

16 September 2019



Commerce Commission's fuel study draft report has material inaccuracies that need to be rectified

Z Energy is committed to working with the Commerce Commission and the government on solutions to improve the retail fuel market but cannot agree with the profitability analysis in the Commerce Commission's draft report.

Z Chief Executive, Mike Bennetts says that while Z appreciates the Commission's intention to engage publicly on their preliminary work, and that no measure is perfect, it's imperative that there is a clear and accurate understanding of the financial position of market participants.

"As a New Zealand-owned company, we're committed to great outcomes for New Zealanders. So, we don't believe it's in the public interest for material inaccuracies in the Commission's draft analysis to become accepted as fact.

"We know the price of fuel matters. The Commerce Commission's role in our society matters. Getting this market study right matters," says Mike.

Draft findings on profitability include omissions and errors

Following independent peer-reviewed analysis, Z has discovered a number of inaccuracies in the draft findings on profitability, including a misrepresentation of Z's 2016-2018 rate of return as about 22 percent, around double Z's independently reviewed calculations of about 11 percent*.

Mike says that Z has alerted the Commission to these errors and provided a detailed analysis throughout its submission today.

"This market study is the first of its kind and needs to be bullet-proof so that decision-makers, other industries and all Kiwis can be confident in the outcome of this and future market studies. We look forward to working with the Commission to resolve some of the concerns we have," says Mike.

Committed to positive changes

Notwithstanding the importance of getting the numbers right, Z remains committed to assisting with positive change in the industry including improvements to the information provided to motorists at the petrol pump, improving competition in the wholesale market and preserving the best of New Zealand's supply chain.

“We've made a suite of recommendations such as an all-of-industry move to fully display all prices, including Premium and post-discount, on price boards and limiting wholesale contracts with distributors to seven years. We're also advocates of terminal gate pricing and an industry code, which works well in Australia,” Mike says.

**based on the standard ROACE (Return On Average Capital Employed) methodology using 2016-2018 data*

For further detail on Z's submission, please see the attached infographic and summary.

Media enquiries: Victoria Crockford – Victoria.crockford@z.co.nz



Just like it says on the tin, “Z is for NZ”. **We’re a NZ-based company with over 2,500 Z employees and contractors around New Zealand working hard every day to deliver a world-class customer experience. We know Kiwis. We are Kiwis.** And because we’re a Kiwi company, we don’t just complain about how things are, we come up with solutions about how much better they can be.



Industry Code

We’re keen on developing an [industry code](#) for the NZ fuels market that sets clear rules. This has been successful in Australia and we reckon it’s a good idea for New Zealand too.



What else is Z committed to?

A big shift in [transparency](#)

- Full disclosure of all fuel prices on price boards.
- Daily site-by-site price & data monitoring.



[Opening up](#) the wholesale market

- Move to ‘terminal gate’ or spot pricing.
- Shorter distributor contracts.



Preserving the best of NZ’s efficient [fuel supply chain](#)

- Retain an efficient supply chain with access for all.
- Sustain the refinery as a key infrastructure asset for NZ.
- Safeguard vigorous competition.

We need to set the record straight on profitability

We agree with a lot of the draft report. We can’t agree with the draft findings on profitability.

The profitability analysis has created an incorrect impression that doesn’t support the Commission’s draft findings. Getting this right is important for everybody.



[This is what we think.](#)





Commerce Commission Retail Fuel Market Study - Summary of Z's position on draft report

Z is committed to great outcomes for New Zealanders. Just like it says on the tin: "Z is for NZ". Our 2,500-strong employees and contractors across the country work hard every day to deliver a world-class customer experience. We know Kiwis. We are Kiwis. We understand the importance of a fair deal.

We therefore support the intent and process of the Commerce Commission study into the retail fuel market and agree with many things in the draft report. However, we cannot agree with the draft findings on profitability.

Profitability draft findings include errors and omissions

We know the price of fuel matters. Getting this study right counts.

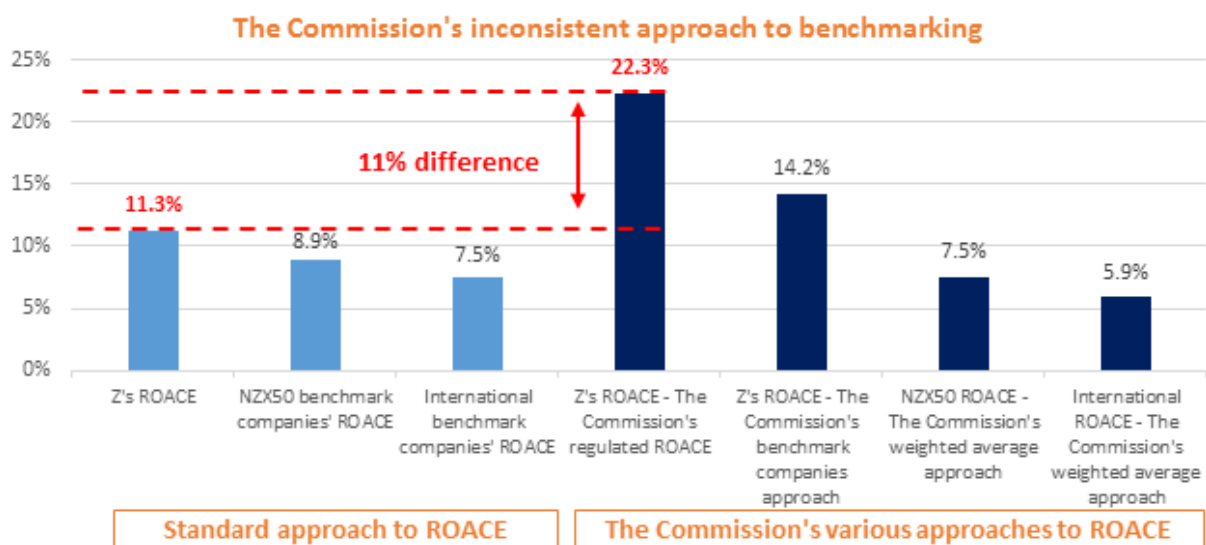
We appreciate the Commission's intention to engage publicly on their preliminary work, and that no measure is perfect. That said, we believe that the draft report contains omissions and errors and misrepresents Z's profitability. The Commission has an important role in our society and one we fully support, so we would not share this view if it did not matter and without double-checking with others.

As you can see in our full submission, we need to set the record straight on the following:

- The draft report doesn't take into account the requirement to generate returns from some of our major investments or the need to earn a return from financing our permanent level of inventory so we can provide security of fuel supply to NZ.
- We believe the draft report overstates our returns by almost two times what we actually achieve (~22% per their analysis, versus ~11% per ours).
- The draft report engages in comparing apples with oranges. Where our returns are compared with companies in other markets, the Commission does not make the same adjustments for these companies as they do for Z. That has the effect of incorrectly increasing our returns and decreasing those of other companies.
- Nor does the draft report always account for differences between currencies when making these weighted average comparisons.
- The OECD figures relied upon are also a case of apples and oranges. The reliance on these figures to support a narrative about our prices relative to other countries is flawed, not least because different countries have

different monitoring regimes (e.g. Korea uses credit card data, others like Australia measure pump prices only in major cities).

- The draft report uses 'Tobin's Q' as a measure of profitability, which is not widely used. Their analysis scores the industry at 1.8x Tobin's Q. That's more than the 'Dotcom' crash in 2000, which was 1.6x. Our market is patently not comparable to that.
- The draft report incorrectly suggests we have opened 35 new sites since 2017. This is a basic error, but it has a big impact as the Commission posits that the opening of a lot of new sites indicates higher than reasonable returns in the industry. In fact, we've not opened any new sites since 2017.
- The draft report also includes the money we make from our whole business, including pies and coffee, in their analysis, which is inconsistent with the mandate to consider the prices people pay for fuel at the pump.



We believe that our 2016-2018 return as measured by the standard ROACE (Return On Average Capital Employed) methodology at ~11% is reasonable given the risk involved in our industry, and how many Kiwis are relying on us to get around.

No attention paid to declining use of fossil fuels

It is widely agreed that the demand for fossil fuels will go down substantially in the future. The draft report has not taken this factor into account.

By failing to consider the certain decline in demand for fossil fuels the draft report is, in effect, anticipating there will be no industry or investor response to the science of climate change (despite the Government proposing economic incentives for electric vehicles during the study).

Z is committed to delivering solutions

While the numbers require a resolution, we understand why Kiwis may have concerns about other points raised in the draft report. As a Kiwi company we believe we have a role in coming up with solutions that will benefit all stakeholders, from officials working on monitoring, to the tens of thousands

of KiwiSaver members benefitting from their shareholding in us, to those focused on a just energy transition, to all the people filling up at the pump daily.

We're committed to a big shift in transparency

- We suggest mandated full disclosure of prices on price boards, including post-discount prices (which we already display for our PUMPED discount program).
- We can deliver on pricing of Premium products on the price board and believe the rest of the industry should too.
- We can assist with the accuracy of MBIE's monitoring regime by implementing daily site-by-site data monitoring (an improvement on unreliable OECD data).

We're committed to opening up the wholesale market

- We recommend a move to 'terminal gate' pricing, through supply contracts or spot pricing.
- We support the shorter duration of distributor contracts (7-year max).
- We support more efficient refinery arrangements.

We're committed to preserving the best of NZ's low-cost sustainable supply chain

- We want to retain an efficient supply chain with access for all.
- We will explore ways to sustain the refinery as a key asset for NZ.
- We believe that retaining these advantages will enable vigorous competition with competitors, including multinationals taking the substantive portion of their profits offshore such as Caltex Australia (Gull), BP and ExxonMobil.

We're committed to working on an industry code

- This has been successful in the Australian fuel market and we think it would work well here too.

Z ENERGY SUBMISSION ON THE COMMERCE COMMISSION'S MARKET STUDY INTO THE RETAIL FUEL SECTOR: DRAFT REPORT

- 1 Z acknowledges the concerns of stakeholders, which led to the market study, and the work the Commission has done to examine competitive conditions in retail fuel.
- 2 In Z's view, wholesale competition is already vigorous; that said, Z puts forward proposals in Part C below that would have the potential to further enhance the conditions for **wholesale competition** and reassure stakeholders as to those conditions. Z's proposals relate to:
 - 2.1 facilitating fuel **access at the terminal gate** (see from paragraph 94), supported by a regulation-based industry code similar to that used for terminal gate pricing in Australia; and
 - 2.2 placing a limit on the **length of contractual terms** between majors and distributors (see from paragraph 109).
- 3 Z also considers that cost efficiencies may be available in the supply chain if the refinery (Refining NZ) switched from operating as a toll refinery to operating as a **merchant refinery** (see from paragraph 155). Wholesale competition will ensure there is a strong incentive to pass through such cost efficiencies.
- 4 To maximise **transparency** for consumers, and to allow for the best possible ongoing external monitoring of competitive conditions in retail fuel, Z proposes:
 - 4.1 Display of premium pricing and post-discount prices on **price boards** (see from paragraph 173).
 - 4.2 Submission of detailed, meaningful and comparable **retail price data** by fuel suppliers to MBIE (see from paragraph 87).
- 5 A table of Z's key suggestions is set out at Appendix 1. That said, Z does not agree with many of the observations in the draft report about the fuel market, which form the basis for the Commission seeking to identify problems and potential recommendations. Most significantly, Z believes that the **profitability** analysis in the draft report materially overstates the profitability of certain firms and the New Zealand fuel industry.
- 6 Z's submission is structured as follows:
 - 6.1 Part A: Profitability (from paragraph 8);
 - 6.2 Part B: Comparison to other countries and monitoring (from paragraph 77);
 - 6.3 Part C: Competitive conditions at the wholesale level (from paragraph 92);
 - 6.4 Part D: Refining and coastal shipping (from paragraph 145);
 - 6.5 Part E: Retail price and product offer (from paragraph 163).
- 7 This version of the submission is public; confidential and commercially sensitive information has been redacted. Release of the redacted information would be likely to unreasonably prejudice Z's commercial position. Please contact us if you receive a request for the information.

