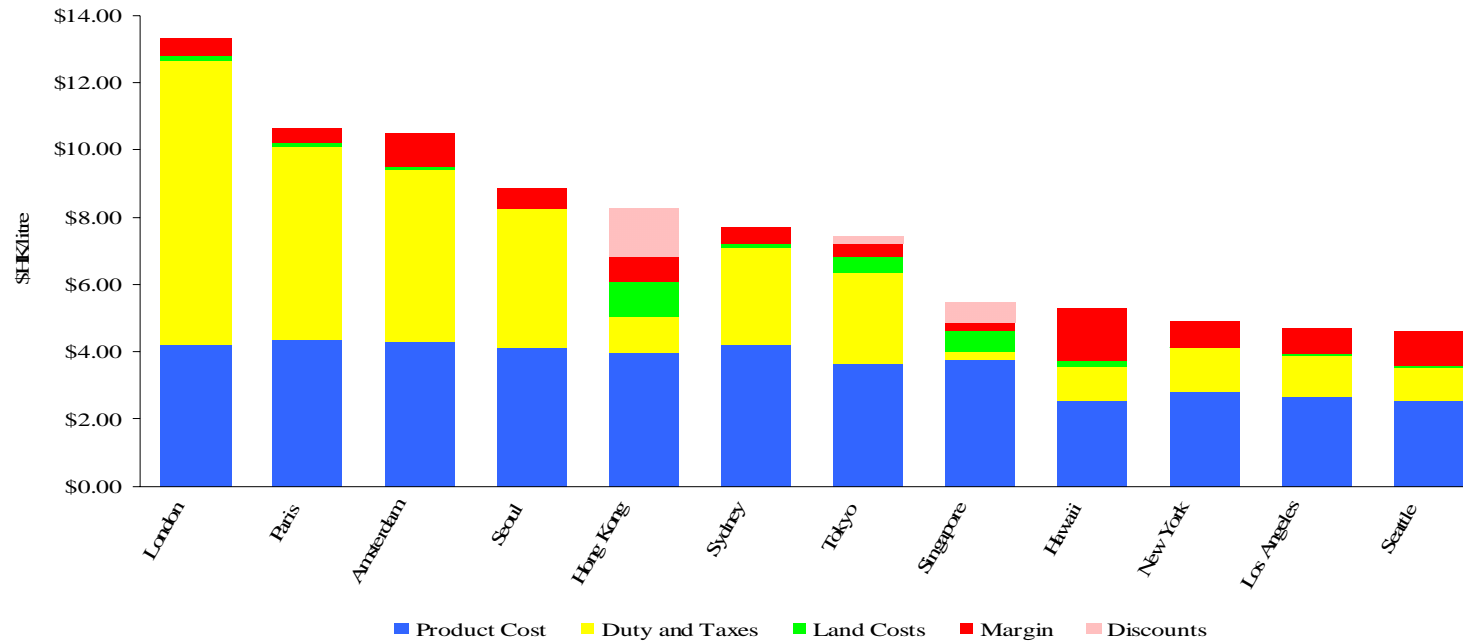
- Very small scale:
 - less than 4% of volume of New York State and the United Kingdom markets and only 26% larger than Singapore market
- Mature and declining market:
 - diesel decreased by 25-30% over last 5 years
 - cross border sourcing
 - adverse impacts on prices/margins given high fixed costs
- Highly vertically integrated
- No refinery:
 - import scale is critical
 - affects price movements
 - potential 'bottleneck' for competitors
 - impact of environmental standards

Hong Kong Margin Analysis

	Regular Petrol HK\$/litre (year to June 2005)	ULSD Diesel HK\$/litre (year to June 2005)
Pump price	12.06	7.23
Typical discounts	0.93	1.45
Price after discounts	11.13	5.78
Excise/duty	6.06	1.11
Product cost	3.00	2.86
Gross margin	2.07	1.81

- Very low non-fuel sales – HK\$0.04 per litre
- Gross margins have fallen since Consumer Council Report (1999) by 14% for petrol and 25% for diesel

