



4 September 2015

Customs process leads to potential one-off earnings impact

Z Energy today said it was in discussions with the New Zealand Customs Service (Customs), the outcome of which could have a material one-off negative impact on earnings.

Z said there was insufficient clarity around what the financial impact might be so was not in a position to update earnings guidance. Z was informing the market today as it yesterday received a communication from Customs outlining that a potential impact across the four shareholders of the Wiri fuel terminal (WOSL) in Auckland could be approximately \$71 million in total. Z's share is estimated to be \$25 million, though it is not possible to predict what the final financial impact might be.

In May 2015, the four shareholders paid Customs \$66 million - \$24 million in what Customs assessed as unpaid duty and \$42 million in penalties – and are currently working to recover these payments from Customs.

Z Chief Executive, Mike Bennetts, said Z was considering its options, including the possibility of launching legal proceedings against Customs. He said once a decision had been taken or when there was increased clarity around a likely financial impact, Z would update the market and potentially update guidance if required.

Z has been in good faith discussions with Customs since 2012 on this matter, has promptly co-operated with every request for information and provisioned \$5 million in the last financial year for a possible one-off cost associated with this process. In addition, note 27 to Z's FY15 financial statements referred to this matter and noted that WOSL had received a letter dated 4 May 2015 containing a reassessment for excise duty and additional late payment duties. Z's share was estimated to be up to \$20 million, but as there was insufficient basis upon which to reliably assess any additional provisioning, this amount was recorded as a contingent liability in the financial statements.

The discussions centre on Customs introducing an additional excise collection point at terminals to capture the operational treatment of co-mingled fuels at bulk fuel storage terminals across New Zealand (see attached explanation). This practice has occurred at every single fuel terminal in New Zealand since the day they started operating.

Mike Bennetts said the entire process with Customs was extremely disappointing. "We're dealing with an effort to generate a very large retrospective payment, going back as far as 1986, from businesses which have never done anything wrong and which have operated consistently, transparently and in accordance with safe, industry best practice at all times.

"We're very disappointed to be having to tell the financial markets, our investors and our customers about this issue which we believe has the potential to damage investor, business and consumer confidence in New Zealand," he said.

Jonathan Hill: 04 498 0212

Overview of the Customs issue

How the system works

Approximately 40 per cent of New Zealand's petrol is pumped from the refinery at Whangarei into the Wiri Oil Services Limited (WOSL) terminal in South Auckland via the Refinery to Auckland Pipeline (RAP).

The RAP transports jet fuel, diesel and petrol.

The WOSL fuel terminal is a joint venture owned and operated by Z Energy, BP, Mobil and Chevron.

From the WOSL terminal, fuel is trucked to customers across the upper half of the North Island and all of Auckland International Airport's jet fuel is pumped to the airport via a short separate pipeline.

Excise duty has always been charged on petrol at the point that it leaves the refinery. Note, there is no excise collected on diesel or jet fuel.

When fuel is pumped from the refinery to WOSL through the RAP, it is pumped at pressure with different products back-to-back – i.e. petrol and diesel - and a small amount of fuel co-mingles in the pipeline. When the fuel enters the terminal, diesel goes into the diesel tanks, jet fuel into the jet fuel tanks and petrol into the petrol tanks. The very small volume of comingled or contaminated fuel – i.e. fuel containing a mixture of two or more fuels – is separated into a dedicated tank.

This comingled fuel is minimised as far as operationally possible and represents approximately 0.3 per cent of total fuel volumes through the WOSL Terminal. This 0.3 per cent of comingled fuel is then blended back into petrol and diesel at minute levels which preserve the specification of the fuel.

Nothing is ever blended back into jet fuel.

The process of re-blending the co-mingled fuel back into petrol and diesel is the only operationally practicable method of dealing with the co-mingled fuel, this is minimised as far as safely possible, and this practice has been occurring at terminals across New Zealand for as long as they have been operating. It is also standard operating practice globally.

