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Market study into the retail fuel sector – BP New Zealand comment on preliminary issues

1. Introduction

BP New Zealand (**BPNZ**) appreciates the opportunity to respond to the Commission's "Invitation to comment on preliminary issues" paper of 31 January 2019 (the **Issues Paper**). BPNZ does not intend to respond to all 40 questions, but rather sets out below some considerations on the main themes arising from the Issues Paper, which it has split into categories addressing industry/pricing trends, measures of profitability and supply chain considerations.

BPNZ is happy to provide more detail to the Commission on any of the points raised.

2. Industry and pricing trends

The Issues Paper raises a number of queries regarding industry and pricing trends. At paragraph 29 it acknowledges the importance of assessing both the current status of the market and the foreseeable future, with a focus on the long term interests of consumers. BPNZ agrees that it is important to view the retail fuel industry by reference to industry trends and to take a forward looking approach.

In particular, it is important to take account of the long term trends experienced within the retail fuel industry in New Zealand since deregulation in 1988. Using these trends to assess how competition may develop in the future is critical to the Commission's market study.

Long term trends in retail fuel market

Since deregulation in 1988, the retail fuel industry in New Zealand has been characterised by long term trends. While recent market conditions have spurred new entry and investment in the industry, that has not always been the case. During the mid to late 2000s, conditions were very difficult for industry participants. During this period many outlets were closed due to a lack of profitability, while several of the majors tried to sell their retail fuel businesses. Equally, incentives to make substantial new investments in the industry were limited.

Accordingly, while the Commission appears to be assessing changes in retailer margins and profitability since 2009, this period is unlikely to be informative of the returns that retailers expect to achieve over the life of their retail assets (i.e. it reflects returns achieved for only part of the business cycle). BPNZ recommends that the Commission take a longer term view in recognition of the timeframe over which retailer exit and entry has occurred. Equally, the substantial new entry and expansion of retail footprints by a range of competitors is having a substantial effect on market conditions in both the North and South Islands. This new entry and investment coupled with advances in technology and the use of digital, for example pay at the pump technology, will result in a materially different competitive landscape looking forward over the short to medium term. Similarly, broader and longer term, market disruption (such as New Zealand's transition to a low carbon future) may well fundamentally change the retail fuel industry.

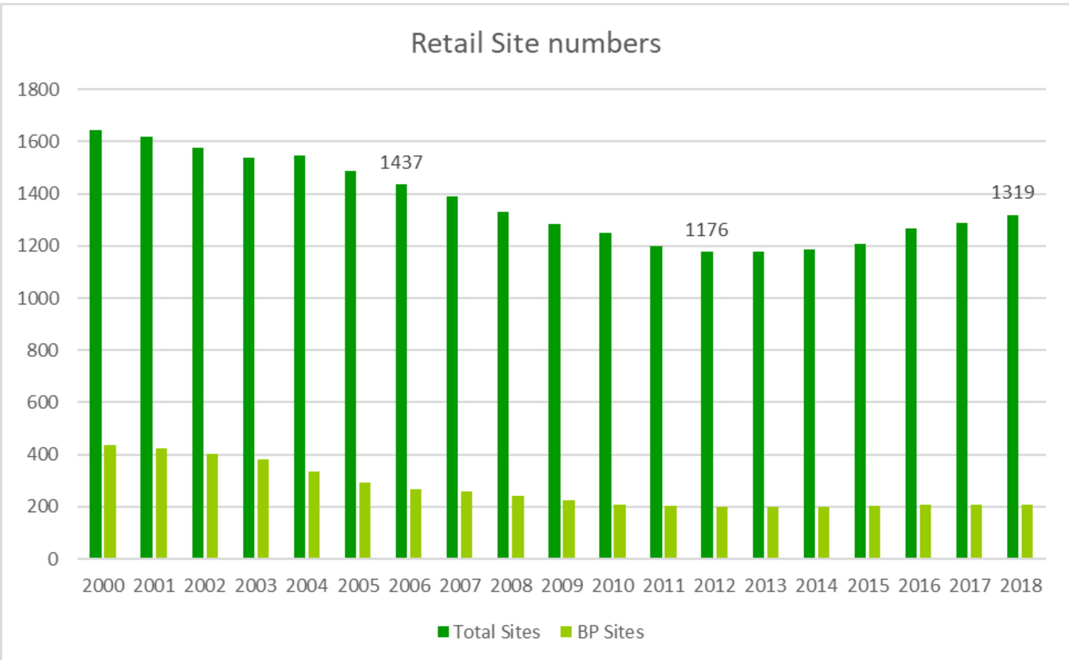
In light of these factors, BPNZ considers it appropriate that the Commission assesses industry trends as part of its investigation. However, it is important that these trends are assessed over appropriate time periods, which will help to inform it of how the industry may develop in the future.

