NOSEWEEK
01 Jan 2015, p.18

Oil companies to gobble up small service stations

New fuel price formula will ruin independents and channel huge profits to the Big Boys. By Ciaran Ryan

HUNDREDS OF PETROL STATION owners across the country are threatened with closure over the next 12 months because of a new fuel price formula that allows oil companies to take a larger bite out of the retailers' margins.

This is the converse of what the new pricing model is meant to achieve and it almost certainly violates the Petroleum Amendments Act of 2003, which is designed to promote small and emerging businesses and prevent vertical integration. It is supposed to stop oil companies from owning the entire fuel chain from refineries to fuel depots and service stations. In practical terms, it does nothing of the sort.

The act prevents oil companies from holding retail licences, but this does not stop them owning the service station assets. The licensed retailer is then, in effect, just a glorified manager. It's a neat way around the prohibition on vertical integration and allows the oil majors to feast on the margins of their service station operators.

A new pricing model known as the Regulatory Accounting System (RAS) came into force about a year ago, its intention being to "introduce transparency" into the fuel price – deemed necessary because the old pricing model was prone to industrial-scale scamming at the expense of the consumer.

The local fuel industry has been regulated since the apartheid years. Then, the idea was to ensure the country had sufficient fuel to counter the international oil embargo. After 1994, the ANC government continued this policy so as to promote black participation in the industry, protect jobs and ensure adequate energy supplies at a fair price.

Now it seems even the regulated market cannot guarantee job security or broader black participation in the industry. Service station owners are cutting back on staff to shave costs, while newer, predominantly black, entrepreneurs appear to be most at risk from the RAS pricing regime.

Oil companies are guaranteed a return on assets of 19%, a big incentive to up their assets, and are investing huge sums in petrol stations and whatever else would boost the asset side of the balance sheet. They went one step further with their accounting legerdemain, counting the assets of their service station operators as their own and claiming additional margin on this. Nice business if you can get it.

Of the current petrol price of R13.61-a-litre payable in Gauteng, about R8.75 of this goes to the oil companies, R3.43 towards levies and taxes, leaving a retail margin of R1.43-a-litre for the service station entrepreneur, and, of this amount, 60.4c is allocated as a return on retail assets. This was intended to reward the service station entrepreneur, but under the new pricing formula, oil companies can claim full entitlement to this amount.

There are roughly 4,500 service stations in South Africa, 60% of which are owned by the oil companies and 40%, privately-owned. There has been a big push in the past decade to transform the fuel retail sector and bring black entrepreneurs into the loop with a variety of soft finance options. An average service station costs about R5m to set up. Many entrepreneurs finance these acquisitions with 10-year loans, but their licence with the oil company is renewable every three or five years. If the oil company cancels the licence after five years (which they have been known to do), the entrepreneur is left with no way of servicing a 10-year loan.

Service station operators rely on the fuel retail margin to cover their debt. With oil companies after a bigger bite out of this, it is easy to see how several hundred service station entrepreneurs wonder whether they will still be in business a year from now.

Oil companies in South Africa make money without having to try too hard. The Department of Energy sets the fuel price at a level that guarantees them a 19% return on assets, no matter how smartly or foolishly they invest. The only one not invited to the feast is the consumer and now, it seems, the service station entrepreneur.

Not everyone is prejudiced by the new pricing model. Those entrepreneurs who own the service station assets get to keep the full retail margin. The problem arises for those who do not own the service station – many of whom paid several million rands in franchise and licence fees to the oil companies – who do not own the service station assets. The new pricing model, like the old one, is based on a guaranteed return on assets. So whoever owns the assets also gets the retail margin.

"Those entrepreneurs who own their own service station assets are doing well out of the new RAS system," says Neal Singh, CEO of Smart Fuel, which provides fuel management systems to service stations. "The more they own, the better off they are in terms of the new pricing system. But it is easy to see how a pricing model based on ownership of assets would hurt those who don't own much in the way of assets.

Since the Gulf of Mexico oil spillage, oil companies are tending to get rid of potential generators of liabilities, such as petrol service stations."

But where you have a system that rewards oil companies for ownership of assets, that's what they will do: acquire assets.

Many of the entrepreneurs operating company-owned service stations argue that the new pricing model is skewed in favour of the oil companies who, in an unholy alliance with the state, have rigged the fuel price to their mutual benefit. Breaking down the fuel price into its component parts, it's staggering just how much of it is snorted by the oil companies and the state.

