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Panel on Economic Development
Meeting on 17 July 2018

**Background brief on the tendering system for petrol filling station sites and
the auto-fuel study conducted by the Competition Commission**

Purpose

This paper provides background information on the tendering system for petrol filling station ("PFS") sites in Hong Kong and the "Report on Study into Hong Kong's Auto-fuel Market" ("the Report") published by the Competition Commission ("the Commission") in May 2017. It also summarizes the views and concerns expressed by members of the Panel on Economic Development ("the Panel") on relevant matters in previous discussions.

Background

Existing tendering arrangements of PFS sites

2. Most auto-fuel in Hong Kong is sold through retail stations. Sites for stations are designated for PFS use by the Government after the consideration of factors including potential demand, environmental impacts, and road and fire safety concerns. Currently, six oil companies are operating 181 PFSs in Hong Kong.¹

3. According to the Report, PFS sites are leased to suppliers for 21-year periods via a tender process. Since July 2000, PFS sites are leased in batches of up to five at a time, rather than one-by-one, and firms may lodge "super bids"

¹ The six oil companies are ExxonMobil Hong Kong Limited, Shell Hong Kong Limited, Chervon Hong Kong Limited, Sinopec (Hong Kong) Petrol Filling Station Company Limited, PetroChina International (HK) Corporation Limited and Feoso Oil Limited.

to lease all the stations together. The basic idea of the "super bid" option was to enable new entrants to obtain scale more quickly, without the uncertainties of acquiring sites on a piecemeal basis. In addition, all PFS sites are now made available for re-tender upon expiry of the 21-year lease, instead of rolling these over as was previously the case. There are also fewer restrictions on whom may submit tenders, e.g. there is no need to hold a Special Import Licence, or a supply contract with a licence holder.

4. The Administration has informed the Panel in March 2017² that out of a total of 181 PFSs in Hong Kong, the land leases of 28 PFS sites will expire in 2018 and be available for retendering for PFS. Of these 28 leases, one will expire on 2 April 2018 while the rest will all expire on 27 June 2018. A PFS will normally be closed for several months for retrofitting works upon commencing the new lease. Given the significant number of PFS involved, there is a need to stagger the tendering of these 28 sites to minimize service disruption to consumers during the period of station closure.

5. Under the existing practice, before expiration of the lease or the site being returned to the Government, the Lands Department will in good time make preparations for the retendering of the PFS site if the site is not required for other planned use and remains suitable for serving as a PFS. In order to minimize the possibility of service disruption, the outgoing lessee might be allowed to stay and operate temporarily subject to payment of market rental and Government rent and compliance of the existing lease conditions and any additional conditions as necessary, to suit Government's tender programme (generally referred to as a "hold-over" arrangement). The outgoing lessee is required to carry out contamination assessment, and if necessary, decontamination work of the site before it is returned to the Government.

6. According to the information provided by the Administration in March 2017, it will maintain the current policy of "super bid" arrangement to provide opportunity for market entry. The Administration aims to handle around five PFS sites in one single tender with two tender exercises a year. Besides, taking into account the normal closure period of eight months for retrofitting works, the Administration will stagger the retendering of the 28 sites in six batches with eight-month time gap between batches. The first batch will be scheduled for retendering in the third quarter of 2018 while the last batch in the fourth quarter of 2021. The whole exercise would be completed in about four years. To match the staggering schedule, the existing occupation of the 28 PFS sites will be extended temporarily by way of the "hold-over" arrangement as described in paragraph 5 above.

² An information paper on the staggering arrangements for the retendering of PFS sites was issued to Panel members on 28 March 2017 vide LC Paper No. CB(4)767/16-17(01).

7. The Administration also advised in March 2017 that during the whole staggering period commencing from the third quarter of 2018 till the resumption of services of the last batch PFS in the second half of 2022, leases of four other PFS sites will expire in the same period. In order to ensure the closure of all these 32 sites (i.e. 28 + 4 sites) upon lease expiry would not cause significant service disruption to consumers, the Administration will also add these four sites into the staggering plan for the retendering of the PFS sites as appropriate with reference to their expiry dates, locations and services provided.

The auto-fuel study conducted by the Commission

8. On 4 May 2017, the Commission released the Report which outlines the findings of its study into the auto-fuel market in Hong Kong. The Report identifies a number of issues which the Commission believes to be hindering competition and which would likely have contributed to high auto-fuel prices in the territory. The Report also makes recommendations on how to address these issues with the aim of furthering competition in the market. To determine the state of competition and whether potential concerns exist in the market, the Commission has looked beyond auto-fuel prices and examined the market's underlying structural and behavioural characteristics. The Commission is of the view that the auto-fuel market in Hong Kong has a number of highly unusual features that have undermined the effectiveness of competition in the market.