Current trends

Notwithstanding the longer term trends of the retail fuel market, there are some important current trends that are shaping the competitive environment. In BPNZ's view, these trends are borne out of a competitive retail fuel industry and are resulting in continually improving customer offers. The key trends are described further below.

- <u>Competition for customers through improving product offerings and service offerings at retail outlets.</u> For example, BPNZ has invested strongly in the look and feel of its retail outlets, its high quality fuel offer with additivised products (Active Technology) and Ultimate 98 octane, its convenience store offerings including market leading coffee and food offerings and its innovative BPMe app improve the customer experience and differentiate the BP offer in the market. We are aware that other fuel suppliers are also innovating and introducing technology to improve the customer experience such as advanced pay at pump offers and improved number plate recognition technology to provide a fast fill and pay service. The increase in the prevalence of loyalty programmes is also indicative of strong competition to retain customers and is of substantial benefit directly to customers.

- <u>Expansion of retail site numbers.</u> The substantial increase in the number of retail sites over recent years is indicative of a competitive market. Based on BPNZ's figures, 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. This compares to a decrease in the preceding six years, 2006 to 2012, of 261 sites or 22% (1437 to 1176) (continuing a decreasing trend from at least the year 2000). This is shown in the following chart.



New retail sites have been established with a range of different formats by organisations with different operating models. For example, while the total number of BP branded sites has remained fairly constant, the mix has changed to a greater number of company owned and operated (**COCO**) sites as BPNZ has invested heavily in a broad offer to customers. At the same time, new entrants have developed a range of full offer, small format and unmanned sites. The result is a greater number of outlets with increased choice for consumers across both the North and South Islands.

- Investment in supply chain infrastructure. To address the increased demand for fuel products, market participants including Refining NZ (**RNZ**) have been required to invest, and are continuing to invest in supply chain infrastructure. BPNZ itself has invested substantially in new terminal infrastructure (as set out in further detail in section 4 below). At the same time, we are aware that a new entrant, Timaru Oil Services Limited, has commenced construction of a new South Island fuel terminal which we expect will lead to even more competition in the South Island.

Overall, these trends strongly support the conclusion that retail fuel markets exhibit "workable or effective" competition. As set out in paragraph 16 of the Commission's draft Market Studies Guidelines:

> When markets work well, firms compete by providing customers with competitively priced offerings and high quality products and services, or using their strengths, skills and other advantages to meet customers' needs more effectively than their rivals. In a competitive market, firms are incentivised to innovate. A competitive market usually provides customers, whether intermediate firms and/or end consumers with increased choice.

BPNZ considers that the trends it describes above are entirely consistent with this description.

Use of pricing trends and international comparisons

The Issues Paper refers to several comparisons of pricing and margin information over time, including an international OECD pre-tax fuel price comparison and MBIE margin data. BPNZ considers that such measures may have material flaws and should not be relied upon in reaching conclusions on the competitiveness of retail fuel markets.

Page 11 of the Issues Paper presents a chart of the "Quarterly Premium Unleaded Petrol Prices in OECD Countries, December quarter 2017". However, the use of the premium fuel (which BP assumes is 95 octane) price limits the usefulness of this comparison. The vast majority of fuel sold in New Zealand is diesel or unleaded 91 octane petrol. Any use of international comparisons should compare the primary fuel types sold in New Zealand.

Furthermore, paragraph 41 of the Issues Paper compares the current situation to 2008, noting that New Zealand then had one of the lowest pre-tax prices for premium petrol. As set out in the chart on page 2 of this submission, market conditions in the years pre and post 2008 resulted in a significant number of petrol station closures. Accordingly, a comparison with prices in 2008 does not provide any meaningful information on whether current prices are consistent with effective competition or otherwise. Regarding MBIE's reported importer margin monitoring figures, BPNZ does not have access to MBIE's method of calculation, including which data sources it uses for each aspect of its model. Without a greater understanding, these figures should not be relied upon to make conclusions on margins or profitability without thorough testing of the method of calculation with industry participants.

