

25 March 2019

The Commissioners
Inquiry into the Economic Regulation of Airports
Productivity Commission



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SUBMISSION IN RESPONSE TO DRAFT REPORT – COMPETITION IN MARKETS FOR JET FUEL

Dear Commissioners

This submission by ACIL Allen Consulting has been commissioned by Mobil Oil Australia Pty Ltd (Mobil). Its subject matter is the analysis in, conclusions drawn and recommendations made in Chapter 8 of the Commission's Draft Report, "Competition in Markets for Jet Fuel". This submission concentrates on the economic analysis in that chapter. Confidential relevant matters of corporate structure which will provide detail in support of matters raised in this submission which come directly from Mobil are appended to this letter. This appendix should not be uploaded to the Commission's website. The operators of each JUHI will respond to the Commission with the information requested as each JUHI is a separate operating entity. This submission is on behalf of Mobil in respect of its own business.

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General observations

As set out in this submission, the Draft Report's reasoning that the markets for jet fuel are not competitive is incorrect, because this reasoning is based on *a priori* assumptions that are not supported by facts; indeed, the Draft Report in places acknowledges that there is not enough information to make definitive conclusions.

The purpose of this submission is to assist the Commission reach more soundly based conclusions in the Final Report; viz, the markets for jet fuel are competitive.

Each of the sections in the Draft Report's chapter is discussed in turn.

Section 8.1 The markets for jet fuel

This section is descriptive. It sets out facts, such as what the physical characteristics of the supply chain and the rising share of imports.

This section also says that the markets for jet fuel have three economic characteristics (a) several parts of the supply chain have natural monopoly characteristics, meaning that the market can be served at least cost with one supplier (ii) there is vertical integration in the supply chain, with four large suppliers all involved in each part of the supply chain (iii) there are joint ventures in parts of the supply chain.

Comment

The Draft Report's discussion of natural monopoly infrastructure, vertical integration and joint ventures sets the scene for its later conclusion that the markets for jet fuel are not competitive by stating that, in theory, these forms of industrial organisation can be (though not necessarily) anti-competitive.

However, in making this high level theoretical argument, the Draft Report does not acknowledge an important factual point, which is that while (say) Mobil is one of the JUHI participants at Melbourne, and Mobil along with Viva and BP own and operate the Somerton Jet Fuel Depot, and Mobil Refining Australia owns and operates the Altona Refinery, and so on, these are separate entities, with strict separation of information and people, so that there is no vertical integration that can be exploited for anti-competitive advantage.