PART A: PROFITABILITY

- 8 Profitability is a critical topic in the draft report. Although the report does not recommend any direct regulation of profits, profitability is used as a key justification for making recommendations.
- 9 As Z understands it, the intention of the draft report is to use profitability as an indicator of whether there may be factors in the relevant markets having an impact on competition. As such the report considers at length, but in a light-touch manner, a variety of possible measurements of profitability, on the basis that any trend may provide insights into the conditions of competition.¹
- 10 While acknowledging the intended light-touch approach, Z has concerns about analysis in the draft report; it includes several errors and omissions, and as a result materially overstates profitability in the industry. In this section Z outlines elements of the analysis it considers require change, including ensuring the Commission understands and accurately uses Z's own data, to assist the Commission's analysis come the final report.
- 11 Z appreciates that the report is in draft and seeks feedback. Z emphasises the analysis in the final report will be important not only if it is used as a justification for recommendations, but also because of its importance in informing all interested parties and the New Zealand public.
- 12 In the following sections Z outlines:
- 12.1 Overall concerns with the **conclusions drawn** in the draft report being based on measures and analyses that are indicative only, and contain the errors noted in other sections below.
- 12.2 Material errors in the **ROACE analysis** in the draft report, limitations to the usefulness of ROACE at a point in time and limitations to the comparator analysis.
- 12.3 Errors and inconsistencies in the use and applicability of **Tobin's q**.
- 12.4 Concerns about the use of internal company **business cases** to draw conclusions about future profits, and clarifications about statements made by Z and the relevance of market dynamics to profitability analysis.
- 12.5 The implications for profitability assessments of the expected **decline in demand**, which underpins energy transition and current investment strategy.
- 12.6 A number of anomalies that have skewed upwards the assessment in the draft report of Z's internal rate of return (**IRR**).
- 13 An independent report by Incenta Economic Consulting is provided with the submission, which outlines the lack of reliability and appropriateness of using Tobin's q as a measure of profitability in general and as it is used in the draft report.

¹ See, for example, draft report, Chapter 3, paragraph 3.33.

Inappropriateness of drawing conclusions from the analysis undertaken

- 14 The approach in the draft report appears to be “light-touch”, seeking indications only rather than to perfect the analysis. The draft covers a range of possible approaches to assessing profitability, running calculations using simplified assumptions, and using the general direction of the results to inform a draft perspective that recommendations may be required.
- 15 Setting aside the material errors in the different analyses and calculations made (discussed further below), Z has concerns with this approach and the messages it might send to interested parties and the public. Multiple short-hand approaches do not verify a concrete overall view i.e. that firms are earning persistently high profits, justifying action.
- 16 Nor is it sufficient for the draft report to acknowledge the uncertainty inherent in its analysis of profitability. Regardless of any disclaimers, the analysis colours the findings in the draft and is used to justify recommendations. Unsurprisingly, the analysis is also relevant to interested parties and the public who may not receive this information alongside an explanation of the nuance of the approach as a whole or the various disclaimers given.
- 17 In the draft report, there are a number of statements acknowledging issues with the reliability and accuracy of the various profitability measures used.² Inaccurate measures of excess returns cannot be indicative. The same applies to analysis that is useful only in conjunction with those inaccurate measures, e.g. margins analysis.
- 18 One of the “other measures of profitability” discussed in the draft report is a comparison of Z’s net profit per litre with that of some of its Australian counterparts, Viva Energy and Caltex Australia. It indicates that Z’s net profit per litre is approximately double that of the Australian comparators. However, in Z’s view, Z’s net profit per litre is not directly comparable. Viva Energy and Caltex Australia are significantly larger, which means they could achieve a lower profit per litre and still earn an adequate return given the economies of scale in their business. In addition, the measure used in the draft report focuses on total firm net profit per litre, yet the companies all have different operating models e.g. Z’s earnings are derived from non-fuel, supply and commercial, in addition to retail fuel. The report notes:³

We currently place little weight on these measures and we report them here for completeness. We note where we have applied some of these approaches, that the results of each seems consistent with the analysis described above. As such this tends to support our preliminary view that the New Zealand fuel firms are currently making significant excess returns.

- 19 Z considers that measures given this little attention should not be used to support even preliminary conclusions. Profitability analysis is a complex task.
- 20 In addition:
- 20.1 The draft report states, “excess returns appear to have persisted for most of the decade and seem likely to continue”.⁴ The draft report points to a number

² See for example, draft report, Attachment D, paragraphs D38, D53, D120 and D183-184.

³ Draft report, Attachment D, paragraph D189 and D196.

⁴ Draft report, Chapter 3, see the heading above paragraph 3.24.

of key findings in support of this statement,⁵ one of which is that “importer margins are growing”. Z notes that the data available to the Commission and MBIE does not support this finding; Z’s importer margins have decreased since 2018. Z’s ROACE has also decreased.⁶

20.2 The draft report focuses on fuel prices and related importer margins for the period 1 July 2018 to 31 December 2018, a period of peak elevated importer margins. Prices and gross margins fluctuate significantly over time and since that period have since been on average lower than the peak period in the second half of 2018.

ROACE is not a reliable methodology for assessing profitability

21 Z does not believe that ROACE is a reliable methodology for assessing profitability. Some of the shortfalls of using ROACE are acknowledged in the draft report, particularly with regards to comparability arising from differences in business models and consistency of data. The inaccuracy of ROACE is also noted in the draft report,⁷ see also the issues acknowledged from paragraph D159 of the draft report.

22 For example, one issue worth highlighting is that the ROACE calculation for Z in the draft report relates to the whole of Z (including non-fuels income, and earnings from commercial and supply businesses) not only retail fuels. This is caused by the nature of Z’s business and accounting, but nonetheless undermines the ROACE findings.

23 Even assuming ROACE was a useful metric and it was possible to understand the profitability of Z’s retail arm from business-wide ROACE analysis, there are material errors in the way it has been assessed in the draft report, as discussed in the next section.

The ROACE analysis contains errors and limitations

24 Z considers there are material errors in the way ROACE has been assessed in the draft report. At a high level:

24.1 Z has calculated its own average ROACE as approximately 11.3% (for the comparable period 2016 – 2018)⁸, using a standard methodology. Z believes that this ROACE shows a reasonable level of return when taking into account risk and the level of reward that should be expected for the operational complexity and risk Z assumes for managing a long supply chain and the exposure to commodity price movements, exchange rates and future stranded asset risk.⁹

⁵ Draft report, Chapter 3, paragraph 3.29.

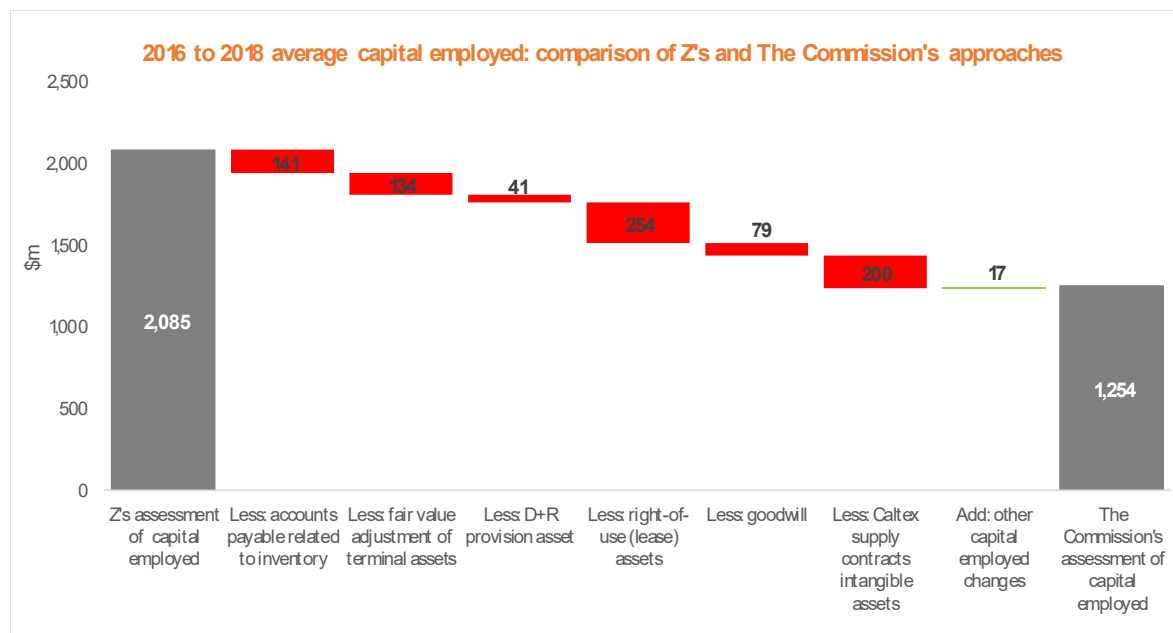
⁶ Most recently, on 12 September 2019, Z gave an earnings update revising down its EBITDAF earnings guidance for FY20, and its dividend guidance. See <http://northeurope.blob.euroland.com/press-releases-attachments/1163115/Z%20Energy%20Earnings%20Update> (accessed 12 September 2019).

⁷ Draft report, Attachment D, paragraphs D183-D184.

⁸ Draft report, Chapter 3, figures 3.2 and 3.3.

⁹ Recent examples from Z’s productivity and optimisation programme include upgrades to scheduling software to optimise secondary distribution and a project with Mobil and Refining New Zealand resulting in refining optimisation.

- 24.2 In contrast, the approach used in the draft report shows an average ROACE for Z of approximately 22% for the period 2016 – 2018.¹⁰ This approach appears to be a material departure from the standard approach to calculating returns.
- 25 Z acknowledges that the Commission has considered the application of ROACE from the perspective of a consumer and, believing it to be appropriate on that basis, excluded the value of supply contracts, leases and goodwill. Z considers this approach inappropriate (as detailed from paragraph 29, and at paragraph 46.3).
- 26 Z has reviewed the data and workings used to calculate Z’s ROACE for the draft report, which shows Z’s ROACE before various adjustments were made. Z considers that the appropriate inclusion of various components of capital employed would reduce Z’s ROACE – on the Commission’s numbers – by approximately 9%.
- 27 The waterfall below shows Z’s calculations for its capital employed, taking into account considerations that Z considers the Commission should also include. By way of cross-check, Z’s capital employed minus those exclusions made by the Commission results in a similar figure to the Commission’s draft report figure.



Note detailed numbers supporting this waterfall are provided in Appendix 2.

- 28 Below Z expands on:
- 28.1 key issues relating to **supply contracts and goodwill**;
- 28.2 **errors calculating Z’s earnings**;
- 28.3 problems based on the **inclusion of non-fuel revenue**; and
- 28.4 **other concerns** with the ROACE calculations undertaken.

¹⁰ Draft report, Chapter 3, figure 3.2.

Supply contracts and goodwill

- 29 In 2016 Z acquired Chevron New Zealand (**Chevron**) for \$785m. The consideration paid by Z included the value of goodwill and long term supply contracts with Chevron (Caltex) dealers. The ROACE calculation in the draft report excludes the value of this goodwill and these contracts.
- 30 The value of these assets is significant. The value of goodwill recognised on acquisition was \$158m and the value of the contracts was \$433m – both material amounts reflecting the intangible value of the Chevron business (and therefore, unsurprisingly, 75% of the price paid). Z would reasonably be expected to make certain earnings plus a reasonable return from the investment made.

Supply contracts

- 31 In Z's view, regardless of the approach taken, ROACE analysis should include the value of the supply contracts acquired from Chevron.
- 32 The draft report notes,¹¹ "If Z had won the contracts organically, no value for the asset would have been recognised." This assessment does not take account of the value exchange that occurred at the time. Chevron entered into these long-term supply arrangements as part of its asset divestment programme, selling sites to dealers – often at a significant discount to market value – and in exchange dealers agreed to enter into the supply contracts.
- 33 Businesses should not be penalised for, and ROACE analysis should not differentiate based on, different business models. The draft report factors in retail sites owned by companies (as it should); it should therefore also recognise the value of supply contracts in dealer-owned models – another business model. Under IFRS 15, if Z had entered into the same transaction Chevron did, it would book an asset on its balance sheet equivalent to the present value of the future consideration receivable in the form of future fuel sales.
- 34 The draft report notes that the value of contracts "is not a cost a firm would incur when expanding (or entering a market)."¹² Z submits that equivalent costs in fact would be incurred. A new entrant would incur costs either for fixed assets or leases (and therefore leases should be included too, discussed further below). In Chevron's case the *equivalent* to those fixed asset costs is the value of supply arrangements traded for physical assets as part of a divestment strategy.

