

**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMPETITION COMMITTEE**

ROUNDTABLE ON COMPETITION IN ROAD FUEL

-- Note by Chinese Taipei --

This note is submitted by Chinese Taipei to the Competition Committee FOR DISCUSSION under Item IX at its forthcoming meeting to be held on 19-20 June 2013.

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1. This report will illustrate the structure of petroleum market in Chinese Taipei and the enforcement of the Fair Trade Act (FTA) in the said market by the Fair Trade Commission (FTC).

1. An Overview of the Petroleum Market in Chinese Taipei

2. Starting in the late 1980s, the petroleum market in Chinese Taipei was gradually shifted toward deregulation and liberalization. In 1987, private enterprises were approved to set up gas stations and the state-owned Chinese Petroleum Corporation (CPC) stopped opening new gas stations in response to the government policy. Up to 1997, the total amount of gasoline and diesel dispensed at private gas stations has already exceeded the amount at gas stations under CPC's direct management. In 1996, the government also gave the green light to private investment in the oil refinery.

3. Chinese Taipei took two steps to lift the ban on the private importation and exportation of petroleum products. In 1999, the importation of fuel oil, aviation fuels, and liquefied petroleum gas was liberalized. And then, the "Petroleum Administration Act" was promulgated on Oct. 11, 2001. Accordingly, the government publicly announced on Dec. 26 in the same year that the restrictions on the importation of all petroleum products, such as gasoline, diesel, and so forth, were being removed.

4. Until now, CPC and Formosa Petrochemical Corporation (FPCC) are the only two existing oil refining enterprises and petroleum suppliers in Chinese Taipei. In wholesale sector, although over a hundred businesses have been registered in accordance with the Petroleum Administration Act as wholesalers of petroleum products, the volumes of petroleum products they import are small and very few of them actually engage in wholesale selling. As for retail channels, there are currently 2,510 gas stations in operation and competition is relatively fierce in the retail sector. In comparison to large gas station chains, independent gas stations purchase very small volumes of petroleum and are therefore unable to get more preferential discounts. Independent gas stations have difficulties to survive so as to reinforce the tendency of conglomeration in the sector.

2. The Pricing Mechanism in the Road Fuel Market

5. In the context of liberalization, the launch of the mass production of FPCC's No. 6 Naphtha Cracker Plant in Sep. 2000 signified that the first private enterprises entered the petroleum market. Moreover, after the Petroleum Administration Act was enacted in Oct. 2001, ESSO started importing petroleum products into the domestic market¹, and the domestic market was completely open to competition.

6. As a result of gradual rise in international crude oil prices and price increase of daily necessities, the Executive Yuan (the Cabinet) on Feb. 14, 2006 promulgated the policy guidelines for the "Review of

¹ ESSO Taiwan obtained the permit to import gasoline and diesel in Feb. 2002 but exited the market in Sep. 2003.

Petroleum Product Prices and Improvement Measures” and the Ministry of Economic Affairs (MOEA) subsequently established the “Operating Principle for the Domestic Gasoline and Diesel Floating Price Mechanism” (the floating price mechanism). According to the floating price mechanism, from Jan. 1 2007, CPC was required to adjust its petroleum product prices regularly to reflect international oil price fluctuations. CPC was also requested to fully disclose the price adjustment calculation equations to the public. The floating price mechanism underwent several revisions, in Sep. 2007, Nov. 2007, May 2008 and Aug. 2008 respectively. Whenever a price adjustment was to be made, CPC was required to report it as well as submit the related data to the MOEA for reference.

7. Since the domestic petroleum market was liberalized, CPC and FPCC have adjusted the prices simultaneously within the same range. This phenomenon raises public concerns about a price-fixing conspiracy between CPC and FPCC, the reasonableness of the prices, and the excessive profits made by the private business. The government adopts the floating price mechanism for facilitating price transparency and responding to international oil price fluctuations appropriately. However, such an approach could also make it easier for the two major suppliers to predict the opponent’s price adjustment decisions and reduce the degree of competition in the domestic petroleum market.