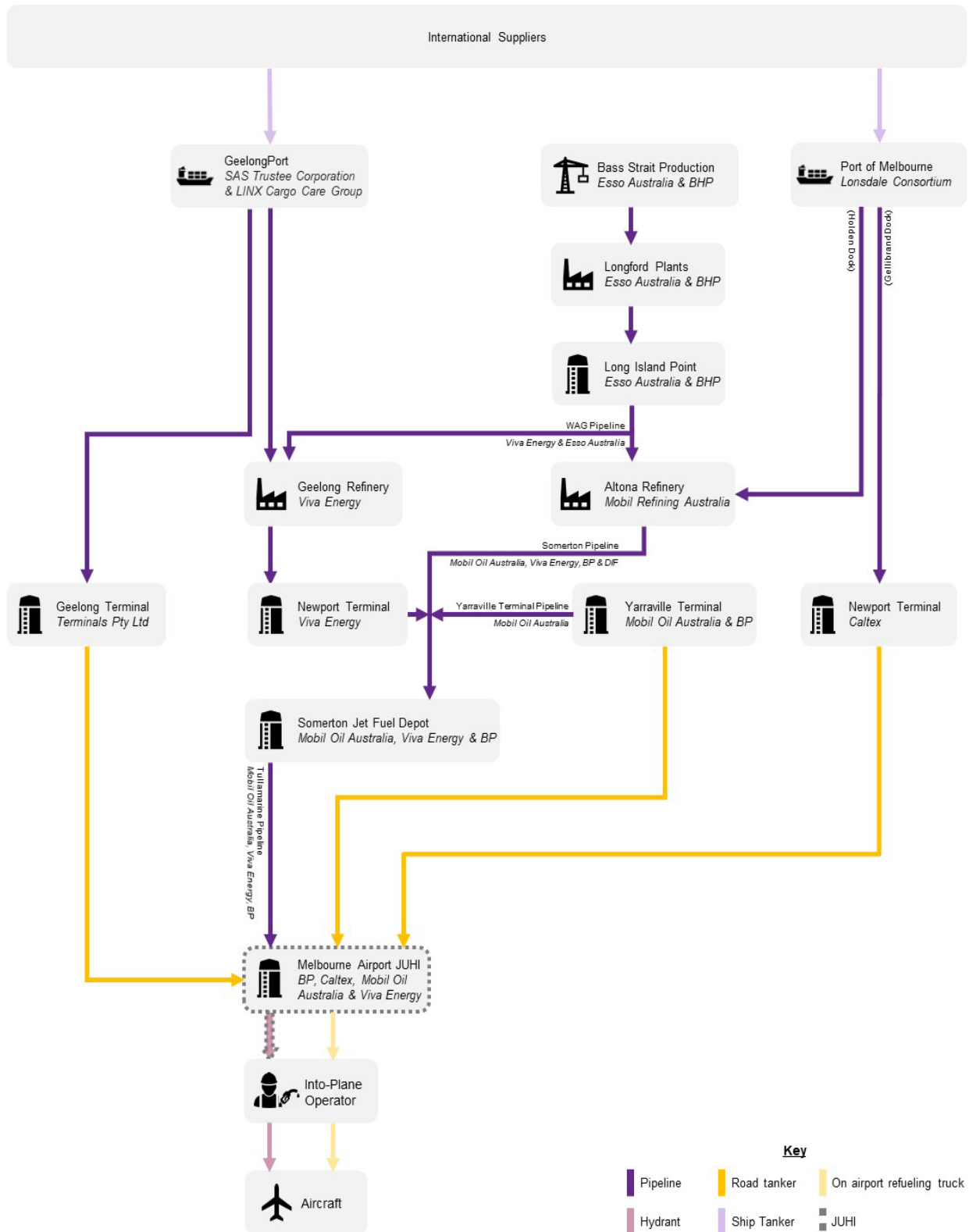
The Draft Report says that a joint venture (JV) may be anti-competitive in the following ways:

- by denying access to infrastructure so that members can share monopoly profits. But this presumes that monopoly profits exist in the first place and does not recognise that the JUHIs are not commercial operations that aim to make a profit.
- by restricting investments that members individually might like to make, but can't because all JV participants need to agree. But this argument ignores that the point of a JV is that decisions are made jointly, and ignores that the ACCC can deny the formation of a JV if it is going to substantially lessen competition.
- by facilitating collusion between JV venturers, by information sharing. The Draft Report does not spell this out, but presumably it means that the JV participants can collude in other markets where they compete with each other. But this argument ignores the reality of jet fuel operations and markets where there are explicit barriers in place to stop this information sharing.

