



# Submission to the Parliamentary Inquiry into the operation and effectiveness of the Franchising Code of Conduct

## 1 Introduction

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Caltex Australia Petroleum Pty Limited (**Caltex**) welcomes the opportunity to make a submission to the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into the operation and effectiveness of the Franchising Code of Conduct.

The only ASX-listed transport fuels company, we have grown from humble beginnings in 1900 to become the nation's outright leader in transport fuels, supplying one third of all Australia's transport fuel needs.

Through our management of complex supply chains, we safely and reliably supply our high-quality fuels to a diverse number of customer segments, including retail, mining, agriculture, aviation, transport, small-to-medium enterprises, marine, automotive and government.

Caltex directly employs more than 4700 people around the country, is WGEA-certified as an employer of choice for gender diversity, and proudly invests in the communities in which we work.

While the focus of our business has been fuels and infrastructure, we are also one of Australia's largest convenience retailers. From 1 January 2018, we have begun operating as two separate but interconnected businesses: Fuel & Infrastructure, and Convenience Retail. The separate business structure allows us to bring into core focus the strategy that will support our growing retail network, which is currently more than 800 retail sites, including around 10 non-fuel convenience sites. This year we will open another 60 retail sites, either refurbished or new-to-industry. Our retail strategy continues to drive growth of our employee base, represented by more local employment both for us and the suppliers who partner with us on our local offerings.

In addition to being a significant employer, Caltex has been a franchisor since 1980, providing hundreds of Australians the opportunity to own and operate their own small business.

Caltex's franchising model has been designed for individuals owning and operating a single site or a small number of sites rather than multi-site operators. The model has relatively low establishment costs and the initial and ongoing fees are designed to enable franchisees to pay themselves a salary for working at the site as well as making a profit on their initial investment while paying lawful wages to their employees. In the vast majority of cases, the model operates in that way. However, where circumstances beyond a franchisee's control

have made a site unprofitable, Caltex has provided profitability assistance – support that is not available to most small business owners.

Caltex announced on 27 February 2018 that, in order to better execute its convenience retail strategy, it would change its business model and move to operate retail sites under company operation rather than under the franchise model. This means that over time Caltex will exit franchising.

Despite making the decision to exit franchising, Caltex believes that its experience and learnings, especially in the past few years, put it in a good position to assist the committee in its important work.

This experience includes:

- disturbing revelations from whistle-blowers of wage fraud within our network;
- identifying that the application of the franchise model and decisions in relation to profitability assistance were not always consistent as they were made at a regional level;
- identifying that, while many franchisees operating sites that had become unprofitable were receiving profitability assistance, a small proportion of franchisees whose sites had become unprofitable had not sought, and were not receiving, assistance;
- identifying that unprofitability was, at a number of sites, caused by the franchisee having paid too large an assignment fee to the original franchisee for the site, with the assignment fee significantly exceeding (on a pro rata basis) the initial franchise fee paid by the original franchisee.

Caltex has sought to address these issues, and improve outcomes for franchisees and their employees, by:

- taking a more interventionist role in ensuring that franchisees are complying with employment laws, including by providing further information and training and committing to a network wide audit to identify and eliminate wage fraud;
- establishing a \$20 million assistance fund for franchisee employees affected by wage fraud;
- establishing a whistle-blower hotline for franchisee employees to raise concerns directly with Caltex;
- improving central oversight of decisions in relation to fees paid by, and profitability assistance provided to, franchisees, to ensure that franchisees are treated in a fair and consistent manner;

- moving from reactively considering requests for profitability assistance by franchisees to proactively identifying sites that might require profitability support;
- being more interventionist in rejecting assignment requests where the incoming franchisee is overpaying for the assignment and is unlikely to be able to operate the site profitably.

It is important to note at the outset that Caltex has not found evidence that there is a correlation between wage underpayment and Caltex's franchise model – on the other hand, there is evidence of wage underpayment in sites that were able to be operated profitably (and pay lawful wages).

We set out below:

- an overview of Caltex's franchise model;
- more detail in relation to the experience and learnings described above and the steps taken to address them; and
- areas where Caltex considers that legislative or regulatory reform might be warranted to improve outcomes for franchisors, franchisees and their employees.