3. The Development of Competition Policy and Competition Law Enforcement

8. Considering the liberalization process and the pyramidal structure of the petroleum industry in Chinese Taipei, the FTC focused on different aspects when formulating the competition policy and enforcing the FTA:

3.1 *Competition related provisions for common violations in the domestic petroleum market*

9. As mentioned above, CPC and FPCC are the only two petroleum suppliers in the market. CPC and FPCC respectively account for about 70% and 30% share of petroleum market. The FTC’s investigations into this duopolistic market mainly focus on monopolization² and concerted actions.

10. As for the retail sector unfair competition claims are a major part of the FTC workload, particularly about vertical restraints (Article 19), misleading representations (Article 21), and deceptive conduct that could affect trading order (Article 24).

3.2 *The law enforcement and key advocacy activities before the enactment of the Petroleum Administration Act*

11. The FTC adopted the following measures to ensure fair competition in the petroleum market before the restrictions on the importation of petroleum products were completely removed:

1. During the period when the Petroleum Administration Act was drafting, the FTC attended nearly 20 meetings and suggested removal of regulations that curb competition in order to address competition concerns regarding barriers to market entry in the oil refining and import industries, trade restrictions on petrochemical businesses, access to pipelines and oil tanks. Some of the suggestions concerning barriers to entry in the oil refining and importation markets were adopted, but issues on the access to pipelines and oil tanks were not taken into account in the draft. In addition, the FTC also recommended that the MOEA could amend the “Administration Rules on setting up Gas Station” to avoid excessive regulations and encourage interested parties to enter the market.

² Article 5(2) states that two or more enterprises shall be deemed monopolistic enterprise if they do not engage in price competition with each other and otherwise meet the definition’s term prescribed in Article 5(1).

2. Before the petroleum market was liberalized, the FTC's law enforcement primarily focused on ensuring competition in the downstream sector (gas stations) to prevent existing operators from impeding market entry with contracts in restraint of competition.

3.3 *The FTC's law enforcement and advocacy activities after the enactment of the Petroleum Administration Act*

12. After the Petroleum Administration Act was promulgated and implemented on Oct. 11, 2001, the FTC's competition policy toward the petroleum market and law enforcement were as follows:

1. The FTC sent letters to advise relative enterprises that the FTC would keep a close watch on the development of the petroleum market and trade practices as liberalization of the market was underway. The FTC also reminded those businesses to ensure the gas station operators have the right to terminate their contract with existing suppliers.
2. The FTC conducted surveys in the retail sector to understand the market structure and relationships between upstream and downstream sectors, as well as the trading patterns of gas stations. The FTC used the result as reference to handle cases involving gas stations and to advocate the removal of petroleum market regulations and pro-competition policies.
3. In 2005 and 2006, the FTC conducted a series of seminars to communicate with businesses from the upstream and downstream sectors of the petroleum market and related associations for promoting awareness of the FTA. The FTC also put forth its competition advocacy with regard to the relations between competition policy and industrial policy for the petroleum industry, and economic development in the "2007-2009 Competition White Paper" published in Jan. 2010.

4. Case Example: The FTC's investigations on the concerted action between CPC and FPCC for adjusting the price of petroleum products simultaneously within the same range.

13. In 2003, the FTC launched an investigation into the CPC and FPCC, the only two suppliers of gasoline and diesel in Chinese Taipei. Between 2002 and 2004, the FTC found that the two companies adjusted the prices of 92 and 95 unleaded gas and premium diesel oil simultaneously and within the same range at least 20 times.

14. The concluded that the pattern of price adjustment was: 1) the initiating company would make a price announcement in advance through public media in order to "test" the competitor's response and "exchange" important information regarding price adjustment; 2) the competitor "followed suit" at the earliest time and the price adjustment was made at the same time and at the same rate; 3) if the competitor would not "follow suit" and the initiating company would immediately "amended" or "withdrew" its price announcement. Consequently, the pattern of price adjustment announcements enabled the CPC and FPCC to adjust prices consistently.

