DEREGULATION: CRUDE OIL

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On 1 January 1988 a new era started for the Australian oil industry when for the first time producers were able to market their oil in whatever manner they chose. Prior to 1 January 1988 producers did not, in any sense of the word, 'market' their oil. Rather, pursuant to the Federal Government's Crude Oil Allocation Policy, all of Australia's oil production, with minor exception, was allocated for sale to the refiners operating in Australia. The price paid for oil so allocated was set by the Federal Government under its Import Parity Pricing (IPP) Policy.

These crude oil marketing policies evolved over 20 years into the form in which they existed immediately prior to 1 January 1988. A brief and simplistic description of the policies at that time follows.

Crude Oil Allocation Policy

With the exceptions detailed later in this paper, crude oil from each separate producing area was allocated for uplift by each refiner operating in Australia. The crude oil allocated to a refiner was based on its relative share of the total sales of certain finished petroleum products (mainly petrol, diesel and aviation fuel).

This meant that if there were six producing areas and six refiners, each of the six refiners had an allocation of crude oil from each of the six producing areas, *i.e.* 36 separate allocations. In practice, refiners exchanged allocations and combined shipments thus substantially reducing the number of separate uplifts and the transportation distances and costs.

Import Parity Pricing Policy

The Federal Government determined the price for crude oil from each producing area based on a number of factors including world price, quality, shipping cost and credit terms. Price was determined at the nearest refinery port to the point of custody transfer between producer and refiner. The price determined was calculated as the cost to that refinery to import crude oil of similar quality. If the refinery was not of sufficient size to theoretically process all of the relevant production, then the cost of shipping the excess volume to the next nearest refinery port was deducted from the price (and so on until all produced crude oil was theoretically used). Where this occurred the volume weighted average price became the IPP of that producing area.

To understand deregulation, why it occurred and what it means requires the background of the regulation to be explained. At the outset it should be mentioned that the regulation which existed was not of a statutory form. The refining and producing industries voluntarily adhered to

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Government policy for over 20 years and it was only in the latter years of the policy that the Government had any form of statutory control. Even then the statutory control was indirect in the sense that Government had the ability to use import duty to ensure 'voluntary' compliance.

HISTORY

Oil in commercial quantities was first discovered at Moonie (Queensland) in 1961, production commenced in 1963 and the first sale took place in 1964. The Government's Allocation Policy was not formally introduced at that time although the Government did 'encourage' domestic refiners to uplift a share of the Moonie production. The Government also became involved in the price negotiations suggesting the price be based on what is now known as Import Parity Price (the price a refiner could expect to pay on the world market for crude of similar quality, plus appropriate transportation costs). The initial agreed price was $2.54/bbl (bbl means barrel).

A Tariff Board enquiry set up to review the issues raised in the Moonie negotiations (reported in July 1965) recommending what has evolved into the Allocation Policy and the Import Parity Pricing Policy. The Government adopted the recommendations. Initially the allocation of crude oil to refiners was on the basis of their relative proportions of crude oil and finished product imports. The Government established a new price of $3.13/bbl comprising the IPP plus a US$0.75/bbl incentive payment to encourage local exploration (the Tariff Board had recommended an incentive payment but at a lower level).

Barrow Island was discovered in 1964 and production commenced in 1967 also subject to the Allocation and IPP Policies. The Barrow Island price was slightly higher than Moonie's due to the better quality of the crude oils.

In 1967 major discoveries of crude oil were made in Bass Strait and it was considered that the policies would require modification to cover the major production anticipated in 1970. As a result of this review, the Allocation Policy was confirmed for ten years from September 1970 but was modified to change the basis of allocation from crude oil and finished product imports to relative shares of the domestic finished product market (a system that was maintained until the scheme was abolished on 1 January 1988).

At the same time, the pricing policy was modified with the US$0.75/bbl exploration incentive being regarded as inappropriate for the large fields discovered in Bass Strait. The initial Bass Strait price was set at $2.42/bbl but the Government also announced that for the five year period beginning September 1970, all prices would be modified to remove the incentive margin, reflect world prices, adjust for the different quality of the Australian crude oils and include a freight adjustment on Bass Strait crude oils to reflect that the nearest refinery port (Westernport) could not handle all production. Prices were fixed for the five year period at:

$2.06/bbl	Bass Strait
$2.21/bbl	Barrow Island
$2.15/bbl	Moonie

(hereafter in this paper, unless otherwise stated, the Bass Strait IPP has been used as indicative of Australian prices.)