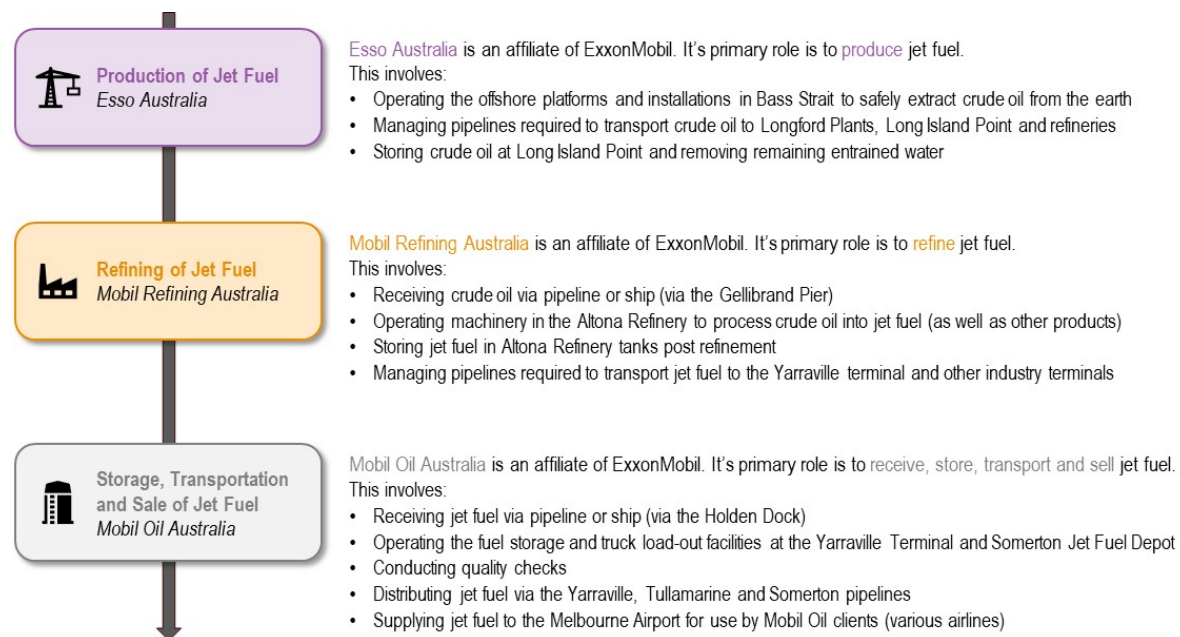
Figures 1 and 2 which follow show how the supply chain in Melbourne is separated so the vertical integration problem does not arise. Attached to this submission, Mobil provides more detail on the arrangements that ensure that information is not shared between different parts of the supply chain, precisely to ensure that anti-competitive conduct cannot arise.

As discussed in Mobil's first submission, JUHIs are not commercial operations that aim to make a profit (let alone a monopoly profit). What is more, the JUHI arrangements are not unique to Australia, with the same structures in existence at airports around the world (e.g. Heathrow, CDG Paris, Singapore, amongst others). As discussed in Mobil's first submission, it is operationally challenging for an airport to have more than one hydrant and multiple storage facilities are far more costly than having just the one – a JUHI is a natural monopoly, by definition, but, its structure, operations and purpose preclude it from exercising monopoly power.

FIGURE 1 MELBOURNE JET FUEL SUPPLY CHAIN (INDICATIVE)



SOURCE: ACIL ALLEN CONSULTING

FIGURE 2 EXXONMOBIL ENTITIES IN THE MELBOURNE JET FUEL SUPPLY CHAIN

SOURCE: MOBIL OIL AUSTRALIA, ACIL ALLEN CONSULTING

8.2 The current regulatory framework

There is nothing in this section that requires comment.

8.3 Third party access to infrastructure services

This section discusses access to infrastructure services at the different parts of the jet fuel supply chain.

Comment

The Draft Report says that the fact that none of the three import terminals in Melbourne is open access limits the ability of a third party entrant to supply jet fuel to the Melbourne JUHI. This is all hypothetical. The Draft Report noticeably does not say that an actual third party has tried to obtain, and been denied, access to any of the Melbourne import terminals. In any case it is a matter for privately owned companies to manage their own assets and capacity of their assets (e.g. to meet product standards and public safety, fuel security and customer demand) and for third parties to approach such asset owners and engage on a commercial basis to discuss access or develop their own facilities.

The Draft Report also says (or at least implies) that the high cost of building an import terminal acts as a barrier to entry. This is wrong as a matter of economics. A barrier to entry is a cost to a potential entrant that is not incurred by an incumbent. Nobody (including the Draft Report) says that it would cost a new entrant more to build an import terminal than it would cost an incumbent to build another one (which is the relevant comparison).