Should the Commission ultimately establish a robust method to measure changes in margins or prices over time, this may assist in guiding its conclusions on the market study. However, even these comparisons would have substantial limitations given the changes that the retail fuel industry is currently experiencing. Given the investment that is being put into the industry, the substantial increase in the number of retail outlets and different operating models and the potential for market disruption (e.g. the transition to a low carbon economy), the state of competition into the future is the critical factor that the Commission must assess. Against this background, there is a limit to what conclusions can be drawn from historical price and margin trends.

3. Measures of profitability

The Commission has asked whether ROACE is a reasonable method to assess the "reasonableness" of fuel prices. BPNZ's view is that:

- there are substantial difficulties involved in generating a reliable range of estimates for an economically meaningful ROACE;
- even if a reliable ROACE were to be determined, there is no straightforward way of determining if it is "reasonable"; and
- a snapshot of ROACE at one point in time is not meaningful – ROACE should be assessed over the period in which investments (many of which are long term in the fuel industry) are made.

In other regulatory roles (such as electricity and telecommunications) the Commission can spend many years seeking to determine what the appropriate returns are for regulated businesses. This has much to do with the measurement, comparison and temporal difficulties described above. In light of these concerns, BPNZ queries whether the benefit of endeavouring to measure ROACE (which ultimately may not provide any meaningful insight into the matters the Commission is seeking to assess) would outweigh the significant cost of doing so. These concerns are exacerbated by the comparatively short timeframe that the Commission has available to reach its views.

BPNZ sets out some further details on each of these concerns below.

Measurement issues

As was determined in the New Zealand Fuel Market Financial Performance Study (**MBIE Study**), the measurement of a meaningful ROACE figure across the retail fuel industry is fraught with difficulty. This is due to a number of distinct measurement challenges, including the following.

- <u>Valuing intangible assets.</u> In many industries intangible assets are significant and difficult to value. In the context of retail fuel, brand value is a significant intangible asset that may be difficult to value reliably and the range of plausible values for the brand (and other intangibles) could be large.
- <u>Estimation of replacement costs.</u> With respect to tangible assets (e.g. service stations, fuel assets, products, pipelines and terminals) the economically meaningful measure of capital employed for the purpose of a profitability assessment is a replacement cost measure that reflects the costs that an entrant would face. Persistent returns in excess of the costs of an entrant may indicate ineffective competition (otherwise entry would be expected to have occurred and those returns would be expected to have been competed away). The problem is that firms' accounts typically record historic asset costs rather than replacement costs, meaning that significant exercises may need to be undertaken to generate estimates of replacement values. Again, there may be a large range of plausible replacement value estimates.

- Allocations of shared costs. The estimates of ROACE would be directed at a specific business activity which is a subset of the full set of activities of the firms in question. These activities differ between the firms in question, as do the accounting standards they apply to cost allocation. Accordingly, there are likely to be challenges around the appropriate allocation of shared costs. The range of justifiable allocations can be large, which again may contribute to large ranges of plausible ROACE measures.

- Accounting distortions. Information in business accounts on revenues, costs and capital employed may be distorted by accounting conventions or one-off items so as to produce a misleading picture of the ROACE that is of interest in the context of a market investigation. To produce economically meaningful ROACE estimates requires a detailed understanding of each set of accounts and investigation of particular items that may unduly inflate or deflate any of these inputs. This was a key issue arising in the MBIE Study.

- Multiple ROACE assessments. In the context of a market investigation ROACE calculations should ideally be undertaken for all or most suppliers (a high ROACE for one firm alone may simply reflect that firm's superior efficiency or innovation advantage). This not only represents a multiplication of assessments with the associated assessment timeframes, but also challenges in ensuring like for like assessments (firms typically do not all follow the same accounting conventions).

Timeframe issues

A ROACE calculation should reflect returns over the longer term, reflecting the term over which investments are made and in which market conditions can change substantially. As set out above, the conditions in retail fuel markets have changed materially, with relevant trends (particularly entry and exit of retail fuel outlets) occurring over a period exceeding the 10 year period that has formed the basis for the Commission's preliminary inquiries. Accordingly, the measurement issues set out above arise over multiple years.

This raises further challenges compared to single year estimates, but is necessary in order to produce any meaningful information, particularly in an industry such as retail fuel where investments tend to be long term.

