RETAIL FUEL STUDY CONSULTATION CONFERENCE
24 SEPTEMBER 2019

SESSION ONE: Opening Remarks From The Commission

MS RAWLINGS: Kia ora koutou, nga mihi ki a koutou katoa. Good morning everybody, thanks very much for being here. It's 9.30 so we'll get started. We've shut the doors just to keep the noise down from outside, but do feel free to come and go as you need to as well.

I'd like to just start by welcoming you all to this conference today on our draft report on the market study into retail fuel. I'm Anna Rawlings, for those of you who don't know me, the Chair of the Commerce Commission. With me are other Commissioners who have been working on the market study with our team of staff as well. They are, to my right, Commissioners Dr John Small and Dr Jill Walker and at the back of the room also Deputy Chair Sue Begg.

A number of Commission staff are also here. They'll contribute to the conference as they have to our work on the study over recent months. At the front table here I'd like to introduce Keston Ruxton, who is our Market Studies Manager and John Groot who's the Principal Advisor on the market study. Also Ben Hamlin who is our Deputy General Counsel Competition, and David Shaharudin and Harshal Chitale, who have been working on the retail work, will join us for this session and as we move through the sessions we'll involve other staff who will forgive me for not going through all of them at this stage.

Many of them will be known to you as a consequence of the time that you've spent with them in preparation for our draft report in any event.

We appreciate the time and energy that many of you have put into assisting us with the study so far, including your recent submissions on our draft report, and we really want to extend our thanks to you for making the time to be with us and for working through those issues with us both in advance and at the conference over the next few days.

As you're aware, just to recap the background, the Minister of Commerce asked us to carry out the study and we're required to make our final report by the 5th of December this year. It's useful, I think, just to briefly summarise the purpose as a setting for the matters that we're looking to discuss in the next couple of days in particular.

The purpose of the study, as you will know, is to identify and assess factors that may affect competition in the supply of retail petrol and diesel used for land transport in New Zealand, and to make recommendations that we consider may improve competition. As you know, the study isn't an investigation into whether aspects of the Commerce Act have been breached, neither is it an exercise in industry regulation. Both of those sets of work are sets of work that we undertake, as you know, throughout other parts of the Commission, but here we're not attempting to draw conclusions on exactly what the price of petrol and diesel should be.

Each of those other processes I've mentioned involve a different kind of a process from a market study and a market study just examines the state of competition in this sector and asks the question whether anything may be done to improve competition as we see it, if we consider that it's not working as well as it could. Ultimately, the overriding aim of the study is the same as the purpose of the Commerce Act itself and that is to promote competition in this market for the long-term benefit of consumers in New Zealand.

The Commerce Act requires us to publish the report that we published around a month ago, as you know, and also to have regard to comments and submissions on it. We've been really interested in those comments and thank you again for taking the time to provide submissions. We've also decided, although it's not strictly necessary in all cases, to hold this conference to provide an opportunity for us to discuss those comments and submissions with you and to provide you the opportunity to hear a little from one another and to ventilate some of those additional issues that may not have been recorded in submissions that you think that we may need to consider as we finalise our report.

The report, as you know, at the moment, sets out some preliminary views on the state of competition in these markets. It's important to reinforce that those findings are preliminary and the conference and your comments on the report are integral in enabling us to reach our final conclusions. So we would encourage you to share your thoughts with us over the next couple of days and we do have some time set aside for some confidential sessions to follow as well. The conference also provides an opportunity for you to clarify the perspectives of others potentially and to perhaps define the shape of the further submissions that you may make.

There will be an opportunity throughout the conference to hear from anybody who wants to contribute to the topics under discussion. Many of you have indicated that you would like to attend as participants in the conference and others as observers, but we'd encourage you not to let that nominated status dictate the role that you play in the conference. If there are broader questions put to the group and you've recorded that you're here in an observer capacity but you wish to make a comment, then please feel free to indicate that and we really would like to hear from all-comers.

As I mentioned, the final report will be available no later than the 5th of December and that is a hard deadline for us.

So I now just want to cover a few administrative matters before we start on the conference sessions. An update on the agenda was published on our website on Friday the 20th of September and, as you'll know from that, there are likely to be a number of confidential sessions as I've mentioned, and those will be closed to the public and closed to parties other than those nominated for those sessions.