The Draft Report says that there is only one pipeline to Melbourne airport, that does not offer access to third parties, but also notes that it is approaching capacity. The report notes that transporting fuel by truck can be a viable alternative to pipelines, but says that in the longer term, the congestion, environmental and safety costs associated with trucking fuel means that pipelines will be the preferred method of transport, all things considered.

In fact, if someone wants to build another pipeline or terminal for supply to Melbourne, they are free to do so. (Furthermore, while trucking fuel might have the costs suggested by the Draft Report, they are external costs (externalities), and not a consequence of any anti-competitive conduct by incumbent fuel suppliers.) As stated in Mobil's first submission, and this is the crucial point, commercially meaningful transport choices exist for all fuel

suppliers. There is nothing to stop potential entrants from building their own infrastructure. If they choose not to do so, it must be because existing arrangements are satisfactory from their point of view.

The Draft Report also questions whether equity access to JUHIs is necessary to manage risks because equity access is not needed for “somewhat similar” services like gas pipelines. The benefits of the equity model for JUHIs, which don’t apply to pipelines, should not be undervalued. These are capital efficiency leading to lower costs; liability and risk sharing. All of this translates to lower operational costs and accordingly lower prices to customers. Another important point to note is that JUHIs have sophisticated processes to manage product quality which is integral to safe airline operations –which is key to public safety.

In any event, structural changes to allow open access at JUHIs, driven by airports through leases, are taking place. One question the Commission should carefully reflect on in revising the Draft Report is whether open access, at the JUHI or elsewhere across the supply chain, really will improve competition, because of the potentially negative, or ‘chilling’, effects on investment. The Draft Report acknowledges that access arrangements should provide “sufficient” incentives for owners of jet fuel infrastructure to invest. But it then says that equity access should not be needed for jet fuel infrastructure because it isn’t needed for gas pipelines which provide “somewhat similar” services. In fact there is no analogue to JUHIs in the gas pipeline industry. Indeed the Commission 2004 Inquiry Report on the National Third Party Access Regime for Natural Gas Pipelines repeatedly cited industry sources on the chilling effects on investment by the then access regime.

On into-plane services, the Draft Report says a competitor will be unwilling to enter a market for into-plane services because currently such services are provided by the four major vertically integrated fuel suppliers, but this may be changed for the better if there were open access arrangements at the JUHI, presumably because a new competitor could then access the JUHI and become a competitor in the into-plane market.

This argument appears to turn on the premise that the JUHI JV participants are in commercial practice integrated upstream and downstream to into-plane services. As discussed above, this premise is false. To reiterate, JUHIs operate independently of any other part of the supply chain. JUHIs do not provide into-plane services. Fuel suppliers can only sell fuel to airlines (their customers) via into-plane services, and have neither the ability or the incentive to act anti-competitively with respect to these services. There are no limitations on the number of into-plane suppliers at an airport, and the players who affect the competitive dynamics of into-plane services are the into-plane operators, their customers and the airports themselves.

8.4 Some markets to jet fuel supply are not competitive

According to the Draft Report, the indicators of a lack of competition are:

- few suppliers at some airports
- a lack of transparency around JUHI access terms
- prices for jet fuel are relatively high
- underinvestment may have occurred in some infrastructure services
- some airports charge fuel throughput levies.

Comment

Few suppliers at some airports

On this issue, there are many points that require discussion and response.

- The number of suppliers in a market is not determinative of the degree of competition in a market; competition can be fierce even with only two suppliers and this is especially true when competition is based on price, and in fact competition in the jet fuel market is (largely if not entirely) based on price (as explained in BP’s submission).
- The Draft Report asserts that there exists a small number of suppliers at some airports because of barriers to accessing jet fuel infrastructure through the supply chain, but it provides *no credible evidence* to support this claim.
- The Draft Report says that “it is aware that a number of new entrants would like to enter the market at some airports but have not been able to do so” but it doesn’t say: who they are, when they tried to enter, what barriers were erected by which incumbents at what part of the supply chain, or whether their inability to enter might have been for ordinary commercial reasons, such as the inability to secure contracts with airlines to supply fuel.

