Comments on "Analysis of Petroleum Haulage Rates"

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We have reviewed the captioned document and comment as follows:

<u>The Issue</u>
The Ministry of Science Technology Energy and Mining (MSTEM) is strongly recommending that "…all marketing companies adopt [its] proposed minimum petroleum haulage rates in order to ensure that the policy objectives are achieved and sustained in the petroleum industry, as well as fairness and equity."[1]

<u>FTC's Position</u>
The FTC does not support any policy which authorizes any central body to publish a schedule of minimum haulage rates for the petroleum industry. Such a policy would (i) likely harm motorists, in terms of higher prices at the pump; (ii) unlikely yield any intended benefits; and (iii) be considered anachronistic in an industry which has been liberalized and deregulated since 1993.

<u>Background</u>
Since the petroleum industry is deregulated, each petroleum haulage contractor (PHC) has the opportunity to negotiate the rates at which it is prepared to transport petroleum products on behalf of each Petroleum Bulk Distributor ('marketing company'). These negotiations typically cover a period of at least one year. The report issued by MSTEM outlines seven challenges currently faced by PHC.[2] The challenges reflect the inability of PHCs to meet financial obligations and industry standards.

<u>Discussion</u>
If the recommendation is accepted, the Government will effectively be guaranteeing a rate of return for investors (PHCs). It is the possibility of making losses which provides the proper incentives for investors to undertake efficient operations. Operating in a liberalized market should be considered a

[1] See Section 9.0 in MSTEM, <u>Charting the Way Forward for a Sustainable Future for Petroleum Haulage: Analysis of Petroleum Haulage Rates</u>, November 2013.
[2] The challenges are covered in 4.1 through 4.9.

privilege earned by operating efficiently and not a right to be enforced by the Government. If PHCs are mindful that the Government is prepared to intervene in negotiating rates to ensure some minimum rate of return for PHCs, then the PHCs will have little incentives to operate efficiently leading to a misallocation of scarce productive resources.

While the FTC recognizes the motivation behind the recommendation is to prevent an "inevitable shutdown of the industry..." the recommendation is likely to have several unintended effects including:

(i) An Increase the rates marketing companies pay for haulage services [intended effect];
(ii) No discernible increase in the incentives for PHCs to meet industry standards with respect to operational and maintenance requirements [unintended effect];
(iii) A reduction in the incentives for PHCs to operate efficiently [unintended effect];
(iv) Harm to efficient PHCs who would be willing and able to operate at haulage rates below the published rates but now face (artificially engineered) competition from inefficient PHCs who could operate only at the higher rates established by the Government [unintended effect]; and
(v) Harm to motorists in terms of increased prices at the pump due to increased haulage rates faced by marketing companies [unintended effect].

In its report, MSTEM argues "…negotiating a fair rate of return on their investment and recovering their cost to remain viable is one of the main challenges that face [PHCs]…"[3] The FTC interprets this statement to mean that the rates freely negotiated by the PHCs with the market companies are unable to cover their costs. The information contained in the report suggests that the prices negotiated are "too low" because of (i) inability of PHCs to forecast movements in petroleum prices over duration of their contract; and (ii) and unsustainable strategy on the part of PHCs crafted to outbid their rivals to secure contracts.

If the Government believes that the low haulage rates arise because of uncertainty in inflation and the price of fuel, then PHCs should be encouraged to negotiate contracts which index their rates to movements in the inflation rate and petroleum prices. Alternatively, PHCs should be trained on better techniques of forecasting these movements.

If the Government believes that the low haulage rates are due to a deliberately calculated strategy of wining contracts, then PHCs who engage in this conduct should bear the consequences (economic losses) which may result from the practice.

<u>Conclusion</u>

The Fair Trading Commission does not support the recommendation of MSTEM as it is likely to have the unintended effects of adversely affecting competition in the petroleum industry by harming motorists as well as harming efficient petroleum haulage contractors in Jamaica. We have suggested

[3] See Section 5 on page 5 of the report.

alternative means of addressing the underlying issue which are unlikely to have the unintended effects outlined above.

Please contact us regarding any clarification of the above or proposed further reviews of the document issued by MSTEM.