Comparator issues

A ROACE measure alone is of no use in a profitability or "reasonableness" assessment. Rather, it needs to be compared to something. Comparators may include measures of ROACE in other countries, or in other industries.

However such comparisons are fraught since they are only valuable if the comparisons are "like for like" (which again may be difficult given the range of parameters that go into a ROACE calculation and the measurement difficulties identified above). Alternatively, a ROACE measure might be compared to a measure of the cost of capital for firms in the industry, such as a measure of WACC. The estimation of WACC brings its own set of estimation challenges, room for debate and a likelihood of a wide range of plausible estimates.

Conclusion on profit measurement

Given these issues, and as evidenced by the difficulties faced by the consultants engaged to conduct the MBIE Study, any sound ROACE analysis is likely to result in a wide range of estimates. Therefore, it is likely that an analysis of ROACE will not be capable of supporting any meaningful conclusions in relation to "reasonableness" of prices or margins. Therefore, BPNZ queries whether the gain from conducting the analysis is likely to be worth the substantial effort and costs that the analysis will imply for both the Commission and the industry.

4. The retail fuel supply chain

The Issues Paper sets out a range of questions about the structure and efficiency of the retail fuel supply chain.

BPNZ considers that the different operating models employed by the participants in the retail fuel industry drives a competitive market as described in section 2 above. Importing, refining and distribution aspects of the supply chain have been established in a way that efficiently delivers retail fuel to market, while facilitating vigorous competition between suppliers and providing incentives to invest in distribution and retail infrastructure.

Furthermore, in assessing the structure of the supply chain, the Commission needs to account for the interrelated nature of the different aspects of the supply chain. The arrangements in place are aimed at achieving maximum efficiency at each level of the supply chain.

Industry exhibits various levels of vertical integration

As the Commission notes in the Issues Paper, various suppliers in the industry have different levels of vertical integration. For example:

- BPNZ is part of the BP global group, which has involvement right through the fuel value chain up to exploration and extraction of crude oil, refining, distribution and retail;
- Z Energy is active only in distribution and retail (with a minority interest in RNZ);
- Gull has historically had no involvement in refining but owns terminal infrastructure and imports refined fuel from overseas which it sells through its retail network, although under Caltex Australia Pty Ltd ownership they will have access to regional refineries;
- numerous distributors and resellers acquire fuel from one of the "majors" and sell it through their retail networks.

Even within these different models there are further differences, such as the prevalence of corporate owned and operated stores, franchised operations and independently owned dealer stores. Yet, despite these wide variations in supply chain models, all active suppliers vigorously compete in the retail fuel industry. Each structure has its own pros and cons, but none which result in any overarching competitive advantages or disadvantages.

Considerations regarding the refinery

The Issues Paper asks whether the operation of the RNZ refinery as a toll refinery rather than a merchant refinery affects competition in retail fuel markets. BPNZ considers that the manner in which the RNZ refinery operates does not have any adverse effect on competition.

Refined fuel is a globally traded commodity and merchant fuel is available to any fuel retailer to import. Less than 70% of New Zealand's fuel requirements are met from RNZ refined products (with BP meeting ~67% of its requirements from RNZ refined products and the remainder from imports of refined products).[1] Accordingly, having access to capacity at the RNZ refinery does not provide the majors with any material competitive advantage as prices of refined products tend to reflect import parity prices for imported fuel. Indeed, depending on trends in international refining prices and capacity, having access to RNZ

[1] BPNZ imports all of its Avgas and 98 octane requirements and uses a mix of domestic and imported volumes of 91 octane, 95 octane, diesel and jet fuel.

refinery capacity (with associated obligations to pay for such capacity irrespective of whether it is used) can carry substantial financial burden. For example, if refining margins reduce as they sometimes do due to international pressures, importing certain grades could be more economic than sourcing these from the RNZ refinery.

Considerations regarding primary distribution

The Issues Paper states that most of the primary distribution assets (except for storage terminals and the Refinery to Auckland Pipeline (**RAP**)) are jointly owned by the major fuel firms. However, storage terminals and the RAP, which are independently owned, account for a significant proportion of primary distribution assets. Jointly owned assets sit within Wiri Oil Services Limited (**WOSL**) and Coastal Oil Logistics Limited (**COLL**), but make up a very small proportion of the primary distribution assets. In particular, COLL owns very limited assets itself (the coastal oil vessels which form a substantial part of its operations are under charter to COLL, representing an ongoing cost). These functions are aimed at maximising supply chain efficiency, including supporting the efficient operation of the RNZ refinery. BPNZ considers that the arrangements relating to COLL and WOSL have no adverse competition effects. It expands on these points below.