- The Draft Report cites with approval the submission by Melbourne Airport that even with the new open access regime at the JUHI, a new entrant may be unable to access an import terminal or the pipeline, *but*: as noted above, there is no economic barrier erected by incumbents that stops potential new entrants building their own import terminal, or their own pipeline (and what's more, as acknowledged in the Draft Report, the existing pipeline is approaching capacity) or transporting fuel to the airport by truck, or accessing into-plane services.
- The Draft Report says that, contrary to the BP submission that fuel suppliers compete vigorously on contracts, "in some cases, international airlines only receive one or two bids on their tenders for fuel supply" and that "in a market with vigorous competition, it would be expected that fuel suppliers would bid on all contacts for supply if they have the capacity"; *but*, (1) the fact, that "in some cases" [how many cases?] "international airlines" [which ones? Some international airlines have only a small presence] receive only one or two bids sounds very anecdotal, with no evidence that this is widespread. (2) Even if there are only a couple of bids, this need not be indicative of a lack of competition. If an airline's existing fuel supplier is supplying that airline at the competitive (i.e. minimum) price, then it is pointless for another supplier to try to win the contract, especially if the airline has a good working relationship with the fuel supplier. What's more, *it is the threat of undercutting* an above-competitive price by competitors – and it is entirely a credible threat, if they have the capacity to supply – that keeps the existing supplier's price at the competitive level. Thus, the absence of many bidders for contracts is entirely consistent with a competitive market.

In revising the Draft Report, the Commission ought to be cognisant of commercial practice in the jet fuel market. It is the buyer that triggers the purchase process i.e. tender or decision to retain incumbent fuel suppliers. Suppliers will submit tenders where it is commercially viable to do so and responses reflect the nature of the invitation (ad-hoc vs regular), cost and return. If there are few bidders, this suggests an inability to service the customer or to supply a price lower than the competition. Suppliers can't be expected to sell fuel at prices that are lower than their costs, and if they can't make adequate returns in a market they will look to alternative markets. Since 2017 Mobil has participated in 65 tenders in the Australian jet fuel market¹ where it has been able to supply jet fuel competitively.

A lack of transparency around JUHI access terms

What the Draft Report means here is that the Commission doesn't know what the access terms are. However, they are available to all access seekers. The steps in the process, furthermore, are in the public domain for some locations, such as Melbourne JUHI.² As set out in Mobil's first submission, to this inquiry, they are as follows for the Melbourne JUHI.

¹ At Adelaide, Launceston, Melbourne and Sydney

² Melbourne JUHI. (2018). MELBOURNE TULLAMARINE AIRPORT FUEL FACILITIES APPLICATION PROCESS. Retrieved from <https://irp-cdn.multiscreensite.com/b796516b/files/uploaded/MEL%20JUHI%20Open%20Access%20Application%20Assessment%20and%20Approval%20Process%20V3.pdf>. Melbourne JUHI. (2018). *The Infrastructure Provider – FAQ's*. Retrieved from <https://irp-cdn.multiscreensite.com/b796516b/files/uploaded/Open%20Access%20-%20FAQs.pdf>

Figure 3 User application process at Melbourne JUHI



SOURCE: (MELBOURNE JUHI, 2018) – REFORMATTED BY ACIL ALLEN

Prices for jet fuel

The Draft Report presents 2017 data showing that Australian airport jet fuel differentials are the highest among 23 airports around the world. The sample of airport comes from a submission by IATA. Notably, and unfortunately, the sample does not include any airports from New Zealand, which would be more like-for-like with Australia, given that transport costs are likely to be similar. The Draft Report acknowledges that high transport costs contribute to high Australian prices but asserts that transport costs do not explain the differentials.