For example, oil companies take a further 6c-a-litre from the retail margin for repairs and maintenance of fuel pumps and tanks, plus rates and taxes. Companies that own underground tanks in service stations, such as Shell, take a further 5.8c.

The most contentious part of this revenue split is the 60.4c-a-litre supposed to be paid by service station operators back to the oil companies as a return on assets in the form of rental and franchise fees.

This leaves the company-owned operator with about 71c-77c-a-litre to cover operating expenses, the biggest of which are labour and electricity – about 70% of the total cost of running a service station. Add the growing use of credit cards to make fuel purchases – which can take another 5% out of the pie – and there isn't much left for the entrepreneur to cover debt and other costs at the end of each month.

Under the previous system which ended in December 2011, service station operators received a "retailer margin" of 16c-a-litre as "entrepreneurial compensation" but the new RAS system introduced by the Department of Energy leaves this up to the discretion of the oil companies to allocate as they see fit. Many service station operators are getting just half of this.

To acquire the BP Madadeni service station in KwaZulu-Natal in 2013, Bonginkosi Mbonambi, mortgaged his house and took a loan from the National Empowerment Fund. He sells about 280,000 litres of fuel a month, which is about average for the country, but does not have a convenience store to supplement his fuel sales. Under the new pricing regime he is making a net operating profit of 8.4c-a-litre, which is about half of what he was making a year ago. This 8.4c-a-litre remains to cover his loan repayment of R38,000 a month, which amount on its own, translates to 14c-a-litre to meet that obligation. He asked BP to reduce his rental of 44c-a-litre plus R22,800 a month and was told they would "look into it". Meanwhile, Mbonambi is having to dig into his mortgage bond to keep the business afloat.

The situation is so dire than the Fuel Retailers Association is contemplating legal action to force the government to stick to the letter and intent of the law.

"We welcomed the new pricing structure when it was announced because, as fuel retailers, we believed we would get a fairer deal than was the case in the past," says Reggie Sibiya, CEO of the Fuel Retailers Association, which speaks on behalf of the roughly 4,600 service stations across the country. "But the way this has been implemented means those who operate company-owned service stations in particular are at the mercy of the oil companies.

Licensed retailers will become glorified managers

"The oil companies continue to enjoy profits from the retailing business through rentals and franchise fees, which amounts to a prohibited practice in terms of the Act. In effect, retailers are little more than managers operating service stations on behalf of the oil companies."

One objective of the Petroleum Products Act of 1977 is to promote development of small business, specifically the retail sector. The act states: "No person may make use of a business practice, method of trading, agreement, arrangement, scheme or understanding that is aimed at or would result in a licensed wholesaler holding a retail licence..."

The problem is that while the fuel price itself is regulated, the margins are not, so there is plenty of scope for oil companies to nibble from other people's share of the spoils. The unregulated wholesale price allows oil companies to get back whatever they deem is theirs by simply invoicing retailers. Any late payments on these invoices, and the product supply can suddenly cease. Then it is a short step to bankruptcy.

The current pricing system is also a recipe for inefficiency. The old system was rife with dodgy accounting, such as oil companies counting privately-owned service station assets as their own in order to claim back additional margin. The new RAS system was supposed to put an end to all this.

"In fact, it maintains the status quo by refusing to acknowledge the principle that whoever owns the asset must get a return for it. Oil companies stick by the existing agreements where they get the full share of return on assets and then prescribe in their own terms what a privately-owned retailer should get for such ownership of assets. This means whatever they have lost from the old dispensation, they can easily claw back from the small businesses," says Sibiya. "To make matters worse the regulator says it is not willing to intervene in what it says are private contractual agreements."

The government doesn't seem too enthusiastic about untangling this mess, especially as it takes 25% of the fuel price in the form of taxes and levies.

The prospect of a deregulated fuel market in South Africa remains a distant dream. In its White Paper on Energy, published more than a decade ago, it paid empty homage to the concept of deregulation, calling inter alia for better support for small business owners. It started with a licensing regime intended to keep the oil companies out of the retail market but they have clearly found a way around this inconvenience.

"There's no question that if government does not quickly intervene, many station owners will soon be out of business. But, as one goes out of business, a new one – not fully armed with all the facts – will come in, only to suffer the same inevitable fate," says Sibiya. ■