Goodwill

- 35 Goodwill is a slightly different proposition. Z considers all of the goodwill on acquisition should be included within capital employed for the purposes of the ROACE calculation. However, Z acknowledges that in theory it may be appropriate to exclude goodwill on the grounds that it is not directly attributable to capital employed; if a business does not change hands, in theory, this capital cost is never incurred. But in the case of the goodwill paid for the Chevron business there are clear differentiating factors that mean at least a portion of it should be included.
- 36 Real benefits have been derived following the acquisition of Chevron resulting from distinctive and incremental changes made by Z. These benefits have not arisen from an increase in gross margin; they've almost exclusively arisen from the operational benefits and efficiencies of combining two businesses. It is important to

¹¹ Draft report, Attachment D, paragraph D156.2.

¹² Draft report, Attachment D, paragraph D156.1.

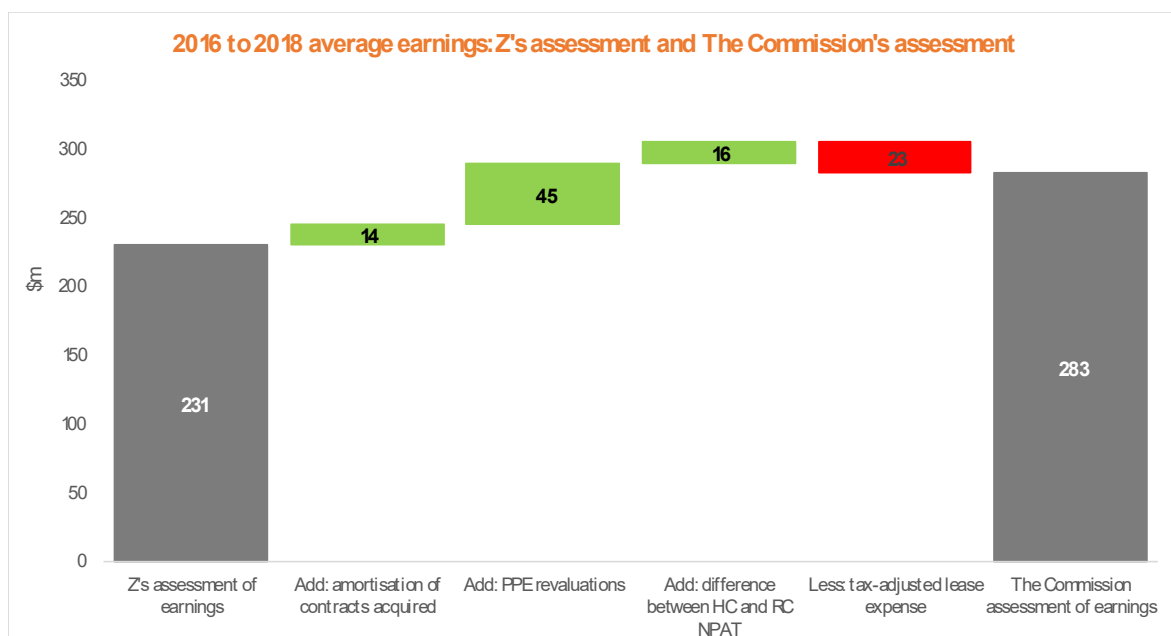
note that Z's margins and returns have declined between the dates of acquiring Chevron and the draft report. As such there is no circularity in including goodwill in the value of capital employed.

Summary on intangible assets

- 37 Z considers that the value of these intangible assets acquired on acquisition of Chevron should be included in a reasonable calculation of ROACE. Z acquired the earnings from these intangible assets (which adds to the ROACE numerator); the value of the assets driving those earnings should be included in the denominator. Note also that the draft report refers to Z's \$785m purchase of Chevron as an "investment in the fuel supply chain".¹³

Errors in calculating Z's earnings

- 38 The waterfall chart below shows the difference between Z's assessment of its earnings and the assessment in the draft report. Z expands further below on the key differences and why Z considers they ought to be taken into account.



Replacement vs historic cost

- 39 The calculations in the draft report are calculated from financial accounts and use a different measure to ascertain the cost of fuel sold – the First In First Out (**FIFO**) accounting principle (based on historical cost (**HC**) accounting).
- 40 Z considers that it is more appropriate to consider earnings on a replacement cost basis, which is the basis Z (and other listed fuel companies) stewards its business and reports to the market.
- 41 Replacement cost is a more appropriate measure of earnings in the New Zealand market given the long lead times and length of the supply chain. The price at which fuel is sold to consumers adjusts to maintain a margin over the current replacement cost of the fuel at the time of sale. In this context HC accounting can lead to large variability in margins (both up and down), as price is set depending on the

¹³ Draft report, Chapter 3, paragraph 3.117.

movement in the underlying commodity (not what the cost of fuel was months in advance).

42 Replacement cost is also more appropriate given:

42.1 it reflects the costs that a new entrant would face; and

42.2 the average capital employed used in the denominator (where earnings are the numerator) to calculate ROACE are – rightly – calculated on the basis of replacement cost.

Inclusion of revaluation gains as earnings

43 The approach used for the draft report includes replacement cost revaluation gains as earnings under “Property Plant and Equipment” in the numerator. Z considers this approach is inappropriate and overstates Z’s earnings.

44 Z is not in the business of trading its property and does not charge higher prices based on higher value assets. Nor are these revaluation gains available for distribution to its shareholders. An approach such as that in the draft report would only fit if Z was able to generate a return based on the higher value assets (i.e. by passing asset values on to consumers through prices), but Z is not. Z’s revaluation gains between 2014 and now have totalled \$322m and in 2014 were as high as \$174m – their treatment in the draft report therefore accounts for a significant uplift in the calculation of Z’s ROACE.

Inclusion of non-fuel revenue likely inflates Z’s ROACE

45 The inclusion of non-fuel revenue will, in Z’s view, increase Z’s ROACE materially because it is reasonable to expect that non-fuel activities will, on average, return more than WACC. This occurs because the risk associated with convenience retail is higher than the fuel business, which is more price inelastic. In addition, capital employed from shared infrastructure required for convenience retail is relatively low.

Other concerns contributing to inaccurate results

46 Z also notes the following concerns with the calculations in the draft report:

46.1 **Brand valuation:** brand valuation in the draft report (and supporting calculations) is likely to be underestimated. Z spends significant amounts each year supporting its brand, e.g. Z has spent on average \$5m per annum on direct branding expenses since 2014, which has not been capitalised on Z’s balance sheet. Only the value of the Caltex brand acquired on acquisition has been booked in Z’s balance sheet. The value of Z’s organically developed brand has not been capitalised.¹⁴

46.2 **Non-interest bearing short-term liabilities:** Z considers that a large part of the inventory and the current liabilities (payables) that “finance” it are permanent in nature, more comparable to fixed assets and debt than working capital. The subtraction of payables related to inventory in the draft report calculations therefore understate Z’s effective capital deployed.

¹⁴ This is a related point to the discussion of Chevron goodwill above. Brand, including that acquired via the Chevron goodwill payment, is an earner the investments in which ought to be included in the denominator.

- 46.3 **Leases:** leased assets have been excluded from capital employed (and the associated lease costs have been included as part of earnings). These assets should be included as capital employed. The Commission has included the value of leased assets in the denominator (depreciated replacement cost) in its Tobin's q calculation.¹⁵ As discussed above in relation to Chevron supply contracts, firms should not be penalised for the ownership models they employ. A significant portion of Z's assets are leased.
- 46.4 **Replacement cost denominator:** Z's leased assets are valued in line with IFRS 16 – based on the present value of expected lease payments. The discounted value is approximately \$282m for Z in FY19. Only lease payments expected to be made by Z are included in Z's ROACE calculation, which will not reflect the market value of a site. It is reasonable to assume that the depreciated cost of a leased asset would typically be worth more than the discounted lease payments for the same asset as the useful life of assets usually exceeds the fixed term of a lease. Z believes the ROACE denominator for leased assets should be based on the replacement cost of the underlying physical assets because replacement cost represents what a new entrant would need to pay.
- 46.5 **Replacement cost:** the value of terminal assets used in the capital employed in the draft report is a depreciated replacement cost valuation. Terminal assets are long life assets which require substantial maintenance each year. Z considers that the depreciation on these assets should be based on a concept of economic depreciation, not accounting depreciation. This is because economic depreciation more accurately matches an assets decline over its life and as such should be very low or zero. As above, it should instead be set at the cost a new entrant would face i.e. full replacement cost. This adds \$149m to the FY19 capital employed balance.
- 46.6 **Decommissioning and Restoration (D&R) costs:** Z's view is that D&R cost provisions should be included within capital employed. Without them, the full replacement cost of acquiring the asset for a new entrant would be understated. The present value of these costs amounts to \$68m in FY19.

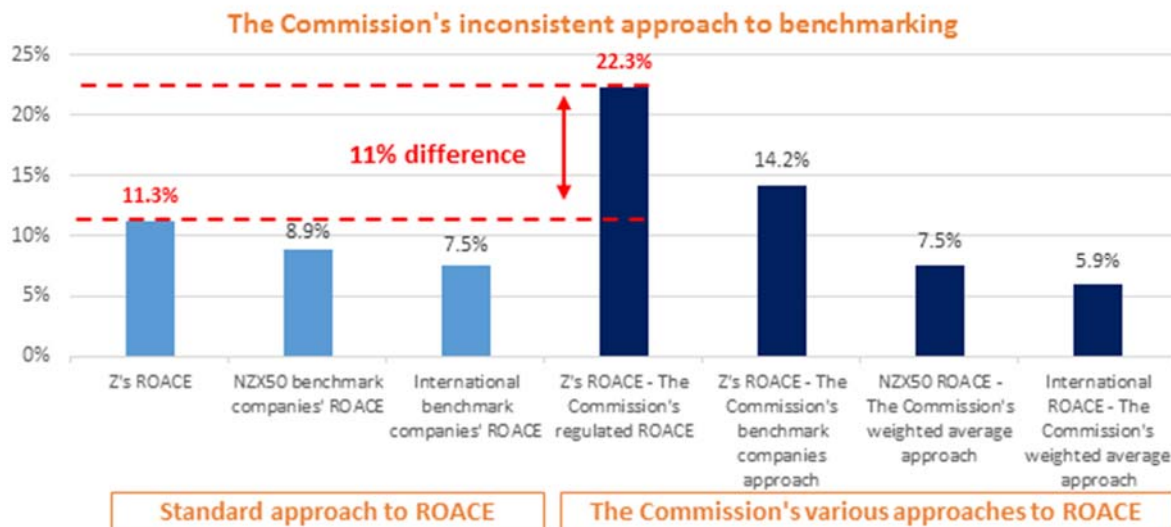
Issues with the ROACE benchmarking analysis

- 47 The draft report includes a comparison of major New Zealand fuel companies' ROACE to other firms.¹⁶ However the data compares two different things:
- 47.1 For the major New Zealand fuel firms, the ROACE figures in this graph ignore the major intangible assets discussed above.
- 47.2 For the international benchmark and NZX50 firms on the same graph, a standard approach to ROACE has been used (different to the Commission's ROACE calculation for Z) *including* consideration of intangible assets.
- 48 The result is a flawed comparison and the appearance of a significantly higher ROACE for the major New Zealand fuel companies.
- 49 We note the Commission has also included Z as a comparator in its international benchmarking group and has therefore calculated the ROACE using the approach

¹⁵ See the information at page 309 of the draft report.

¹⁶ Draft report, Chapter 3, figure 3.3.

taken for the comparator group. In this context, the draft report calculates a materially lower ROACE of 14% (compared with 22% based on the standalone calculation).



