

A Utility Operator's Perspective on the Sri Lankan Regulatory System Shell Gas Lanka Limited

1. Overview of the Business

Shell Gas Lanka Limited (SGLL) was formed when the Government owned Colombo Gas Company was privatized in 1995. It is a Joint Venture company where Shell has a 51% shareholding while the Government of Sri Lanka owns the balance 49%. SGLL is engaged in marketing and selling Liquefied Petroleum Gas (LPG) in Sri Lanka.

The privatization agreement granted exclusive rights to SGLL for a limited period of five years from 1995 to 2000. The agreement enabled SGLL to develop the LPG market in Sri Lanka whilst requiring Shell to make further capital investments in order to build a LPG import and storage terminal. Because the growth prospects of the LPG industry was heavily dependent on infrastructure that de-bottlenecks supply constraints and guarantee supply reliability, the requirement to invest and build such a terminal was significant. In a country that depends on imported LPG to bridge the growing gap between demand and the limited production by Ceylon Petroleum Corporation's (CPC) refinery, not having the infrastructure to receive and store imported LPG safely in large quantities was a significant bottleneck.

Shell's investments in the LPG business to date are over US\$ 135 million. These investments include the acquisition of 51% stake in Colombo Gas, the building of a 8000mt import and storage terminal, the upgrading of the LPG tanker fleet and the modernizing of the LPG bottle filling plant.

In keeping with the obligations of the privatization agreement, Shell built a modern import and storage facility in Kerawalapitiya. It is fully owned by Shell but operated by a separate company, Shell Terminal Lanka (pvt) Limited. STLL offers import and storage facilities to all LPG marketers in Sri Lanka. Thus, not only SGLL, but its competitors also can benefit from these terminal facilities in order to ensure growth in their businesses while not having to build their own storage facilities.

With the ending of the 'exclusive right' period in December 2000 the market was opened and competition ensued. At present however, competition is limited to two main players, Shell Gas and Laugfs.

Around 75% of the LPG consumers are households. Commercial establishments, bulk industrial LPG users and automobile users running on LPG are the other key market segments. Available estimates show that market penetration of residential (domestic) LPG use is around 25-30%. The western province accounts for about 50% of the total LPG consumption. Despite market potential however, overall market growth in 2003 was low at around 3%. Similar trends are expected this year too.

2. Regulatory Environment for LPG Industry

In the first five years between 1995 and 2000, the main regulatory mechanisms were the privatization agreement in relation to pricing, and the Consumer Protection Act No. 1 of 1979 in relation to compliance on safety standards and measures.

In March 2003, the Government enacted the Consumer Affairs Authority Act, and created the Consumer Affairs Authority (CAA). The new Act repealed the Consumer

Protection Act No. 1 of 1979, the Fair Trading Commission Act No. 1 of 1987 and the Control of Prices Act (Chapter 173).

The regulatory environment for LPG businesses took a new turn in May 2003, when the CAA issued a directive that authorized the cross filling of LPG cylinders by competitors.

The cross-filling directive enabled a third entrant, Mundo Gas, to refill LPG cylinders belonging to competitors without requiring them to invest in their own cylinders. The impacts of the new regulation were wide ranging and included the violation of trademark and intellectual property rights, the negating of brand integrity, and the serious undermining of consumer safety as the re-filler had no obligation to be responsible for the safety of the cylinder. This was a clear instance where the impacts of a new regulation were not comprehensively studied prior to implementation.

In August 2003, a new Gazette notification was issued by the CAA listing LPG gas used for domestic purposes as a "specified good" under the CAA Act, along with four other items (cement, milk powder, mosquito coils and match boxes). The implication of this Gazette notification was that LPG companies were subject to price controls and thereby required to obtain approval from the CAA if they intended to increase price.

Although the privatization agreement granted SGLL (and STLL) the right to price its products at commercial prices as deems fit in the market, the new regulation subjecting SGLL to price controls contradicted this agreement.. Furthermore, although one of the primary objectives of the CAA Act was to promote competition, it is not clear how this objective could have been reached in the context of price controls in LPG businesses.: Artificial price manipulations do not necessarily provide the incentives to attract competition.

3 Safety Standards

At the time of Shell's entry to the industry there were hardly any internationally accepted LPG industry safety standards available in Sri Lanka. Shell in collaboration with the the Sri Lanka Standards Institution (SLSI) actively participated and contributed to develop these standards in Sri Lanka. The Safety standards and codes of practice that were developed, are now published by the SLSI. These standards cover product quality, cylinders, cylinder filling, storage and use, LPG accessories (hoses, regulators), LPG transport, bulk customer sites, auto-gas and filling plants.

Despite efforts to develop safety standards for the LPG industry, their application is voluntary and not legally enforceable..This situation coupled with the absence of an independent LPG Regulator is conducive to fostering a non-level playing field for competition.

4 SGLL's Responses

4.1 Pricing

During the exclusive period, pricing was governed by the privatization agreement. The parameters affecting LPG tariff were, FOB price, freight costs, taxes and duties, terminal throughput charge, company recovery and channel margin. The agreement allowed SGLL to revise prices of domestic LPG twice a year up to a maximum of Rs.