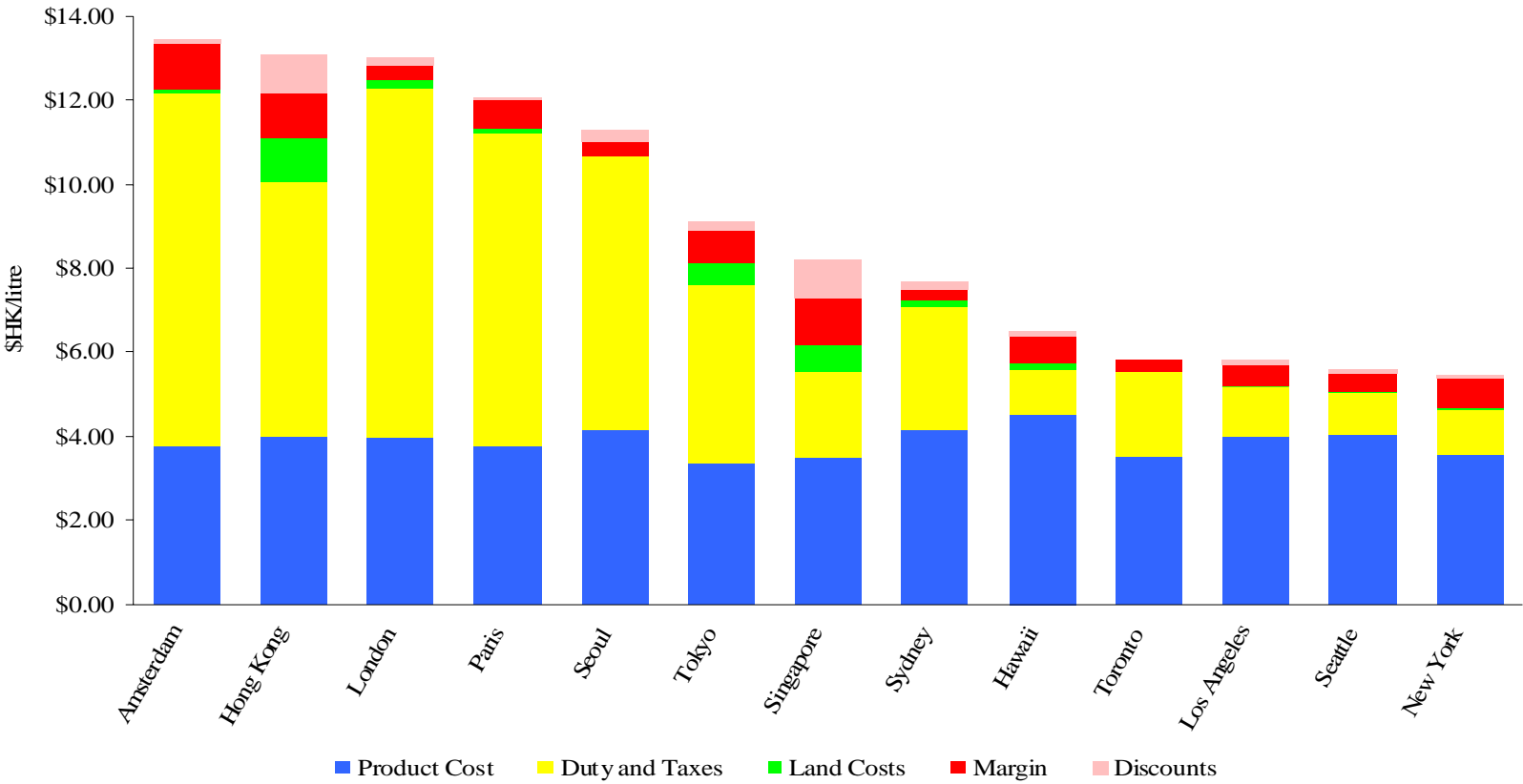
International Margin Comparison for Diesel



