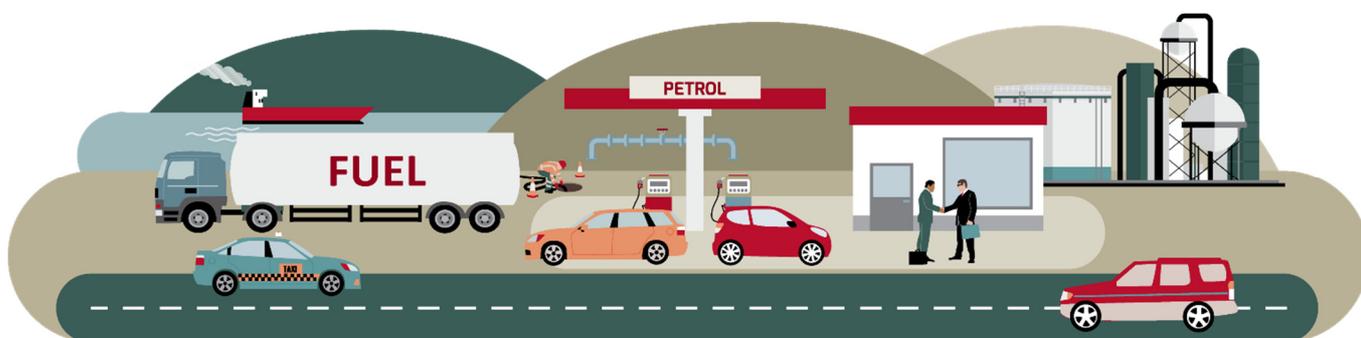


# Market study into the retail fuel sector

## Final report – Executive summary

**Date of publication:** 5 December 2019



## Executive summary

### Purpose of this paper

- X1 This report sets out the findings of our study into New Zealand's retail fuel markets. The study considers factors that may affect competition for the supply of retail petrol and diesel used for land transport in New Zealand, whether competition to supply retail petrol and diesel is functioning well for consumers, and if not, how it could be improved.
- X2 Fuel is an essential purchase for many New Zealanders and money spent on petrol and diesel can be a significant proportion of household and company bills.
- X3 Roughly 3.2 billion litres of petrol and 3.6 billion litres of diesel are consumed annually in New Zealand. Fuel purchased at service stations, unmanned sites and truck stops accounts for about 98% of the petrol and 73% of the diesel consumed, at an annual cost of more than \$10 billion.
- X4 Petrol and diesel prices have attracted considerable public attention, with concerns raised about whether New Zealanders are getting a fair deal at the pump. Public interest in fuel prices prompted the Minister of Commerce and Consumer Affairs to ask us to undertake this study.
- X5 The study looks at a range of outcomes that we would expect to see in a market that is working well for consumers over the long term. These include the choices available to consumers, the price and quality of the fuel and services on offer, as well as levels of investment, innovation and profitability in the sector.
- X6 New Zealand consumers pay relatively high prices for petrol and diesel. Our pre-tax fuel prices are currently amongst the highest in the OECD and have trended upward and departed from other OECD countries since about 2010.
- X7 The price consumers pay at the pump is affected by a range of factors, including New Zealand being a lightly populated country located a long way from the major global sources of imported crude oil and refined fuel, the global crude oil price, the level of the New Zealand dollar, taxes and changes in fuel company operating and distribution costs.
- X8 Whether consumers consider fuel prices to be high or low does not necessarily mean the market is, or is not, workably competitive. When it comes to price and profitability, an important outcome in a workably competitive fuel market is that both will tend to reflect normal rates of return over time, after covering efficient supply costs.

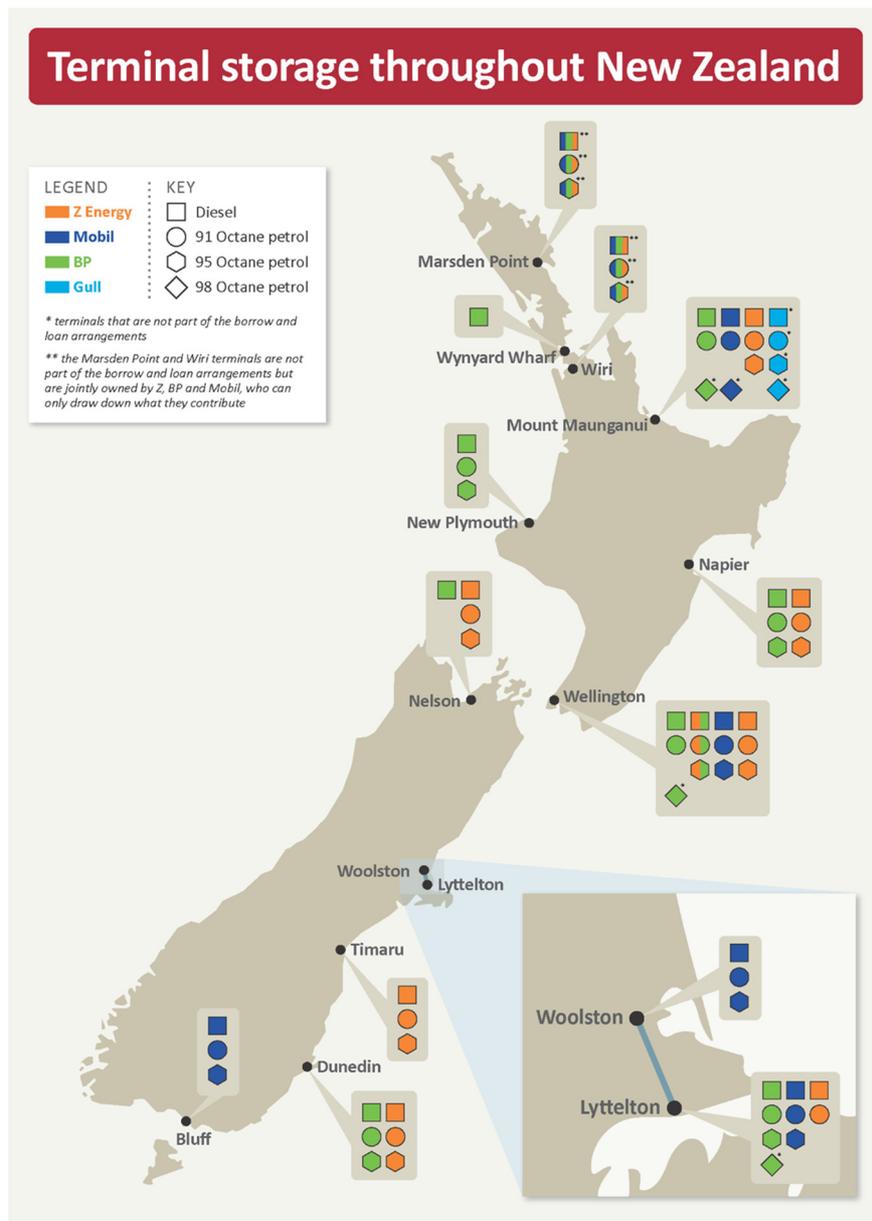
- X9 In the study we are not concerned with short-term profits, which can be high for many reasons, including strong performance. They are not necessarily indicative of competition concerns. Rather, we are focused on longer term profitability and whether this is persistently high, as that could suggest prices are 'too high' and competition is not working as well as it could.
- X10 As a result of our study, we consider that many fuel companies are achieving a level of profitability in New Zealand that is persistently higher than what we estimate a reasonable return would be in a workably competitive market.
- X11 For consumers, this means they are currently paying higher pump prices for petrol and diesel than could be expected in a competitive market.
- X12 We have identified several factors we consider are hindering competition and contributing to these high returns. In our view, the core problem is that an active wholesale market does not exist in New Zealand. This is weakening price competition in the retail market.
- X13 In addition, there are features of retail markets that limit the intensity of price competition. These markets are geographically dispersed, purchase sizes are small, service levels are differentiated and discount and loyalty programmes draw consumer attention away from board prices. Retail markets are also vulnerable to leader-follower pricing conduct, partly because low purchase sizes limit the risk of attempts to lead prices higher.
- X14 We have made recommendations that we consider could improve competition in wholesale and retail markets and improve outcomes for New Zealand consumers. These take into account our views on the factors affecting competition at all levels of the market.
- X15 In reaching these recommendations we have had regard to information gathered throughout our study, including feedback received on our draft report, published on 20 August 2019. Submissions on our draft report were received in writing and during our consultation conference in September 2019 from a range of parties, including industry participants, motoring and consumer representatives and everyday consumers.
- X16 We have reported our findings and recommendations to the Minister. It is now up to the Government to decide how to respond to this report.