15. The firms under oligopoly are highly interdependent in making decisions and the interdependence could lead to price rigidity. The FTC admits that simple uniform pricing (parallel conduct) could not necessarily be unlawful. However, if competitors reach mutual understanding through public price announcements or news releases which results in the pricing of relevant products in the market, the FTC contends that this public exchange of views would be different from a parallel conduct. In fact, the FTC's investigation showed that circumstantial evidences such as the incentive, economic benefits, the timing and degree of price increase, and frequency were sufficient to constitute a violation of the Article 14 (1) of the FTA. The FTC concluded that the two companies didn't just reach the same price levels, but their public information exchange can be considered as a form of mutual understanding, and thus a prohibited concerted action.

16. The two companies appealed the FTC's decision to the Appeal and Petition Committee and the Administrative Courts. The Taipei High Administrative Court in 2006 and the Supreme Administrative Court in 2009 both upheld the FTC's findings on the two companies' unlawful concerted action. Moreover, the Supreme Administrative Court also supported the original ruling of the Taipei High Administrative Court that the characteristics of the price adjustments between the CPC and FPCC were enough to prove the existence of a concerted action. The presumption could be rebutted when only the parties could provide concrete and convincing to justify their behaviours.

17. Ever since the CPC officially launched the floating price mechanism in Jan. 2007, the FTC has initiated investigations on every price adjustment made by CPC and FPCC. Currently, CPC performs its petroleum price adjustments according to the floating price mechanism under the supervision of the MOEA. Meanwhile, FPCC claims to be acting in line with the policy of the government and adjusts its prices after CPC. No mutual understanding in any form has been detected and no evidence has shown that the two companies are engaging in any unlawful concerted action.

5. The Operation of the Competition Mechanism and the Limitations Encountered in Law Enforcement

18. The current duopoly in the petroleum supply market in Chinese Taipei includes one state-owned and one private enterprise. The attributes and purposes of the strategic decisions are different but the two companies often adjust their prices simultaneously and the gas stations immediately change their retail prices accordingly. The public often questions whether the price adjustments have been the result of conspiracies between the two enterprises to avoid competition. In competition laws, it is required to have concrete evidences to prove the existence of a mutual agreement for a concerted action. Such evidence may include direct and circumstantial evidence (like structural evidence, economic evidence, and behavioral evidence). With "conscious parallelism" resulting from the mutual interdependence in an oligopolistic market, however, mutual agreement cannot be applied as evidence of a concerted action. Moreover, according to the OECD's "Prosecuting Cartels without Direct Evidence 2006", when enforcing laws against concerted actions without direct evidence such as a contract or agreement, parallel behaviour that complies with economic principles cannot be applied as proof of a cartel agreement. Additional circumstantial evidence, such as plus factors or facilitating practices, is needed to make the final judgment.

19. On the other hand, questions have been raised with regard to the "reasonable adjusted range" and the "excessive profits" in the price adjustments made by the petroleum suppliers, and the FTC was forced to closely examine the justifiability of the price increases and investigate whether the said companies have been making windfall profits. The issue may involve the definition of "reasonable prices" and the criteria of "rate of return" if it is probed under Subparagraph 2 or 4 of Article 10 of the FTA regarding the improper changing of prices or abuse of market power by monopolistic enterprises. However, as it is difficult for the competition authority to obtain information on the costs of businesses, also due to the problem of information asymmetry, even if the competent authority is able to acquire complete cost information, how the common costs are split up can lead to more questions. As petroleum products are joint production, the allocation of common costs, long-term costs, short-term costs, direct costs, indirect costs, and operating expenses is difficult. There are certainly doubts about the possibility of establishing reasonable recognition of the costs of the gasoline and diesel business of CPC and FPCC. As proclaimed by CPC, each time an adjustment is to be made according to the floating price mechanism, it has to report and submit the market data to the MOEA for reference. In other words, CPC's price adjustments are under the control of the regulatory authority. If the petroleum prices of CPC are reasonable, as they are determined under the supervision of the regulatory authority, and FPCC merely sets the same prices after CPC, it is difficult to accuse the two enterprises of improperly adjusting the prices of their petroleum products and, hence, there is no monopolistic manipulation or improper pricing.