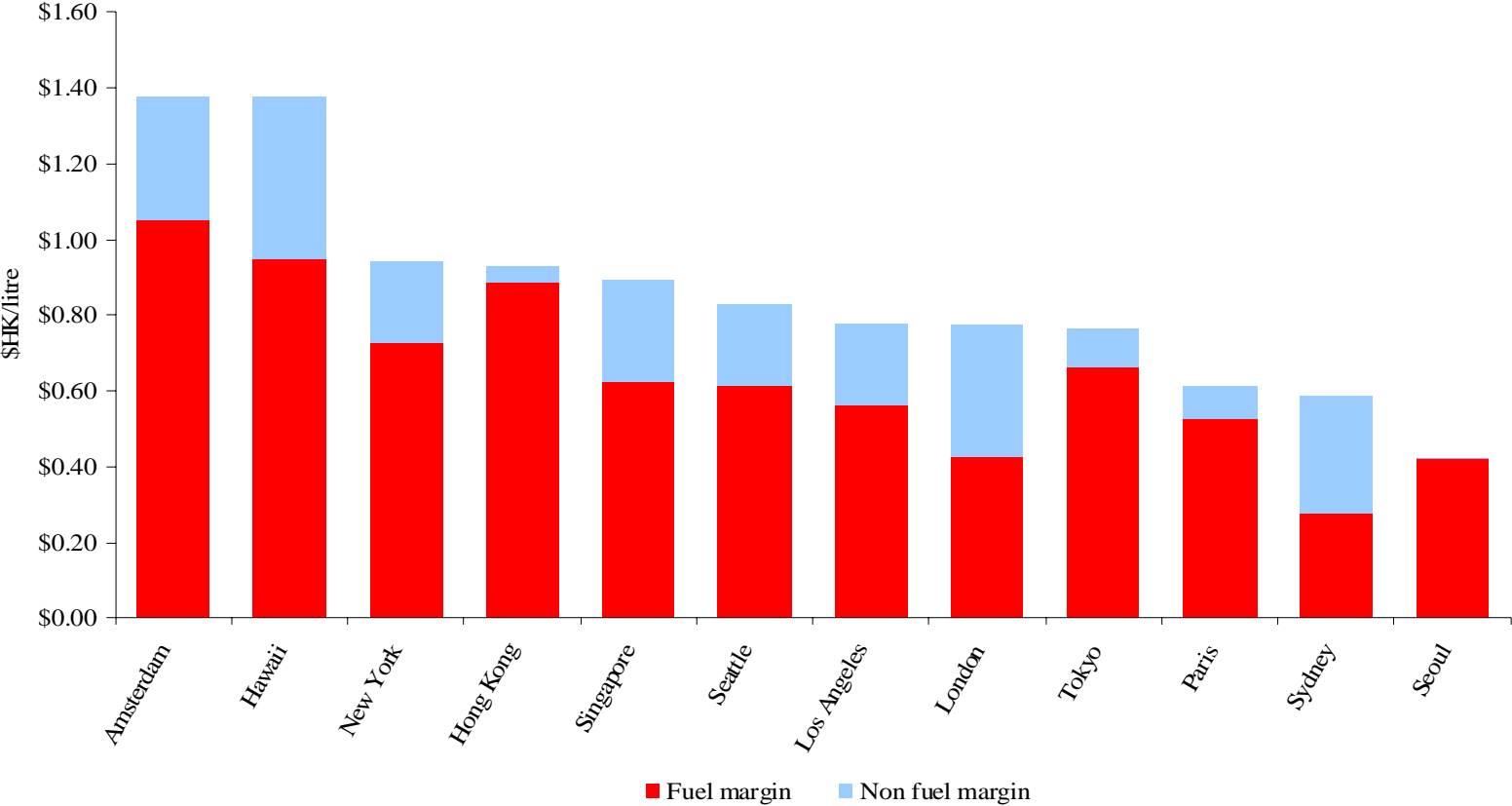
- Comparison limited by lack of diesel discount data in other markets:
 - Hong Kong gross margin higher than markets where diesel discount data available (Tokyo and Singapore)
 - But discounts outside Asia tend to be much lower and so difference probably not as great between Hong Kong and other markets
 - Even with discounts assumed in other markets, Hong Kong gross margin for diesel would be high but not an outlier

International Margin Comparison for Petrol

- Only sufficient data for gross margin analysis after land (which is biggest cost).