While it's really important to us, of course, that our process is transparent and that parties have the opportunity to hear from one another and to test the views of one another, of course some of the information, and more in some cases than in others, is commercially sensitive and it's really important that we make provision to hear that information in a closed session so that parties can elaborate on explain their positions further to us and elaborate on comments made in public sessions. We've reviewed copies of all submissions and, for those who haven't identified them already, public versions are available on the Commission's website to everybody.

I'm shortly going to invite parties who have provided a submission and who have indicated that they wish to do so to provide some introductory comments and a brief summary of the key points of their submission that they really want to emphasise to kick the conference off. And also I'd encourage you to identify matters that you're hopeful that we will discuss throughout the conference so that we can ensure that we've covered issues of importance to everybody here today. The sessions that will follow will broadly follow the areas of discussion from our draft report and we'll step through those one at a time, as you can see from the agenda.

The discussion in each session will be led by one of the Commissioners and parties may individually or collectively be asked to address some of the questions that we have and we'll also ask for contributions from staff as we need to on those sessions and round out the sessions with an opportunity for some final comment from parties. Depending on whether time allows, we're conscious that there may be some further comment that people want to make that isn't provided for in the conference setting and we'd really encourage you to hold those thoughts and bring them to us in your further submissions if you'd like to.

At the same time, we'd like to encourage discussion during the conference and also follow-up submissions to really be focused on issues that haven't previously been discussed, points that haven't really come out already in the submission and investigation-type process through the preparation of the draft report just so that we can keep the timing and the material as tight as possible. We don't anticipate that parties would question other attendees at the conference, but to the extent that we can, as I've said, we'll provide some time for people to comment on issues raised by others.

The sessions will be recorded. When you're asked to speak therefore I'd ask that you ensure that you're somewhere near a microphone. There should be plenty for people to access. And also that you speak reasonably slowly into the microphone to enable our stenographer to pick up what you're saying and keep up with you without difficulty hearing you. For those who aren't seated at the table with microphones, if you do have something to say I'd encourage you to come forward and take some of the more vacant seats so that you are near a microphone and can be heard or move towards a microphone if you need to at the time.

A transcript of the sessions will be posted on our website as soon as we can manage that. So some instructions on operation of the microphone; many of you will be familiar with this format, but there's a push button on the microphone. When the light is off the microphone is not on. If you could just press the button so that goes green when you want to speak and then turn it off again when you're not finished then we won't all pick up your private conversations either.

For media present in the room, you're welcome to attend the public sessions over the next two days. Commissioners won't be available for further interview or discussion at this time, but if you have queries then I'd encourage you just to contact Christian or Rachel who are in the back of the room here. As you'll see from the agenda as well, breaks have been scheduled throughout the day to provide for a break for everybody. Commissioners won't be available for discussion during those breaks but if any matters arise for any party that you'd like to discuss with a member of staff, then I'd encourage you just to approach Keston at the first instance and we'll see what we can do to resolve any questions that you have. Any documents that you might wish to provide to the Commission for the first time also should be passed to Keston so that we can ensure that those are properly processed into the record for the Commission.

Following the conference we've asked for additional comments by 11 October. We may also follow up with some additional questions for parties relating to issues arising out of the conference or out of the draft report and submissions and/or any other information that we think might assist our preparation towards the final report. I should add that we'll probably revisit our process and let you know about that after the conference once we've heard comments and further submissions and considered what further matters and process we may need to follow.

Now the pointy end of health and safety and housekeeping matters which I'll let you know about; an emergency briefing. So the hotel tells us that we're all protected by an advanced fire protection system which can evacuate single floors or the entire building. So in the event of an emergency you'll be warned by an electronic alarm in the ordinary way. If it's sounding here in this room then we must evacuate to the evacuation point which is across the road from the hotel entrance in front of 1 Grey Street. While on the conference floor here you can proceed to the nearest emergency exit and use the main hotel stairs or the fire exits beside Aurora and Featherston rooms out in the foyer there.

If the exit is blocked, then come back to this room and remain. In the event of an earthquake or a major incident, obviously remain calm, stay in this room. We're encouraged by the hotel drop cover hold as would be expected and listen for an announcement over the hotel PA system which will provide further instructions as to what to do next. The conference staff will let you know if you need to evacuate into the lobby. We'd just encourage you to follow instructions from the hotel staff in case of an emergency.

Bathrooms, you may have found on your way in; they're located just at the right as you exit this room and there are also further bathrooms located to the left of the restaurant on the ground level if you need them.

The very important matter of WiFi access, you should have instructions, I think, circulated in the room, but in any event if you're looking for wireless you can select the network "IC Public Wireless" and on the welcome page select the visitor tab enter the password which is Sep19. That's very important housekeeping matters.