These prices were very attractive to the producers for a short while (indeed there were some complaints from other parties that they were artificially high) but by 1971 world prices had escalated to the point where Australian crude oil was cheaper than imported crude oils.

The problems and complaints about the system took on new directions. Refiners who were reluctant participants in the scheme for the previous five years suddenly loved the system, whilst producers who had gained a price advantage for a number of years felt cheated. In August 1975 the Federal Government closed the gap between Australian and world prices by the imposition of a $2.00/bbl excise payable directly by the refiner to the Government.

In September 1975 major changes were made when the price of oil from the three producing areas was set based on cost and rate of return issues. The Barrow Island crude oil price jumped from $2.21/bbl to $2.75/bbl with further scheduled increases over two years to $3.17/bbl. These increases were to reflect escalating capital and operating costs. The Moonie crude oil price jumped from $2.15/bbl to $3.00/bbl increasing thereafter to $5.25/bbl. These increases were intended to provide a satisfactory rate of return on past and planned capital expenditures. Bass Strait production only received a modest price increase from $2.06/bbl to $2.33/bbl and this increase was intended to provide for the costs of producing the new fields Mackerel and Tuna. A 23 percent after tax rate of return on its oil interests could be calculated from BHP's annual accounts and this was considered sufficient.

The $2.00/bbl excise remained on top of these prices.

The Government also announced that oil discovered after 14 September 1975 would be priced at full IPP (which approximated $9.00/bbl by that time) less the $2.00/bbl excise which would still be paid by the refiner to the Federal Government. In August 1976 the $2.00/bbl excise was removed for any oil discovered thereafter, with full IPP being paid by refiner to producer.

In May 1976 the Government referred the question of appropriate prices for crude oil discovered pre-September 1975 to an Industries Assistance Commission (IAC) enquiry. The IAC (reporting on 30 September 1976) recommended that the concept of Import Parity Price be again applied to Moonie and Barrow Island production (less the Government excise of $2.00/bbl) and that the price of Bass Strait oil should be gradually increased to 49 percent of Import Parity by 1980. At the time of the enquiry the IPP was approximately $11.00/bbl with the Bass Strait price at $2.33/bbl. The IAC pointed out that the subsidy to consumers by virtue of the Australian price being pegged at the lower level was $1,000 million/year. Interestingly the IAC stated that the Free Market option was preferable to the Allocation and IPP Policies. The IAC also stated 'it is not in Australia's interest to forego any local production of crude oil that can be undertaken at, or less than, the cost of imported oil of equivalent quality'. BHP and Esso, in submissions to the IAC, both stated that given the low price they received for old oil, they had little confidence that the new oil policy would be adhered to, should a significant discovery be made.

The phase-in to 49 percent of IPP for Bass Strait was the first step in what the IAC proposed as full IPP by no later than 1985. In association with the concept of full IPP the IAC believed that the excise should be removed but also that the Government should review the taxation measures (including royalty) applicable to oil production to ensure that the producer/community share of profits was appropriate. The IAC also referred to the possibility of a resource rent tax. Almost one year later, in the August 1977 Budget, the Government accepted the IAC's recommendation and began phasing in IPP.

The phase-in was two pronged in that IPP applied to the greater of 6 million bbls/year or a proportion of production rising from 10 percent in the first year to 20 percent, 35 percent and 50 percent for the following three years respectively. At the same time the excise was increased to $3.00/bbl. The IPP was to be recalculated each six months.

In the August 1978 Budget the Government took a major step and introduced a policy whereby all oil produced and sold in Australia was priced at full IPP to the refiner with the producer being responsible for the payment of excise to the Federal Government. Much to the producers' disappointment, the full increase in the price of Australian crude oil was paid to the Government in the form of higher excise. From this time forward the major issue from the producers' viewpoint became not the price of oil but the split between producer and Government. This matter is dealt with later in this paper.

The principle of IPP did not change over the next decade but the actual calculation was subject to a number of variations.