## **Market context**

- X17 The competition issues affecting retail fuel prices in New Zealand have their historical origins in a time of government funded infrastructure and regulated wholesale pricing.

- X18 Prior to 1988, the wholesale price of fuel was regulated with the aim of providing a 13% return to importers. These importers – BP, Mobil, Caltex and Shell – were prohibited from being retailers and instead supplied fuel to independent retail sites at regulated prices.
- X19 To reduce costs and maximise production and distribution efficiencies, importers set up a series of joint ventures that enabled them to share key infrastructure assets. This included the construction of the Marsden Point refinery in the 1960s and the creation of a coastal shipping network to transport refined fuel to shared terminals at regional ports.
- X20 When the fuel industry was deregulated in 1988, the majors immediately entered the retail market, buying prominent retail sites of their own and securing long-term supply contracts with independent retailers. This effectively prevented the development of a competitive wholesale market.
- X21 As a result, New Zealand’s fuel industry is now essentially a vertically integrated oligopoly. The three majors (Z Energy, BP and Mobil) benefit from the cost efficiencies of their infrastructure sharing arrangements. They supply more than 90% of the retail fuel sold through a network of retail sites they own and operate, dealer owned retail sites that carry their brands, and distributors which in turn supply their own dealers and/or retail sites that they own and operate.
- X22 Z Energy, BP and Mobil each import crude oil to be refined at Marsden Point, which produces approximately 58% of the petrol and 67% of the diesel used in New Zealand. From here it is transported either by pipeline – to service Auckland and Waikato – or by coastal shipping to the companies’ storage terminals at regional ports.
- X23 These three companies also import refined fuel, which generally arrives at ports in Mt Maunganui, Wellington and Lyttelton.
- X24 New Zealand’s only other fuel importer, Gull, is not party to any of the infrastructure sharing arrangements. Gull imports fuel into its Mt Maunganui terminal and from there trucks it to its North Island retail outlets. Gull has recently opened its first South Island site and plans to open six more sites over the next two years. However, its ability to expand and compete in the South Island depends on securing wholesale supply arrangements. Gull has had a positive impact in reducing prices for consumers in some areas where it operates. However, it is also incentivised to maximise its own profits and can do so by setting its prices beneath the majors’ average retail prices, without the threat of additional competition driving prices down further.
- X25 Figure X1 below shows the location and ownership of terminals throughout New Zealand.

**Figure X1 Terminal storage throughout New Zealand<sup>1</sup>**



Source: Commerce Commission analysis of industry participants' data.

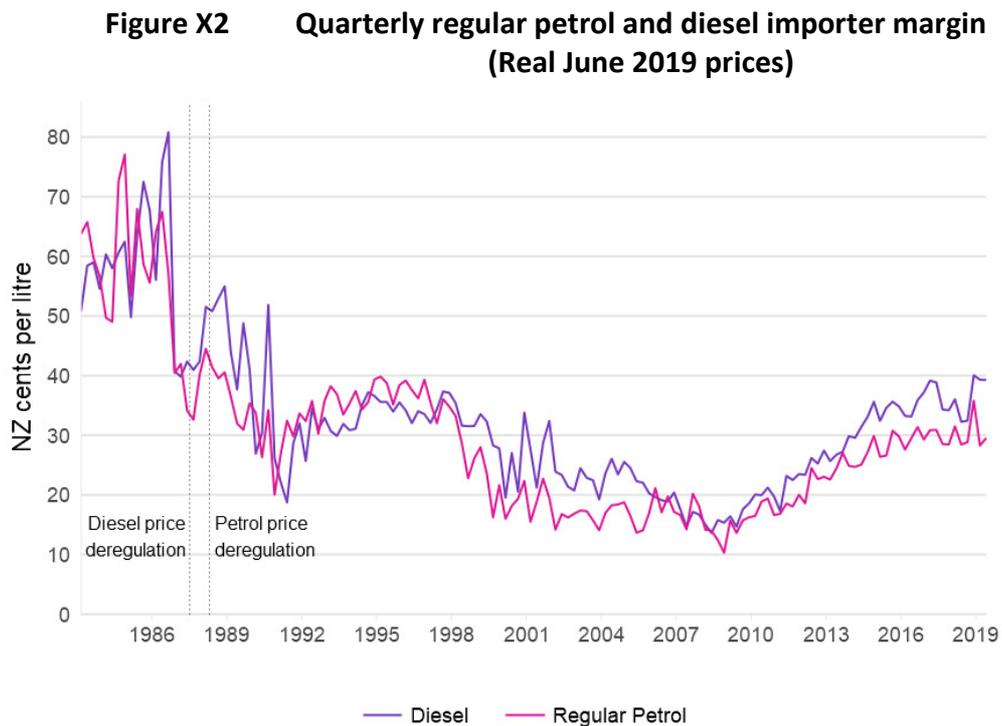
- X26 Currently, retail consumption is a near even split between petrol and diesel. Premium fuel (95 and 98 octane) makes up about 23% of total petrol consumption.

<sup>1</sup> In addition, Z Energy has a small amount of private storage of B100 (bio-diesel) at its plant in Wiri, the Wiri terminal and at its Mt Maunganui terminal. Z Energy currently operates no other private storage.

- X27 Collectively, Z Energy, BP, Mobil and Gull control the supply of fuel to more than 1,300 retail sites under 20 different retail brands, either directly or indirectly through a distributor or reseller. About 200 sites have been added to the New Zealand retail landscape since 2010, with an increase in the number of sites operated by non-majors and a reduction in the number of sites operated by the majors.
- X28 Approximately 60% of retail sites carry brands outside of the majors. However, these sites only account for 20% of petrol volumes sold in 2018, up from 11% in 2011. Many of these sites are outside the major metropolitan areas.
- X29 In addition, a new importer – Timaru Oil Services Limited (TOSL) – is currently building terminal storage at the Port of Timaru with the aim of commencing trading from 2020.

### Rising fuel margins

- X30 Following deregulation, importer margins initially fell before rising again until Gull and Challenge entered the market in the late 1990s. As shown below, margins were then on a downward trend until around 2008. Shell exited the market in 2010, selling its assets to the newly created Z Energy.



Source: MBIE (2019).<sup>2</sup>

<sup>2</sup> MBIE “Weekly fuel price monitoring” (2019) <<https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-statistics-and-modelling/energy-statistics/weekly-fuel-price-monitoring/>>. (Viewed on 26 November 2019).