The purpose of WOSL is to receive and store fuel from the RNZ refinery, on behalf of the shareholders, who then distribute it through their own supply chains, primarily within the Auckland region. WOSL is operated independently of its shareholders.

Similarly, COLL's primary function is to facilitate the efficient transport of fuel products from the RNZ refinery to terminals throughout New Zealand. It also schedules the import shipments of the shareholder fuel companies to efficiently distribute fuel into the right ports at the right time and not clash with coastal vessel deliveries. The import shipments are arranged independently by the shareholder fuel companies. Like WOSL, COLL is operated independently from its shareholders.

The operation of COLL, along with the terminal sharing (including "borrow and loan") arrangements between the majors allows for efficient distribution of fuel from the RNZ refinery throughout New Zealand. Absent these arrangements, the RNZ refinery users would require a much greater number of ship movements and unnecessary duplication of terminal infrastructure. This would increase the cost of distributing fuel throughout New Zealand. COLL also facilitates the efficient delivery of imported products by participants, although participants source their import volumes independently.

Furthermore, absent COLL and the terminal sharing arrangements, the efficient operation of the RNZ refinery would become much more difficult. The RNZ refinery relies upon the prompt uplift of product to enable it to maintain its output at close to full capacity. COLL is able to coordinate the uplift of this product more efficiently than would be possible were the RNZ refinery users to uplift product independently. Accordingly, it is important to recognise that the operation of the RNZ refinery, COLL, the RAP, WOSL and the terminal sharing arrangements have a degree of interconnectedness and cannot be viewed in isolation when considering the retail fuel supply chain.

While delivering significant efficiencies in the supply chain, none of the arrangements discourage the fuel suppliers from investing in new primary distribution assets. Because terminal infrastructure is independently owned, terminal owners charge a throughput fee to other users of terminal assets via bilateral arrangements. The level of this fee is determined by market forces. Where constraints occur, BPNZ may choose to invest in new terminal infrastructure. BPNZ has invested approximately $70M in recent years in new terminal developments and new infrastructure to meet growing demand. This includes new infrastructure in Dunedin (2016/17), Nelson (2018) and construction of the Seaview Terminal in Wellington (commissioned in 2011) and New Plymouth (2017/18).

Against this background, BPNZ is confident that the primary distribution arrangements in place have the purpose and effect of achieving efficient distribution of fuel to terminals throughout New Zealand. At the same time, the arrangements are structured in such a way as to ensure that participants:

- have full incentives to invest in new infrastructure should market conditions warrant such investment;
- have the ability to increase or decrease import volumes quickly and independently; and
- have the ability and incentive to compete vigorously in retail and wholesale fuel markets.

Considerations on secondary distribution and wholesale fuel

As set out in the Issues Paper, there are a variety of different models of secondary distribution and wholesale supply. BPNZ itself supplies fuel to its own retail sites, BP branded dealer sites and to major resellers such as GAS and RD Petroleum and McFall Fuel. Secondary distribution can be arranged by BP as the fuel supplier or by the reseller. It is a competitive market being undertaken by third party contractors. BPNZ is not aware of any aspects of the secondary distribution function that could have an adverse effect on competition in retail fuel.

Equally, BPNZ considers that the reseller sector that exists in New Zealand is indicative of strong competition in wholesale fuel markets, resulting in a strongly competitive retail fuel sector. As the Issues Paper acknowledges, the number of reseller retail outlets has expanded substantially in recent years. This expansion would not have occurred if the wholesale market was not operating effectively. Resellers are amongst the most aggressive competitors on price, indicating that their wholesale terms do not act as a constraint on their ability to compete.

Considerations on retail competition

As set out elsewhere in this response, BPNZ considers that the retail fuel industry in New Zealand exhibits vigorous competition. The efforts of fuel suppliers to differentiate themselves by reference to service, convenience store and coffee offerings, loyalty programmes and fuel quality is indicative of strong competition rather than any competition concerns.

5. Conclusion

BPNZ looks forward to working with the Commission during the course of the Market Study to expand on the matters addressed in this response.