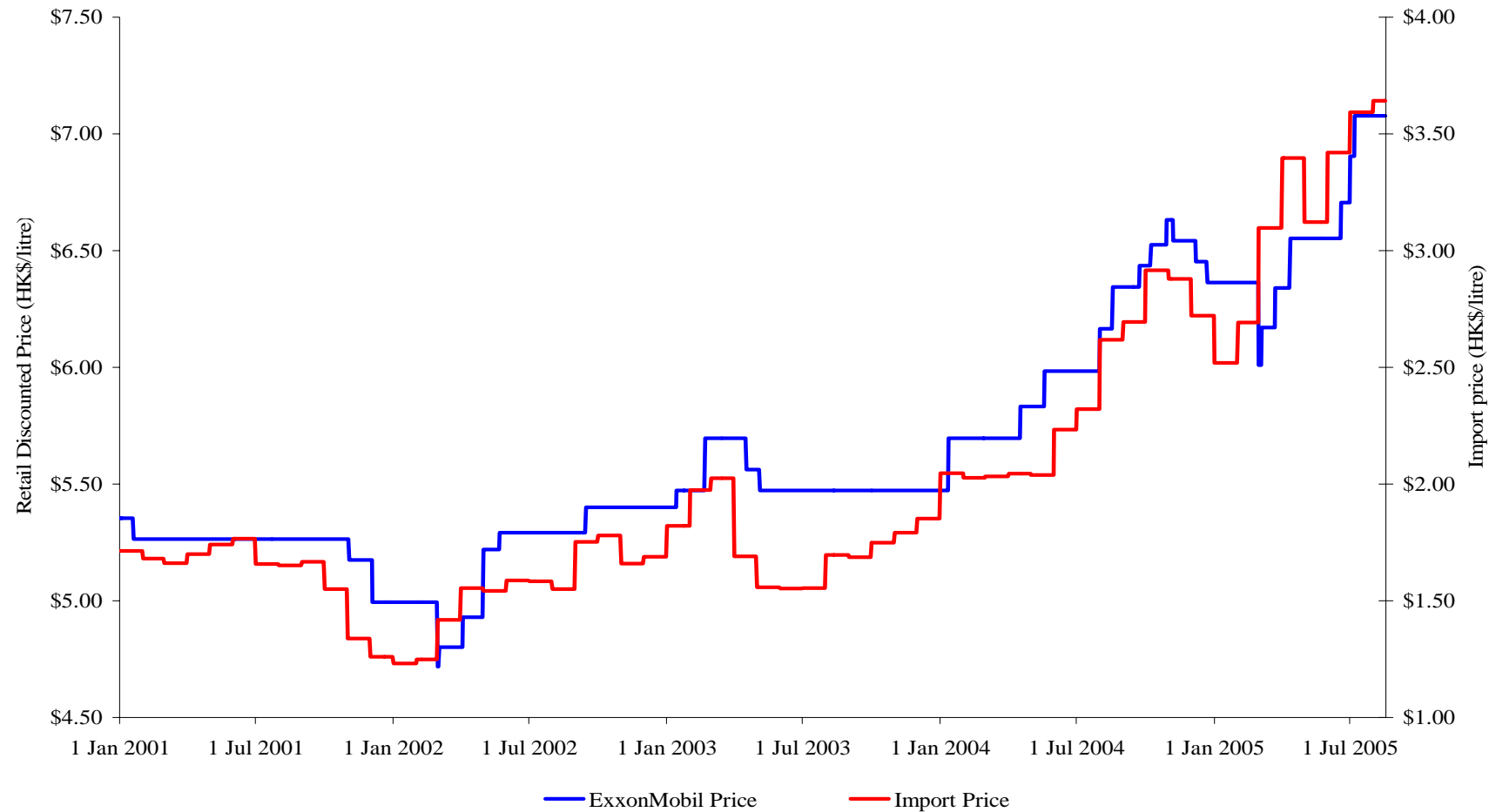


International Comparison of Combined Margins



- More reliable guide because reflects need to recover fixed costs across all revenue streams earned at a PFS site

Retail Discounted Diesel Price (Ex-Tax) versus Import Price



Conclusions on Margins

- Hong Kong auto-fuel market is becoming more competitive
- Even so, gross margins for petrol are on the high side compared to other markets
- Less clear with diesel, but gross margins also likely to be on high side. Net margin analysis shows diesel is probably more competitive in Hong Kong
- On combined margins, Hong Kong's relative performance improves compared to viewing diesel and petrol margins in isolation because of the lower non-fuel revenue in Hong Kong
- Differences in costs between Hong Kong and US markets only go some way towards explaining higher margins: with cost adjustments, Hong Kong ends up in mid range of US markets
- Margins are high enough to be of concern, but on their own not so high as to indicate collusion

Legal Analysis

- A prosecution may not even get to “first base” in Hong Kong because there is no coordinated pricing:
 - prevalence of discounts means that prices differ and oil companies have difficulty tracking each other’s prices
- Even if coordinated pricing, rational explanations which could rebut any suggestion of collusion:
 - price movements reflect product costs
 - “smoothing” reflects import dynamics
 - lack of RON product range reflects scale of market and PFS site size

If not collusion, what are the Competitive Problems in the Hong Kong Market?

- Concentration of market amongst three biggest operators – Shell, ExxonMobil and Chevron account for over 90% of the market
- Lack of scale of three smallest operators:
 - at retail level, no geographic presence across Hong Kong;
 - at upstream level, no import scale
 - creates “vicious” circle

Recommendations

1. Enhancing Competition

- The Government PFS site tender system gives Hong Kong a unique advantage in progressively addressing incumbent power
- Full effects of previous policy adjustments not fully realised – 10 sites coming up for retender in next few years
- Recommendations to enhance process:
 - move from “single shot” tender to auction model like Hong Kong 3G spectrum
 - streamline approvals process so PFS can be brought into operation quicker
 - reduce restrictions on PFS site use to allow increased non-fuel revenue

Recommendations

2. Protecting Competition

- While no evidence of collusion, it remains a risk and preventive measures are warranted:
 - could be general competition law or sector-specific law: hence, await outcome of CPRC Review
- If sector-specific competition law, consider:
 - Anti-cartel rules: civil and criminal, although phased approach may be appropriate
 - Merger rules: similar to telco sector
 - Auto-fuel commissioner on an “as needs” basis with no permanent establishment