## 2 Overview of Caltex franchise model

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### 2.1 Agreements with franchisees

Most Caltex franchisees have entered into a Star Franchise Agreement with Caltex. The agreements generally are for a five year term with the franchisee having the option to renew for a further five years.

Franchisees pay Caltex a royalty on shop sales and receive a commission on fuel sales. In addition, franchisees pay:

- an initial franchise fee (which is payable upfront or in three instalments over the first two years of the agreement); and
- an occupancy fee for a license to occupy the site.

These fees are set on a site by site basis.

The initial franchise fee is set by Caltex at a relatively low level with a view to enabling the franchisee to earn a salary and to make a profit from their investment, based on the expected revenue and expenses of the site. Caltex's intention was to attract franchisees who wanted to operate a single site or a small number of sites and who would be fully involved in the business, rather than larger multi-site operators or passive investors.

In light of its experience and learnings over the past few years, Caltex has taken steps over time to refine its franchise model to ensure fair outcomes for franchisees. For example, Caltex has implemented more central oversight of the calculation of initial franchise fees and occupancy fees to ensure consistency and updated its model for calculating occupancy fees.

In late 2016 and early 2017, following speculation about the fairness of the company's franchise model in the context of evidence of wage underpayment by franchisees, Caltex undertook a review of its franchise model. The review examined the profitability of the model for franchisees. (This review was separate to the two-year review of Caltex's retail operating model described in section 3 below.)

Caltex is confident that its franchise model enables franchisees to make a profit and earn a salary while also paying employees in accordance with lawful wage rates.

External factors beyond the control of the franchisee occasionally affect the profitability of the business during the term of the franchise agreement. Some factors have a long term impact (such as the opening of a new competitor), while other factors have only a short term impact (such as a decision by Caltex to install a new fuel tank). However, Caltex considers that the proportion of its sites that have become unprofitable in this way compares favourably to other franchised businesses and to small businesses generally.

In addition, when external factors do affect the profitability of one of its franchisees, Caltex has a 'safety net' in place to support the affected franchisee in the form of profitability assistance. The profitability assistance program generally involves Caltex reducing or not charging the occupancy fee for the site and, if necessary, providing financial assistance to enable the franchisee to generate a reasonable return. In 2016, Caltex paid \$3.7 million in profitability assistance to franchisees.

While the review of Caltex's franchise model identified that the model enables franchisees to operate profitably, it did identify a small proportion of sites that had become unprofitable. Many of those sites were receiving profitability assistance but some were not. Caltex had historically relied on individual franchisees to approach Caltex and raise the need for profitability assistance. The findings of the review suggested that some franchisees were unwilling to come to Caltex to make a request for assistance. As a result, Caltex has become more proactive by insisting that all franchisees provide profit and loss statements and then reviewing those statements to identify sites that have become unprofitable and should be considered for profitability assistance.

## **2.2 Assignments**

Franchisees are entitled to assign their franchise agreement with Caltex's consent. The grounds on which Caltex can withhold consent are set out in the Oilcode.

The existing franchisee negotiates an assignment fee with the incoming franchisee. The incoming franchisee is provided with financial information in relation to the site to enable them to form a view on the merit of the assignment and encouraged to seek independent legal and business advice. Rejecting the assignment would deprive the existing franchisee of an opportunity to realise their investment at a profit and Caltex has an obligation under the OilCode not to unreasonably withhold consent to an assignment. Historically, therefore, Caltex has not intervened to reject an assignment, even where the assignment fee has been significantly greater than the initial franchise fee charged by Caltex (pro rated for the remaining term of the franchise agreement).

In recent years, however, Caltex became aware of a number of instances in which the incoming franchisee struggled to operate the site profitably taking into account the large assignment fee. Caltex has therefore taken a more interventionist approach in rejecting assignment requests where it considers that the assignment fee is too high to enable the incoming franchisee to operate the site profitably. Caltex considers that it is entitled to take that approach consistent with the terms of the Oilcode, even though the size of the assignment fee is not specifically identified as one of the grounds for refusing an assignment. However, as discussed below in section 5, Caltex suggests that consideration be given to amending the Oilcode to make it clear that an assignment can be rejected on this basis.

