

21 February 2019

Keston Ruxton  
Manager, Market Studies  
Commerce Commission  
By email to [marketstudies.submissions@comcom.govt.nz](mailto:marketstudies.submissions@comcom.govt.nz)

Dear Keston

### **Submission on Market Study into the retail fuel sector**

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission's invitation to comment on preliminary issues for the Market Study into the retail fuel sector published 31 January 2019 (the "issues paper").<sup>1</sup>
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.

#### **Q9: Is "return on average capital employed" (ROACE) a reasonable method to assess the reasonableness of prices (the approach taken by the 2017 Fuel Study)?**

3. The short answer is no! There are 2-parts to the long answer:
  - ROACE is not reasonable because it is an incomplete analysis and therefore no conclusions can be on the level of historic economic profits<sup>2</sup>; and
  - The Commission should use its well-established and conceptually robust methodology for calculating historic economic profits for entities regulated under Part 4 of the Commerce Act 2010. That methodology calculates historic economic profits by translating accounting information into economic profit accounts. We refer to such accounts as Economic Value Added (EVA)<sup>3</sup> accounts because a key difference between accounting financial statements and EVA is the opportunity cost of capital is included in the latter.

The opportunity cost of capital is estimated using the Weighted Average Cost of Capital (WACC). Transforming financial statements to EVA also involves applying a well-established framework using company specific information or a reasonable estimate if data is unavailable. There are nuances in interpreting the transformation rules that are non-trivial to implement. Once applied correctly the results are

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<sup>1</sup> URL [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0027/119187/Retail-fuel-market-study-Preliminary-issues-paper-31-January-2019.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0027/119187/Retail-fuel-market-study-Preliminary-issues-paper-31-January-2019.pdf) at <https://comcom.govt.nz/about-us/our-role/competition-studies/market-study-into-retail-fuel>

<sup>2</sup> An example of the complexity is that ROACE used in the MBIE 2017 analysis was before tax whereas the Commission's EVA approach calculates economic profit after-tax. It would be a coincidence rather than a reflection that annual tax costs were a simple value to net off, if pre-tax ROACE results for every business in the market study were a simple multiple of actual historic post-tax profits.

<sup>3</sup> The EVA framework is the same economic profit accounts. Other similar terminology is used as a descriptor.

unambiguous as they are based on audited accounts and any uncertainty on the opportunity cost of capital or opening asset values in the time series of data considered can be tested with sensitivity analysis.

4. A similar question arose in the Electricity Price Review issues paper of 11 September 2018 where a partial analysis was made to estimate if excess economic profits by vertically integrated electricity suppliers had been earned in the past. MEUG's submitted that analysis was incomplete and recommended the Electricity Price Review panel use the Commission's Part 4 methodology.<sup>4</sup>
5. The 2017 Fuel Study noted "In addition, due to the issues with comparability, it has not been possible to report a market view of ROAC." (section 4.2, p35). Instead the Fuel Study considered the ROACE of those companies it had some information for and instead concentrated on an analysis of margins across the whole sector. MEUG does not consider margin analysis as a reliable alternative to the Commerce Act Part 4 methodology for calculating historic economic profits.
6. If the 2017 Fuel Study had conducted a sector wide ROACE analysis, we would still have been uncomfortable in assuming the results of a ROACE analysis would align with an analysis of historic economic profits using the Commerce Act Part 4 methodology.

Yours sincerely



Ralph Matthes  
Executive Director

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<sup>4</sup> MEUG submission 23 October 2018, URL <https://www.mbie.govt.nz/dmsdocument/4192-major-electricity-users-group-electricity-price-review-first-report-submission> , response to question 18, p13.