9. According to the Commission, the local auto-fuel market is highly concentrated with five major market players. With no oil refinery facilities, Hong Kong is wholly dependent on refined auto-fuel imports which have to be stored in terminal storage facilities that are owned by four oil companies. The market exhibits a high degree of vertical integration with the vast majority of auto-fuel sold through retail stations owned by these companies. As a result, these major retailers are likely to have broadly similar cost structures, with no low-cost "maverick" competitor. Hong Kong's unique topography also limits opportunities for alternative retailing models to emerge. The market is also characterized by high barriers to entry and expansion. The lack of access to storage facilities and huge cost in obtaining PFS sites prevent new entrants or existing players from exerting greater competitive pressure on competitors.

10. The Commission is of the view that the availability of effectively one single product for petrol is another unique feature of the market. Hong Kong stands alone in the world where only 98 RON, one of the most expensive and highest grades of petrol, is available for motorists. Both the "standard" and "super" varieties of petrol on offer here are 98 RON, which is either offered alongside a cheaper alternative or not at all in most international markets.

11. The Commission has also pointed out that it is harder for consumers in Hong Kong than in other markets to gauge and compare prices, partly due to the low visibility of pump prices. Some PFS sites do not have large price boards and those that are in place are not always easily visible from the streets or they are not used for displaying price information at all. Another special feature of the Hong Kong market is the prevalence of discounts. The headline pump prices serve merely as a starting point from which various discounts are applied. However, the Commission finds the discount system complex and opaque, making it difficult for consumers to compare the actual prices. Discounts are also not offered to all consumers in a uniform way. The Commission is of the view that discounts are not a perfect substitute for price competition. It is also found that retail pump prices in Hong Kong move infrequently and exhibit no geographic variation, whereas in most international markets, prices differ geographically due to the variations in demand and supply in different areas.

12. To address the above issues, the Commission has made four short term recommendations and one long term recommendation in the Report to further competition in the Hong Kong's auto-fuel market. The short term recommendations include:

- (a) re-introduce 95 RON³ petrol;
- (b) increase the number of PFS sites;
- (c) review of the tendering system for PFS sites; and
- (d) prominent display of pump prices and walk-in discounts at PFS.

13. In the long term, the Commission recommends exploration of potential "structural" reform options, such as the provision of economically priced terminal storage enabling new entrants to import their own suppliers of auto-fuel and explore alternative sources of auto-fuel supply.

14. In response to the question raised by Hon Starry LEE at the Council Meeting of 24 May 2017 on the Report, the Administration has set out its response to the recommendations made by the Commission as follows –

³ 95 RON petrol is a lower octane grade of petrol than 98 RON petrol which is presumably cheaper than 98 RON petrol.

Re-introduction of 95 RON petrol

15. The Administration has pointed out that the existing legal requirements as well as the lease conditions of the PFS sites do not prohibit the supply of 95 RON petrol. To avoid engine knocking and the resulting excessive emissions, the Air Pollution Control (Motor Vehicle Fuel) Regulation (Cap. 311L) requires petrol to have a minimum of 95 RON. For petrol engines that are designed to run on 95 RON petrol, using petrol of a higher RON will not bring forth additional emission merits. The Environment Bureau ("ENB") will seriously consider the Commission's recommendation that 95 RON petrol should be re-introduced into the market to provide more choices to consumers. ENB will discuss with the relevant Government departments and the oil companies whether and how the Administration may specify in the lease conditions the requirement to supply 95 RON petrol in the 28 PFSs due to be re-tendered starting by batches from July 2018 having regard to the site constraints at individual PFSs and other factors.

Increasing the number of PFS sites

16. The Administration has advised that the Commission's recommendation for providing more PFSs involves planning and land matters. ENB notes that the existing PFS sites can meet the market demand for auto-fuel. Given the scarcity of land in Hong Kong, the Administration needs to consider the different needs of the community in deciding whether more land should be allocated to PFS use. Site reservation for new PFS would have to be justified by the anticipated growth of an area (such as a new development area) and all relevant factors including land use compatibility, traffic, environmental and fire safety. ENB will work with the relevant Government departments to monitor the possible need for more PFS sites.

Review of tendering system for PFS sites

17. The Administration has advised that existing "super bid" tendering arrangement has already facilitated new entrants in acquiring a critical mass of PFS sites to achieve economy of scale for an effective competition in the auto-fuel retail market. Since the introduction of the "super bid" tendering arrangement, two new operators have obtained 35 out of the 61 PFS sites put up for tender and successfully entered the market. The share of the three biggest operators in terms of the number of PFS has dropped from over 90 percent to about 70 percent. These figures demonstrate that the above tendering arrangement has effectively enhanced competition in the auto-fuel retail market. ENB is prepared to consider suggestions to improve the tendering system.