In July 1979 the Government sought industry views on the future of the Crude Oil Marketing Policy which was due to expire in September 1980. It is interesting to note the positions taken by the various groups at this time. The refining industry acknowledged longer term benefits in a free market but wanted the current policy to remain in place. In a world oil market that was becoming very volatile, the refiners saw substantial benefits in the security of supply provided by the Allocation Policy and in a price which was significantly lower than that applying to imported crude oil (due to the six monthly lag in setting the Australian price). The producers supported the adoption of a free market but acknowledged that small refiners would need protection to ensure certainty of supply at a competitive price.

On 17 September 1980 the Government announced that the Allocation Scheme (with minor modification) and IPP would continue to apply until 31 December 1984.

In 1983 the Government approved the export of Bass Strait crude oil production that was surplus to Australia's requirements and the first shipment took place in November 1983. It is interesting to understand how the need to export arose. In the first half of 1983, Bass Strait producers were forced to curtail production due to an inability to sell the oil already produced. This meant that the Government lost significant revenue from excise which prompted it to propose a penalty duty on imported oil to ensure that local production was uplifted. The refiners opposed such a step explaining that a number of factors had caused the problem. These included the unplanned shutdown of several refineries, a

high level of gasoline imports to cope with industrial stoppages, imports of crude oil to meet what turned out to be optimistic demand forecasts, decline in Australia's consumption of finished products and higher oil production due to a reduction in Bass Strait industrial problems. The refiners undertook to lift 385,000 bbls/day of Bass Strait production during 1983/84. The Government approved exports to clear the backlog of production and any production above this 385,000 bbls/day. The Government required that 'new oil' (discovered post September 1975) went to the export market thus ensuring that the 'old oil' on which it got greater excise went to the higher priced domestic market.

In January 1984 a further leg to the Crude Oil Marketing Policy was introduced in the form of the 'Bass Strait Coastal Freight Adjustment'. This involved the refiners paying a levy on Bass Strait crude oil, which levy was then redistributed amongst them based on the relative costs of transportation from Bass Strait to their respective refineries.

In February 1984 it was agreed that the production of Blina oil (a small field in northern Western Australia) would be invoiced entirely to one refiner, BP, with the Bass Strait allocations being adjusted between refiners to compensate.

In June 1984 and following discussions with producing and refining industries, a discussion paper contemplating modification to the Allocation Policy was issued by the Federal Government. The proposed modifications were for either partial allocation of Australian crude oil or a move towards a free market.

In response to this discussion paper one refiner and BHP/Esso made submissions supporting a free market. The other refiners and the small producers all supported a continuation of the then existing policy although many sought minor modifications which were to their commercial advantage. The refiners pointed out that while they philosophically supported a free market they did not seek an immediate change. They also noted that a free market at the production end of the business made no sense if the market for refined product remained regulated.

Arising from the June 1984 discussion paper and the comments received from industry, a further paper was issued in September 1984 setting out more fully two alternative approaches that the Government was considering:

— a partial allocation system
— a modified free market system.

A partial allocation system would result in all production from small producers (less than 50,000 bbls/day) and most of the production from large producers being allocated. This meant that only Bass Strait would be subject to less than full allocation. The amount of Bass Strait crude oil allocated was expected to fall marginally from the 385,000 bbls/day referred to earlier but this would be reviewed on a six monthly basis. The IPP Policy would remain in place for all allocated crude oil.

Under a modified free market approach, only small producer production would be allocated to refiners. All other production would be sold under free market arrangements. The definition of a small producer under this arrangement was not necessarily the 50,000 bbls/day level considered under a partial allocation scheme.

Effective 1 January 1985 new arrangements along the lines of the partial allocation scheme were introduced. Under these new arrangements all production from small ventures (less than 50,000 bbls/day) plus the first 350,000 bbls/day from Bass Strait was subject to the Allocation and IPP Policies. Production above this 350,000 bbls/day threshold could be sold by the Bass Strait producers on the free market (*i.e.* either domestic or export markets). In addition, production from the Jabiru Field was exempted from the Policy because of its remoteness. As part of these arrangements, the Government announced that it intended to have a further review in 1987 with a view to possibly introducing the free market system from 1988.