We'll get started on the first session and what we'll do, just for the purpose of transcription, and I appreciate it's quite a large room, but I think some of you will be known to one another and others will not. So we might just start and go around the room and just briefly introduce yourselves with the organisation that you're from and your name if you don't mind. We might just start doing that on the left here.

MS GREGOR: Kia ora, I'm Stephanie Gregor from the Motor Trade Association.

MR BAGGOTT: Good morning, I'm Ian Baggott from the Motor Trade Association.

MR STOCKDALE: Mark Stockdale from the Automobile Association.

MR FITCHETT: Scott Fitchett from AA Smartfuel.

MR YOUNG: Jonathan Young, Energy Resources.

MR SHEWAN: Glenn Shewan, Bell Gully.

MR BONE: Maurice Bone, BP.

MR DUKE: Charlie Duke, BP.

MS LYNCH: Rachael Lynch, BP.

MR CROWTHER: Torrin Crowther, Bell Gully.

MS BOFFA: Debi Boffa, BP.

MR IRELAND: Courtney Ireland, BP.

MR GREEN: Larry Green, Gaspy.

MR NEWTON: Mike Newton, Gaspy.

MR MILLER: David Miller, Gull.

MR BODGER: Dave Bodger, Gull.

MR PARHAM: Simon Parham, Waitomo Group.

MR FITZGERALD: Rob Fitzgerald, Mobil.

MR McNAUGHT: Andrew McNaught, Mobil.

MR ABURN: Bradley Aburn, Russel McVeagh.

MS CROCKFORD: Victoria Crockford, Z Energy.

MR TEMPLETON: Sebastian Templeton, Chapman Tripp.

MS COOPER: Lucy Cooper, Chapman Tripp.

MR McLAUGHLIN: Sam McLaughlin, Z Energy.

MR JONES: Lindis Jones, Z Energy.

MR BAIRD: Andy Baird, Z Energy.

MS LAW: Nicola Law, Z Energy.

MS RAWLINGS: Thanks very much. We'll move on then to our introductory sessions and the purpose of these sessions, as I mentioned, is just to provide some introduction for those who were interested on our summary views from submissions and also just to highlight some of the issues that are really important to you to get out of the next few days. So we've got four parties that have expressed an interest in providing some introductory comments, but if there are others as we get to the end we do have a bit of time, so I'd encourage you to let me know. Perhaps if we begin with Z I think. I think we're going to start with Lindis Jones CFO, is that right? Thank you.

SESSION ONE: Introductory Comments From Parties

MR JONES: Thank you. My opening comments will deal with those issues that we think are most important to be dealt with over the next two days. But most importantly I want to start with an apology. So in our press release in response to the draft report, Z incorrectly attributed a comment to the Commission staff about the number of new sites that Z had opened. That was incorrect. It frankly shouldn't have happened and this industry doesn't need any more misinformation, so in particular to the Commissioners, the Commission staff, apologies for that.

The rest of my opening remarks I'd like to discuss Z's view on profitability, why getting this right matters and touch upon the recommendations included in our report.

Firstly in regards profitability, my comments on the draft report are just that, they're comments on a draft report for which the Commission has invited some feedback and response. We also acknowledge that the inherent difficulty of calculating profitability for a complex industry like fuel retailing. For many it's predictable that a company such as ourselves in this situation would defend its position and set out to refute the findings of the draft report, in particular that excess returns exist, that they've persisted and seem likely to continue.

However, Z believes that getting a more accurate assessment of industry profitability matters for reasons much more than just self-interest. In particular, overestimating profitability could lead to the pressure for interventions, that will have the effect of increasing cost to the industry and ultimately consumers. The bigger the perceived problem, the bigger will be the appetite and expectation for intervention and the costs that go with this.

In Z's view, the analysis within the draft report excludes costs that a new entrant would incur - just to be absolutely clear, "would incur" as opposed to "wouldn't occur" -

and inflates returns with items that in several cases are not actually available for distribution to owners.

To put this into perspective, the analysis included in the report and shared with Z excludes more than 40% of the costs associated with building capital in our business. Examples of these exclusions totalling more than $800 million include maintaining a fixed inventory to ensure supply security, ensuring remediation of sites at the end of their useful life, investment in contracts to secure a long-term income stream in lieu of direct investment in sites, and building capability and capacity to operate a business, serve customers and compete, and in doing so suggests an underlying assumption that goodwill is somehow created at a capital event such as acquisition.