Prominent display of pump prices and walk-in discounts

18. The Administration has informed that ENB had already commissioned the Consumer Council to develop the "Auto-fuel Price Calculator" and its respective smartphone applications to facilitate consumers to obtain the pump prices and discounts information offered by different oil companies or PFS for making wise choices. The Administration agrees to the Commission's recommendation to further increase the transparency of fuel price information to consumers, and will discuss with the relevant Government departments and the oil companies whether and how the Administration may specify in the lease conditions the requirement to display pump prices and discounts prominently at the PFSs due to be re-tendered.

Exploration of potential "structural" reform options

19. On the Commission's long term recommendation regarding potential structural reform options, the Administration has advised that as pointed out in the Report, many of the measures to facilitate new entrants would incur substantial costs. For example, the proposal of introducing a new open access terminal storage facility will require the provision of new land, while the suggestion of constructing a pipeline to import fuel from the Mainland will also have substantial implications on land use, environment and safety. The Administration will need to carefully consider the pros and cons as well as the tenability of the suggestions before determining whether it will undertake any detailed study.

Previous discussions

20. At the Panel meeting on 22 May 2017, members were briefed on the Report. The Panel in general supported the recommendations made in the Report, in particular review of tendering system for PFS sites and the re-introduction of 95 RON petrol. Some members considered that as the land leases of some PFS sites would expire from 2018 onwards, it was an opportune time for the Government to review the tendering system for these sites with a view to introducing more competition into the Hong Kong auto-fuel market. To provide more cheaper options to consumers, a member suggested that the Government could consider specifying in the lease conditions that a majority of PFSs should supply 95 RON petrol while 98 RON petrol could be supplied in some PFSs as an optional premium product. Sizable PFSs with sufficient space could be mandated to supply both products.

21. A member suggested that the Government should consider introducing into the market a pricing adjustment mechanism similar to the ceiling prices adjustment mechanism adopted for liquefied petroleum gas ("LPG") at dedicated auto-LPG filling stations. Under such a mechanism, the award of PFS tender should be primarily based on the lowest fuel prices offered to customers instead of the highest land premium offered to the Government. Another member was of the view that the Administration should devise a mechanism to monitor the pricing of oil products set by oil companies in revamping the tendering system for PFS sites. For example, the tenderers could be required under the new lease conditions to display prominently pump prices and walk-in discounts at PFS and provide more information on the pricing formula of their oil products including the gross margin.

22. Having regard to the difficulty in allocating more land for PFS use, a member suggested that some large PFS sites could be divided into smaller sites and allotted to different operators to drive market competition. The Administration advised that currently Hong Kong had over 180 PFSs and over 60 LPG filling stations which were sufficient to meet the demand of auto-fuel. Nevertheless, the Administration would examine the feasibility of splitting large PFSs into smaller ones in consultation with the relevant Government departments, having regard to the relevant planning criteria and environmental conditions at individual PFSs etc..

Council questions

23. At the Council meetings on 14 October 2015, 4 May 2016 and 24 May 2017, Hon Emily LAU, Hon Frankie YICK and Hon Starry LEE raised questions relating to the tendering system for PFS sites and the Report. Hyperlinks to the Council questions and the Administration's responses are provided in the **Appendix**.

Latest developments

24. Hon James TO, Hon WU Chi-wai and Hon Andrew WAN jointly wrote to the Panel in May 2017 proposing to discuss the Government's review on the tendering system for PFS sites and its exploration of various "structural" reform options to further competition in the auto-fuel market.

25. In its response to the Panel regarding the request from the above members, the Administration advised that to tie in with the tendering work, it planned to complete the study on the relevant tendering arrangements by early 2018. It would report the outcome to the Panel after it has completed the study.

26. The Administration will brief the Panel on an update on the tendering system for PFS sites and the follow-up to the Report at the meeting on 17 July 2018.

Relevant papers

27. A list of relevant papers which are available on the Legislative Council Website (<http://www.legco.gov.hk>) is in the **Appendix**.

Council Business Division 4
Legislative Council Secretariat
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List of relevant papers

Issued by	Meeting date/ Issue date	Paper
Panel on Economic Development	24 April 2017 (Item II)	Administration's paper
	22 May 2017 (Item V)	The Competition Commission's paper Joint letter from Hon James TO, Hon WU Chi-wai and Hon Andrew WAN (Chinese version only) Administration's response to the joint letter from Hon James TO, Hon WU Chi-wai and Hon Andrew WAN Background brief Minutes
	26 March 2018 (Item V)	The Competition Commission's paper Background brief Minutes
Council Meeting	14 October 2015	Council question on "Retail prices of auto-fuel" raised by Hon Emily LAU
	4 May 2016	Council question on "Fuel prices" raised by Hon Frankie YICK
	24 May 2017	Council question on "Competition Commission's report on Hong Kong's auto-fuel market" raised by Hon Starry LEE