For the first time, the 1985 arrangements introduced real teeth into the Government's policy in that the Customs Tariffs (Standby Duties) Act 1985 was enacted. This imposed penalty import duties ($5.00/bbl) should refiners fail to meet their obligations under the Government policy.

Effective January 1985 the IPP was reviewed every two months with an actual price adjustment being made only if a variation greater than $1.00/bbl existed.

In May 1985 and in response to significant lobbying for the Government to introduce a free market system earlier than 1988, the Government issued a further discussion paper on the rationale for a free market. This pressure arose because the rapidly falling exchange rate meant that significant price rises were lagging considerably behind what would have been achieved in a free market. At times the lag resulted in theoretical losses as high as $10.00/bbl. Notwithstanding the effect of the price lag, the small producers stepped up their campaign opposing the free market primarily on the basis that in the longer term they would receive a lower price and this would result in reduced exploration. The Government was not persuaded to change the previously announced timetable because of the major transitional difficulties it saw in a change from the Allocation Policy to a free market.

In July 1985 the IPP formula was modified to change the world crude oil benchmark from the official selling price for Arab light to 50 percent spot and 50 percent official price. This was in response to complaints that the official price no longer reflected the world price because the volume traded at the official price was rapidly declining with more and more spot and special deals being entered into. In January 1986 the IPP pricing mechanism was further modified to provide for 20 percent official and 80 percent spot prices.

In March 1986 a 'proxy' for the Arab light oil price was introduced due to the unavailability of reliable price data on Arab light oil. Thus a basket of Middle East crude oils became the benchmark for the IPP calculation. In addition, the Government determined that the IPP would be reviewed monthly.

Exemptions from Allocation Policy

Over the years a number of exemptions from the Allocation Policy were created. While each of these was based on valid grounds the creation of more and more exemptions was undoubtedly part of the reason for the abandonment of the Policy on 1 January 1988. The exemptions were:

Producers' Entitlement — where producers marketed condensate (a light crude oil obtained from natural gas) as part of the crude oil stream, they were entitled to retain an equivalent volume of crude oil for disposal outside of the Allocation Scheme.

Small Refineries — subject to Ministerial approval, small refineries constructed to process oil from remote deposits were able to obtain crude oil outside of the Allocation Policy.

Test Oil — subject to Ministerial approval, oil produced in the exploration and appraisal phase of a project was exempted from Allocation.

Blina — as outlined earlier in this paper, although Blina oil remained part of the Allocation scheme, the arrangements were modified to allow only one refiner to purchase it.

Jabiru — because of its remoteness, oil produced from the Jabiru oilfield was not subject to the Allocation Policy.

Bass Strait Excess Production — as outlined earlier, from 1983 onward some portion of Bass Strait production was exempted from the Allocation Policy.

Secondary Taxation

To fully understand the position with respect to the crude oil marketing policies of the Federal Government, one must also be aware of the taxation policy on crude oil production. Since 1975 crude oil has been subjected to some form of secondary tax. As mentioned earlier, this was initially in the form of a \$2.00/bbl excise paid by refiner to Government but also 'deducted' in calculating the price paid by refiner to producer. Shortly after the introduction of this excise the Government announced that it would not apply to oil discovered after August 1976. In the August 1977 Budget the excise was increased to \$3.00/bbl. In 1978 the excise arrangements were substantially modified and with the introduction of full IPP all of the increase in oil prices was taken up in additional excise.

Effective 1 July 1979 modified, and complicated, new excise arrangements applied. The announcement was worded by describing the producer share of IPP for 'parity oil' as being:

For Fields with production:

— less than 2 million bbls/year	Full IPP less a \$3.00/bbl excise,
— between 2–15 million bbls/year	\$10.66/bbl plus 25 percent of increase in IPP on or after 1 July 1979,
— greater than 15 million bbls/year	the lesser of \$9.59/bbl plus 100 percent of increase in IPP on or after 1 July 1979 or \$9.59 indexed by CPI after December 1978.

It must be remembered that not all Bass Strait production was subject to these returns to the producer as the phasing-in rules of August 1977 still applied and had only reached the point where 35 percent of production was subject to the higher return. For the remaining 65 percent, the producer only kept $2.33/bbl. The terms 'parity oil' and 'non-parity oil' were used to describe these two categories.