- X31 At the time, the majors considered the margins were not sustainable, or at least not sufficient to attract investment. Shell's desire to compete on price to drive volumes can help explain these relatively low margins prior to it exiting New Zealand.
- X32 BP submitted the past trends in margins could be explained by the business cycle, with a decline in the number of retail sites when margins were low subsequently followed by an increase in margins.<sup>3</sup> In a workably competitive market, rising margins can be expected to encourage new entry and the resulting increase in competition can be expected to reduce margins to competitive levels. If margins fall below sustainable levels, this will prompt retail sites to exit once again. However, we have not observed this happening in retail fuel markets. In fact, margins have continued to rise even as the number of retail sites has grown.<sup>4</sup>
- X33 When Z Energy purchased Shell it publicly stated its intention to increase fuel margins. Consistent with this, the importer margin has been rising since around 2010.
- X34 Between 2012 and 2017 Z Energy published its Main Port Price (MPP) – the price that is used at most of Z Energy's retail sites in the South Island and lower North Island. Figure X3 shows the average national board price margins of diesel and regular petrol respectively, and the number of retail sites, over the past decade. The time period during which Z Energy published the MPP is indicated by the black vertical lines. Z Energy ceased publishing the daily MPP in July 2017 following MBIE's review of the fuel industry.<sup>5</sup>

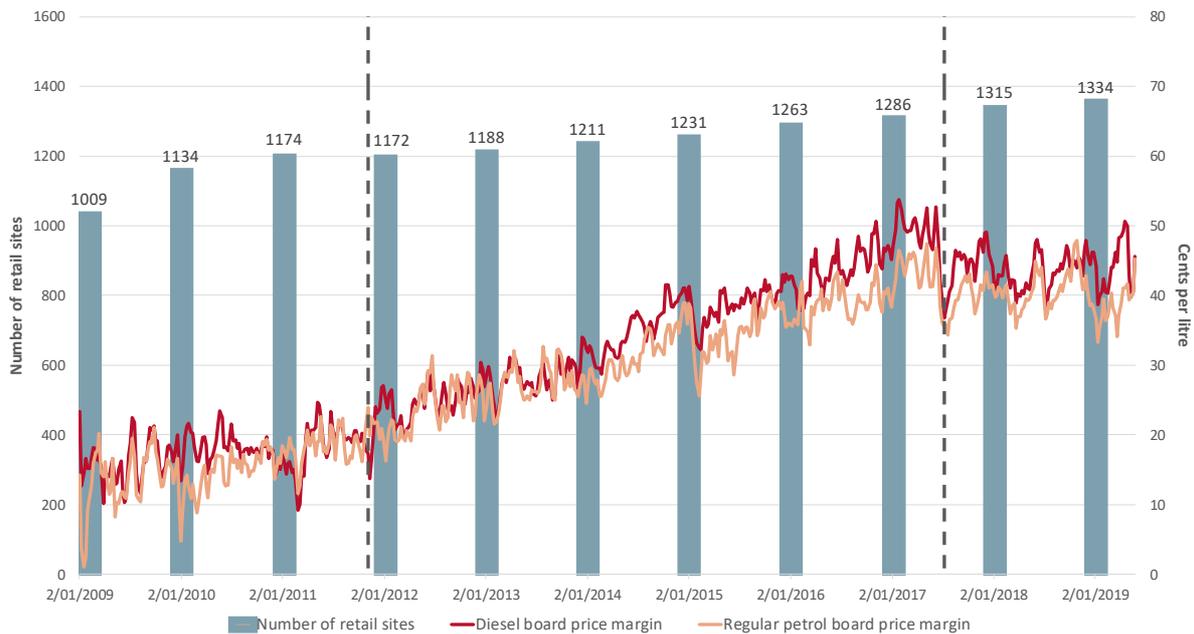
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<sup>3</sup> CRA, on behalf of BP. Transcript of retail fuel study consultation conference – Day 1 (24 September 2019) at 65 (lines 10-21).

<sup>4</sup> Ibid at 64 (lines 11-13).

<sup>5</sup> The 2017 Fuel Study identified that Z Energy's publication of its MPP potentially serves as a retail pricing signal that can dampen competition. NZIER, Grant Thornton, Cognitus Economic Insight "New Zealand fuel market financial performance study" (prepared for the Ministry of Business, Innovation and Employment, 29 May 2017) at v. Available at <<https://www.mbie.govt.nz/assets/dd96ac0bb4/fuel-market-financial-performance-study-report-back.pdf>>. (Viewed on 17 November 2019).

**Figure X3 Average weekly national board price margins and number of retail sites (Jan 2009 to May 2019)**



Source: Commission analysis of MBIE data and information provided by industry participants.<sup>6</sup>

- X35 Despite an increase in the number of retail sites since 2012, it appears that average margins increased during the period when the daily MPP was published and have levelled off or decreased since publication ceased. While there may be other explanations for this, it would be consistent with at least one market participant's suggestion that the MPP was used as an indicator of market list prices.<sup>7</sup>
- X36 This evidence therefore appears to support a conclusion that the retail market is vulnerable to accommodating behaviour through price transparency and leader-follower pricing. We also consider that this conduct has been, and may remain, at least a contributing factor to the margins that we observe.
- X37 We consider that measures to improve competition at wholesale and retail levels of the fuel supply chain will reduce their vulnerability to accommodating behaviour as well the potential effect of any such behaviour that does occur.

<sup>6</sup> MBIE monitors and publishes weekly importer margins for retail petrol and diesel. We used this data to calculate average weekly board price margins for diesel and regular petrol, inclusive of GST and other taxes. Available at <<https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-statistics-and-modelling/energy-statistics/weekly-fuel-price-monitoring/>>. (Viewed on 7 November 2019). We calculated the total annual number of active retail sites in New Zealand using information provided to us by fuel retailers.

<sup>7</sup> [ ]

- X38 There is evidence to suggest the recent growth in margins and profits has levelled off and may have peaked. It is difficult to forecast future margins and we have not sought to do so in this study. Nonetheless, we have not been persuaded that the industry's experience of excess returns has come to an end.
- X39 Indeed there is a clear risk that competition could weaken. This is because the new retail sites which have opened are predominantly supplied with fuel by Mobil<sup>8</sup> and are therefore potentially exposed to a change in strategy from Mobil relating to wholesale pricing and access. Competition which depends on the individual strategy of one market participant may not endure over time.

