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BP New Zealand feedback on Working paper - Focus Areas

1. Introduction and summary

- 1.1 BP New Zealand (BPNZ) appreciates the opportunity to respond to the Commission's "Working paper - Focus areas" paper of 18 April 2019 (the **Focus Paper**). The Focus Paper describes the focus areas for the Retail Fuel Market Study (the **Study**) proposed by the NZCC. BPNZ sets out below its considerations on these focus areas. It is providing feedback separately on the Commission's "Working paper - Assessing profitability" (**Profitability Paper**).
- 1.2 In summary, BPNZ broadly agrees that the Commission is focussing on the areas relevant to its terms of reference.
- 1.3 However, the Focus Paper does not provide detail on the Commission's proposed methodology for assessing the various areas. BPNZ considers that unless all parties to the study are fully appraised of the Commission's methodology and given an opportunity to comment, there is a risk that the Commission's conclusions may lack rigour. BPNZ considers that the draft report stage is too late a stage in the process to obtain parties' views on the methodology it intends to use for important aspects of its analysis. Setting out those methodologies at the draft report stage will not provide the Commission with adequate time to properly consider parties' views and refine its approach if necessary. The draft report should primarily be aimed at testing conclusions that the Commission has drawn from applying its methodologies to the data. The Commission should release more detailed working papers on relevant aspects of its review ahead of its draft report.
- 1.4 In addition, BPNZ considers that the Commission should place more emphasis on the dynamic nature of competition in the market, including innovations on product offerings at existing outlets and the substantial new entry and expansion that has recently occurred and continues to occur. The terms of reference for the Commission's review require it to assess whether wholesale and retail price and service offerings of petrol and diesel are consistent with those expected in "workably competitive markets". The developments in retail fuel markets over time are entirely consistent with the operation of, and outcomes from, workably competitive markets.
- 1.5 The leading New Zealand case assessing what is meant by "workably competitive markets" is the High Court's decision in *Wellington International Airport*.¹ Key excerpts from this judgement follow (with emphasis added).

¹ *Wellington International Airport Ltd and others v Commerce Commission* [2013] NZHC 3289 (11 December 2013).

[18] In our view, what matters is that **workably competitive markets have a tendency towards generating certain outcomes**. These outcomes include the earning by firms of normal rates of return, and the existence of prices that reflect such normal rates of return, after covering the firms' efficient costs.

[19] Of course, firms may earn higher than normal rates of return for extended periods. On the other hand, firms may earn rates of return less than they expected and less than commensurate with the risks faced by their owners when they made their investments. They may even make losses for extended periods. **Prices in workably competitive markets may never exactly reflect efficient costs, including a normal rate of return.**

[20] But the *tendencies* in workably competitive markets are towards such returns and prices. **By themselves, these tendencies will also lead towards incentives for efficient investment (investment that is reasonably expected to earn at least a normal rate of return) and innovation.** That is to say, the prices that tend to be generated in workably competitive markets will provide incentives for efficient investment and for innovation.

[21] **The same tendencies towards prices based on efficient costs and reasonable rates of return will lead also to improved efficiency, provision of services reflecting consumer demands, sharing of the benefits of efficiency gains with consumers, and limited ability to extract excessive profits.**

[22] In short, the tendencies in workably competitive markets will be towards the outcomes produced in strongly competitive markets. **The process of rivalry is what creates incentives for efficient investment, for innovation, and for improved efficiency.** The process of rivalry prevents the keeping of all the gains of improved efficiency from consumers, and similarly limits the ability to extract excessive profits.

- 1.6 The Court's description of workably competitive markets describes very accurately the retail fuel markets in New Zealand. Conditions in retail fuel markets have resulted in incentives for efficient investment and market participants have responded to these incentives (e.g. both integrated suppliers and new entrants investing in terminal capacity and a range of providers investing in new retail sites). Market conditions have also resulted in substantial innovation and provision of services reflecting consumer demands (such as new apps and "fast lane" services, continued development of loyalty reward offers and improved convenience offers for customers). All the while, market participants continue to strive to find efficiencies in their supply chains. Accordingly, it is critical that the Commission assesses the dynamic nature of the market, including the ways in which market participants have responded to incentives created by the market, as this is delivering the outcomes expected from a workably competitive market.
- 1.7 BPNZ expands on these issues below and is happy to provide more detail to the Commission on any of the points raised.