During 1983 the above three tranches were substantially modified so that as a field's annual production increased over ten stepped threshold levels the excise on the incremental production increased. This was to avoid what became known as 'black holes' occurring. Where a field was capable of producing say 2.2 million bbls/year, the incremental production of 0.2 million bbls/year above the $3.00/bbl excise threshold of 2 million bbls/year would result in the *entire* production now being exposed to a very substantial increase in excise. Clearly the producer would not produce above 2 million bbls/year in this case and this created a 'black hole'.

Excise on new oil was again introduced as from 1 July 1984 but at a lower rate than that applying to old oil. The excise on new oil was re-introduced because the Government wished to capture a share of the profit from the Fortescue Field in Bass Strait. This confirmed Esso/BHP's concerns expressed in 1976.

In late 1984 an 'intermediate' excise scale was introduced to encourage the development of certain marginal projects.

In July 1986 the excise on those sales of oil made outside of the Allocation Policy was modified so as to vary with the actual realised price.

In August 1986 the IPP had fallen to $15.75/bbl from over $40/bbl a year earlier and the Government announced that excise on onshore production would be waived for as long as the IPP remained below $20.00/bbl. At the same time the top marginal rate of offshore excise was reduced from 87 percent to 80 percent.

In January 1987, but retrospective to July 1985, the excise and *ad valorem* royalty applicable to Barrow Island production was replaced by a resource rent royalty.

In June 1987 the levy was abolished for the first 30 million barrels of production from onshore fields.

In January 1988 legislation was passed replacing levy and royalty on all offshore projects which were not the subject of a licence as at 1 July 1984 with a resource rent tax.

The Final Review

In January 1987 the Government issued a further discussion paper covering the subject of a free market. The Government pointed out that the environment had changed significantly from that existing at the time of the previous discussion papers. There had been a substantial decline in oil prices, a substantial change in the exchange rate and Australian crude production was expected to decline in the near term.

These factors which the Government felt were significantly different provide some interesting analysis. The decline in oil prices and the

exchange rate changes were in fact offsetting. It was well known that Australian crude oil production would decline even at the time of the previous discussion papers. One could conclude that the Government's mind was, in fact, already made up and they were now going through the motions to justify the change.

The Government also stated that as had been announced in June 1985, it was committed to the reduction of unnecessary business regulations. The discussion paper reiterated that the objective of the Government's Crude Oil Marketing Policy was to ensure that the local producers had an assured market at world prices in order to encourage exploration and development.

The alternatives put forward in the paper were:

— continue the partial Allocation Policy;
— allow Bass Strait crude to be sold on the Free Market; or
— deregulate completely.

In the paper the Government suggested that the price of oil under a free market would most likely drop to the export parity price, although it did see some possibility of the large Bass Strait producers being able to obtain a price closer to the import parity price. From data in the discussion paper it could be calculated that a $3.00/bbl reduction in oil prices would mean a 2/litre drop in petrol prices, resulting in a 0.2 percent reduction in the CPI. Not surprisingly the Government was inundated with strongly worded submissions from opposite view points.

In the main, but not unanimously, refiners supported the change to deregulation arguing that the existing system was inefficient and resulted in more expensive end product. The refiners were concerned that the Import Parity Pricing Policy resulted in a price above the true cost of their alternative feedstocks. They also pointed out that the world was awash with cheap crude oils and refined product and that the Government's policy did not take into account the ability of an individual refiner to operate on the basis of the best available crude oils (in terms of price and technical qualities). Interestingly, refiners did not strongly push the line that lower priced end product was a benefit of deregulation. Refiners wanted the deregulation to continue to the end product, *i.e.* no Government price control through the Prices Surveillance Authority. Refiners were also concerned that there should be no impediment to the free use of foreign flag vessels.

Unions associated with refining and shipping were opposed to deregulation fearing the loss of jobs through both the use of foreign flag vessels and the shut down of refineries due to the import of finished product.

Producers were split into two camps supporting or opposing deregulation. BHP had strongly advocated deregulation over a number of years. BHP had expressed concern that as oil prices were rising, the Government was slow to adjust Australian prices upward but, as prices fell, the Government became much more eager to implement the change. Anticipating future price rises, BHP had a concern that the Government would again become tardy. In addition, in a rising market, the delay between prices moving on the world market and the Government changing the price (even if on a regular monthly basis) was detrimental to the

producer. BHP like a few other companies in the production/exploration industry also found it impossible to argue against deregulation when they had a philosophical view favouring lower Government regulations. Initially the major producers argued against any form of Allocation because they felt this would close some of the market opportunities for them. In the latter period of the debate they did however acknowledge that the very small producers should be protected through a partial allocation scheme.