Interventions decide to deliver a reasonable outcome for profitability according to analysis in the draft report we believe would severely constrain the earning capacity of participants in the industry. This would have three very real material impacts.

Firstly, as a CFO of a commercial enterprise, I'm very aware what we would have to do is cut our cloth and minimise investment to operate under such expectations. An example of what this could look like is the industry in the first decade of this century. Retail sites were closing at the rate of one a week and a trend for underinvestment in the supply security was established. This would actually compromise, we believe, the core purpose of the industry to provide fuel when consumers and businesses require it.

Secondly, such expectations would have the effect of increasing barriers to exit. Those owners of businesses at any level of the industry, including the more than 1,000 sites owned by independent business people, would be confronted with realising a dramatically lower value for their business when they look to exit and a value that doesn't reflect their day-to-day efforts or their investment.

Thirdly, and perhaps most ironically, the reduced earning capacity of industry participants and inability to recover costs of operation would stymie new entrants at all levels in the industry. If they cannot generate returns associated with costs they will incur, such as holding petrol and diesel for sale, building or acquiring new sites, or investing in capability to build relationships with customers, and more generally build value in their business, then their incentives to enter the market are much reduced.

Finally in regards profitability; interested parties will reasonably take the headline findings of the report without any appreciation for the nuances or disclaimers to inform their commentary and view of the industry. Z simply doesn't have the ability to correct these views and reverse the impact on our reputation with our customers, our staff, our investors and stakeholders. For this reason, it's important to Z that the final report should be accurate and clear to the extent possible, and not only in the actual assessment of profitability but in comparisons made. So where comparisons with other companies or industries are made, the same adjustments need to be apply. Where metrics or methodologies are introduced, how and why they are used needs to be clear, and where the data shows that the profitability of the industry is declining we should use that as well.

For instance, Z believes that the conclusion that New Zealanders pay relatively high prices for petrol and diesel based upon the OECD data is probably unsound. The way the data is collected, and the actual data itself, varies by country. It's not representative of the actual prices paid by New Zealanders for 91 octane, the main fuel purchased, and is heavily influenced by the conversion of different currencies. An analysis based upon an equilibrium rate of exchange provides a significantly different conclusion, that the price paid for fuel is about the average of prices paid by consumers in these different countries.

Analysis between sectors is also important. The majority of the difference in the returns calculated in the report and those of other listed companies when compared to Z is actually down to the adjustments made to Z's returns and not to those of the other companies.

So while Z believes it's of fundamental important for the study to be as accurate in its assessment of returns as possible, what level of returns should exist is perhaps less useful when agreeing what, if anything, should be done. Margins and returns have increased at the start of this decade, but we also observe that competition's increased and as a result returns have declined. Across the 2016 and 18 period, included in the draft report, Z returns, as calculated by Z, went from 12 to 10%; last year they declined to 8.5%; this year we forecast them to be about 7%.

Finally, while an accurate measure of assessment of profitability is critical to the success of this market study, Z believes that we all need to be responsible for the concerns of the stakeholders. This is a really complex industry and it's arcane in how it operates in some respects, and that has the effect of almost covering the industry in a shroud of mystery.

So although we can't agree with a lot of the profitability analysis and the conclusions that arise, there are many things in the report that we can agree with. That's why we've made recommendations in three areas. In particular, regarding transparency of pricing at retail sites and enabling effective monitoring of prices all the time.

Secondly, we agree that we should enhance conditions for competition in the wholesale market. These set the tone for conditions in the retail market and for the industry more generally.

Thirdly, we think it's important that we reinforce the best of New Zealand's domestic supply chain.

Finally, I'd like to say Z looks forward to and is committed to working with the Commission constructively over the next four days. Thank you very much.

MS RAWLINGS: Thank you. I think we'll just go through the comments and reserve questions on those issues to the sessions particularly on profitability. If I move then I think next to BP perhaps to provide some comments.

MS BOFFA: Hi, I'm Debi Boffa from BP New Zealand and I'm here today representing a business that has been operating in New Zealand since 1946 and employs more than 3,000 New Zealanders, both directly and indirectly. BP is committed to the New Zealand market and this is evidenced by the over $1 billion that we do have invested in capital in this market, as well as the investment we make in local communities in which we operate.

We invest on average approximately 50 to 70 million New Zealand dollars every year into pipelines, terminals and retail sites and have developed our retail offer and supported our resellers and our distributors to build both theirs and our businesses into what they are today. We consider that the New Zealand retail fuel market is workably competitive and serves New Zealanders well.