The Draft report goes on to say that Australian jet fuel suppliers have not provided the Commission with any evidence to justify the differentials, and that the airlines have not provided details of the prices they pay. The obvious reason why neither sellers or buyers of jet fuel have provided this information to the Commission is that it is so commercially sensitive. For example, if the prices that airlines pay (and jet fuel suppliers receive) became public knowledge, this could easily create (or be suspected to create) an anti-competitive situation where suppliers do not attempt to undercut each other, with the known price becoming a reference floor price. (This type of anti-competitive price signalling has been recently been made unlawful by amendments to the Competition and Consumer Act 2010.) Thus the Commission, on the one hand at page 246 of the Draft Report, says that that the suppliers' JVs provide incentives for them to collude (while having no evidence that they do collude) and on the other hand at page 259 of the Draft Report complains that the suppliers are not providing data which if it was to become public, would really facilitate collusion.

The Draft Report says that the Commission does not have the information that would enable it to conduct a full analysis of prices and costs associated with jet fuel supply but concludes anyway that “on balance”, the structure of the jet fuel markets has “likely contributed” to relatively high jet fuel prices. The evidence that the Commission uses to come to this conclusion is the vertical integration of suppliers and concentrated ownership of infrastructure. Aside from the fact that the apparent vertical integration is not real (as discussed above) and concentrated ownership is not determinative of monopoly power (also discussed above), this is circular reasoning. The Draft Report starts by examining data on prices to see if they provide independent evidence of monopoly power, and, unable to find this evidence, concludes that the data nonetheless shows that jet fuel suppliers have (and are using) monopoly power, because they have (it says) monopoly power. Thus the Commission reaches its conclusion by assuming the conclusion. Not only that, the Commission contradicts itself. At page 258 of the Draft Report, it says “The

Commission considers that price differentials by themselves are not sufficient evidence that prices in Australia reflect a lack of effective competition”.

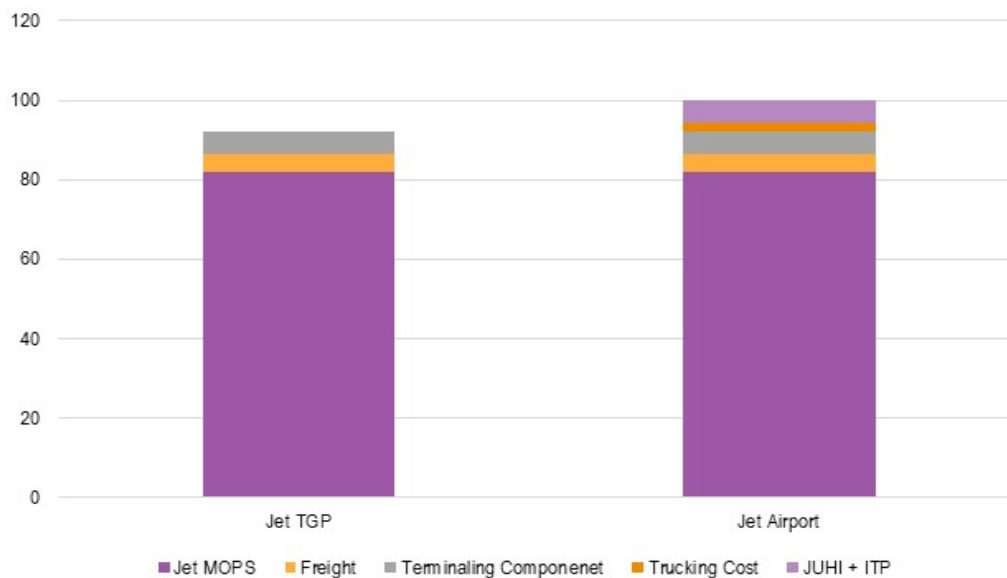
The Commission also says that the fact that Qantas self-supplies at Sydney airport (by becoming a member of the Sydney JUHI) is evidence that incumbent suppliers are charging prices higher than would be expected in a competitive market. In response, (i) Qantas’ decision to self-supply could be for other, commercially valid reasons, such as managing of the risk of not having enough jet fuel (without which its planes can’t fly), and nothing to do with price; and (ii) Qantas itself has not said the reason it self-supplies is to undercut high prices charged by jet fuel suppliers.