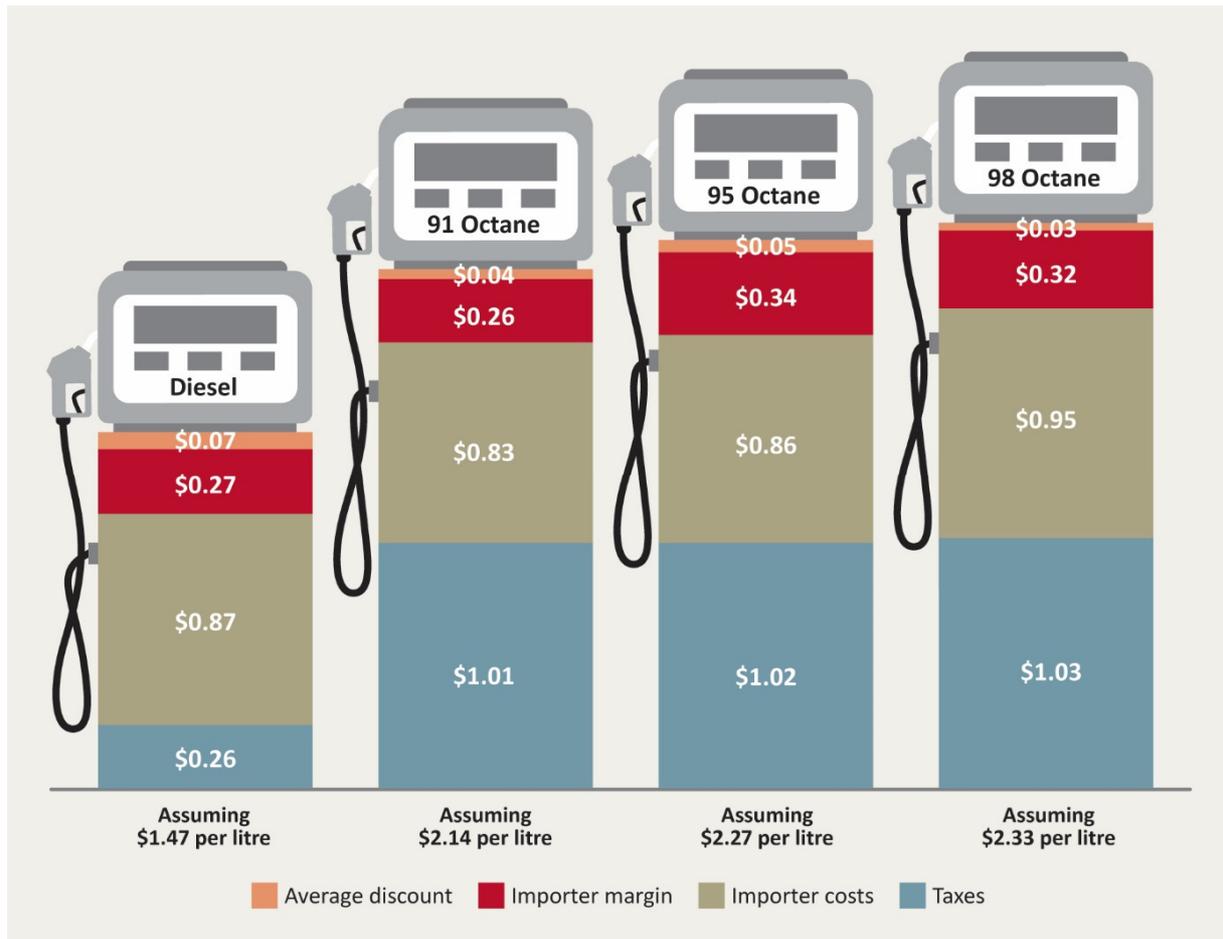
### **Retail price components**

- X40 While most headline fuel prices are openly advertised on service station price boards for consumers to see, the wholesale price of fuel is not easily observed. However, we can break down retail fuel prices to show what components it is made up of including government taxes, the landed cost of the fuel itself, and the gross margin importers earn (which includes domestic operating costs as well as profit). We also calculated the average discount consumers claimed at the counter.

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<sup>8</sup> This is very evident in the graphs on new openings in the South and North Islands from 2014 to 2019 in BP's own submission. See, BP New Zealand "Submissions on the August 2019 Draft Report" (13 September 2019) at [3.5-3.6]. NPD, Waitomo, Allied and Gull (until January 2019) were all supplied with fuel by Mobil.

**Figure X4 Estimated components of the board price of fuel (2018 calendar year)**



Source: Commerce Commission analysis of data provided by industry participants.

- X41 Figure X4 shows that in 2018 the average board price for a litre of regular fuel (91 octane) was \$2.14 and the average discount was 4 cents. Taxes accounted for roughly \$1.01 a litre and the estimated landed cost of fuel was 83 cents, leaving 26 cents as the gross margin for importers. It also shows that the average gross margin was higher for diesel and premium fuels in percentage terms.
- X42 The breakdown outlined is the national average. The gross margins importers earn on any given litre of fuel will vary by region.

### Fuel market outcomes

- X43 Fuel companies have made several innovations in the retail market that they compete over, such as fast lanes, coffee ordering apps, improved service and better equipped convenience stores. Improvements in pay-at-the-pump technology are also lowering the cost of entry for retailers wanting to offer a basic service to price-sensitive consumers. These developments can offer benefits to consumers.

X44 However, we consider price competition in fuel markets is not working as well as it could be for consumers. Our reasons for this are:

X44.1 fuel companies appear to have been making persistently high profits over the past decade;

X44.2 regional differences in retail fuel prices are not all explained by cost differences;

X44.3 discounting does not compensate for higher pump prices; and

X44.4 there is an increasing price difference between regular and premium petrol which is not all explained by cost differences.

X45 Each of these reasons are explained in more detail below.

### **High prices and persistently high profitability**

X46 There are a range of indicators that in our view suggest the profitability of New Zealand fuel companies is high. These include:

X46.1 import margins have more than doubled since 2008;

X46.2 fuel company returns on new investment have averaged 20% per annum over the past 5 years – well above our estimate of a reasonable return (6.9 - 8.6%) and the average historic returns made by international comparator companies;

X46.3 new retail sites often exceed the company's own profitability expectations, with some achieving unusually fast pay back on investment for what are long-lived assets; and

X46.4 ratios of fuel firms' market value (sale price or sharemarket value) to replacement cost (value of its assets) are approximately 1.5-1.8, meaning they are valued significantly higher than their physical costs to build. We would expect values closer to 1 in a workably competitive market.

X47 While any one measure of profitability will have its limitations, a range of measures consistently indicate that fuel companies have been achieving a level of profitability in New Zealand that is persistently higher than what we estimate a reasonable return would be in a workably competitive market.

- X48 High profitability is also reflected in the fact that the number of retail sites is growing faster than the volume of fuel sold. For example, in a May 2019 presentation Z Energy stated that 35 new sites had been built across the retail fuel industry, growing capacity by 2% over a period in which petrol sales declined by 1.5%.<sup>9</sup>
- X49 By implication, the average volume of fuel sold at each site is declining slightly, yet firms on average expect to generate strong profits on new investment. The high returns expected seem to be attributable to high margins, and not new investment growing volumes.
- X50 Commentary in internal fuel firm documents we reviewed indicates firms have been aware that margins were high enough to attract new entrants since around 2012. However, these documents also noted that entry would be difficult due to the cost involved in building a distribution network in New Zealand.
- X51 However, retail sites can still be added by existing firms. Gull and other relatively low-priced retailers, particularly those supplied fuel by Mobil (Waitomo, NPD and Allied) have grown their retail presence, primarily through less costly unmanned sites.
- X52 This retail expansion does not appear to have materially reduced the profits observed across the fuel industry.

#### **There is no clear trend towards more competitive levels**

- X53 There are indications that returns may have now peaked but their future trajectory appears stable. The majors and financial market analysts expect profitability to remain at elevated levels for some time. This is an indication that competition is not working well to bring profitability back to a more competitive or 'normal' level. It is uncertain what will happen to margins and returns in the future. However, we are not convinced the industry's experience of excess returns has come to an end under current policy settings. The underlying factors affecting retail fuel competition have not changed.
- X54 We also note that while most fuel companies in New Zealand are profitable, some retail sites owned by individual dealers are not. Certain dealer-owned sites operate on relatively slim margins compared to the majors who supply them.

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<sup>9</sup> Z Energy "2019 Results Presentation for the year ended 31 March 2019" (2 May 2019) at 6. Z Energy's submission to us on the preliminary issues paper made a similar point using data from 2016. See, Z Energy "Market Study into the Retail Fuel Sector: Z Energy's Response to Invitation to Comment on Preliminary Issues" (21 February 2019) at [12].