50 The comparison is also flawed in the following ways:

- 50.1 The draft report relies on a weighted average of the International ROACE Comparables, which has skewed the benchmark companies down from 7.5% to 5.9% due to the weighting of the larger capital intensive companies. There is no need for this weighting; a standard approach is to consider the simple average that all companies earn.
- 50.2 The workings for weighted average ROACE for international benchmark companies include numbers for earnings and capital employed that have not been converted into a consistent currency (e.g. JPY added to AUD on a 1:1 basis), which then results in an incorrect weighted average being calculated, undermining the integrity of the comparisons.
- 50.3 The international benchmark companies selected are not comparable to Z in terms of scale, business mix, geography, operating structure and earnings mix. For example, Z is not involved in any aspect of upstream fuel business.
- 50.4 We note the Commission has excluded banks from the NZX50 benchmark due to their high leverage, however material outliers such as Sky TV and capital intensive companies such as the gentailers and infrastructure companies have been included, skewing the weighted average NZX50 benchmark down. The ROACE for the NZX50 excluding companies within the financial, property, gentailer and regulated infrastructure sectors is 8.9%.
- 50.5 Different accounting standards and rules apply differently by international location, meaning the international benchmarks are not comparable unless these differences have been adjusted for. For example, GAAP accounting standards used in the US use a Last In First Out (**LIFO**) method for measuring cost of goods sold, whereas IFRS accounting standards use FIFO. GAAP also uses historic cost asset valuation whereas IFRS typically refers to fair value.

Usefulness of "point in time" ROACE analysis generally

- 51 The simple point in time does not reflect that Z's ROACE has been declining since 2015 (refer to Z's 13 October 2017 submission to MBIE). The draft report focuses on the three year average ending FY18 (refer page 73 of draft report). A wider range may be more useful, for example Z's ROACE in FY19 is lower than the time series selected.

There are errors and inconsistencies in the Tobin's q analysis

- 52 Z believes that Tobin's q is an inappropriate measure of profitability and, like ROACE, there are errors in the way it has been calculated. Z refers also to the independent report by Incenta Economic Consulting regarding the appropriateness of Tobin's q generally (provided with this submission).
- 53 Z's key concerns with Tobin's q include:
- 53.1 Like ROACE, Tobin's q has been calculated at the company level for Z, Chevron and Caltex Australia (Gull). This means it includes earnings from non-fuels, and the Commercial and Supply arms of those businesses. Z considers it inappropriate to make assertions about the retail fuel market on the basis of this analysis.
- 53.2 There are limitations on replacement cost data for market participants other than Gull, Chevron and Z. These three entities are not representative of the entire market. Assessment of profitability using such a small sample size is unlikely to be reliable.¹⁷ Furthermore, Gull's replacement cost values appear to be based on Z's asset values, which further limits the reliability and usefulness of the data.
- 53.3 Z notes that Tobin's q has been calculated over different periods for Gull, Chevron and Z – namely 2017, 2016 and 2019 respectively – raising concerns about consistency and comparability.
- 54 Z raises specific issues with the consideration of the numerator and denominator (replacement cost of assets) in the draft report in turn below.

Tobin's q for Z: inaccuracies in the numerator

- 55 Z raises the following concerns with the consideration of the numerator in the draft report:
- 55.1 **Correct number of shares:** calculations used for the draft report appear to have misapplied the 429 million "total authorised and issued capital". The actual number relevant to this calculation is 400 million.¹⁸
- 55.2 **Treatment of tax:** it is not clear to Z why deferred tax liability has been added in when calculating the numerator. The numerator is supposed to be the market (enterprise) value of the activities; including deferred tax liability (albeit adjusted) is treating the Government as if it is a shareholder, or source of capital, funding the operating assets.

¹⁷ See draft report, Attachment D, paragraph D53 for reference.

¹⁸ See page 95 of Z's 2019 Annual Report.

55.3 **Share price will reflect many factors:** the share price of any company may reflect a large number of factors at any point in time and may not be reflective of the underlying value of the core business. For example:

- (a) For Z a particular contributor to its current share price is likely to be the "drive for yield" from many investors as a response to record low interest rates.
- (b) It may also be possible that Z's share price factors in some option value associated with its sites and assets that could be realised even if the demand decline of the downstream petroleum sector occurred more quickly than expected.

Tobin's q for Z: the denominator - replacement cost of Z's assets

56 Z raises the following concerns with the consideration of the denominator in the draft report:

56.1 **Depreciation estimates:** the depreciation of the replacement cost estimates may not be fit for purpose; accountants tend to over-depreciate long-lived assets, such that the depreciated (replacement cost) asset base may be too low when considering the full economic life of assets.

56.2 **Replacement cost and a new entrant's position:** Tobin's q is intended to reflect the position of a new entrant, and so the replacement cost valuations should reflect the standards to which it would be subject (i.e. the position of the marginal supplier). As noted above in the commentary on ROACE, Z considers terminal assets should be restated to full replacement cost and PPE should include the cost of D&R. This change would increase the total replacement cost of PPE assets for Z and Chevron on page 309 by \$217 million.

56.3 **Working capital allowance:** the point noted above in the commentary on ROACE regarding non-interest bearing short term liabilities applies equally to the Tobin's q calculation. Short term liabilities required to fund working capital, which are permanent in nature, such as inventory in Z's supply chain, should be added as a separate component of the capital cost that would be borne by a new entrant.

56.4 **Operating lease value should be the replacement cost of the underlying assets:** Z agrees with including values for operating leases in the calculation of Tobin's q, however notes leased assets have been excluded from capital employed in the assessment of Z's ROACE. In addition, the draft report applies the same value to the numerator and denominator (the present value of lease payments), which Z considers to be an error. Rather:

- (a) The numerator value should be the contribution of the operating lease to enterprise value, which has been correctly included. Lessors are treated the same as debt providers – namely as someone else having a right to a share of the cash flow of the enterprise.
- (b) The denominator should include the replacement cost of the underlying physical assets, because that is what a new entrant would need to reproduce. It would be unexpected for present value of the lease liability to be the same as the (depreciated) replacement of the underlying physical assets. Ordinarily, several years into a lease the

present value of lease payments would be much lower than the depreciated replacement cost.

56.5 **Brand valuation is likely to be underestimated:** Z questions the adequacy of the brand valuation. The economic literature on Tobin's q suggests that 30% of selling, general and administrative expenses should be capitalised and depreciated over 5 years to provide a better estimate of the intangible assets of firms.

56.6 **Physical assets underpinning the contracts and goodwill that were purchased from Chevron:** as discussed above in relation to ROACE, many of the supply contracts Z acquired from Chevron included a recovery of capital assets that Chevron had funded. These assets should be included in the denominator of the Tobin's q calculation at their (depreciated) replacement cost.

Conclusions about future profits rely on inappropriate evidence

57 The ROACE and Tobin's q analysis discussed above is inherently historical, not forward-looking. For its forward-looking analysis and the Commission's draft view that excess returns "seem likely to continue"¹⁹ the draft report relies on so-called expectations of future profits, including within internal business cases. Z has concerns with the robustness of this approach and the way in which statements and market dynamics have been applied.

Internal business statements are not an accurate measure of expected profitability

58 Looking at business cases in isolation without considering sites' actual performance is not a valid assessment of profitability. Z has not consistently achieved the volumes expected in its business cases (in Z's view because its business cases have under-recognised the risk of increasing competition).

59 Business cases tend to involve hopeful and at least imprecise judgements about how investments will perform, hence why they are often paired with reasonably high hurdle rates to account for the risk that they are materially inaccurate. Z considers the risk of cashflows when setting its project discount rate.

60 It is also inappropriate to use a group WACC to value risk for a project, because doing so implies that the project and corresponding cashflows will have the same risk characteristics as Z overall. Z applies higher discount rates above WACC as a practical means of managing the risk of over-optimistic forecasts. Hurdle rates for each project are assessed on a case by case basis. These hurdle rates do not reflect expected long term returns in excess of WACC as indicated in the draft report.

61 Business cases are also a poor proxy for average returns (which are the focus in the draft report's statement about likely future trends). The incremental IRR for an individual project provides no insight into average returns. The analysis in the draft report also does not take account of the relative size of new investments compared to the considerable sunk costs already invested.

62 Business cases for incremental investments also ignore sunk costs from firms' supply chains and shared fixed sunk costs such as overheads, branding and marketing. In other words, the business case does not take account of the sunk

¹⁹ Draft report, Chapter 3, see the heading above paragraph 3.24.

costs that will inherently benefit the investment. A hypothetical new entrant would need to meet those costs before it could invest in equivalent assets.

Clarification of market dynamics and Z statements

63 The Commission has erred in the manner in which it has considered business cases given real market dynamics.

Z's investment strategy

64 In response to considerable uncertainty about the future demand for fuel Z has publicly committed to capping the level of capital employed in its core fuels business to 2018 levels.

65 The draft report quotes Z's expectation of five-year discounted paybacks from new investment in its core fuel business, noting that these paybacks are remarkably short relative to the service life of the assets.²⁰ This statement is not being used in its correct context. In fact:

65.1 Z has stated publicly that as part of its revised investment approach (where Z does not seek to grow volumes with new capital) Z will only invest in assets with a five year discounted payback threshold. This represents capital rationing, not a confident expectation about returns (in which case Z would presumably be investing new capital too).

65.2 Z's strategy is to invest in capability such as customer experience, digital products, productivity, innovation and brand. These investments naturally have much shorter service lives than fixed assets such as retail sites and this is reflected in the depreciation rates that accounting standards require Z to use.

66 In short, Z's investment strategy supports a theory of increased demand risk and uncertainty about returns, not the reverse. Z's statements do not apply to new retail investments which are the subject of the analysis in the draft report.

67 If the Commission intends to refer to business case analysis in the final report, Z requests that it at least remove all references to Z's five year discounted payback, given this it is not relevant to the context under consideration. The quote at paragraph 2.62 could also be misunderstood as 35 new Z sites. To clarify: this figure represents 35 newly built "industry" sites.

Share price reaction to the Chevron acquisition

68 The draft report notes that Z's share price climbed and market capitalisation increased when the market learnt of Z's proposal to acquire Chevron: "[t]his implies investors viewed the price paid by Z Energy as a bargain".²¹

69 In fact this share price reaction reflects the cost benefits anticipated by Z and the market, not a "bargain" or the acquisition of unusual margins. That market interpretation has been proved correct, with \$39m of cumulative benefits captured post-acquisition. Crucially, there has been no meaningful increase in gross margins post-acquisition.

²⁰ Draft report, Chapter 3, paragraph 3.32.

²¹ Draft report, Attachment D, paragraph D62.2.

The expected decline in demand is relevant to the assessment of profitability as well as the analysis generally

- 70 The analysis in the draft report does not take into account the substantial uncertainty over demand in the medium term anticipating that there will be no response to the science of climate change. While many disagree on the exact timing of the end of retail fuel, there is no question that fuel volumes will decline during life of investments in this sector. Scenarios provided by the Business Energy Council (BEC)²² suggest a decline in petrol use between 10-35% from 2020 – 2030.
- 71 It is natural for business cases to factor in demand risk driven by the expected decline in aggregate demand and the final report ought to quantify this factor when analysing returns expectations, if business case analysis continues for the final report. Z notes also that demand risk is asymmetric, as a meaningful increase in demand for retail fuel is highly unlikely. WACC does not address the risk of stranded assets. It is reasonable to earn returns in excess of WACC to address this risk during the remaining life of fuel related assets.
- 72 The draft report does note that “[i]nvestors are not currently valuing the fuel sector as a sunset industry”.²³ “A firm that is dying, or operating in a dying industry, would be expected to have a value of q of less than one. So would a firm whose capital stock has been rendered obsolete by technological progress.”²⁴ Z disagrees on this point. The majority of Z’s value is captured in its cashflows expected to be generated over the next 10 years, so it is not surprising that Tobin’s q is greater than 1. This does not mean that there is no risk of stranded assets.

Anomalies have skewed upwards the calculation of Z’s IRR

- 73 The draft report calculates Z's IRR as 34% from 2010 to 2019.²⁵
- 74 Z has not seen the underlying calculations for this IRR, however Z assumes that to achieve this level of IRR the Commission includes equity contributions at the time of the Infratil/NZ Super acquisition from Shell in 2010, up until the share price at the date of the draft report.
- 75 Z does not consider it is appropriate to consider IRR over this period given the change between private and public ownership. In a private company, the quantum of leverage is typically larger than in a listed context. The use of debt has leveraged the equity return during the time of Infratil/NZ Super ownership.
- 76 If the consideration period was during the time of public ownership, Z estimates the appropriate IRR to be approximately 20% pre-tax (approximately 18% excluding imputation credits).

²² BEC is a consortium of participants from a wide cross-section of New Zealand public and private sector entities, including MBIE and the Commerce Commission.