The many medium and small producers were almost unanimous in their opposition towards deregulation although they did acknowledge that Bass Strait and any other producing area that so elected should be free to opt out of the Allocation Policy. There is no question that the position taken by these companies was one of self-interest (some even argued survival). What concerned these producers with deregulation was that the price received would unquestionably fall. The degree of the fall would depend to a large extent on the alternatives available to the producer, but even the best placed small producer could only expect to obtain slightly above export parity price (export parity being the price that the producer would receive for a f.o.b. sale into the export market). For a major producer with some bargaining strength, a negotiation between the refiner (whose alternative was Import Parity) and the producer (whose alternative was Export Parity) would result in a price somewhere towards the middle of this range being achieved. However, smaller producers, even if well served by export facilities, could expect the bargaining strength of the refiners to drive the price closer to export parity. Worse still, those producers with no physical ability to export were at the mercy of the refiners and could expect to receive even less than a theoretical Export Parity Price. The small/medium producers pointed out to the Government that their exploration and development decisions had been made on the basis of the IPP Policy and that it was unjust for the rules to be changed. Various estimates of the loss that would be suffered by the small producers were made with the most commonly quoted number being between $4.00 and $5.00/bbl. The small producers and the exploration industry at large also argued that import parity was the true alternative to both the refiners and the community and that the exploration incentives created by the higher regulated price were justified when one had regard to the fact that Australia would shortly face crippling import bills unless further discoveries were made.

The Government looked at a number of alternatives: continued regulation; partial deregulation to the extent that only Bass Strait would be deregulated; partial deregulation to the extent that those producing areas with ability to export would be deregulated; or that the full industry be deregulated. The common view was that the Government's decision would be to deregulate those producing areas above a certain threshold level. A level of 10,000 bbls/day was the most commonly rumoured threshold although the medium sized producers were still hoping for 50,000 bbls/day.

On 21 June 1987, and much to the surprise of many of the smaller producers, the Government announced full deregulation with effect from 1 January 1988.

The Government suggested that crude oil prices would fall by between $1.00 and $4.00/bbl dependent on the relative bargaining strengths. While the Government saw the initial bargaining strength was in favour of the refiners due to the glut in world markets, they did see this changing in favour of the producers in future years. The Government considered that there was an offsetting factor in that it had announced earlier in June modified taxation measures which exempted from excise the first 30 million barrels of production from any onshore field. The Government advised that it had been promised by the refiners that there would be no refinery closures, that the production of small producers (less than 5,000 bbls/day) would continue to be lifted and that the Refiners would continue the use of Australian flag vessels.

WHAT HAS BEEN THE IMPACT OF DEREGULATION

At the time of preparation of this paper it is still too early to tell what the full impact of deregulation has been on the different sectors. Some preliminary views on the production side of the business can be given.

The two concerns over deregulation were:

— Would the oil be uplifted/sold or would shut-ins of production occur?
— How far would the price fall?

With respect to the first concern there does not appear to have been any problems occurring in the first quarter of 1988. All producing areas were able to enter into arrangements with refiners for the sale of their crude oil production or, in the case of some Bass Strait production, were able to export. The undertaking supposedly given by refiners (although denied by some of them) that they would uplift all production from small producers appears to have resulted in a satisfactory outcome. Late in 1987 there were a number of worried producers when negotiations for the sale of their oil had not been finalised. The refiners were undoubtedly playing 'brinksmanship' (a perfectly legitimate commercial approach). As 'Deregulation Day' drew closer, producers became more concerned about their oil being uplifted than about the price they would receive and this was undoubtedly what the refiners had intended.

To quote the publicly uttered words of one refiner: 'Finally, I would like to say that the Suppliers were very suitable prey.'

The second concern is difficult to address as there are no publicly available figures for crude oil prices. Almost certainly every producer has suffered a drop in average price over the first quarter of 1988. The notional IPP price (had the Government set one) would have been $24.23 for January, $25.79 for February and March, $21.83 for April and $23.90 for May.