This process has been occurring at the WOSL fuel terminal since the facility opened in 1986 and at other terminals around New Zealand, albeit at much smaller levels, since the day they opened – some more than 100 years ago.

While this practice does lead to very small incremental volume increases of petrol leaving the terminal, this incremental volume gain is offset through natural evaporation of fuel throughout the rest of the supply chain after it leaves the Refinery.



The Terminals NZ case

This is a very different process to that which concluded with the 2012 Court of Appeal decision concerning Terminals (NZ) Limited (Gull). In that case Gull had been blending up to five per cent of butane into its petrol at its terminal for discretionary commercial reasons.

Customs successfully argued that fuel 'manufacturing' was occurring at the Gull terminal and that excise duty should be charged on the total fuel volume leaving the terminal – after the butane was blended into the fuel. Gull was charged unpaid duty. It is not known whether penalties were applied.

Although a very different issue – standard and necessary operational activity as opposed to non-standard and discretionary commercial activity – the industry started conversations with Customs on this matter back in 2012.

The Customs case against Gull was rejected by the District Court, but Customs successfully appealed to the Court of Appeal in 2012 (a decision which was upheld by the Supreme Court in 2013).

Creating an additional point of obligation

Customs have introduced an additional point of excise collection for excisable fuel before it leaves the terminal.

This new approach sees duty charged on the incremental increase in fuel volume generated by blending diesel and jet fuel from the co-mingled fuel tank back into petrol.

Z has engaged fully and in good faith with Customs on the issue since first it arose. Z collects approximately \$500 million in duties per year on behalf of the government and there has never been any intent to minimise any excise duty collected.

Z has promptly provided every piece of operational data requested by Customs.

Z has also raised with Customs that the new additional point of collection at terminals does not account for losses that occur elsewhere throughout the supply chain. As petrol is transported by coastal ship and then transferred to terminals, and then from terminals through the distribution network to customers, a small amount of petrol naturally evaporates into the atmosphere. The "loss" that occurs through this evaporation offsets gains that Customs claim the industry is benefitting from via operational management of co-mingled fuel. By introducing an additional point of obligation, the offset that arguably existed has now been removed, thereby increasing the taxes that will need to be collected from consumers.

The bills

On 4 May, WOSL received a letter from Customs demanding \$66 million in unpaid duty from the WOSL terminal dating back to 2011. This comprised \$24 million in assessed unpaid duty and \$42 million in penalties. Payment was demanded within 20 days or further penalties of 2.5 per cent per month would be levied.

Z's estimated share of this invoice was \$8 million for unpaid duty and \$15 for penalties. Very quickly, Customs invoiced Z for an additional \$5 million covering other terminals, of which approximately two thirds was penalties.

Z has paid \$28 million to Customs and has been in discussions over how much of the \$28 million paid can be recovered.

Under Section 87(2) of the Customs and Excise Act, the Chief Executive of Customs has a discretion to refund any additional duties paid.

Z met with the Customs Minister and the Customs Chief Executive in August and outlined the issue and the company's unhappiness with the process and effort to retrospectively generate revenue.

On 3 September, WOSL received an additional letter from Customs outlining intent to take the taxable period going back to 1986. The potential WOSL exposure ranges from \$109 million to \$71 million, again inclusive of the \$66 million already paid by the WOSL JV partners.

Z is not yet clear as to what its share of the additional money might be, nor has any decision been made on whether or not to accept the offer or reject the offer and pursue the issue through the courts.

A brief timeline

- May 2012 – High Court decision in Gull's favour
- December 2012 – Court of Appeal decision in favour of Customs
- December 2013 – Court of Appeal decision upheld by Supreme Court
- May 2015 – Customs demand for \$66 million for period of present back to 2007
- September 2015 – Customs letter suggests backdating the process to 1986; range of potential outcomes between \$71-109 million, again inclusive of the \$66 million already paid by the WOSL JV partners.