²³ Draft report, Attachment D, see the heading above paragraph D111.

²⁴ Draft Report, Attachment D, paragraph D112.

²⁵ Draft report, Chapter 3, paragraph 3.49.

PART B: COMPARISON TO OTHER COUNTRIES AND MONITORING

The OECD comparison is not useful

- 77 The draft report notes that “New Zealand consumers pay relatively high prices for petrol and diesel. In the March 2019 quarter, New Zealand had the third highest pre-tax petrol and diesel prices in the OECD” (noting that “fewer than half the OECD countries have data on regular petrol”).²⁶
- 78 In Z’s view this data and comparison have significant limitations. Rather than rely on this problematic data and comparison, Z supports a monitoring regime facilitated by fuel firms providing to data (which would incorporate the effect of any discounts) to allow MBIE to accurately monitor prices and trends in margins. The limitations are:
- 78.1 The way the OECD data is collected varies significantly by country and as a result it does not give a genuine “like-for-like” comparison.
- 78.2 Data used for New Zealand is not representative of actual pump prices in New Zealand. Z has concerns with the methodology used to collect prices.
- 78.3 Regardless, the comparison is of limited use. There are many reasons to expect that New Zealand ought to be one of the more expensive countries for fuel in the OECD.
- 79 Z expands briefly on each of these concerns below.
- 80 Z notes the work done by Donal Curtin that illustrates the significant sensitivity of the OECD comparison to the basis on which currency exchange calculations are carried out.²⁷ This reinforces the conclusion that the use of such international comparisons is fraught and that the best way to monitor the competitiveness of New Zealand retail fuel markets is with access to meaningful, detailed and comparable data from local market participants.

There are data inconsistencies across the OECD comparison

- 81 The data relied on is taken from the International Energy Agency (**IEA**), but the IEA does not collect the data itself. The data is collected by local government agencies and therefore the methodology used varies depending on the agency collecting it. This means the data is not a genuine “like-for-like” comparison.
- 82 Z notes, by way of illustration:
- 82.1 Australian data is a weighted average taken from the state capital cities only (and because the weighting is based on state population, the data is likely to be skewed towards prices in Sydney and Melbourne in particular). The difference between regions and capitals is likely substantial, e.g. the Australian Competition and Consumer Commission (**ACCC**) has compared the average regional price to the average price across the five largest cities,

²⁶ Draft report, Chapter 3, paragraph 3.72.

²⁷ See: <http://economicsnz.blogspot.com/>.

finding a difference ranging from 3cpl to 17cpl from April 2018 to March 2019.²⁸

82.2 New Zealand data is an average across Auckland, Hamilton, Wellington and Christchurch.²⁹ Z would expect that only Auckland prices would be comparable to Australian state capital cities given their size and import locations, particularly given even those prices used by the IEA are likely skewed towards Sydney and Melbourne, as noted above.

82.3 Korean data is a national average based on credit card transaction data.³⁰ This means the Korean data inherently captures all discounts offered off the pump price, whereas in other OECD countries the data may ignore or merely estimate discounts.

82.4 Different countries have substantially different quality specifications for the same general fuel grades. New Zealand's fuel quality specifications are particularly high. The Commission itself notes the "relatively tight specifications in New Zealand" when explaining the complexities of unloading one shipment of fuel in multiple countries.³¹

83 Generally, there are some oddities with the data that lead Z to question its reliability. For example, most countries have a similar "rank" for premium petrol and diesel, however Korea and Australia have surprisingly expensive petrol compared to inexpensive diesel. For Sweden, Greece and Finland the reverse is true. While there may be explanations other than data collection problems, these ambiguities reflect the need for more rigorous, New Zealand-centric monitoring.

New Zealand data is not representative of New Zealand fuel prices

84 MBIE collects relevant data for New Zealand. MBIE's task is currently a difficult one. In Z's view:

84.1 The New Zealand data does not appear to be weighted (unlike, for example, Australia), meaning higher prices outside Auckland will bring up the New Zealand data average.

84.2 The New Zealand data does not accurately reflect discounts (unlike, for example, the Korean data which is based on credit card transactions rather than posted prices). As Z has previously explained to MBIE and the Commission, MBIE's discount estimates lag behind price data, rely on a selected few sites, are not weighted by volumes, and rely on the outdated and now largely unused concept of "main port price".³²

84.3 The OECD premium data is based on 95 unleaded petrol only. In New Zealand, both 98 and 95 are offered, with very little 95 sold.

²⁸ See: <https://www.accc.gov.au/system/files/Petrol%20Quarterly%20Report-June-Quarter%202019.pdf>, chart 4.1.

²⁹ See: <https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-statistics-and-modelling/energy-statistics/weekly-fuel-price-monitoring/>.

³⁰ See: http://wds.iea.org/wds/pdf/EPT_countrynotes.pdf, page 62.

³¹ Draft report, Chapter 4, paragraphs 4.65 – 4.71.

³² See Z's 13 October 2017 submission to MBIE on the Fuel Market Performance Study, page 13.

85 Until now, MBIE has (reasonably, given the available data) struggled to keep pace with changes in the market, such as new entrants, changes in service differentiation such as the growth of unmanned sites, and the rapidly changing discounting and loyalty environment. Z recommends that industry participants actively give MBIE accurate and up to date information, as discussed from paragraph 87.

Features of the New Zealand context are relevant to the prices observed here

86 Regardless of issues with the data, in Z's view it would not be surprising for fuel to be relatively expensive in New Zealand. In particular, Z points to New Zealand's:

86.1 significant geographic isolation from oil fields compared to the rest of the OECD, increasing shipping costs. New Zealand has one of the most expensive costs of crude oil in the OECD;

86.2 lack of scale due to small population compared to many of the other countries in the OECD. Scale increases shipping costs in terms of economies of scale and also increases domestic costs across the supply chain; and

86.3 geography (i.e. a long, skinny network) and low population density, which further increases domestic costs across the supply chain – especially the cost of primary distribution by road.³³

A New Zealand-specific monitoring regime is appropriate

87 Z supports a transparent monitoring regime aimed at enabling MBIE to effectively monitor the retail fuel market. A full and effective solution would enable MBIE to monitor prices and accurately assess retail margins each month (taking into account prices, discounts and importer costs for the same period).

88 Z already provides to Stats NZ monthly retail volumes and sales data by LAPT region.³⁴ Z has previously offered to supply transactional data and fund its share of a digital system to be made available to the public and government. Z is willing to provide more data in the future if the whole industry does the same, to enable accurate and effective independent monitoring. Z recommends that:

88.1 all fuel retailers agree (or be required) to provide detailed volumes and sales data in an agreed format and covering agreed timeframes; and

88.2 MBIE and the industry agree a methodology for calculating delivered import costs that fairly represents the full cost of fuel delivered to the pump.

89 MBIE's current approach to determining the cost of importing fuel is reasonable given the data available, but can be vastly improved.³⁵ Monitoring will only be effective if MBIE can as accurately as possible track input costs and therefore calculate margins.

³³ Although Z notes that primary distribution costs are not so relevant to the OECD data specifically, given it measures only Auckland, Hamilton, Wellington and Christchurch.

³⁴ Excluding card data, as card transactions relate to commercial, not retail, customers.

³⁵ MBIE's approach uses some high level assumptions and considers the cost of purchasing fuel in Singapore, shipping it to New Zealand, insurance and losses, and wharfage and handling. Ideally MBIE would be provided data to allow it to more accurately calculate those costs (on timeframes matching price data) and also factor in other key components such as terminal operating costs and secondary distribution costs.

- 90 It is also important that the time periods match for the input costs and price data being compared. MBIE's current weekly approach results in differentials in weeks where there is significant price volatility.
- 91 Z notes that the approach proposed above would be fuller than levels of monitoring in other OECD countries. For example, Z is aware that agencies in Australia and Germany focus on price monitoring; Z's approach allows for margins also to be monitored (involving substantially more data, given it takes into account the full costs of petrol acquisition, transport to the pump and other costs).

PART C: COMPETITIVE CONDITIONS AT THE WHOLESALE LEVEL

- 92 In this section, Z sets out its proposal for nation-wide terminal gate pricing, supported by limits on the maximum length of contracts with distributors.³⁶
- 93 Nevertheless Z also sets out its views that:
- 93.1 Current port terminal infrastructure arrangements bring some efficiencies, although they do not send appropriate investment signals.
- 93.2 The wholesale market is currently competitive:
- (a) Distributors are vigorous and effective competitors.
 - (b) Relationships with individual dealers also appear to be pro-competitive.

Terminal gate pricing has the potential to further enhance competitive conditions in the wholesale market

- 94 As Z has demonstrated in its previous correspondence with the Commission, wholesale fuel markets in New Zealand are competitive (see also below from paragraph 109). Nevertheless, in Z's view, wholesale markets could potentially be further enhanced by providing wholesale access to fuel at the terminal gate (including at Wiri) based on "terminal gate pricing", similar to the approach in Australia. This proposal should be considered alongside Z's proposal for limiting the maximum length of wholesale supply arrangements between majors and distributors (see paragraph 131 below).
- 95 Specifically, in place of the current borrow and loan arrangements, terminal owners, including at Wiri, would be required to make refined product available to any third party at the terminal gate at a publicly available "terminal gate" spot price. This model has been successfully implemented in Australia, and in Australia is looked on favourably by the industry and ACCC.³⁷ Z proposes an industry code governing terminal gate pricing, implemented by regulation, as is the case in Australia.
- 96 Customers would not necessarily buy at the terminal gate spot price. As in Australia, wholesale customers may choose to enter into longer term supply arrangements at prices other than the spot price. Terminal gate spot prices would nevertheless have the potential to safeguard the competitiveness of pricing of those arrangements by providing pricing transparency and making options clear to customers. In Australia, term arrangements are typically priced based on a discount to the terminal gate spot price.
- 97 Note that Z also proposes supply contracts with distributors should have a maximum term of 7 years (see paragraph 131 below). Regular opportunities for distributors to

³⁶ Requiring the use of published terminal gate prices is one of the options the Commission is seeking feedback on – see draft report, Chapter 6, paragraph 6.109.

³⁷ See, for example, the Australian Government's 2016 report on its latest review of the Competition and Consumer (Industry Codes–Oilcode) Regulation 2006 (**Oilcode**), which recommended that terminal gate pricing arrangements under the Oilcode be retained in their current form. In particular, the report comments that retailers find terminal gate pricing provides "a useful reference price for both market participants ... and the community at large and should continue to be maintained", and that the ACCC uses terminal gate pricing as a "benchmark for wholesale prices ... to ensure compliance with the CCA and identify anti-competitive behaviour" (both at page 18 of the report, available at <https://www.energy.gov.au/sites/default/files/oilcode-review-final-report-2016.pdf>).

test the market in relation to these contracts would provide a check on the competitiveness of their terms, complementing terminal gate pricing.

- 98 This terminal gate pricing proposal would have the potential to:
- 98.1 Further enhance wholesale competition by safeguarding supply at the terminal gate, and ensuring customers are able to observe prices in the market, choose the supplier that suits them best, and choose between longer term security of supply and buying at wholesale spot prices.
 - 98.2 Result in owners of terminal assets genuinely risking losing customers if they are unable to supply product to their customers. As indicated in the draft report:³⁸ “[w]hen suppliers face vigorous competition, they risk losing customers if they are unable to supply product to their customers.”³⁹
 - 98.3 Make it easier for an entrant terminal owner to obtain customers and compete. Entry of new terminal players (if warranted by demand) would also result in additional potential imports. There would also be nothing to prevent commercial deals allowing a non-infrastructure owner to use an infrastructure owner’s tank capacity (e.g. if Timaru Oil Services Limited (**TOSL**) wished to operate on the basis of selling its capacity). This has previously occurred – **[REDACTED]**.
 - 98.4 Enable terminal owners to seek a competitive market return on their investments, creating appropriate investment incentives.
- 99 These likely benefits accrue without adding material cost or complexity, or requiring the exchange of sensitive information among competitors, since each terminal owner would simply be responsible for setting (and publishing) its own terminal gate prices and monitoring its own stock levels.
- 100 Z notes that, even with appropriate investment incentives, significant new storage investment should not be expected, especially given TOSL’s imminent terminal at Timaru and the further terminal that appears to be planned at Mount Maunganui. As Gull (owned by Caltex Australia) explains, “Gull estimates that the current terminal capacity across the network is sufficient to meet the current demand, with an amount of spare capacity available the (sic) existing or new users (should access be provided in the future).”⁴⁰
- 101 Further, regardless of the specific timeframes contemplated in the draft report, the Commission must accept that retail fuel markets are not likely to grow materially, and will ultimately decline. The assertion that terminal storage capacity constraints are a sign of failing competition in “a profitable, growing industry” is not accurate.⁴¹

³⁸ Draft report, Chapter 3, paragraph 3.142.

