

Commerce Commission  
PO Box 2351  
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7 May 2019

Attention Keston Ruxton (by email: Keston.Ruxton@comcom.govt.nz)

**Re: Comments on working papers**

Dear Keston

Thank you for the opportunity to provide comment on the two 18 April 2019 Working Papers released by the Commerce Commission - the **“Working Paper – Focus areas”** (“the **Focus Paper**” or **“FP”**) and the **“Working paper on assessing profitability”** (“the **Profitability Paper**” or **“PP”**) (together the **“April Working Papers”**)

**Introduction**

The April Working Papers suggest that a number of issues of concern to the MTA are being picked up in the Fuel Market Study. That is positive. But there are some gaps, and points which we are concerned might get “lost” if they are not specifically in focus in the study.

**The Focus Paper:**

First and most importantly, although the Focus Paper covers some important ground as to whether much of the retail and independent wholesale market is tied down in long term exclusive supply arrangements from the majors<sup>1</sup>, MTA seeks to invite the Study to focus (more) on:

- whether and to what extent independent retailers and independent wholesalers are effectively and in practical terms contractually bound, directly or indirectly, to exclusive long-term supply arrangements with one of the majors;
- how much of the market this involves, including what proportion of the market is ultimately served by entities that are (directly or indirectly) locked into that sort of long term exclusive contractual arrangement under a major, or a vertically integrated major, as opposed to other entities; and
- what broader effect those contractual constraints (alongside the vertically integrated arrangements) have on competition in this market, including:
  - whether and if so to what extent such contracts mean such participants are not able to compete (apart from within whatever margin they secure from their sole supplier) or engage with a liquid market to obtain competitive prices (particularly for

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<sup>1</sup> The MTA is pleased to see that the Focus Paper covers several important issues arising from this point, in its inquiry into contract terms as factor that impacts on competitive outcomes in retail fuel markets (para 18.1, the FP), including focussing on:

- whether “the terms and conditions in wholesale supply agreements affect new entry and expansion from importers or resellers, or competition between the major firms” (para 34.3 Focus Paper);
- the structural conditions for entry and expansion, as that impacts on barriers to independent sources/supply chain and new entrants/expanding existing participants (paras 36-38, Focus Paper);
- whether the terms and conditions agreed between major fuel firms and their wholesale or retail customers affect new entry/expansion by importers/resellers and competition between major firms at wholesale level (para 42-46), in various respects.

- wholesale “raw” fuel products) - except occasionally as they approach the end of their contract terms; and
- whether this has the effect that the wholesale price isn’t being cleared, or set, on transfer but only occasionally when long term contracts come up for renewal.

Secondly, whether (as well as clouding the issues for consumers making choices) fuel/loyalty/discount cards also raise issues as to the extent to which those arrangements are obscuring where, within the supply chain, margins are being accrued (including whether retailers or supplier wholesalers/distributors are bearing any associated discounts), and/or impacting on or providing a barrier to competition within the fuel market itself.

### **The Profitability Paper:**

First, MTA supports the use of profitability as one indicator for the level of competition for the Fuel Market Study (FMS). The MTA maintains that, particularly as there are concerns as to the extent to which data relevant to that assessment will be available, that should not deflect attention away from other important indicators identified in the FP, and the factors identified by MTA<sup>2</sup>.

Secondly, MTA endorses the observations in the PP that *“evidence that the level of competition is around normal or competitive levels does not necessarily mean that there are no factors adversely affecting competition in the market”* (para 43, PP). It notes, by way of an example, that a reasonable level of profitability can be associated with adverse outcomes for consumers such as where a vertically-integrated firm achieves reasonable profitability in the retail market, but excessive profitability in the wholesale market, thereby producing cost inefficiency for consumers. It also reiterates the first point made above regarding the FP. The MTA maintains that it is important that the FMS drills into profitability within the vertically integrated firms, and within different elements of those firms.

Thirdly, in that context, it is accepted that there are many methods available to calculate profitability.

- Some of the factors identified already will be relevant to the selection of a method to measure profitability:
  - Exclusive long-term supply contracts of independent retailers, and other independent wholesalers, tied in directly or indirectly to the majors
  - Reduced and less than transparent sale margins due to fuel/loyalty/discount cards
  - Vertical integration of majors which could involve different cost structures for their retailers compared with independent retailers or which could involve significant profits being taken earlier in the supply chain.
- The MTA maintains that a gross margin method, simply calculated, will not account for many of the areas impacting on MTA’s independent retailer/wholesaler members.
- MTA accepts that a return on average capital employed method (ROACE) is likely to some extent to be a better fit, provided that detailed data (including data for calculating net operating profit) is available with respect to the relevant market trading – which the Commission recognises may be problematic.

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<sup>2</sup> In summary form, MTA identified 5 factors: (i) vertical integration of majors across the wholesale and retail markets; (ii) exclusive long term supply contracts of independent retailers and independent wholesalers; (iii) reduced retail margins due to fuel/loyalty/discount cards; (iv) an illiquid wholesale fuel market; and (v) absence of direct regulatory oversight.

- But MTA also has concerns that a ROACE assessment is unlikely to be a good fit or offer a useful measure in relation to smaller owner operated low capitalised businesses (where owner-operator labour may be a significant part of the investment). It notes that, according to Fig 8 of the NZIER Study<sup>3</sup> nearly two thirds of all retail sites can identify as independent, so it is likely many will be in the owner operator category.

Fourthly, the PP (para 94, PP) reports that the FMS approach to calculating profitability proposes to place greater weight on the results of firms which are locally owned, and on those whose activities are most focused on the retail fuel markets. Potentially this may shift the focus away from the class of vertically integrated firms, and arrangements higher in the supply chain, which may well be achieving higher profitability. Again, the MTA maintains those firms and that part of the supply chain should be in focus.

Finally, given the wide range of business operating models within the retail fuel market combined with the concerns raised by the Commerce Commission over timeframes and limitations of its proposed analysis, we suggest that a focus on understanding the various business operating models and comparing profitability across these models might be useful. For example, understanding how a company owned-company operated site can compete within a geographical area where other retailer's losses may be supported by a national pricing strategy (whereas an independent site must absorb its own losses) may be revealing in terms of how this market is operating.

Should you require any clarification on these comments, please do not hesitate to get in touch.

Yours sincerely



Ian Baggott

**Sector Manager-Energy & Environment**

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<sup>3</sup> The New Zealand Institute of Economic Research "New Zealand fuel market financial performance study", "A report for the Ministry of Business, Innovation, and Employment", 29 May 2017 – as defined in MTA's 22 February 2019 Submission to the FMS.