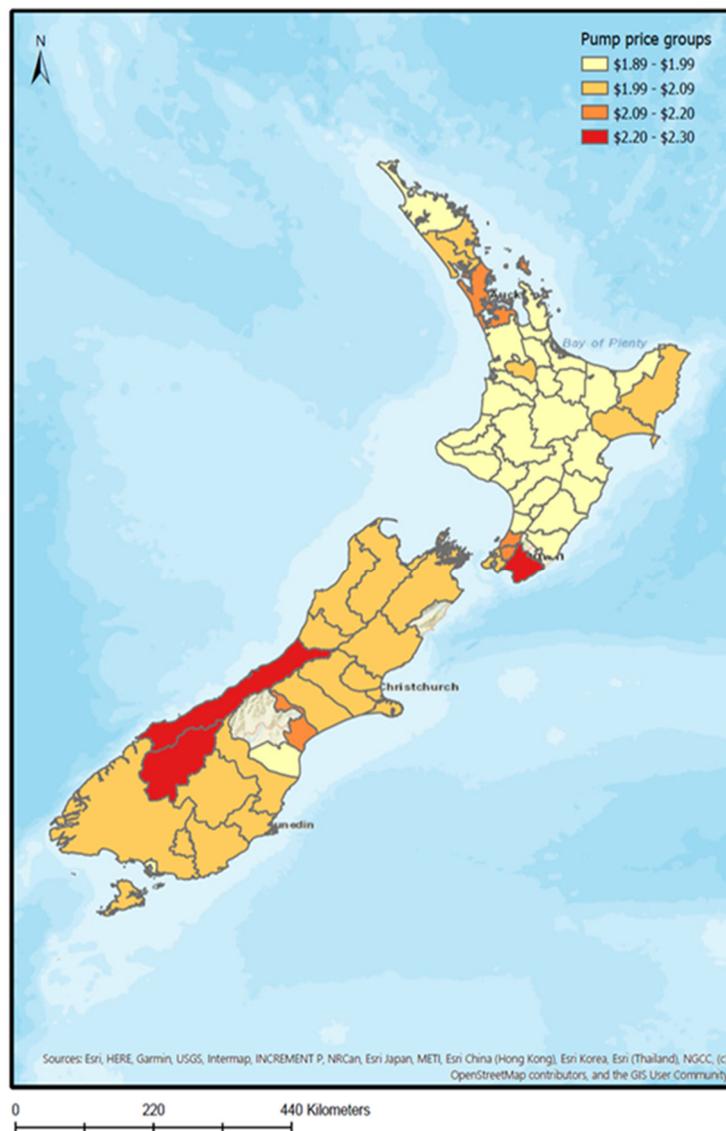
## Regional differences in retail fuel prices

X55 It is well known that there are material variations in fuel prices between regions and locations. These differences are shown in Figure X5, which shows average retail board prices across New Zealand in 2019 for regular petrol. In some cases, regional price differences can be partly explained by differences in cost or taxes. For example:

X55.1 the West Coast of the South Island has some of the highest prices in the country. There is no storage terminal on the West Coast, so fuel needs to be trucked long distances from other terminals (at relatively high cost); and

X55.2 Auckland prices are subject to the regional fuel tax introduced in 2018.

**Figure X5 Average retail board prices across New Zealand for regular petrol (2019)**



Source: Analysis of data provided by industry participants.

- X56 In many cases regional price differences are better explained by differences in competitive conditions. For example, prices are generally higher in Wellington than Masterton, although it is more expensive to truck fuel to Masterton from Wellington. The price difference is likely to be partly explained by Gull having a service station in Masterton, but not in Wellington.
- X57 The fact that all fuel sold in the South Island originates from the majors also appears to be linked to weaker price competition and therefore higher prices. The opening of new NPD sites, which only operate in the South Island, appears to have had the greatest impact on reducing the majors' prices.
- X58 Prices in Wellington and the South Island may reduce in the future if comparatively low-priced retailers expand into these areas and TOSL's entry in Timaru is successful.
- X59 Our recommendations could also assist with this, especially in relation to the contractual restrictions applying to potential wholesale customers.

#### **Discounting is not a substitute for more generalised price competition**

- X60 Discount and loyalty programmes like AA Smartfuel, Z Energy's Pumped and Mobil Smiles, as well as supermarket docketts, are a prominent feature of New Zealand's retail markets.
- X61 In 2018 more than 41% of petrol and diesel sales were made at a discount to the advertised pump price. This has almost doubled since 2011. The average size of the discounts offered has also increased from 2 cents to 11 cents per litre for petrol and from 2 cents to 16 cents per litre for diesel over this period. The majors have submitted that this is a sign of strong retail competition. However, in our view, discounting is a poor substitute for more generalised price competition.
- X62 Discounts are correlated with higher board prices and have increased as margins have increased over the past decade. The greater use of discount and loyalty programmes avoids direct competition on board prices.
- X63 Discounting can in effect 'sort' or discriminate between customers who claim discounts and those who do not. Some consumers may be excluded from discount offers due to the criteria in place.
- X64 Discounts can also shift consumer focus away from the actual price they pay to the size of the discount or reward. They can also make it more difficult for consumers to compare post-discount prices between retailers and understand which one is offering the lowest actual price. In those circumstances, consumers are less likely to switch in response to competing offers and retailers have weaker incentives to offer them.

X65 Discount and loyalty programmes are costly for the fuel firms to provide and for consumers to take advantage of. There is no evidence they increase the total volume of fuel sold. While discounting provides benefits to some consumers, those who do not participate pay higher board prices and discounting has been associated with higher margins overall. If board price competition was stronger, margins could be lower, there would be less discounting, and all consumers could benefit from lower prices.

#### *Commercial fuel cards*

X66 Although the study is focused on the retail market, sales to commercial fuel card holders – typically small and medium-sized businesses – account for about a quarter of volumes sold at retail sites.

X67 Fuel cards can deliver significant benefits to buyers by enabling them to receive a single bill at the end of the month, place limits on purchases made (for example, fuel can only be purchased during certain hours), and receive discounts off pump prices. However, these benefits may come at the cost of softening price competition in a similar way to consumer discount and loyalty programmes.

X68 Fuel cards are valuable to retailers as they provide a steady base of buyers who are relatively indifferent to the pump price at the retail site they obtain their fuel.

X69 Fuel card holders are known as ‘sticky’ customers and are unlikely to shop around in response to a short-term price rise, as they may be more focused on the benefits they consider their card offers them. This tends to weaken competition on board prices.

X70 We also consider fuel cards may soften competition by reinforcing the majors’ control of their supply chains.

#### **Premium petrol margins**

X71 Premium petrol, which is retailed at higher prices and margins than regular petrol, is also contributing to high industry profitability.

X72 Premium (95 octane) petrol prices currently tend to be about 13-15 cents above the price of regular (91 octane) petrol, after accounting for discounts. The difference was about 7-8 cents in 2011. 98 octane petrol prices carry an additional price premium. This has meant the premium petrol margin has increased faster than regular petrol.

X73 The extra margin fuel companies are earning on this product does not appear to reflect actual cost differences between premium and regular petrol.

X74 We believe one explanation is that premium petrol prices are seldom displayed on price boards, making it difficult for consumers to compare prices. Premium petrol consumers may also be less price sensitive.

- X75 We also consider that some consumers may be purchasing premium petrol unnecessarily, potentially due to a lack of understanding about whether it is needed for their car or the benefits it provides.

