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Chevron Hong Kong Limited
Submission to the Legislative Council Panel on Economic Services – Auto-fuel Prices
(March 20, 2007)

Chevron Hong Kong Limited ("Chevron") thanks the Panel on Economic Services of the Legislative Council for the invitation to the Panel Meeting on March 26, 2007.

I. Chevron's position on auto-fuel price setting

Chevron values the opportunity that the Panel offers to us to discuss our business challenges in this meeting. We always strive to maintain an open and transparent dialogue with our stakeholders in any place where we operate.

Our position on auto-fuel prices has been discussed extensively in public forums including the media. We have also provided extensive proprietary data requested by the government-commissioned consultant for the recent study of the auto-fuel retail market. We are pleased to provide a written summary of the factors which affect Chevron's setting of fuel prices for your reference.

Chevron appreciates that the local market is highly sensitive to retail prices of oil products. Because of this, we are very prudent in all our pricing decisions to ensure the prices of our products are competitive in the market.

II. Factors impacting local pump prices in Hong Kong

(i) Pump prices are broadly in line with import costs

Retail prices for auto-fuel are determined by dynamics of the free market. Hong Kong has no refining facilities and all auto-fuel must be imported in a refined form from nearby countries such as Singapore, Thailand and South Korea. Retail auto-fuel prices, therefore, are inevitably and largely driven by international refined product prices which are beyond Hong Kong's ability to influence.

The import costs for refined oil usually are made with reference to the Mean of Platt's Singapore Oilgram (MOPS) as a price index. It is not set based on international crude oil prices because we import refined oils and there are various processes as well as significant cost differences involved in transforming crude oil into refined fuel. Oil companies are required to declare the import unit value of an oil product to the Census and Statistics Department (C&SD) every month, while the average retail prices are collected from retail outlets in the Monthly Retail Price Survey by the C&SD. Therefore, the public can easily track the trend and movements of import and retail prices of major oil products in the C&SD's tables and graphs. The information and data compiled by the C&SD, including the most recent report published in March 2007, shows local pump prices are generally and broadly in line with the import price trends.

The correlation between local price setting and shifts in import prices has also been verified by the study of the auto-fuel retail market conducted by a government commissioned consultancy team. There is a widely held public perception that Hong Kong retailers rapidly increase their prices following an import price increase, but are slower to reduce their prices in response to import price decreases, known as the "rockets and feathers phenomenon". But after careful study, the team found the "rockets and feathers" phenomenon was a misconception and did not appear to be occurring in the Hong Kong market where local pump prices largely corresponding to import prices.

(ii) Costs for operating auto-fuel service stations are huge

Import product costs only account for a portion of the pump prices. The retail prices of oil products in Hong Kong, in fact, are subject to a number of other elements apart from import costs which affect the prices paid by purchasers at the pump. These include government taxes and a range of different costs for land, labor, terminal storage, transportation, distribution, operation, government rent and rates, investments in environmental protection infrastructure as well as promotions and discounts etc.

High land premium

According to the Study of the Hong Kong Auto-fuel Retail Market, the land premiums paid for petrol filling sites (PFS) are very high compared to the cost of land in overseas markets. Hong Kong PFS land costs, on a per liter basis, are double those of Tokyo's land costs and nearly six times of London's. In 2005, the average real premium paid for a PFS was nearly HK$100 million. Apart from the high prices for PFS land, government and private landowners have also substantially increased the rents for tenancy leases and rates in the past two years.

Expensive labor

Labor costs are also high in Hong Kong, with the hourly wages of PFS staff among the highest in the world, according to the auto-fuel study consultants. As well, staffing levels are higher in Hong Kong because local drivers demand greater levels of service. The labor costs in Hong Kong are estimated by the consultants to be HK$0.09 per liter higher than in the US.

Stringent requirements for environmental protection

Hong Kong's environmental requirements for auto-fuel are among the strictest in the world. As early as April 2002, diesel sold in Hong Kong was required to meet Euro IV standards and ultra low sulphur diesel (ULSD) while from January 1, 2005, all unleaded gasoline sold in Hong Kong needed to meet Euro IV emission standards and have a maximum sulphur content of 50 parts per million (ppm). These upgrades in environmental requirements have cost implications for auto-fuel suppliers as we need to install new equipment and import tailor-made products for Hong Kong market. The HKSAR government is currently studying the feasibility of introducing near-zero sulphur fuels (NZSF) before January 2009. Again, Hong Kong will probably be pioneering in Asia and be the first to implement NZSF in Asia and there will be substantial cost implications for end-users. We welcome efforts to improve the environment but wish to point out that there are associated costs.

In 2005, legislation requiring the installation of vapor recovery systems (VRI & VRII) in PFS facilities was passed. We must complete installation within a three-year grace period - the installations are costly not only because of the huge investment in sourcing and installing systems, but also the loss of sales during closure of our sites during works.

Vigorous competition to win customers through offering discounts
Discounts for gasoline and diesel customers in Hong Kong are among the highest in the world and are provided to the substantial majority of customers. Currently, we are offering at least HK$0.85 discount per liter for gasoline customers and at least 15% discount for diesel users. In addition to discounts at the pump, there has been considerable growth in the coverage and number of the various discounts offered by Hong Kong's oil companies through various credit card and loyalty programs. The reason for such phenomenon is explicit: fierce competition amongst oil companies in a shrinking market. The Hong Kong Auto-fuel Retail Market Study Report has rightly pointed out that discounts on the pump price for both gasoline and diesel are almost universally available in the Hong Kong market and historically have been significant.

As such, the retail prices for auto-fuel have been greatly and structurally affected by a number of factors other than import prices. The high operating costs of auto-fuel service stations also play an important role in shaping and determining retail prices for auto-fuel.

III. Business Challenges in Hong Kong auto fuel marketing

The oil industry in Hong Kong has encountered some of the most extensive difficulties it has ever faced in conducting business due to volatile product costs, which are brought about by global and unique local economic factors. More importantly, the local market for oil has been dwindling.

Hong Kong has a relatively small number of private car owners compared to overseas markets. There are fewer than 350,000 licensed private cars and 90.8% of households do not own a car, according to the recent consultants' study report. The Hong Kong auto-fuel market is significantly smaller than most other markets. The total consumption of auto-fuel in Hong Kong is approximately 1,500ML per year, which is only around 2% of the fuel consumption in California. The overall scale of the auto-fuel market is limited and declining; diesel sales volumes have fallen 25-30% since 2000 due to the LPG conversion program for taxis and minibuses. As the overall fuel consumption has been decreasing year on year, it becomes difficult to maintain the economies of scale, resulting in the surge of unit operating cost.

In addition to falling sales volume, many of our PFS leases are due to expire and are required to be returned to the government at the end of a 21-year lease for future mega tenders, which amalgamate a number of sites in parcels for bidding. Such bidding mechanism forces industry players to substantially increase the cost for obtaining PFS sites and maintaining a desirable network size. The gradual loss of sites and shrinking network size will have a significant impact on us in our attempts to achieve economies of scale.

We hope the above information and facts will help the Panel Members to better understand the challenges of the auto-fuel industry. We maintain a fair and competitive approach with our pricing strategies in order to ensure they can be benchmarked with international product prices, adequately reflect the operating costs and serve the best interests of our customers. We have been providing significant discounts to retain existing users and win new customers. As usual, we continue to monitor the international pricing landscape, making sure we compete aggressively with highly competitive prices as well as quality products and services in this market.

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