20. Besides the consideration of a safe inventory threshold, there are other factors to be taken into account when assessing whether there are barriers of entry in the market, including a number of precedents, the level of productivity expansion, the costs, risks and profits, the reputation of existing businesses, the cost to acquire permission from the competent authority, and economies of scale and economies of scope to a certain extent. As the current domestic petroleum supply market is a duopoly, the following question needs to be asked: How are the timeliness and likelihood of new oil refiners or importers emerging in the domestic market? Since CPC started to adopt the floating price mechanism, the domestic petroleum prices have remained the lowest in this part of Asia. Foreign oil companies may have the capacity to enter the domestic market but there is little incentive as there will be no profit, not to mention the tight petroleum price regulations. There are opinions being expressed that the oligopolistic market is the cause of the synchronous price increases between CPC and FPCC and the government ought to allow a third business to enter the market. Nevertheless, as the domestic petroleum prices are the lowest compared to neighboring countries and if this phenomenon continues, it is a question if any oil company will be interested in entering the petroleum market here.

6. Studies on the Domestic Petroleum Market

21. The FTC has conducted its own studies and commissioned other institutions to carry out studies on the petroleum market. The outlines of these studies are as follows:

1. Staff working papers: In Dec. 2009, the FTC published “A Study on the Precedents of Violations of the FTA in the Domestic Petroleum Market”. The study reviewed and analyzed more than 150 cases taking place at the upstream, midstream and downstream sectors of the petroleum market and concluded that the concerned parties in these cases had been mainly the suppliers at the upstream sector and gas station operators at the downstream sector and most cases had coincided with a time point in the different stages of the removal of government control over the petroleum market. The report also pointed out that in spite of the transparency of the current floating price mechanism and the preliminary announcements of impending price adjustments due to such adjustments being a public concern, excessive government intervention in petroleum product pricing to ensure openness and transparency could reduce the willingness of domestic petroleum suppliers to engage in price competition. Considering that international oil prices could still continue to rise and the government had also made a plan to revise the energy and oil tax system, the study therefore suggested that the government review the current floating price mechanism in the future when revising the oil tax system or when international oil prices became stable. The prices of petroleum products should be determined in accordance with the legislative spirit of the Petroleum Administration Act; excessive intervention should be avoided.
2. Commissioned Studies: Take the report “A Study on the Domestic Petroleum Market” (2009) as an example. The major findings were: 1) the important factors that had an effect on domestic petroleum product pricing included the average price of imported oil, the number of businesses competing in the domestic petroleum market, and government policy toward the petroleum market; 2) the design of the floating price mechanism was inappropriate and its implementation had triggered a variety of problems in petroleum product pricing in the country; 3) vertical integration in the petroleum market was a prerequisite for domestic oil companies to maintain profits and stabilize production and sales and currently there was no significant evidence showing that any oil company could become a monopoly through vertical integration. The report also suggested that the government revise the floating price mechanism to fix the flaws in the design. In the long run, the government should remove the floating price mechanism and other price control measures and stop intervening in the pricing of petroleum products, so that the petroleum market in the country could function normally to attract domestic and foreign businesses to enter

and compete in the domestic petroleum market and consumers and businesses would be able to enjoy the economic benefits resulting from reasonable petroleum prices.

7. Conclusion

22. The FTA prohibits any obstruction to market competition such as manipulation or concerted action. However, the high concentration of the oil refining industry due to its nature of economies of scale and economies of scope has led to a lack of competition in the market. To solve the competition problems in the oil refining industry once and for all, the FTC will continue to act in line with the policy of the competent authority of the industry for the liberalization of the petroleum market in order to build a competition environment that is both free and fair.