### **Causes of these outcomes**

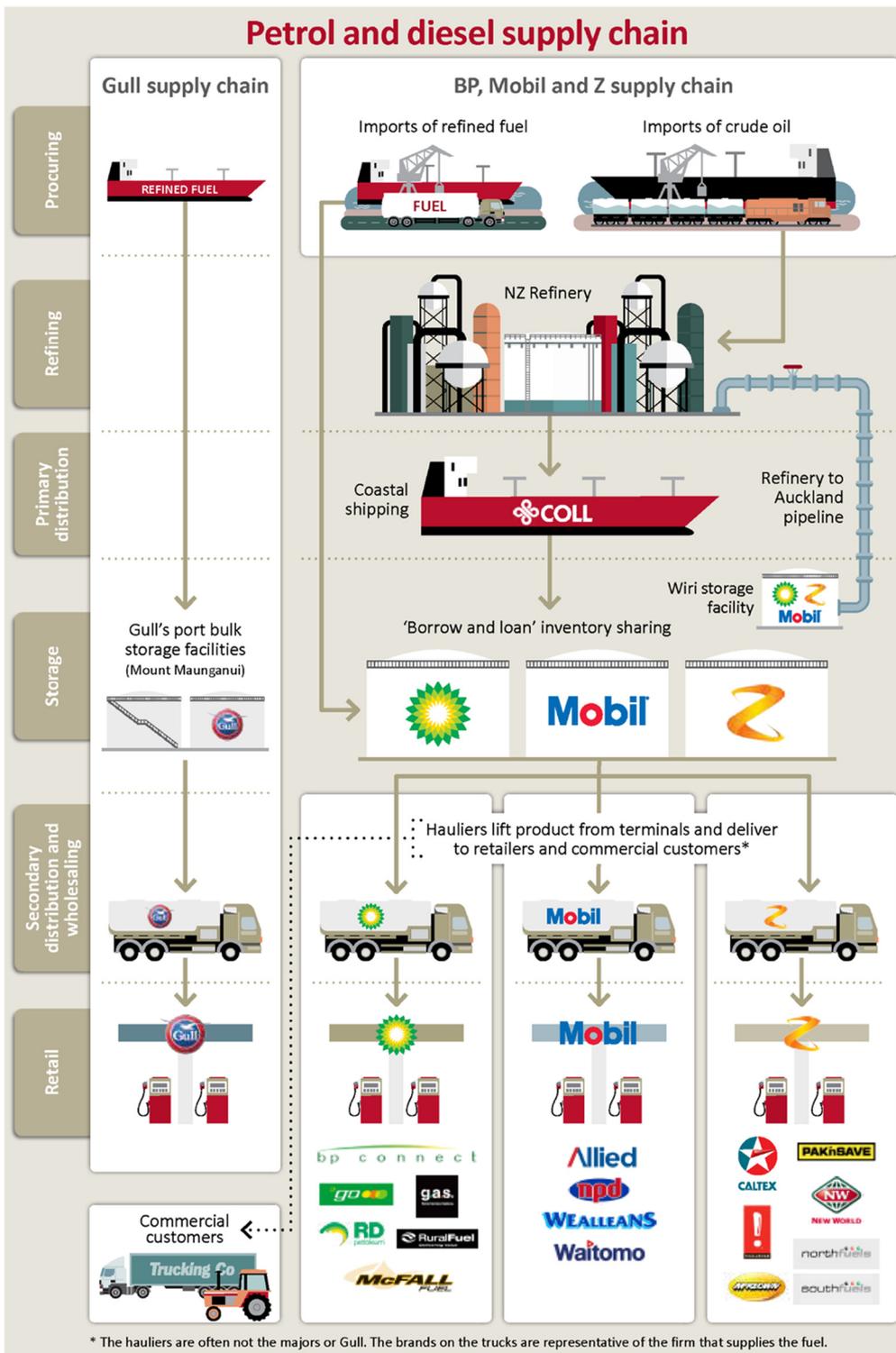
- X76 We believe the market outcomes described above indicate that competition is not working as well as it could be in wholesale or retail markets. While we have identified some retail market measures that should assist competition, our most significant recommendations involve changes further up the supply chain in the wholesale market.
- X77 The most significant problem, in our view, is that an active wholesale market does not exist in New Zealand and has not existed since deregulation 30 years ago. The majors operate through vertically integrated networks and often through long-term exclusive wholesale supply agreements. These arrangements have removed the scope for meaningful price competition at the wholesale level. This is where we would normally expect to see particularly strong price competition given the large volumes resellers are prepared to purchase and the commodity nature of each grade of fuel.
- X78 Without an effective wholesale market, competition is largely limited to retail markets, where strong price competition is less likely to occur because the markets are smaller, geographically scattered and retailers have differentiated their service offerings. In addition, the retail market is more vulnerable to leader-follower pricing behaviour. The absence of wholesale competition increases the cost of fuel for retailers which places a floor under retail prices.
- X79 Resellers, predominantly those supplied fuel by Mobil, can and do offer petrol and diesel prices below the majors and Gull, primarily by offering low cost service offerings like unmanned, pay-at-the-pump stations. However, there is a limit to the price competition they can offer. This is dictated by the wholesale price they pay their suppliers and the individual strategies of the majors, which may change.
- X80 There are two interrelated factors that we consider limit wholesale competition:
- X80.1 The majors' joint infrastructure network gives them an advantage over current and potential rival resellers, who are unable to acquire fuel from terminals throughout the country other than under contract with a major; and
- X80.2 Wholesale supply relationships, including restrictive contract terms, between the majors and their resellers reduce competition and limit resellers' ability to switch supplier.

X81 The combination of infrastructure sharing arrangements and restrictive supply relationships has also helped to prevent rival fuel importers from entering the market or competing more vigorously against the majors. In addition, the majors have limited incentive to compete strongly against each other on price at either the wholesale or retail level.

#### **Infrastructure sharing and effects on competition**

X82 The majors have overcome some of the challenges associated with delivering fuel to New Zealand consumers by sharing key infrastructure. This includes a complex mix of interrelated arrangements covering everything from the processing of crude oil, coordinated scheduling of distribution of refined fuel by pipeline and coastal shipping vessels, and access to a nation-wide fuel inventory through shared terminal storage facilities under the 'borrow and loan' arrangement (see Figure X6 below).

Figure X6 The petrol and diesel supply chain



X83 By combining their resources in this way, the majors have reduced their costs of supply compared to any rival importers that need to establish separate stand-alone supply chains.

- X84 While there are terms and criteria under which a rival importer may participate in any of the infrastructure sharing agreements, this has never happened. In reality, these terms are untested, the majors appear to have considerable discretion on allowing participation, and the process and criteria for applying to participate are not made readily available.
- X85 We consider a published process and criteria for participating in these shared infrastructure arrangements would be expected in a workably competitive market. We have made a recommendation to this effect.