³⁹ Z believes that other competitors and customers’ ability to switch the port they truck product from will constrain all existing terminal owners at every port location in New Zealand.

⁴⁰ See Gull’s 22 February response to the Commission’s preliminary issues paper, response to question 24.

⁴¹ Draft report, Chapter 3, paragraph 3.142.

102 Regardless, calibrating investment incentives is worthwhile to ensure new investment, and maintenance of existing infrastructure, takes place if and to the extent it is efficient.

Terminal gate pricing is preferable to alternatives

103 An alternative to terminal gate pricing raised in the draft report is access to tank capacity. This would be a much more intrusive regulatory step than terminal gate pricing given it would provide for access to privately held assets. In Z's view access to tank capacity would not have potential competition benefits additional to appropriate terminal gate pricing (see from paragraph 94 above).

104 Access to tank capacity would also be more complex to administer than the terminal gate pricing described above. That is, access to tank capacity would be likely to:

104.1 Introduce significant technical complexities. There would need to be rules to govern the terms of access, tank maintenance and outages, buffer stock, allocation of space within tanks, and product quality⁴² (especially if access seekers intend to use terminals for imported refined product).

104.2 Undermine cost efficiencies and increase the cost of the domestic supply chain. For example, it would prevent suppliers from optimising deliveries and stock, and undermine the efficiencies of coastal shipping logistics. Note that if the refinery were to sell into capacity on the basis of open access, any inefficiencies in the refining/coastal distribution would be incurred by the owner of the tankage. The simplest way to distribute is to have confirmed ullage in the tank before any journey starts.

Port terminal infrastructure is efficient

105 The draft report notes concerns about the level of investment in terminal storage⁴³ and the frequency of port coordination events.⁴⁴ Contributing factors discussed include that benefits of investment do not flow entirely to the investor, that coordination rules discourage investment and the presence of "insulation risk", where coordination does not disproportionately affect any one party.⁴⁵

106 Z agrees that while the shared storage arrangements have some upsides for efficiency (avoiding inefficient duplication of terminal assets), investment incentives are not well configured in the borrow and loan arrangements. Historically, the borrow and loan arrangements worked when the majors were roughly "in balance" – holding similar tankage to their market share. Recent changes in that balance have brought to the surface the incentive problems highlighted in the draft report.

107 The Commission considers in the draft report that there are flow-on detriments that apply to the wholesale market. These are that the lack of investment and resulting "just in time" fuel supply:⁴⁶

⁴² A consideration also raised by the Commission in relation to exclusivity of supply – see draft report, Chapter 6, paragraph 6.67.

⁴³ Draft report, Chapter 3, paragraph 3.136.

⁴⁴ Draft report, Chapter 3, paragraph 3.140.

⁴⁵ Draft report, Chapter 3, paragraphs 5.83 – 5.86.

⁴⁶ Draft report, Chapter 5, paragraph 5.88.

107.1 “weakens distributors’ ability and incentives to switch to another supplier”;
and

107.2 “limits the majors’ ability and incentive to compete for new customers”.

108 Z does not agree with these draft findings; the wholesale market is competitive.

Distributors are vigorous and effective competitors

109 The Commission is considering the extent to which distributors:

109.1 complement (rather than compete with) their supplier’s retail networks; and

109.2 are able to negotiate for competitive terms, including the ability to switch supplier.

110 In summary, Z:

110.1 Notes the continued expansion of distributors into retail markets as independent competitors, which is indicative of competitive wholesale and retail markets.

110.2 Does not consider that suppliers have an advantage in terms of bargaining power, or are able to use supply prioritisation or access to fuel card schemes to control distributors’ behaviour.

110.3 Considers distributor contracts appear to be pro-competitive.

111 Nevertheless, to reassure the public and other stakeholders as to the competitiveness of distributor contract terms Z would support regular refreshing of suppliers by limiting distributor contracts to a maximum length of 7 years.

112 In Z’s view, different considerations apply to arrangements between suppliers and individual dealers. This is discussed in the next section from paragraph 135.

Distributors can and do compete with their supplier

113 The Commission has sought feedback on the extent to which distributors compete with their suppliers:

113.1 Z agrees that most distributors began by taking on particular types of customers or regions from their supplier. To some extent distributors evolved to complement their suppliers’ businesses.

113.2 However distributors have now moved into genuine retail fuel offerings, opening sites outside their traditional regions, and increasingly competing with their own suppliers. Z refers in particular to:

(a) the increase in numbers of distributor-branded sites in general;⁴⁷

(b) NPD’s recent significant expansion into Christchurch and as far south as Invercargill;

⁴⁷ For more detail see figure 2 and surrounding commentary of Z’s 21 February 2019 response to the Commission’s preliminary issues paper.

- (c) Hamilton-based Waitomo recently opening new sites and announcing further plans in Wellington and Canterbury; and
- (d) McKeown expanding its retail network including in direct competition with Z and Caltex sites, e.g. at Kaiapoi, Dunedin (Andersons Bay) and Hornby.

114 There are different distributor models, relationships and degrees of integration across the industry. For example, BP tends to have ownership stakes and directorships in its distributors and Mobil, at least in the past, appears to have used distributors to differentiate its service offering. These factors, as well as the historical development of distributor businesses, may contribute to the site distance analysis in the draft report for Mobil and BP.⁴⁸

115 As such, Z does not consider that the relationship between distributors and suppliers hinders competition. Nevertheless, terminal gate pricing supported by regular refreshing of distributor contracts would help to minimise any incentive for distributors to ensure their retail network is complementary to that of their supplier.

Security of supply and fuel card access do not hinder wholesale competition

116 Two factors are noted in the draft report that the Commission considers may influence site location and act as a barrier to distributors switching supplier:

116.1 Supply priority: the Commission has questioned whether, during times of relatively tight supply, suppliers may prioritise distributors with whom they have long-term relationships and especially those with more complementary (i.e. less overlapping) networks. This may result in lack of major/distributor competition and/or discourage switching.⁴⁹

116.2 Fuel card access: the Commission has questioned whether majors may selectively offer distributors access to their fuel card schemes in order to influence site location, and whether distributors may be wary of switching supplier due to a concern that they might lose fuel card volumes.

117 Z does not act in the manner described in the draft report. Z does not seek to prioritise supply, and nor does it give access to fuel card schemes, based on outcomes it expects in terms of distributors' retail site locations.⁵⁰ Z is highly incentivised to win new distributor volumes (discussed in the next section) and would not seek to undermine its chance to win volumes by punishing the distributor for its network by way of security of supply or fuel card access terms. For example, [REDACTED].

118 Nor does access to fuel cards act as a barrier to distributors switching supplier. All suppliers have fuel card schemes that distributors could negotiate access to (which Z believes suppliers would be likely to give if it was decisive in winning the new

⁴⁸ Draft report, Chapter 6, figures 6.1 and 6.2.

⁴⁹ Draft report, Chapter 6, paragraphs 6.31 to 6.33.

⁵⁰ Note that Z does contract with some individual sites for them to accept Z's fuel cards where Z has a gap in its network of fuel card-accepting sites. Z makes these arrangements with whomever best completes Z's network, including other majors and the distributors they supply.

volumes). Distributors also have access to substantial independent providers such as CardLink and NZ Fuel Cards⁵¹ as well as Kiwi Fuel Cards and Fuel 2 Go.

- 119 It is also important to avoid over-estimating the influence of fuel cards. Fuel cards are little more than payment mechanisms with different billing structures. They are not difficult to set up or join, and commercial drivers tend to carry multiple fuel cards; they are not particularly sensitive to network effects. Z's own data shows that Z sites do not have a common base of fuel card business; instead it varies according to the local market and competitive factors.
- 120 Z does not agree that fuel cards engender "much stronger" loyalty than retail loyalty scheme cards.⁵² In Z's experience fuel card customers hold more than one card and are particularly price conscious, for example when the customer manages a large commercial fleet and petrol is a large portion of its cost.

Distributors have bargaining power

- 121 The Commission considers in its draft report whether suppliers have relative bargaining strength over distributors, and the impact of various contractual terms.
- 122 Z believes that suppliers have sufficient ability and incentives to compete to win distributors' volumes. In particular, supply of large blocks of volume assists to manage the commercial risks associated with always being committed to substantial minimum output from the refinery and a national distribution network. These incentives, and the lack of other structural barriers, give distributors options and therefore bargaining power.
- 123 Z has set out above why suppliers do not have power to lock in distributors on the basis of given security of supply or desire for access to fuel cards. The draft report also discusses whether the possible use of "financial inducements" locks distributors in. However the draft report notes that these inducements may be possible due to profitability in the wholesale market (which Z discusses separately in Part A above) – it is not clear how inducements grant one supplier excessive bargaining power assuming alternative suppliers could make similar offers.
- 124 The draft report also focuses on an apparent lack of churn. Lack of churn is not evidence of a lack of competition, absent other factors.⁵³ Z reiterates points previously made to the Commission that:

[REDACTED]

- 125 Ability to supply does not prevent majors from competing for new distributors' volumes. Suppliers are able to increase import supply at reasonably short notice and refinery participants are incentivised to maximise the volumes they supply over their high fixed cost supply chain. Here, it is important to bear in mind that aggregate demand for diesel and petrol is largely flat, so new distributor volume generally means the loss of volume elsewhere; in that context, infrastructure and the locally-refined component involved in supplying the lost volume is theoretically available to the winner of the new volume.

⁵¹ Noted by the Commission at draft report, Chapter 6, paragraph 6.37.

⁵² Draft report, Chapter 2, paragraph 2.60.3.

⁵³ For example, [REDACTED].

126 By way of example, [REDACTED].

The terms of distributor contracts appear to be pro-competitive

127 The draft report notes that:

127.1 Historically majors have transferred portions of their businesses, given upfront capital injections and even given assets in exchange for volume commitments or exclusivity, and longer terms of supply.⁵⁴

127.2 The provisions under review can be beneficial and pro-competitive, including facilitating relationship-specific investments, avoiding hold-up problems and reducing transaction costs.⁵⁵

127.3 Product quality may justify exclusive supply.⁵⁶

128 Z agrees these factors mean the original basis for the contracts was pro-competitive; suppliers were making choices about how to compete most effectively, and in some cases that involved effectively divesting parts of their distribution. And based on the recent success of distributors in retail markets, the contracts were and remain pro-competitive in that they have not prevented distributors from moving beyond the businesses and regions of operation that they inherited, and developing highly competitive retail businesses.

129 As such, Z considers that the contracts remain pro-competitive under current market conditions. They reflect mutually beneficial agreements and are not indicative of unbalanced bargaining power. For example:

129.1 [REDACTED]

129.2 [REDACTED]

130 In that context, in considering any changes that might be appropriate it is important to be conscious of the pro-competitive nature of these bargains, and care must be taken to avoid undermining mutually beneficial ongoing commercial relationships.

131 Z considers contractual terms with a maximum length of 7 years would strike an appropriate balance and be reasonable in the circumstances. A shorter maximum term could not be justified for the reasons given above (particularly the investment that is required in a term contract can easily take 7 years to pay back).

132 Z is prepared to discuss with the Commission how the appropriate changes to contractual terms could be made in practice. Z notes that any such steps will need to:

132.1 take into account the value that has been traded, as failing to do so risks undermining investments and distorting the market;

132.2 be implemented alongside a workable and industry-wide terminal gate pricing, as discussed in more detail from paragraph 94; and

⁵⁴ Draft report, Chapter 6, paragraph 6.22.

⁵⁵ Draft report, Chapter 6, paragraph 6.45.

⁵⁶ Draft report, Chapter 6, paragraph 6.67.

132.3 be implemented across the industry. Without such consistency the Commission's goals will not be met and those firms that do change could be disadvantaged relative to others.

133 Z considers the limit on the maximum length of distributor contracts could be incorporated into an oil code that gives effect to terminal gate pricing.