### 3 Decision to exit franchising

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Caltex announced on 27 February 2018 its decision to exit franchising and move to a company-owned and operated retail model. This followed a two-year review of Caltex's retail operating model to determine how best to structure the business to align to the broader Caltex strategy – Freedom of Convenience and the creation of a Convenience Retail business. The review determined that controlling Caltex's core business was the best way to achieve its retail growth objectives.

The long-term market for petrol is set to decline as passenger vehicles transition to becoming more energy-efficient and move towards electric power. Caltex therefore expects that income from convenience retailing will eventually overtake income from petrol and fuel sales at its retail sites.

As a result, the company wishes to restructure its core business and utilise its significant asset in the form of its existing retail sites, transitioning them from being predominantly fuel focussed to predominantly convenience retail focussed.

To gain the best results from the expected transition of Caltex's business, new initiatives and investment opportunities must be explored. Caltex is interested in considering potential partnerships with third parties. These opportunities would be difficult to pursue whilst

operating in a franchise model. It was for these reasons that Caltex decided to move to a company owned and operated model during this period of significant transition.

At an appropriate stage in the long-term, Caltex may decide to re-enter the franchising model. This will be once the necessary changes to its own operations and other franchising models have been successfully delivered and executed. Regardless, Caltex remains a supporter of the franchise network model, and acknowledges it to have significantly assisted in growing the Caltex business and provide valuable opportunities for franchisees – with many of whom we have had long partnerships.

Caltex appreciates its decision to change to a company-operated retail model to be significant, affecting many of its franchisees over the next two years. Caltex therefore intends to work with franchisees to manage the impact of the change of circumstances and seeks to mitigate any unintended consequences. For example, Caltex intends to offer a range of employment opportunities within the new retail model to current franchise employees.

As part of Caltex's transition, existing franchisees in the Caltex network will be made offers based on factors including when their franchise term is due to expire, and financial compensation will be offered to them accordingly.

For franchise agreements extending beyond 2020, Caltex will be offering them to agree to an early termination. Acceptance of this offer is completely voluntary and franchisees will receive fair compensation if they accept it.

## 4 Wage underpayment in the franchise network

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Shortly after public allegations of wage fraud in another franchise network in September 2015, Caltex received complaints of wage fraud at a number of sites in its franchise networks. In response to these allegations, Caltex began working proactively to eradicate instances of wage underpayment from its franchise network.

Caltex implemented targeted audits of franchise sites by gathering information concerning compliance with workplace laws, including by inspecting payroll and associated records of those franchises. A total of 46 sites were subject to an audit by an independent firm between October 2015 and December 2016. Following the findings of these audits, Caltex expanded its program of franchisee payroll investigations to cover its entire franchise network and commenced another round of audits in December 2016. A total of 139 sites were included in this round of audits. In July 2017, Caltex commenced a further rounds of audits as part of its franchisee payroll investigations. A total of 107 sites were included in this round of audits.

The franchise model review and ongoing audit program has revealed some franchisees in the Caltex network whose behaviour the company does not condone and will not accept, including

underpaying employees. In some instances, Caltex considered that the breaches were incapable of being remedied by the franchisee due to the systemic nature of the underpayment and immediately terminated the franchise agreement. In other instances, Caltex made it clear by issuing Default Notices to the franchisees that, if the defaults were not remedied, Caltex would terminate their franchise agreement. For those who continued to refuse to remedy, or indicate a willingness to remedy, their defaults, Caltex terminated the franchise agreement. Caltex also terminated certain franchise agreements where the franchisee failed to cooperate with the audits. Caltex has terminated a total of 77 franchise agreements on one of these grounds. A number of franchise agreements were also terminated by agreement with franchisees after the franchisee received an audit letter from Caltex but prior to the completion of the audit for that franchise site (in some cases following mediations with franchisees who disputed Caltex's right to conduct the audit).

Caltex is confident that there is no direct link between site unprofitability and the sites that Caltex has terminated for wage underpayment. Caltex's franchise model has allowed franchisees to make a profit, draw a wage, and pay employees in accordance with lawful wage rates. This is supported by the information discussed in section 2 of this Submission.