The 'Free Market' price received by a producer will vary from the notional IPP price for two reasons. First, the 'contractual' price agreed to by the Producer will be calculated on a different basis than the IPP. Even though many of the same components would go into the calculation, there will be significant differences in application. For example, it is unlikely that any Australian crude oil is now sold using the 'basket' of Middle East

crude oils that was the benchmark for the IPP. Secondly, once set, the IPP applied to all crude oil sold in the relevant month whereas in most free market contractual arrangements, the price and Exchange Rate will probably vary on a daily basis thus making the Producer's price dependent on date of shipment and/or payment.

One can calculate separately the variation from IPP applicable to the contractual terms and the timing differences. Given the fluctuations in crude oil prices over the December 1987 to March 1988 period and the substantial strengthening in April 1988, it is likely that the timing effect was slightly positive in January 1988, slightly negative in February 1988, substantially ($2.00/bbl) negative in March 1988 and substantially positive in April 1988.

As to the contractual variation there is a wide range of views and supposed actual results. Some generalisations can be drawn from these. The first is that the smaller the producer the greater the loss. The second is that the initial losses in January 1988 were smaller than expected. This could be due to the fact that while Middle East prices were used in the IPP calculation, Far East prices are being used in contractual arrangements. The relativity between the price of Far East crude oils and Middle East crude oils varied by a substantial amount during late December 1987/early January 1988. Since January this anomaly has corrected itself and the price reductions between contract and IPP have increased significantly. The loss due to contractual arrangements ranges between $1.50 and $4.50/bbl. Combined with timing differences, losses as high as $6.50/bbl from IPP prices were seen in March 1988. This is a 25 percent reduction in revenue to the affected group.

Contracts entered into between producer and refiner have tended to be short term or have regular review and/or escape clauses. This is due to the uncertainty existing in world markets and the belief that one of the Bass Strait producers did not actively pursue sales with domestic refiners. Only three months into the 'Free Market' the refiners are understood to be seeking renegotiation of pricing arrangements.

Based on the lower prices resulting from deregulation, the price of petrol should have fallen by approximately 2¢/litre. In addition, a further reduction of approximately 2¢/litre should have occurred due to the reduction in worldwide oil prices during the first three months of 1988. Because of widespread discounting of petrol in most capital cities, it is difficult to determine if this reduction in oil price has flowed through to the consumer.

Associated Issues

The change from Allocation/IPP to Free Market has resulted in some interesting associated changes, at least in the Cooper/Eromanga Basin oil marketing arrangements in South Australia and Queensland. As most of the readers would know, the oil exploration/production industry operates almost exclusively through a joint venture structure with each joint venturer being entitled to a share of production. Under the Government's Oil Marketing Policy, the disposal of the oil took place on a joint basis with the relevant operator dealing with the refiners. The issues

to be dealt with were logistical in nature, *e.g.* when would a ship arrive, how much would it uplift, which refiners had not taken their share, *etc.*?

With the advent of the Free Market, producers had to also become marketers — who would they sell to, what price would they negotiate, *etc.*? This resulted in individual producers looking at the possibility of separate marketing arrangements for their share of crude oil production.

In the Cooper/Eromanga Basin a major change has taken place in that in South Australia Delhi(Esso) has decided to market its own oil and one other joint venture party, the South Australian Oil & Gas Corporation (SAOG), has decided to appoint Esso its marketing agent. In Queensland, Delhi(Esso) is marketing its own oil. In both South Australia and Queensland all other joint venturers have continued to market the production jointly and have appointed SANTOS as their marketing agent.

The reasons for such a change are mainly philosophical. They include the belief that one can market better than anyone else, the desire to control one's own destiny and the desire to have access to one's own crude production for self use. Whatever the reasons are, this separate marketing has created new issues to be dealt with. Shipping arrangements need to be co-ordinated. The inability to accumulate full cargoes needs addressing. Arrangements for under/over lift by an individual party need be put in place. Entitlement to product and storage/shipping facilities becomes relevant.