2. Competitive outcomes

Focus areas for competitive outcomes - general comment

- 2.1 The Focus Paper identifies the three main areas on which the NZCC intends to focus its analysis of competitive outcomes. These are:
- (a) profitability of firms in New Zealand retail fuel markets;
 - (b) regional variations in prices and margins; and
 - (c) pass-through of changes in input costs to retail prices.
- 2.2 The Commission has indicated that other areas, "such as quality and innovation of product and service" are not primary focus areas (although it notes it will have regard to these when reaching its conclusions). However, BPNZ considers that fuel suppliers' endeavours to

differentiate themselves on the basis of service/product quality, technology, customer experience and other factors are demonstrative of competition in action and should be central to the Commission's review.

- 2.3 Indeed, the Commission frequently assesses the importance of non-price factors as an indicator of competition and this has been endorsed by the courts. For example, in the Commission's decision in *Woolworths* it states:²

[t]his process of rivalry, where it is effective, impels firms to operate efficiently, by: achieving the lowest level of costs and prices consistent with desired quality levels; developing new products or services; and exploiting particular strengths, skills or other advantages to meet customer needs more effectively than competitors.

- 2.4 The High Court and Court of Appeal³ endorsed this approach, with the High Court finding that "*[aside from price,] other indicia of rivalry also need to be considered. Prices are only one dimension of competition and are only one factor that consumers take into account when purchasing goods and services.*"⁴
- 2.5 While BPNZ acknowledges that competitive pricing is very important to consumers, the NZCC should not ascribe any less weight to other competitive factors as demonstrating the degree of overall competition in retail fuel markets. BPNZ sees its investments in customer experience to be a critical factor enabling it to compete against the range of competitors in retail fuel in New Zealand. The innovations in retail fuel markets in recent years have resulted in substantial benefits to consumers. BPNZ set out further detail in its response to the Commission's preliminary issues paper⁵ (**Preliminary Issues Response**) on some of the innovations in its retail offering and those of competitors. Competition by way of quality improvements and innovation is consistent with a workably competitive market and should not be underestimated when assessing the competitiveness of retail fuel markets.

Analysis of competitive outcomes over time

- 2.6 When setting out how it intends to assess competitive outcomes, the Commission does not provide detail on how it will assess changes in these outcomes over time. Rather, the Commission appears to be focussing primarily on the outcomes it is currently observing in retail fuel markets. As set out in BPNZ's Preliminary Issues Response, it is critical when assessing the level of competition in retail fuel markets to assess both longer term and current trends. The following trends are consistent with a highly competitive market:
- (a) a high level of investment in the industry;
 - (b) substantial increases in the number of retail fuel outlets;
 - (c) strong and increasing price competition;
 - (d) the expansion of existing competitors (e.g. the announced expansion of both Waitomo⁶ and Gull⁷ into the South Island and Wellington, and the new fuel terminal being developed in Timaru⁸);
 - (e) continued and increasing use of technology / innovation to change established operating models;
 - (f) a high potential for market disruption (e.g. transition to low carbon economy).

² *Woolworths Ltd and the Warehouse Group Ltd* [2007] NZCC 606 and 607 at [190].

³ *Commerce Commission v Woolworths* [2008] NZCA 276, [2009] NZCCLR 12 at [190 - 205].

⁴ *Woolworths Ltd v Commerce Commission (No 2)* [2008] NZCCLR 10 (HC) at [156].

⁵ Market study into the retail fuel sector - BP New Zealand comment on preliminary issues, 21 February 2019.

⁶ <http://www.waitomogroup.co.nz/fuel-stop-finder/>

⁷ https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=12220200

⁸ <https://www.stuff.co.nz/timaru-herald/news/111017455/timaru-ports-tank-farm-development-on-track-for-mid2020>

- 2.7 The Commission's study must fully incorporate an assessment of these trends into its assessment of the degree of competitiveness in the market and how that will continue to develop in future. Further details of these trends (other than the new announcements of further competitor expansion in the South Island and Wellington) are set out in BP's Preliminary Issues Response.