25/= per year, based on changes to these parameters, the dollar exchange rate and changes in the consumer price index. It had a special provision to make an immediate tariff adjustment if the FOB prices changed by more than 30%. Price revisions throughout the exclusive period were done according to the agreement and with the consent of the Government.

After the exclusive period, SGLL continued to use the same parameters to make its pricing decisions, as there was no industry regulator appointed to consult and develop a long term pricing mechanism.

In March 2002, SGLL and the Government signed an agreement on a monthly pricing mechanism for LPG..The parameters governing the prices continued to be the same as those in the privatization agreement. The agreement expired in March 2003 (after one year). Although the Government was not willing to extend the agreement further, SGLL continued to follow the same pricing mechanism in order to review and revise prices on a bi-monthly basis while keeping the Government informed of its decisions. Meanwhile, in the absence of an independent regulator, competitors adopted their own methods for setting prices.

The new Consumer Affairs Authority (CAA) that was established in March 2003 issued a Gazette notification in August 2003 listing LPG as a specified good and thus subject to price control. SGLL responded by following the law and forwarding its bi-monthly costing and price reviews to the CAA in order to revise prices. After a lengthy period of study, the CAA recommended price adjustments following SGLL's value chain cost structure. In keeping with the long-term interest of the LPG industry, SGLL proposed a price stabilizing mechanism to the CAA. In order to allow for competition and market growth, it is necessary to remove price control and establish an industry pricing formula..

4.2 Safety

Despite the lack of legally enforceable LPG safety standards in the country, SGLL implemented its own high standards of safety in all its operations and activities.

Not having proper safety standards and the required legal muscle to enforce them poses a safety threat to consumers. Additionally, it creates conditions conducive to unfair competition. It may even direct the growth in the LPG industry to more or less chaotic situations with competitors cutting corners on safety in order to save costs. The following examples from the market elaborate this point.

- Safety issues were completely disregarded in the CAA's cross-filling directive. SGLL has challenged the directive in courts and the case is currently in progress. With any third party filling cylinders owned by a particular company, there is no guarantee that the cylinder has been properly maintained, viz, inspected for leaks, checked for re-qualification date (age) and checked to determine the condition of the valve. There is also no guarantee that the cylinder has been filled to the correct quantity.
- There are petrol vehicle users who use LPG in domestic cylinders as a substitute fuel without using the proper conversion kit. This is often due to the relatively high cost of proper conversion kits as well as due to the lack of support from the Government to ban these unsafe practices and provide appropriate incentives to promote proper conversion. SGLL has taken several initiatives to raise awareness on the dangers of using LPG cylinders in

vehicles. However, supporting legislation that bans such unsafe acts is required in order to eliminate the threat to passengers.

In addition, there is lack of regulatory enforcement on the safety of LPG installations such as LPG filling plants, auto-gas retail stations and bulk customer installations. Although SGLL is imposing its own standards internally there is no guarantee that new entrants would follow similar principles.

4.3 Competition

SGLL believes in competition. The exclusive period granted to SGLL in the privatization agreement was not something that Shell negotiated but was offered in the tender to all bidders during the privatization process. The opening up of the LPG industry to competition after the exclusive period was an important phase in SGLL's journey. In particular, the focus of the company both internally and throughout the distribution chain was the dimension of service: It was easier to convince everyone that with the entry of competition customers would not be wholly dependent on SGLL's offerings as they would have greater choice.

Laugfs was the first competitor to enter the LPG market. It entered in 2001 under a special deal with the Ceylon Petroleum Corporation (CPC) to purchase total LPG production at a subsidized cost. There was no tender process for CPC's LPG volume. This special deal enabled Laugfs to sell LPG at a lower price than SGLL. Subsequently, the CPC deal agreement was revised and extended till 2007..Purchase price was set following global FOB prices but fell short of import parity as there is no freight cost incorporated.

The second competitor to enter the LPG market was Mundo gas in 2003. Its 3000mt LPG barge was allowed to occupy the commercial pier of the Galle harbor on a permanent basis thus compromising port safety norms. In addition, the cross-filling directive accommodated Mundo's intention to refill the LPG cylinders of other competitors. SGLL however, was able to obtain a court injunction that prevented Mundo Gas from refilling Shell branded cylinders: the court case is still in progress.

5 Concluding Remarks

SGLL's experiences over the past eight years highlight two important issues:

- a) An independent LPG regulator is imperative if one is to foster and promote a level playing field and thus attract healthy competition and growth in the LPG industry. The absence of an independent LPG regulator has resulted in there being no formal mechanism to bind competitors to adhere to industry safety standards, facilitate government-industry liaison, and address issues of pricing.
- b) The absence of proper impact assessment of new regulations. This can most clearly be seen through the CAA directive on cross filling.

These concerns measure the investment climate for new entrants into the LPG business in the country and should therefore, should be resolved urgently.