When fuel suppliers participate in the tender process triggered by the airlines, the suppliers provide a jet price based on a product benchmark price and a number of additional components reflecting the cost to deliver product to the airport. The additional components or add-ons are commonly referred to as ‘differential’. The components of the jet fuel price offered to airlines includes, amongst other things, the following costs borne by the industry

- the jet fuel benchmark price is the marginal cost to supply product. This is the international purchase price (import parity) plus freight to move the product to the import location (i.e. Australia)
- additional import costs (such as wharfage, demurrage, infrastructure costs associated with terminals and pipelines);
- Transportation costs to airport (pipeline or road tanker);
- the cost of storing and handling product at the airport e.g ,labour, product quality testing and insurance amongst others
- the cost of moving jet fuel through the hydrant reticulation system at the airport;
- the cost of delivering jet fuel into aircraft via hydrant servicer or via on airport refuelling truck

In addition to the above, airlines may also be charged throughput fees charged by the airport along with duties, fees and taxes. An important distinction between jet fuel and ground fuels is the additional costs associated with stringent product quality controls for jet fuel (including filtration and testing regimes).

Figure 4 below shows the composition of jet fuel costs for jet fuel at Melbourne airport. The data come from publicly available sources. It is not possible to publicly disclose more detailed information as this is very commercially sensitive and would arguably be anti-competitive price signalling. There is no public information on any other factors or variables included in price by suppliers, which given competition laws and commercial sensitivity is to be expected. Nonetheless, the information is interesting in so far as it demonstrates that approximately 90% of the cost of supply is associated with the base cost of the product and freight to Melbourne. A reasonable generic assumption is that suppliers will want to recover these costs. How each supplier determines ultimate supply price to customers will depend on supplier’s internal pricing assumptions. Further details regarding Mobil’s pricing information can be provided to the Commission on a confidential basis.

FIGURE 4 DERIVED MELBOURNE JET FUEL COST ANALYSIS

Note: Index = 100 based on publicly available industry sources

Jet TGP (landed Jet Terminal Gate Price) is based on:

- Jet MOPS - Mean of Platts Singapore, price basis quoted to airlines
- Freight - World Scale % (Singapore to Australia 30KT) & Singapore to Melbourne WSFR
- Terminal Component - Average delta between terminal gate price and landed price for ground fuels (based on ACCC report – “Monitoring of the Australian Petroleum Industry –Dec 2017”). Excludes Product Quality and Filtration costs specific for Jet Fuel

Jet Airport includes Jet TGP plus:

- Trucking - Based on B-Doubles travelling 25 kms from Yarraville terminal to Melbourne Airport
- JUHI + ITP - Publicly available International airport reference

SOURCE: MOBIL OIL AUSTRALIA

In revising the Draft Report, the Commission should have regard for the detailed analysis done by the NCC, in its 2012 report on Jet Fuel Supply infrastructure at Sydney Airport. It found (at paragraph 4.29) that jet fuel differential data has “limited, if any, value in establishing ... excessive pricing or abuse of market power” and concluded at paragraph 4.41 that limited bids are reflective of supply and capacity constraints rather than “lack of access or abuse of market power”.

Underinvestment may have occurred in some infrastructure services

The Draft Report says that the natural monopoly characteristics of jet fuel infrastructure as well as the market power from vertical integration *may* (its word) have distorted incentives for incumbent firms to invest. It goes on to say that it does not have much if any evidence to assess the extent of any underinvestment. It also acknowledges the obvious point that any underinvestment was caused by the infrastructure owners having insufficient security of tenure at airports, such as was the case until recently at Melbourne airport.