134 The Commission is also considering requirements in distributor contracts for distributors to provide financial and other information to their suppliers.
[REDACTED]⁵⁷

Dealer contracts appear to be pro-competitive

135 Dealer contracts (e.g. in Z's case supply arrangements for independent Caltex sites) operate differently to distributor contracts. The issues discussed above, and the potential justification for and upside of shorter contractual terms, do not apply in these cases. In particular Z notes:

135.1 Dealer-owned sites are a different business model for supply to market (compared to company-owned sites); in contrast, distributors are large bulk customers with a separate competing brand.

135.2 In any event, in practice dealers exert substantial countervailing pressure on their suppliers.

Dealer contracts represent a choice of operating model and are pro-competitive

136 Firms wishing to supply fuel via a retail brand have two main design choices and levels of investment available to them:⁵⁸

136.1 Company-owned model (capital-intensive): the supplying firm owns the retail brand and sites, employs retail staff, sets retail prices and owns the fuel until it's sold at the pump to a consumer.

136.2 Dealer-owned model (capital-light): the supplying firm owns the retail brand but contracts with individual dealers who own and operate the branded retail sites. Those dealers acquire fuel, set their own prices, and sell it at the pump to consumers.

137 Z's sites are all company-owned,⁵⁹ whereas the Caltex network is almost entirely dealer-owned. Z understands that other major brands such as Mobil and BP also use a mixed model, choosing whether to own the site or contract with a dealer on a site-by-site basis.

138 The two models are simply two different channels to market for a supplier. In practice, dealer-owned sites are offered substantial assistance from their brand owner, typically including price support, marketing and brand-funded loyalty

⁵⁷ [REDACTED]

⁵⁸ Note: a third option available is an agency model, where a third party owns the retail sites but sells the supplier's fuel directly as an "outlet", with prices set by the supplier. [REDACTED]

⁵⁹ With one exception – Z Onetangi – which is in the process of being moved to a Caltex site to fit with the ownership model being used with the respective brands.

schemes. The majors have moved between the two levels of capital investment depending on relevant factors at the time. For example, historically:

138.1 Shell and Z owned a smaller proportion of the sites operated under their brands.

138.2 Chevron owned a significant portion of the Caltex sites until it moved to a less capital-intensive model and sold those sites to local family-style investors.⁶⁰

139 Dealers therefore operate (and are contracted) very differently to distributors:

139.1 Distributors are genuine wholesale buyers with their own brands and competing business model. Distributors generally choose where and how to operate, including strategic decisions such as the style of offering (e.g. manned or unmanned).

139.2 Dealers are better considered a devolution of their supplier's business model (i.e. with capital investment moved from the supplier to a local owner/operator). The supplier owns the brand and has a strong interest in the way those branded sites are run, offering price and other support. In many cases, the supplier first built or acquired the site before switching it to a dealer-owned operation.

140 The draft report rightly identifies that there are some instances of dealers switching from one wholesale supplier to another.⁶¹ Z expects this to continue, but dealer switching has clearly different implications in the market than distributor switching. Dealers are independent businesses but also component parts of a brand and network.

Dealers have bargaining power

141 Dealers are able to exert substantial pressure on their suppliers, in particular through the ability to negotiate collectively, e.g. Caltex retailers do so successfully via the CT Fuel Retailers Association.

142 [REDACTED]⁶²

143 [REDACTED]

144 [REDACTED]

⁶⁰ See the discussion from paragraph 32, explaining the substantial value therefore contained in those Caltex dealer supply contracts given they were agreed as a quid pro quo for Chevron's sale of local sites.

⁶¹ Draft report, Chapter 6, paragraph 6.123.3.

⁶² [REDACTED]

PART D: REFINING AND COASTAL SHIPPING

145 In this Part, Z sets out its views that:

145.1 The current arrangements for refining and primary distribution are efficient and pro-competitive.

145.2 A merchant refinery (as opposed to the current toll refinery) could capture additional efficiencies.

Refining and primary distribution are efficient and pro-competitive

146 The draft report discusses the nature of various “midstream” arrangements between Z, Mobil and BP and related entities such as the refinery and Coastal Oil Logistics Limited (**COLL**) that cover:⁶³

146.1 refining at Marsden Point;

146.2 transport of refined product through pipelines;

146.3 coastal shipping of refined and imported product for delivery into terminals at ports across New Zealand; and

146.4 the “borrow and loan” of refined product in, and access to, terminals included within the industry shared storage arrangements.

147 The Commission’s key concerns appear to be:

147.1 The majors’ participation in the midstream, and the interrelationship between the different elements of the midstream, may give them a cost advantage in the supply of refined fuel products.⁶⁴

147.2 The borrow and loan arrangements may be deterring necessary investment in terminals, resulting in underinvestment and frequent coordination events to the detriment of consumers.⁶⁵ This is addressed in Part C above.

148 Inherent in the cost advantage concern is the fact that the midstream arrangements are efficient and can be pro-competitive in that they allow access to fuel at multiple locations across New Zealand without requiring unnecessary duplication. The concern raised in the draft report is that these efficiencies are not appropriately shared with other market participants and passed on to retail consumers.

149 Z agrees that it is efficient for New Zealand to effectively have a single midstream supply chain. As well as being highly cost-effective, there is no reason it should not

⁶³ See draft report Chapters 4 and 5.

⁶⁴ Draft report, Chapter 5, paragraphs 5.10 – 5.11.

⁶⁵ Draft report, Chapter 5, paragraph 5.49.

be consistent with competitive retail markets as long as wholesale competition is vibrant.

Locally refined product does not provide a cost advantage over imported product

150 Z does not agree that locally refined product has a cost advantage over imported product. Imports of refined product are a realistic, readily available and competitive alternative to locally refined product. Z notes:

150.1 Each of the three majors supplements its refinery supply with imported refined product, including where imports are more cost effective (as well as where the refinery does not have the capability to produce a certain fuel or is unable to meet demand). For example, in 2019 Z was able to import mogas more cheaply than refine it.

150.2 In fact, import-only models such as Caltex Australia's (Gull) may well at times give rise to cost advantages relative to that of the majors (in times of below average gross refining margins, above average oil prices or a higher than average New Zealand Dollar). It is telling that Gull has competed at the retail level, and has expanded its network, with a business model based largely on importing refined product and without the use of the shared storage arrangements. Gull's model has proven longevity, with it having competed since 1998. [REDACTED], which strongly suggests imports can be cost-effective.

150.3 In many cases a perceived cost advantage of locally refined product over imported product is the result of an importer securing returns outside New Zealand. For example:

- (a) When Caltex Australia acquired Gull it noted substantial benefits of approximately \$5m per annum expected from supply chain integration. These gains will be captured in Singapore, not reflected in New Zealand data.
- (b) TOSL similarly has the ability to supply to New Zealand at marginal extra cost given its strong position in the Pacific.

150.4 Auckland is identified in the draft report as a region where the cost implications of imported compared with refined fuel are particularly relevant. However, as Z has previously identified, while New Zealand refined product is likely to be lowest cost for the refinery participants at Auckland (other than Marsden Point itself), given distribution using the Refinery-to-Auckland-Pipeline (**RAP**), Gull and other independents are demonstrably price competitive in Auckland.⁶⁶ The draft report notes that it is aware that Gull supplies the Auckland and Waikato regions by importing refined fuel into Mount Maunganui and trucking it to sites in those regions, and "appears to have had success in growing market share in Auckland this way".⁶⁷

150.5 As above, the refinery's toll fees are intended to result in the cost of local refining being equivalent to importing refined product. Due to the structure of

⁶⁷ Draft report, Chapter 5, paragraph 5.109.

the processing fee, the relative advantage or disadvantage of the majors to the import-only alternative fluctuates with variations in gross refining margins, oil prices, freight economics and the strength of the New Zealand Dollar.

- 151 As such, in Z's view, access to the refinery does not confer any advantage except possibly access to the RAP (and, in that regard, it is worth reiterating that Gull is highly price competitive in Auckland despite not having access to the RAP).
- 152 Furthermore, Z has a view that over time the use of the refinery under current arrangements is becoming less competitive compared with the import alternative due to the refinery's sub-scale size and the lack of incentive to optimise that arises from its toll basis. For example:
- 152.1 The cost of any short loading of the coastal vessels, or demurrage incurred by less-than-optimal finished product parcels or production constraints is currently borne by COLL rather than the refinery, even though the refinery has a role in controlling this.
- 152.2 When the refinery enters an unplanned shutdown (e.g. due to technical failures in the refining process), the cost of covering the lost supply, which may take the form of distressed purchases, is entirely borne by the fuel suppliers. Again, the refinery is as a technical matter more able to control this.
- 153 Furthermore, any business case for improving refinery performance is compromised in the eyes of the refinery's management because of the margin share that goes to customers. This is exacerbated in an environment where margins are closer to the cap.
- 154 In that context, Z considers that efficiency in the single midstream supply chain would be potentially improved by switching the refinery from a toll to a merchant model.

A merchant refinery could potentially capture additional efficiencies

- 155 As above, currently the refinery operates as a "toll" refinery. The majors select, acquire and arrange delivery of crude to the refinery. The refinery carries out the refining and takes a fee in the form of a "gross refining margin".⁶⁸ Z considers that a merchant refinery model may unlock further cost efficiencies and make them available to all customers.
- 156 Under a merchant refinery model:
- 156.1 The refinery would acquire crude and sell refined product. This would entail the refinery making its own decisions about the refining settings and the crudes to acquire (which two decisions to some extent control the makeup of the outputs).
- 156.2 The refinery could also choose to buy finished product itself if it perceived an advantage in doing so. For example, the refinery may perceive that it could sell more than only refined product volumes, or choose to switch to imports if

⁶⁸ More detail on the current model is available in Z's application to acquire Chevron, the Commission's determination granting clearance, and the Commission's draft report.

the economics supports it or to continue supply during periods of shutdown (as the participants do today, but potentially with more scale efficiencies).

- 156.3 The refinery could also choose to export refined fuel to other markets, as the participants choose to do from time to time currently.
- 156.4 The refinery would continue to own the RAP, and would likely take responsibility for coastal shipping operations (currently carried out by COLL). That is, the refinery would sell refined product from the RAP, at Marsden Point, and at ports around New Zealand.
- 157 Benefits in Z's view would include:
- 157.1 **Optimisation gains in crude acquisition:** the refinery would form a larger buyer and make its own efficient optimisation choices with its whole customer base in mind.
- 157.2 **Shipping efficiency:** by carrying out coastal shipping the refinery could optimise storage at the refinery, production and vessel scheduling. Currently, COLL scheduling naturally trades off the unique needs of each participant.
- 157.3 **Refinery incentives:** in taking 100% of the margin between refined fuel and imported product, the refinery would have maximum incentive to pursue efficiency-enhancing initiatives that are entirely aligned with those of its customers, and compete with imported product.
- 158 Given the wholesale market is competitive (and Z has suggested measures to potentially further enhance competitive conditions), there would be pressure to pass down efficiencies captured by this change.
- 159 A merchant refinery would be able to deliver product directly to customers with storage facilities. Currently, this would allow delivery in New Zealand to the majors, Gull, TOSL and large commercial customers with their own storage capabilities (e.g. Talleys). However, Z cautions that it would not expect any material direct change as far as refinery-level competition is concerned. Z considers that, in practice, Gull, TOSL and any other potential import entrant would not have an incentive to commit to refinery usage given the cost advantages they can access through their import supply chain. Furthermore, a merchant refinery would likely require commitments from Z, BP and Mobil to operate successfully.

A merchant refinery would address other concerns

- 160 The draft report notes several other concerns that would be addressed by moving to a merchant refining model. The Commission:
- 160.1 considers whether the refinery's allocation mechanism (a three-year average) and/or the RAP's capacity allocation (a one-year average) limit the majors' ability to increase supply;⁶⁹ and

⁶⁹ Draft report, Chapter 5, paragraph 5.103.

160.2 raises concerns that information exchange involved in the refining operations and COLL joint venture could facilitate accommodating behaviour between the majors.⁷⁰

161 Z does not agree with these concerns. Regardless, Z's proposal addresses them: a merchant refinery would no longer allocate product to the majors in the same way, and would also require much less information exchange among them.