The Free Market has raised trade practices implications. Can the parties to a joint venture market jointly without Trade Practices Commission (TPC) authorisation? Can several production joint venturers who put their crude oil into one pipeline (in which they may or may not have equity) jointly market without TPC authorisation? If TPC authorisation is necessary, is joint marketing in the public interest?

The Free Market has resulted in the appointment of 'marketing agents' as opposed to the operator being responsible for 'logistics' under the Allocation Policy. The appointment of such agent, his authority and liability needs to be resolved and appropriately documented. Many new players have appeared on the scene. Brokers and dealers have attempted to become middlemen between producer and user — although there do not appear to have been any actual appointments.

Under the Free Market, producers may feel more exposed to the quite violent fluctuations in 'world prices'. This raises the issue of 'hedging'. Unfortunately the markets in which one can trade 'paper crude' to hedge the physical crude oil sales are not the same markets which determine the price of physical crude oil sales in Australia. For example, the New York Mercantile Exchange (NYMEX) which is the major market for hedging through forward sales or options is based on West Texas Intermediate (WTI) crude oil. This crude oil can trade in a range some $3.00/bbl above or below Far East/Australian crude oils. Therefore a company could sell forward its crude on NYMEX intending to hedge against a drop in crude oil prices only to find that while the price of its physical crude oil has fallen, the price on NYMEX has risen resulting in a financial loss on the hedge — a double whammy rather than protection!

Under the Allocation Policy few contracts for sale were executed. Even though a number of producers drafted contracts, the refiners generally would not execute them. The Free Market requires such contracts to be put in place. Claims for demurrage (waiting time) and compensation for dead freight (less than full cargoes), quality variations, *etc.* will all arise.

CONCLUSION

For over 20 years the oil production industry and the refining industry have 'voluntarily' adhered to the Government's Crude Oil Marketing Policy. That fact in itself would suggest that the Policy could not have been all that bad.

The twin policies of Crude Oil Allocation and Import Parity Pricing were intended to encourage local exploration and development in a country that was deficient in indigenous crude oil production. They were introduced at a time that oil prices were low and when oil was readily available on the world market. Over the last two decades, the policy worked and Australia achieved self-sufficiency in crude oil. The world scene however changed to one of tighter supply and higher prices (mainly, but not entirely, artificial constraints through OPEC).

With the changes in the world scene different pressures arose in Australia. The unquenchable thirst for increased Government revenues, consumer pressure for lower petrol prices and refiner and producer desires for increased profits began to take their toll. More and more exemptions from the Allocation Policy were introduced. Continuous changes to the method of calculation of IPP and the 'share of the cake' taken by Government through excise occurred. No matter what the then current position was, one side or the other was unhappy and lobbying for change. The major parties certainly could not be accused of consistency. Perhaps the policy was too successful; perhaps the Government should not have listened to the lobbyists. No matter, it is all behind us and we face the new era. After only three months — so far so good in terms of implementation but some of the ramifications will take years to be felt. The impact of lower prices on exploration are not capable of being measured but they will be felt.

The surprising aspect is that when we look at Australia and the world today, we find that it is not all that different from 20 years ago. Australia is facing a rapid decline in its level of self-sufficiency. Oil in the world is plentiful and relatively cheap. It is interesting that the reasons for introducing the policy 20 years ago were the same reasons given in 1987 for abandoning it.

Even before 1 January 1988 arrived some voices were suggesting deregulation would not last. In a paper published by the Economist Intelligence Unit, Dr. Fesharaki, a leader of the energy programme at the East-West Centre in Hawaii and a leading international oil industry analyst suggested that 'regulation could return in a few years'. He also suggested that assurances given by refiners to buy the output of small producers were 'cosmetic' and 'many small producers may go out of business'.

Those in the producing industry who opposed deregulation see the real test of the Government's bona fides as being in the action it takes in respect of deregulation of the LPG market. In this area we are only at the discussion paper stage. The cynics look at page 1 of the Government's LPG paper wherein it states: 'However, it needs to be recognised that the LPG industry differs in a number of important ways from the oil industry' and conclude that the Government has no intention of deregulating that market.

All in all the Free Market for crude oil means lower prices for producers (which should flow into lower petrol prices), the necessity for producers to devote substantially more resources into marketing and logistics and significantly more management time on crude oil issues and a new workload for the legal profession. Hardly comforting for the producer but a welcome new source of employment for the audience.