Commission's assessment of its focus areas

- 2.8 BPNZ welcomes the Commission's release of its Profitability Paper. This is an important aspect of the Commission's review and BPNZ appreciates the opportunity to comment on the Commission's methodology.
- 2.9 However, BPNZ considers it equally important that it, and other interested parties, have an opportunity to consider and comment on the Commission's proposed methodology for analysing regional variations in prices/margins and pass-through of changes in input costs to retail prices. For example, the Commission has not set out:
- (a) how it will assess margins across regions including how it will assess input costs for vertically integrated retailers;
 - (b) how it proposes to assess the "pass through rate" (e.g. which data it will use for retail prices, input costs etc.); and
 - (c) how it will use this analysis to draw inferences or conclusions regarding the effectiveness of competition between fuel retailers.
- 2.10 Absent a clear methodology for its quantitative analyses being established up front, which can be tested by interested parties, there is a risk that the draft report will be based on analysis that is not robust. Accordingly, BPNZ submits that the Commission should release working papers in relation to all of its proposed quantitative analysis exercises in advance of issuing the draft report. Taking asymmetric pass-through of input costs as an example, although there may be perceptions of asymmetric responses of retail prices to input prices, BPNZ urges the Commission to assess such perceptions with empirical analysis before reaching any conclusion on whether asymmetry exists, and to explain its proposed methodology for assessing whether asymmetry exists in an advance working paper prior to its draft report. BPNZ notes that competition authorities in other countries have not found clear evidence to support such perceptions when they have analysed the data available to them (see for example the UK OFT's study in 2013).⁹

3. Factors affecting competition

Focus areas for competitive outcomes - general comment

- 3.1 Overall, BPNZ considers that the focus areas for competitive outcomes are appropriate. Once again, it is important when assessing these factors that the Commission takes into account the dynamic nature of the market. In particular, substantial weight must be placed on the new entry and expansion that has been spurred in recent times by perceived profitability of retail fuel markets, but also the market exit that occurred prior to this as a result of very low profitability in retail fuel markets (see BPNZ's Preliminary Issues Response at pages 1 and 2).
- 3.2 Importantly, such exit and subsequent entry and expansion have taken place with relevant horizontal and vertical arrangements in place. This is strong evidence that these arrangements are not limiting competitive outcomes.

⁹ OFT (The Office of Fair Trading) (2003), "UK Petrol and Diesel Sector, An OFT Call for information", January 2013.

Structural conditions for entry and expansion

- 3.3 BPNZ considers it appropriate for the NZCC to consider structural conditions for entry and expansion. The substantial recent and ongoing entry and expansion in retail fuel markets provides evidence that entry and expansion barriers are low. As set out in BPNZ's Preliminary Issues Response, the total number of retail sites in New Zealand increased from a low of 1176 in 2012 to 1319 in 2018, an increase of 143 new sites or 12% over 6 years. Subsequently, in early April this year Gull has announced its expansion into the South Island and Wellington, while Waitomo is also expanding into those areas (detailed at 3.7 below).

Infrastructure sharing (horizontal) relationships

- 3.4 BPNZ considers that the joint horizontal agreements in the fuel supply chain referred to by the NZCC drive a competitive market.
- 3.5 Importing, refining and distribution aspects of the supply chain have been established in a way that efficiently delivers retail fuel to market, while facilitating competition between suppliers and providing incentives to invest in distribution and retail infrastructure. It is difficult to conceive of a more efficient arrangement under current market conditions, and forcing changes could produce unintended consequences (such as higher supply costs under an arrangement lacking the efficiency benefits from co-loading).

Wholesale (vertical) supply arrangements

- 3.6 The Focus Paper raises the concern that retail-only suppliers may have limited ability to compete effectively with majors due to their supply arrangements. It also considers whether retailers have limited ability to switch.
- 3.7 However, such conclusions would be wholly contradictory to the actual behaviour of retail-only firms in retail fuel markets. These firms have grown substantially, accounting for a very high proportion of overall market growth. NPD, for example, has increased its number of retail outlets in the South Island from 49 to 63 (an increase of 29%) since the beginning of 2017. Waitomo has plans to begin its South Island expansion in Christchurch,¹⁰ following its recent opening in Wellington.¹¹ It has added 8 outlets (an increase of 15%) since the beginning of 2017. This growth is apparent in rural and urban centres across New Zealand. The evidence demonstrates that wholesale supply arrangements are serving retail only competitors (and competition) very well.