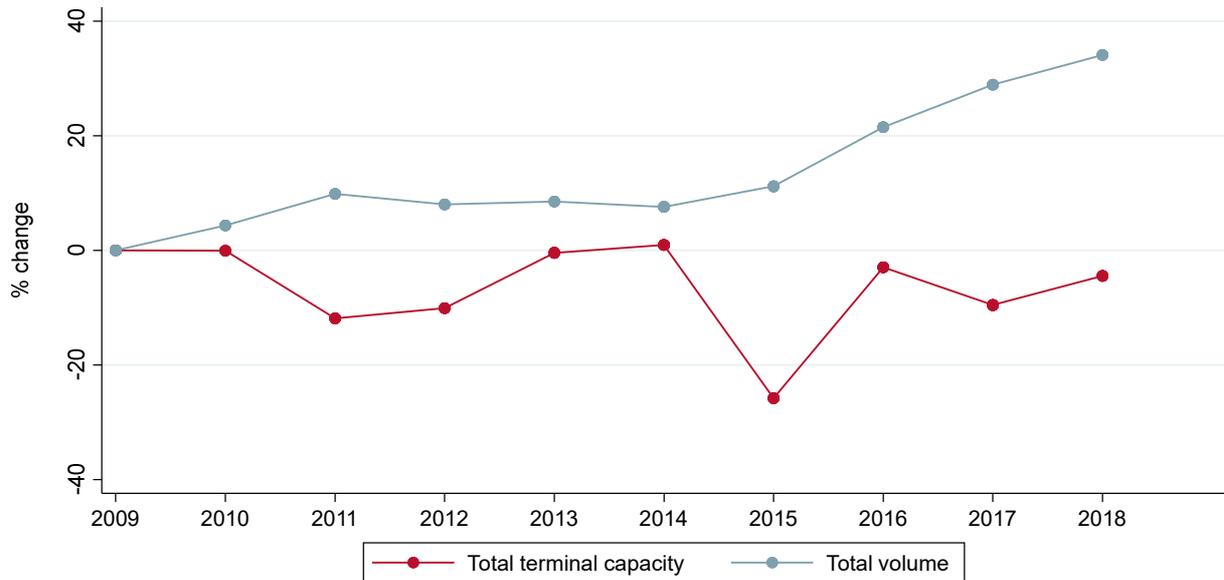
#### *Refinery allocation*

- X86 We also consider that current refinery arrangements may be limiting competition between the majors. Capacity at the refinery is allocated based on a three-year average of market shares. This means there is a significant lag before an increase in market share flows through to greater refinery allocation.
- X87 If a major wants to grow its market share it would initially need to import more refined fuel to meet increased demand. This is likely to lead to a cost disadvantage in the short term, particularly in the Auckland market which receives fuel directly from the refinery via pipeline. We consider a shorter allocation process would be preferable to reduce the impact of this lag and the costs of this change are low.
- X88 Further, the refinery allocation and borrow and loan arrangements currently require that information on past and future demand be shared between the majors. This may improve their understanding of each other's likely strategies and help them to accommodate one another's market behaviour. We recommend changes to the allocation process to reduce the current level of information sharing.

#### *Capacity constraints are increasing*

- X89 We consider that infrastructure sharing arrangements may be diluting incentives to invest in infrastructure, contributing to tight supply conditions at many ports. This is reflected in insufficient investment being made in shared storage terminals over the past decade, despite increased demand for fuel from the majors (see Figure X7).

**Figure X7 Total fuel volumes and shared storage capacity indexed to 2009**



Source: Commission analysis of refinery production data, majors' import data and industry storage.

- X90 The impact of limited investment in storage on capacity constraints is evidenced by port coordination events, which are used to ration out available supply between the majors and their downstream partners, when terminals are forecast to run out of supply before the next shipment arrives. While coordination events have fallen recently, some ports have been under coordination up to 40% of the time for certain fuel types.
- X91 However, the case for significant future investment in terminals is uncertain, particularly given the signalled entry of TOSL and future expectations of relatively flat fuel demand. We recommend reviewing features or rules that may be acting to disincentivise investment in shared storage, to ensure timely investment occurs if and when it is required.
- X92 There is evidence suggesting this tight supply position serves to limit competition between the majors at the wholesale level. The formulas used to ration fuel during port coordination events reduce the ability and incentive of the majors to compete for additional contracts; and large resellers appear to be deterred from seeking to switch suppliers out of fear their needs may not be met during a coordination event.

## Wholesale supply relationships

- X93 Switching at the wholesale level is rare. Resellers, comprising of independent dealers and distributors, rarely use the same competitive tendering processes used by large commercial customers and typically continue to obtain supply from the same major. This reflects a combination of:
- X93.1 non-contractual features of the relationship between resellers and majors that have evolved over time; such as security of supply, access to fuel card schemes, and the location of resellers' retail sites, which result in resellers being dependent on their existing suppliers; and
  - X93.2 restrictive contract terms that make switching difficult.
- X94 The lack of switching we see in the wholesale market also reflects some distributors' relatively comfortable position, where they are sharing in the high profitability we are seeing across the industry.

### *Relationship dependence reinforces barriers to switching*

- X95 Many of the wholesale supply relationships majors have with resellers have been in place for decades. In some cases, a major helped establish the reseller through transfer of assets, financial investment, technical assistance, or access to customer lists.
- X96 Since their establishment, many distributors have grown materially by building their own customer base, and in some cases acquiring other distributors. Increasingly they are building their own retail sites, particularly unmanned pay-at-pump sites.
- X97 Despite this growth, resellers are not diversified businesses. Maintaining a reliable supply of fuel is critical to their success and they purchase all of their core product, petrol and diesel, from a single supplier. In most cases this is the same supplier they have always had.
- X98 The established relationships between the majors and their resellers appear to discourage switching between suppliers. This is reflected in some resellers:
- X98.1 needing access to the majors' fuel card;
  - X98.2 being unwilling to open new retail sites in locations where they would directly compete with their own supplier; and
  - X98.3 factoring security of supply risks into their decisions.

- X99 As mentioned previously, commercial fuel card holders are often valuable to retailers. Resellers can therefore be relatively dependent on their suppliers' fuel card scheme. The majors' fuel cards, which are accepted at a nationwide network of sites, are particularly valuable to resellers. The potential loss of fuel card volumes at resellers retail sites acts as a disincentive to switch to another supplier, or switch to a new importer that does not have a fuel card scheme.
- X100 Access to fuel card schemes also potentially influences where resellers choose to open new retail sites and what services they offer at those sites. Resellers may seek to avoid establishing new retail sites too close to those of the major they are supplied by in case the major does not enable its fuel card scheme to be used at the reseller's new retail site.
- X101 Resellers often open new retail sites at locations that complement their supplier's retail network, rather than competing directly with them. Even if a reseller wished to switch supply to a different major fuel company, the location of their established retail sites may mean they are unlikely to get a better wholesale price from a new supplier they would then be competing against.
- X102 Another factor influencing resellers' decisions appears to be the supply risk associated with port coordination events or shortages. For example, a reseller may be concerned that a major may choose to prioritise supply to other resellers who that major has long-term relationships with. This may be especially so if the major's existing resellers have retail sites that are complementary to that major. This acts as a further disincentive to resellers to switch suppliers.

*Restrictive contract terms*

- X103 In our view the wholesale supply agreements between the majors and resellers have a combination of features that are not consistent with what we would expect to see in workably competitive fuel markets in New Zealand. These agreements:
- X103.1 are typically exclusive, preventing resellers from obtaining any of their fuel from an alternative supplier, for example to trial a new supplier or diversify their supply;
  - X103.2 commonly have long durations (for example, 10 to 15 years, but in some cases much longer), further limiting resellers' ability to regularly test the market and 'shop around';
  - X103.3 are sometimes tied to retail prices or are unclear on the methodology for calculating wholesale prices, and typically provide the majors the ability to change wholesale prices at their discretion, making it difficult to compare offers between suppliers; and
  - X103.4 include other contract terms, such as 'first right of refusal' and restraint of trade clauses, which reduce a reseller's ability and incentive to switch supplier.