162 In the event Z's proposal is not adopted, Z is open to reconsider the refinery's allocation mechanism and to ensuring information is exchanged only for the purpose and to the extent reasonably necessary for the refinery's activities to be carried on effectively.

⁷⁰ Draft report, Chapter 5, paragraph 5.117.

PART E: RETAIL PRICE AND PRODUCT OFFER

163 In this Part Z covers:

163.1 The interplay between wholesale and retail competition, a primary focus of Chapter 7 of the draft report.

163.2 The matters directly linked to retail price and product offerings, including discounting and loyalty, premium fuel and price boards, service and product differentiation, and retail competition (from paragraph 168).

Wholesale competition and retail competition are linked

164 The draft report sets out the Commission's preliminary view on the various ways in which wholesale markets have "spill-over effects that weaken retail competition",⁷¹ being:

164.1 the presence of fewer independent retailers; and

164.2 wholesale prices being higher than the Commission considers would be expected in workably competitive markets.

165 Accordingly, the draft report explains that the draft report is focused primarily on wholesale competition rather than retail markets.⁷² Z refers to Parts B and C above, which discuss infrastructure, the supply chain and wholesale supply arrangements (with recommendations aimed at increasing the conditions for wholesale competition).

166 The draft report compares the potential for competition in wholesale and retail markets, with the Commission considering that wholesale competition could be much stronger than retail competition because:⁷³

166.1 wholesale: other than price "there is not necessarily any other significant form of value that importers can compete over"; and

166.2 retail: has more differentiation, no single location for trade, includes different forms of discounting and involves consumers less invested in getting the best price.

167 Z supports a focus on wholesale markets, but retail markets are worthy of independent consideration (see from paragraph 183 below). Z believes that the Commission should recommend that retailers add premium petrol and post-discount prices to price boards (see from paragraph 173 below).

Greater transparency in retail prices for consumers and government could provide reassurance that retail markets are competitive
Discounting and loyalty are pro-competitive

168 The draft report makes various observations on discounting and loyalty in retail fuel markets, noting that it is not currently considering any measures to directly limit

⁷¹ Draft report, Chapter 7, paragraph 7.12.

⁷² Draft report, Chapter 7, paragraph 7.93.

⁷³ Draft report, Chapter 7, paragraphs 7.9 – 7.10.

those activities; “[r]ather, our focus is on promoting wholesale competition so as to increase retail price competition.”⁷⁴

- 169 The draft report observes that discount and loyalty schemes have become increasingly common and note trends in discounts alongside increases in margins. The draft report notes that these schemes can be costly for fuel firms to provide and it is unclear whether they are beneficial to consumers.
- 170 Z reiterates the points it has made previously.⁷⁵ The increased use of loyalty and discount schemes has resulted in substantial price and other benefits to consumers and has not materially increased customer switching costs.⁷⁶
- 171 Z is aware that the ACCC has accepted undertakings with the effect of capping discounts at 4cpl, aimed at assisting independent retailers who in Australia were not connected to major non-fuel firms (in the case of Australia, supermarkets).
- 172 The draft report also discusses:
- 172.1 the relevance of product and service differentiation, and the extent of local competition between each type of retail site. These factors are discussed below from paragraphs 179 and 183 respectively; and
- 172.2 “discount and loyalty programmes may move the focus of consumers away from board prices and make it harder for consumers to compare prices.”⁷⁷ Z understands this concern and in the next section discusses changes that can be made to improve transparency for consumers.

Price boards could provide more transparency

- 173 The Commission invites comment on two considerations relating to price boards:
- 173.1 A concern that prices for premium fuels are not usually advertised on price boards, reducing price transparency for consumers.⁷⁸ The Commission notes various ways that this makes consumers unlikely to seek, or be able to seek, the best price.⁷⁹
- 173.2 The fact that some retailers are introducing new price signs that display post-discount prices (plus terms).⁸⁰ The Commission invites comment on the potential impacts in a change in practice of this nature.
- 174 Z supports both measures – premium and post-discount prices on price boards. Both measures will improve transparency and the comparability of offers for the benefit of consumers.

⁷⁴ Draft report, Chapter 7, paragraph 7.23.

⁷⁵ See Z’s 21 February 2019 response to the Commission’s preliminary issues paper, paragraphs 61 – 67.

⁷⁶ See Z’s data given in that response about the significant volume swings as a result of discount days and Z’s survey data on attitudes to loyalty programmes.

⁷⁷ Draft report, Chapter 7, paragraph 7.21.2.

⁷⁸ Draft report, Chapter 7, paragraph 7.62.

⁷⁹ Draft report, Chapter 7, paragraphs 7.70 – 7.72.

⁸⁰ Draft report, Chapter 7, paragraph 7.39.

- 175 The draft report considers that displaying the price of premium petrol alongside regular petrol on price boards is likely to benefit competition and consumers (outweighing concerns about the possibility of increased scope for coordination).⁸¹ Z supports such an approach and agrees it would aid price comparability and transparency.
- 176 As for price boards displaying post-discount prices, Z agrees that industry-wide uptake of this approach would potentially result in consumers more easily comparing post-discount prices from competing retailers. Z does not consider this approach would mislead consumers who do not have access to the discounts. Price boards with pre- and post-discount prices would clearly indicate that certain simple conditions need to be met to obtain the discount, and retailers have strong incentives to make their discount schemes simple, well-marketed and easily accessible.
- 177 Z encourages the Commission to make recommendations to encourage industry-wide uptake of premium and post-discount prices on price boards. Industry-wide uptake is critical to maximise their potential effectiveness and so as not to impose significant cost on only some market participants.⁸² If all players do not take up the recommendation within a specified period, consideration could be given to mandating it in the oil code that implements terminal gate pricing.

Other transparency concerns about premium fuel

- 178 The draft report also raises a concern that consumers are not well informed about the need to use premium petrol.⁸³ Z supports ensuring consumers understand the benefits and appropriate uses for premium petrol.

Service and product differentiation are pro-competitive

- 179 Z agrees with the view in the draft report that increased product differentiation has led to greater choice for consumers. Product differentiation is a clear result of competition. New Zealand consumers have a wide range of levels of service to choose from and are able to make trade-offs between price and level of service.
- 180 The Commission notes that “[p]roduct differentiation may also be a response to high margins, seeking to keep and retain these margins instead of competing them away through lower prices.”⁸⁴ Z disagrees. All sites constrain each other regardless of their service offering. For example, consumers are willing to move to unmanned offerings if they do not perceive that prices at premium sites justify the upgrade in service. For example, Z has recently opened its first unmanned site.
- 181 The Commission is continuing to consider “the extent to which the firms are differentiating their offer to gain and retain the marginal customer instead of competing on board prices.”⁸⁵ Z notes that in workably competitive markets firms would be expected to compete on service and price. Choosing to offer a better service rather than lowering price is not evidence of a lack of competition (noting that, in reality, service-focused brands clearly do both).

⁸¹ Draft report, Chapter 7, paragraph 7.72.

⁸² For the Commission’s information, Z estimates that it would take approximately [REDACTED] to make these changes to all price boards across the Z and Caltex networks.

⁸³ Draft report, Chapter 7, paragraph 7.62.

⁸⁴ Draft report, Chapter 7, paragraph 7.57.

⁸⁵ Draft report, Chapter 7, paragraph 7.59.

182 The Commission considers also whether consumer choices would look different in a scenario where lower wholesale prices supported lower retail prices, noting “[c]onsumers may prefer fewer services and a lower board price, supported by lower wholesale prices”. In Z’s view consumers are in fact less price sensitive, and more likely to prefer quality service, where prices are generally low. The higher retail fuel prices are, the more people are inclined to switch away from a premium brand in favour of low prices.

There is vigorous and effective retail entry, expansion and competition

183 The draft report covers various other, related points about retail entry, expansion and competition. Specifically, it:

183.1 Notes that the retail fuel market may be vulnerable to accommodating behaviour.⁸⁶

183.2 Addresses barriers/conditions for entry and expansion in retail fuel markets, including via new sites.⁸⁷

183.3 Gives some initial analysis on the growth and competitive impact of new retail sites.⁸⁸

184 The Commission makes no draft recommendation on any of these topics. In Z’s view, the continued growth of independent retail brands and different service offerings prove there are sufficiently low barriers to entry, and drives competition to the benefit of consumers.

185 Recent expansion is substantial and continuing (also discussed at paragraph 113.2). Z points in particular to NPD’s recent significant expansion into Christchurch and Invercargill, and Waitomo and Gull’s expansions into Wellington and the South Island.⁸⁹ Retailers are reacting to the market through differentiation in service offering too. For example Gull and some distributors are increasingly expanding across the full range of service differentiation, from unmanned sites to full-service sites with convenience store offerings (see for example NPD Moorhouse, Rolleston and Queenstown). The benefits of differentiation are discussed from paragraph 179 above.

186 As also covered above, Z responds to all competition and believes that unmanned sites – not just those with similar service levels to Z sites – pose a significant competitive threat. Z has changed its investment strategy in response to competition, committing to cap the level of capital employed in its core fuels business to 2018 levels (also discussed in relation to profitability from paragraph 64) and recently opening its first unmanned site.

⁸⁶ Draft report, Chapter 7, paragraph 7.83.

⁸⁷ See Chapter 4 of the draft report.

⁸⁸ Draft report, Chapter 7, paragraph 7.88.

⁸⁹ For more detail see figure 2 and surrounding commentary of Z’s 21 February 2019 response to the Commission’s preliminary issues paper.

APPENDIX 1: TABLE OF KEY Z SUGGESTIONS

#	Topic	Para	Suggestion
Wholesale competition			
1	Terminal gate pricing	94	Z proposes terminal gate pricing based on the successful Australian model (by way of an industry code implemented by regulation).
2	Distributor terms	131	Z would support a maximum length of distributor contract of 7 years being included in the oil code that implements terminal gate pricing.
3	Distributor terms	134	Z wishes to receive information from distributors it supplies only to the extent necessary for the purposes of the relationship.
Infrastructure and sharing arrangements			
4	Merchant refinery	155	Z proposes that the refinery and users, with the support of the Commission, consider moving to a merchant refinery model, including taking on responsibility for coastal shipping.
5	Refinery allocation and information exchange	162	In the absence of a merchant refining model, Z is willing to reconsider the refinery's allocation mechanism and take steps to ensure information exchanged is the minimum reasonably necessary for the commercial relationships.
Transparency			
6	Premium on price boards	174	Z supports a recommendation (and, if necessary, a requirement in the oil code that implements terminal gate pricing) to display premium petrol prices on price boards.
7	Post-discount price on price boards	174	Z supports a recommendation (and, if necessary, a requirement in the oil code that implements terminal gate pricing) to require post-discount petrol prices to be displayed on price boards.
8	Information about premium petrol	177	Z supports steps to inform consumers about premium petrol.
9	Monitoring	87	Z supports a recommendation that fuel retailers provide to MBIE or Stats NZ data that would allow effective price and margin monitoring.

APPENDIX 2: DATA USED FOR CAPITAL EMPLOYED WATERFALL

See the waterfall at paragraph 27 above.

Capital employed reconciliation

\$m	2015	2016	2017	2018
Z capital employed	1,469	1,533	2,631	2,714
Less: right-of-use (lease) assets	(226)	(226)	(282)	(282)
Less: goodwill	-	-	(158)	(158)
Less: accounts payable related to inventory	(113)	(75)	(172)	(238)
Less: Caltex supply contracts intangible asset	-	-	(407)	(384)
Less: fair value adjustment of terminal assets	(118)	(119)	(149)	(149)
Less: D+R provision asset	(26)	(37)	(50)	(47)
Add: deferred tax	-	-	-	-
Add: other capital employed changes	20	25	12	7
The Commission capital employed	1,006	1,101	1,425	1,463

Earnings reconciliation

\$m	2015	2016	2017	2018
RC NPBT		189	252	284
Add: lease expense		30	31	34
Add: net interest expense		32	56	52
Total RC NPBT plus lease and interest expense		251	340	370
Tax		(70)	(95)	(104)
Z's net operating profit after tax		181	245	267
Add: amortisation of contracts acquired		-	19	23
Add: PPE revaluations		115	5	15
Less: tax-adjusted lease expense		(22)	(22)	(24)
Add: difference between HC and RC NPAT		(72)	61	58
The Commission net operating after tax		202	308	339