Consumer behaviour and pricing strategies

- 3.8 The Commission is considering the competition impact of increased discounting, loyalty programmes and bundling with other products. BPNZ considers that these are all indicative of a highly competitive market. Loyalty programmes are a key element of competition and bring substantial benefits to customers. Loyalty programmes are widely used by customers and there are no costs of switching between programmes. Indeed, a majority of BPNZ's customers use multiple fuel retailers, despite BPNZ's strong loyalty offer.
- 3.9 Loyalty programmes and discounting come at a significant cost to suppliers but at no cost to consumers, as the benefits do not require total loyalty (just registration in BP's case, which is free). They are evidence of the lengths market participants will go to differentiate their products and win customers and a feature of a highly competitive market. Furthermore, loyalty programmes are certainly not unique to fuel markets, but are common across a wide range of markets with a range of different market structures and characteristics.

¹⁰ <https://www.stuff.co.nz/business/109303385/waitomos-cheaper-petrol-reaches-south-island-after-wellington-move>

¹¹ <https://www.stuff.co.nz/business/112686891/waitomos-first-wellington-petrol-station-opening>

3.10 Again, it would be beneficial for the Commission to publish more detail on its proposed methodology for assessing the competitive impact of loyalty programs and discounts.

Coordinated effects

3.11 BPNZ considers that there is no evidence of coordinated effects in retail fuel markets and numerous factors count against such a finding. These factors were discussed at length by the majority in the *Z/Chevron* determination¹² and they are even more applicable in today's market. The key factors are:

- (a) the presence of a large number of competitors nationally. The Commission noted in *Z/Chevron* that "coordination is unlikely with three players and non-existent with four players".¹³ Gull in particular was identified in 2016 as "the type of vigorous competitor that makes coordination very difficult"¹⁴. The competitive constraint imposed by Gull is likely to be strengthened with its proposed expansion into Wellington and the South Island.¹⁵ While in the Focus Paper the Commission queries the degree of competitive constraint imposed by competition from retail-only fuel suppliers (para 51.1), as set out above, these suppliers are a major (and expanding) competitive force. These competitors accordingly continue to provide a strong counter to any attempt to coordinate pricing;
- (b) the parties compete strongly on price but also differentiate their product through quality (including proprietary additives, 98 Octane products etc.), service quality (from full forecourt concierge services down to unmanned self-service pumps), and convenience offerings, amongst a range of other factors. Such a degree of competitive differentiation is not conducive to tacit coordination, as competitors would find it difficult to reach any implicit agreement nuanced enough to reflect these differences in service;¹⁶
- (c) furthermore, the innovations that have taken place in the market are evidence themselves of a lack of coordination. As noted by the majority: "while we do not, and do not expect to see, much innovation in the sense of new products being launched, we do observe that there has been innovation in service and pricing offers in recent years. This type of conduct would make it more difficult to achieve a coordinated outcome, but, perhaps more relevantly, is not conduct that we consider is consistent with firms acting in a coordinated way";¹⁷
- (d) the differences in retail costs faced by each competitor. While the major firms share many wholesale costs, the high degree of differentiation on product and service quality set out above flows through to significant retail cost variations for all fuel providers. Furthermore, competitors such as Gull have a significantly different operating cost base¹⁸ which would make achieving a coordinated outcome very difficult. The additional presence of independent retailers further complicates the ability of firms to reach a coordinated outcome because coordination in each local market would require their participation.¹⁹

3.12 Accordingly, BPNZ considers that coordinated effects are not a material issue in retail fuel markets.

¹² *Z Energy and Chevron New Zealand* [2016] NZCC 10.

¹³ At [197].

¹⁴ At [202].

¹⁵ <https://www.stuff.co.nz/business/industries/111865313/gull-prepares-to-open-first-south-island-station-in-maheno-with-five-more-planned>

¹⁶ At [172].

¹⁷ At [194].

¹⁸ At [145].

¹⁹ At [186].