- X104 We acknowledge terms like these can be found in commercial contracts in workably competitive markets. They can have a range of benefits and may be required to achieve efficiencies, such as securing long-term demand to justify investment.
- X105 However, we consider that in many cases the benefits claimed could be achieved through means that are less restrictive of competition in the wholesale fuel market. In other cases, any historical justification these terms may have had, no longer appear relevant.
- X106 In addition to these contract terms, if a reseller does consider switching it can be hard to find the best offer because some of the key information they need, such as the future supply price, may not be provided by a major. There is no wholesale spot market in New Zealand, which would potentially provide a useful reference point when considering entering a new supply agreement.
- X107 Resellers' lack of switching contrasts with large commercial buyers who typically enter much shorter contracts and actively test the market by inviting tenders from multiple suppliers.
- X108 We have made recommendations to limit the use of certain terms in wholesale supply contracts to give resellers' more freedom to obtain competitive supply arrangements.

*Land use restrictions*

- X109 Separately, we have also observed that when fuel companies close retail sites they sometimes place 'restrictive covenants' on the land that prevent its future use by another fuel retailer.
- X110 Given retail site locations are often selected based on traffic flows and accessibility, as well as local zoning restrictions, the reduced ability to access suitable land potentially raises a new competitor's cost of entering the retail market or limits their ability to expand into new areas.

**The impacts of infrastructure sharing and a locked-up wholesale market**

- X111 The combination of infrastructure sharing arrangements and restrictive wholesale supply relationships has restricted rival fuel importers' entry into the market and has limited competition.
- X112 Rival importers do not have the ability to match the majors' comparatively low cost of production and distribution, and on entering New Zealand would find it difficult to attract wholesale customers who are committed to restrictive wholesale supply agreements.
- X113 This has the effect of restricting competition primarily to the retail level.
- X114 We have made recommendations to address these issues.

## **Stimulating competition and improving outcomes for New Zealanders**

- X115 We consider that competition in the wholesale fuel market is not delivering the benefits for New Zealand consumers that it could. Under current practices, New Zealand consumers appear likely to continue paying more for fuel than we would expect if a workably competitive wholesale market existed.
- X116 There are signs that the market is responding to the high margins being earned over the past decade. Developments that could improve outcomes for consumers in the long term include the following.
- X116.1 The successful establishment of TOSL's new import terminal in Timaru has the potential to bring lower fuel prices to some South Island drivers, if it can secure supply agreements with existing resellers.
- X116.2 Further expansion by Gull and resellers like Waitomo and NPD may provide consumers with the option of lower priced fuel in more locations.
- X116.3 The development of alternate sources of energy like electricity or hydrogen to power our cars and trucks may help reduce the retail price of petrol and diesel.
- X117 However, these developments will not address the core problem we have identified with the wholesale market.

### **Recommendations to improve competition**

- X118 The following recommendations are made in light of what we have heard throughout the study, what we consider to be feasible and our views of the potential costs of the recommendations in relation to the likely benefit to consumers. Cost benefit analysis may be undertaken as part of the decision-making process about which recommendations the Government chooses to take forward and in what form.
- X119 Our recommendations reflect our views on factors affecting competition at all levels of the supply chain. We consider them to be interdependent of one another.
- X120 Our view is that the recommendations most likely to improve competition will be those directed towards the creation of an effective wholesale market, in which all fuel importers compete to supply wholesale customers. In the long-term this is likely to be the greatest driver of increased competition in retail markets.
- X121 We recommend the introduction of a Terminal Gate Pricing (TGP) regime. A TGP is a spot price at which wholesale suppliers will sell fuel to wholesale customers at storage terminals. We recommend this regime is based on the Australian equivalent, with some adaptation for New Zealand market conditions.
- X122 We consider a TGP regime will improve competition at the wholesale level by:
- X122.1 creating the potential for a liquid wholesale spot market to develop;

- X122.2 lowering barriers to entry and expansion for both importers and distributors;
- X122.3 providing greater pricing transparency for wholesale customers; and
- X122.4 providing competitive benchmark information for industry and government, including for those wholesale customers negotiating prices for their wholesale supply agreements.
- X123 We consider a credible threat of further regulation if a TGP regime does not facilitate competitive wholesale prices within a reasonable period of time would also incentivise the majors to offer competitive TGP prices.
- X124 This type of regulatory intervention is likely to be lower cost and with a reduced risk of unintended adverse consequences compared to regulated participation in infrastructure sharing arrangements or price control. It would be complementary to the borrow and loan arrangements and would preserve access to fuel at all terminals even if terminals were removed from those arrangements.
- X125 We also recommend that parties to the coastal shipping joint venture and borrow and loan arrangements improve industry understanding of them, including publishing their process and criteria for considering applications to participate in the arrangements. We also recommend that parties to the arrangements review aspects of the borrow and loan arrangements that may be acting to disincentivise investment in shared storage.
- X126 We recommend regulation to limit the use of certain terms in wholesale supply contracts to allow greater contractual freedom for resellers to compare offers and switch suppliers. In particular, we recommend the following.
- X126.1 All wholesale contracts should be written in clear and concise language and should include a transparent cost-based pricing clause.
- X126.2 Wholesale contracts should permit a distributor to take a prescribed minimum percentage of their supply from other suppliers.
- X126.3 Distributors should not be committed to wholesale supply contracts exceeding a prescribed maximum period without a right to terminate on notice, unless a longer term is directly connected to relationship specific investment and reasonably necessary for that investment to occur.
- X126.4 Other terms of wholesale fuel supply contracts should be regulated to prevent unjustifiable limitations on the ability of distributors to compete.
- X127 We consider an enforceable Industry Code of Conduct would be an effective way to give effect to a TGP regime and recommendations relating to restrictive contracts.

- X128 While our recommendations are primarily focussed on stimulating wholesale competition, we also recommend several changes to more directly improve competition in retail fuel markets.
- X129 These are directed at improving the ability of consumers to make more informed purchasing decisions when it comes to buying premium fuels which we observed are more expensive than regular fuel, sold at higher margins and with margins increasing over time.
- X130 We recommend that Government regulates to require retail sites to display premium petrol prices on price boards to better enable consumers to compare the available prices of premium fuels without needing to drive into the retail site to check the pump price.
- X131 We recommend the introduction of regulation to require fuel cap or fuel flap stickers specifying the minimum octane level required for a vehicle to assist consumers to better understand whether they need to buy premium fuel for their vehicle. This will help to avoid consumers unintentionally buying premium fuel when they only need regular fuel, spending more than they need to, or inadvertently buying regular petrol when their vehicle in fact requires premium fuel.
- X132 We do not recommend regulation, but we do recommend monitoring, of the display of discount pricing on price boards. The display of discount pricing on price boards has evolved over the course of our study. Some retailers display discounted prices alongside undiscounted prices for regular fuel. It is unclear whether this practice benefits consumers and some industry participants have suggested it might limit competition. Further, the practice may cause consumers to focus more on the level of discount available than the price they actually pay for fuel.
- X133 Other potential interventions that could be considered in retail markets are not being recommended at this time. For example, we consider that care is required before pursuing options that could facilitate coordination, such as the promotion of price comparison tools. In addition, no recommendations are made in relation to the use of discount and loyalty programmes, although we encourage retailers to consider the potential for their discount and loyalty programmes to cause consumer detriment.

- X134 We have also made several other recommendations that support our primary recommendations. These include:
- X134.1 improving information and record keeping about the fuel market for future market analysis; and
  - X134.2 changes to current industry practices that may enhance the potential for the majors to coordinate and weaken competition through information sharing in relation to their joint shipping network and refinery capacity allocation.
- X135 Further details about our recommendations are outlined in Chapter 8.