

11 October 2019

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Dear Keston

### **Retail fuel market study – post conference submission on draft report**

1. This is a submission by the Major Electricity Users' Group (MEUG) to the Commerce Commission following the conference held 24<sup>th</sup> and 25<sup>th</sup> September on the draft report "Market study into the retail fuel sector" published 20<sup>th</sup> August 2019. These are referred to as the "day 1" and "day 2" conferences respectively and the "draft report."<sup>1,2</sup>
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions. This is MEUG's third submission on this important precedent setting inaugural market study.<sup>3</sup>

### **Estimating excess profits**

3. At the heart of a market study and whether regulatory interventions are warranted is the question of whether sustained excess economic profits have been earned from suppliers in the retail fuel sector. Sometimes we refer to this as "excess profits." Care is needed in using this abbreviated format to remember "profits" are estimated in economic not accounting terms and must be sustained over time not transitory.
4. Dr Small in opening the conference session on profitability stated:<sup>4</sup>

"I think we've said repeatedly in the draft report and prior to that that profitability will always be an imperfect indicator of the strength of competition, and similarly I think we'd all agree that any particular, well, measures of profitability generally are themselves subject to error and imperfect in various ways."

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<sup>1</sup> Refer [Day 1 transcript](#) and day 2 at [Day 2 transcript](#)

<sup>2</sup> Draft report at [Retail-fuel-market-study-Draft-report-20-August-2019](#)

<sup>3</sup> Refer [MEUG to CC, Market Studies Guidelines, 31-Jan-19](#) and [MEUG to CC Preliminary-issues-paper-21-February-2019](#).

<sup>4</sup> Day 1, p57, lines 18 to 21.

5. We agree with Dr Small that “measures of profitability generally are themselves subject to error and imperfect in various ways.” The challenge therefore is to choose the best measure of profitability for the purpose intended.
6. The retail fuel market study used several measures to assess excess profits. Several parties agreed with the Commission that having a range of measures, such as ROACE and margin analysis, were appropriate because no one measure is going to be perfect.<sup>5</sup> In other words, because of the specific shortcomings of each measure chosen for the market study, the Commission and most submitters perceived a benefit of using multiple measures to see if using a range of measures clear evidence of sustained excess economic profits would emerge.
7. The draft report and conference highlighted the shortcomings of the measures chosen. The primary shortcomings of the measures analysed in the draft report are all the same, i.e. the complexity and uncertainty on the correct treatment of and source of data for parameters such as the value of assets and depreciation. These are well known shortcomings of ROACE and the same emerged in the conference discussion on Tobin’s Q. Another key weakness of Tobin’s Q for MEUG is it is a poor reliability of a measure over time to assess sustained patterns of excess profits.

#### **Economic Value Added proved to be the best measure of excess profits**

8. A highlight of the conference was the evidence and written submissions to date by Garth Ireland of Ireland, Wallace & Associates on the use of Economic Value Added (EVA) for measuring excess profits.<sup>6</sup> Compared to the measures the market study has focused on to date, EVA uses publicly available audited accounting information and techniques used by the Commission to transform into economic profits.
9. Mr Ireland, at his own expense, has been able to quickly update EVA results as new recent audited accounting information has been published contrary to the view stated by Dr Small:<sup>7</sup>

“I was particularly taken by your approach, it was very interesting indeed, and obviously this is not a Part 4 analysis and we just don't have the resource to conduct that level of exhaustive inquiry in this context, but nevertheless I think I would agree, it's useful to think about that as a concept in this context”.
10. Surprisingly other conference participants had not considered EVA even though Mr Ireland and MEUG separately in earlier submissions had noted the benefits of EVA relative to other measures of excess profits.<sup>8</sup> On reflection the conference agenda could have explicitly set time aside to discuss EVA so that participants were better prepared, and the pros and cons of EVA as a methodology and results published by Mr Ireland were fairly and thoroughly considered when all experts were present.

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<sup>5</sup> e.g. refer day 1 transcript, p60, line 8 “MS FISH: Sure, I am happy for there to be a range of measures.” Refer also p59 lines 8 to 32, quoting Dr Small and Mr Jones.

<sup>6</sup> Day 1, p60-61, p62, p77, p98.

<sup>7</sup> Day 1, p61, lines 7 to 10.

<sup>8</sup> Day 1, p61, lines 22 to 23, “MS FISH have to admit I haven't read Garth's submission yet but I'm happy to provide some written comments on it within the next two weeks if that's helpful.”

11. MEUG suggests that the market study approach of starting with a range of measures of profitability on the assumption no single measure was best for an initial screening was a costly mistake. If EVA had been undertaken at the outset, then:
  - a) If there had been no evidence of excess profits earned to date then the market study could have been concluded, and the Minister informed accordingly.<sup>9</sup>
  - b) If it had not been clear if excess profits in aggregate have been earned to date, then targeted analysis could have been undertaken to firm up a yes or no view on profiteering. This more targeted analysis step would be designed based on the findings of the initial EVA analysis and include targeted information requests from companies.
  - c) If an EVA analysis clearly showed sustained excess economic profits earned to date in aggregate by the sector, then the market study should focus on understanding the barrier(s) to competition and whether the benefits of feasible interventions exceed the costs.
12. An example of such a three-step market monitoring process that progressively becomes more intrusive in terms of information from affected parties is the Electricity Authority's enquiry, review and investigation stages for monitoring anomalies, complaints or requests by the Minister "to look into an issue" in the electricity industry.<sup>10</sup>
13. Compared to using EVA as an initial screening tool, the approach in the market study of using a wide range of measures from the outset has:
  - a) Added compliance costs to affected companies as they respond to less targeted information requests compared to those that an EVA analysis would have required;
  - b) Added implementation costs to the Commission in terms of having to analyse and weigh observations from the wide range of different measures.
  - c) A lack of clarity to the Commission and affected parties on how to interpret the disparate results of the wide range of measures for profitability. This problem has been compounded by lack of transparency or delay in the Commission publishing some its analysis.
14. It's not too late to compliment the analysis to date with an aggregate sector EVA analysis. The benefit of EVA is it is conceptually robust and transparent. Without EVA the market study results will depend on a range of measures of profitability that have similar shortcomings and therefore the results will be unclear or even misleading.

Yours sincerely



Ralph Matthes  
Executive Director

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<sup>9</sup> If a market study found using EVA analysis no evidence of excess profits to date; however, the market study continued to consider other measures of the strength of competition then for MEUG that would weaken the case for interventions.

<sup>10</sup> <https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/our-three-stage-process/>