Here, it is worth reiterating the point made in Mobil’s first submission to this inquiry. ExxonMobil has invested over \$400 million into fuel-supply improvements at the Yarraville terminal and Altona refinery over the past seven years. Of that amount, \$75 million was invested to construct a new jet tank at Yarraville terminal, a new 2.6km pipeline from Yarraville terminal to the Somerton pipeline and an expansion project at the refinery to increase jet fuel production. Also, Mobil is investing a further \$50 million to expand its crude storage capacity at Altona Refinery. In addition, execution of a new lease at Melbourne Airport in July 2017 has enabled the participants of Melbourne JUHI to proceed with investment in the construction of two new storage tanks, also a significant capital investment.

Airports charging fuel throughput levies

The Draft Report is equivocal about whether these levies are inefficient, saying they might be part of an efficient two-part pricing structure, and that it needs further evidence before concluding.

Here, the Commission should be firmer. Since the airports are unambiguously monopolists (in this context they are the monopoly landlords of the JUHIs) who can and do exploit their monopoly power, the burden of proof should be on

the airports to justify fuel throughput levies as efficient pricing, rather than a revenue enhancer which they impose because they can.

8.5 Is there a case for reform?

In this section of the Draft Report the Commission concedes that it has not enough information to conclude that jet fuel markets are not competitive, and then goes on to conclude (in Draft Finding 8.1) that jet fuel markets are not competitive. The apparent basis for this conclusion is the (false) premise that “fuel companies” own infrastructure throughout the supply chain and therefore have the ability and incentive to restrict supply, increase prices and charge monopoly prices.

As discussed in this submission, the premise is false because there is no single “fuel company”, or companies, that own the complete supply chain infrastructure. But even if the premise were true, the Commission has presented no evidence that jet fuel prices are above the levels that would exist in a competitive market. The only facts it does present, on jet fuel differentials, as discussed above, are not even close to being evidence of suppliers setting prices above competitive levels.

Recognising that it needs more facts, the Commission goes on to request information from jet fuel suppliers: return on assets on various assets; the terms and conditions of third party access; the number of successful applications to JUHI infrastructure; and details of JUHI access applications process, with this information to be “published and scrutinised by others.”

Unfortunately this request is problematic because Mobil does not set prices by reference to return on assets, which it uses as a measure for initial assessment of capital investments. Return on assets is not monitored on an ongoing basis as it does not provide value to Mobil. Furthermore, comparisons of returns across companies is challenging, given different business structures competing at different levels in the market. So this measure for assessment will be inconsistent due to different business models.

On options for improving competition, the Draft Report canvasses two possible access regimes:

- Use of the National Access Regime
- An Industry Specific Access Regime.

Whatever the merits of these alternatives, the more important point is this: access regimes can only be justified if there is a problem that needs fixing (which the Draft Report has not demonstrated) *and* that the access regime would improve outcomes for end-consumers (which the Draft Report acknowledges might not happen).

Finally, the Draft Report recommends the introduction of a jet fuel supply coordination forum involving fuel suppliers, airports and government agencies. This forum, suggests the Commission, could discuss capacity constraints, linkages between infrastructure, demand forecasts and security of supply and future infrastructure requirements and investment planning.

Mobil did participate with the Victorian Government in a similar forum when there were supply concerns at Melbourne airport. However as noted in Mobil’s initial submission, the main barrier to investment at Melbourne Airport was a lack of security of tenure for the JUHI. Notwithstanding this, ExxonMobil invested over \$400 million in the past seven years in its own supply infrastructure upstream of the JUHI in order to meet its own customer demand so it is questionable whether such a forum will deliver a better outcome for airlines. In fact, intervention in the capital decision making processes of private companies can have a chilling effect on investments as noted above.

In revising the Draft Report, the Commission should articulate a counterfactual and comprehensively assess it against the operation of the current market. Mobil looks forward to the Commission developing and sharing the outcomes with industry and welcomes the opportunity to further engage with the Commissioners in respect of a continuing competitive market for the supply of jet fuel.

Yours sincerely

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