Caltex has established an assistance fund for franchisee employees who have not been paid their full entitlements by Caltex franchisees. While Caltex has no liability to pay franchisee employee entitlements, the fund has been established because Caltex wants to do the right thing by franchisee employees. The fund allows franchisee employees to claim wage underpayments for the period from 1 January 2015 to date. When franchisees are exited from the Caltex network due to wage underpayment or non-compliance with Caltex audit requirements, employees and former employees have three months to make a claim from the date the franchisee exited the network (although in practice Caltex accepted claims made up to nine months after the date the franchisee exited the network).

## 5 Opportunities for reform

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### 5.1 Whistle-blowers

Caltex supports the Australian government's introduction of the *Treasury Laws Amendments (Whistle-blowers) Bill 2017* (Cth) in July 2018. However, the reforms do not directly apply to whistle-blowers in a franchise network. Given that the recent issues within Caltex's franchise network were identified by whistle-blowers, Caltex recommends that Parliament consider whether changes should be made to whistle-blower protection laws to specifically address the position of franchisee employees.

## 5.2 The Oilcode

Caltex suggests that two changes should be made to the *Competition and Consumer (Industry Codes – Oilcode) Regulation 2006* (Cth) (**Oilcode**).

Caltex supports the Australian Government's introduction of the *Fair Work Amendment (Protecting Vulnerable Workers) Bill 2017* and its capacity to hold franchisors liable for contraventions of the *Fair Work Act 2009* (Cth) by their franchisees. Caltex agrees that, in light of evidence of underpayment in franchise networks, it is appropriate to place more responsibility on franchisors. However, if Parliament requires franchisors to take on this level of responsibility, it must also arm them with the ability to effectively discharge their obligations.

The existing Oilcode limits the circumstances where a franchisor can terminate a franchise agreement and fails to provide a franchisor with the right to immediately terminate an agreement for non-compliance with workplace laws. Caltex has been met with the argument from franchisees that Caltex is not a regulator and that it is not entitled under the Oilcode to examine whether franchisees have been complying with workplace laws. While Caltex does not accept that argument, Caltex considers that the position should be clarified through an amendment to the Oilcode to explicitly provide franchisors with the right to conduct thorough workplace audits and to terminate franchise agreements in cases of serious non-compliance with workplace laws, such as underpayment. This reform will ensure franchisors can more effectively address any illegal and unethical activity occurring within its network and help to balance the responsibilities of franchisors with their rights to take action.

Caltex further considers that the Oilcode should be modified to ensure franchisors are provided with a greater capacity to reject assignment requests from existing franchisees. In the past, Caltex has experienced incoming franchisees taking assignment of a franchise agreement and paying an assignment fee significantly greater than the initial franchise fee paid by the outgoing franchisee. As a result, a number of incoming franchisees have been unable to operate the site profitably. The Oilcode identifies a number of circumstances in which consent can reasonably be withheld. However, the level of the assignment fee is not one of them.

Therefore, Caltex considers that an additional factor should be included that allows a franchisor to withhold consent when it reasonably considers that the incoming franchisee will be unable to operate the site profitably having regard to the size of the assignment fee and the projected earnings of the site.

## 5.3 Role of the Fair Work Ombudsman

In addition to the changes to the Oilcode considered above, Caltex suggests that more comprehensive consideration needs to be given to the problem of wage fraud and the role of



the Fair Work Ombudsman in addressing it. While the changes to the *Fair Work Act 2009* (Cth) are a start, it is clear that they will not, of themselves, be sufficient to address the issue.

Part of the difficulty of this issue stems from the fact that the workers themselves are aware of the underpayment and accept it for a range of reasons, including because they would otherwise be in breach of student visa conditions. Combined with the number of small businesses in which wage fraud is potentially occurring, detecting underpayment is extremely difficult.

In the franchising sector, the FWO has proposed Proactive Compliance Deeds as a means of securing the assistance of franchisors in detecting underpayment. However, it is not clear that using these Deeds to outsource regulation to franchisors provides an effective solution to the problem. As it evident from the experience of other franchise networks who have entered into Deeds, the Deeds do not appear to have been effective in detecting and eradicating underpayment.

Caltex believes that there are more effective tools which could be used, however these require franchisors and the regulator working together to detect and eradicate this type of conduct.

## 6 Conclusion

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We trust that the information provided above will be of assistance to the Committee. Caltex would be happy to provide any further information in relation to its experience or suggestions if that would aid the Committee in its work.