Fuel retailers across the board have invested substantial sums in their businesses to deliver a range of customer offers while maximising efficiency through the various supply chains. Substantial new entry is occurring at the terminal level via Timaru Oil Services, or TOSL, and their entry into Timaru and Mt Maunganui, this is very significant. Our estimate is that approximately NZ$100 million will be invested across both those locations.

At the retail level we see independent retailers rapidly building new sites, both unmanned and with full service offerings, increasingly on prime sites and in main metropolitan streets.

These investments would not be occurring if TOSL did not believe it could attract wholesale customers, or if retailers did not believe they could secure competitive access to wholesale fuel on an ongoing basis, either via the existing suppliers or by TOSL. No amount of theory can undermine the fact that people are making these investments and they are expanding, which is precisely what you would expect in a workably competitive market.

Put simply, we believe the growth in independents in both the North and the South Islands of New Zealand, especially in a period of flat to declining market, does not at all sit comfortably with the notion that the wholesale market is broken. These retailers have accessed the majors' infrastructure by way of bilateral contracts, as you would expect in a workably competitive wholesale market; and in the case of Gull, by establishing its own terminal.

If the wholesale market was broken, or if the majors enjoyed a structural advantage which impacted workable competition, we would not have expected to have seen a total of 76 sites from just the independent retail brands - being Gull, Waitomo, NPD and Allied - being built in the last five years alone. This is a substantial amount of new entry and site capacity for the New Zealand market and further to this, the entry of TOSL in itself is inconsistent with the assertion that importers face barriers to entry.

BP does agree with the Commission's observation that the supply chain is efficient. But it should be noted that it's also a very complex system. Any changes to the supply chain system need to be considered carefully to avoid unintended consequences. In workable competitive markets margins will change over time with the business cycle resulting in periods of higher and lower margin, and we're seeing exactly the same thing in the New Zealand retail fuel market. When margins were low, between 2000 and 2010, we saw almost 400 retail sites close and the exit of Shell from the industry. More recently, as margins have restored, we've seen expansion and investment as we would expect, resulting in consumers now having the benefit of the broadest range of offers ever.

Our profit is not excessive given these significant long-term and ongoing asset investment in the complex and risky business that we operate, and not as high as the Commission calculated. The analysis conducted by CRA has identified that the measures of profitability that the Commission adopted cannot be used as a basis for finding that BP is making excessive profits. To elaborate on these I will speak to a few of the main points raised by CRA.

Firstly, importer margins have risen from an all time low over the past 10 years to reach a peak in what is a much longer business cycle. Further to this, analysis using importer margins will overstate the profit that retailers actually make on fuel, operating costs which have been rising over time must be deducted from this importer margin.

Secondly, using ROACE analysis based on the historic cost of BP New Zealand's entire asset base provides no direct links to whether BP returns reflect pricing above competitive levels. CRA analysis of ROACE shows that returns are not consistently above the Commission's estimation for WACC for the major retailers and the ROACE has in fact fallen in 2018.

Thirdly, future profitability measures used by the Commission do not accurately describe the competitive pressures that the fuel suppliers are likely to face over the next few years. Therefore, you should not conclude that profit margins will remain the same or increase when expansion and retail capacity continues to substantially outpace the growth in demand for retail fuel.

Due to the complexity of the fuel industry and the significant amount of detailed information provided to the Commission, combined with the relatively short period of time to review and draw conclusions, it's not surprising that there are aspects of the draft report that we believe do not accurately reflect the market that we are operating in. On that basis, we disagree with the need for many of the options that are up for recommendation as presented by the Commission in their draft report.

That said, it's important that New Zealanders have confidence that the retail fuel market is workably competitive and we acknowledge the role of the Commission in that process. BP has worked openly with the Commission in support of that objective, as we did with MBIE in previous studies, providing significant amounts of data, information and context.

We look forward to continuing our engagement with the Commission, and the Government once the report is finalised, to ensure that the market is accurately represented and that both intended and unintended consequences of any recommendations are well understood before action is taken. This, we believe, will ensure the best outcomes are delivered for New Zealanders.

MS RAWLINGS: Thanks very much for that. I think I will call now on Dave Bodger from Gull to make a few comments.

MR BODGER: Thank you for the opportunity but we'd signalled we were just going to introduce ourselves which we've done. Thank you.

MS RAWLINGS: Thank you. I think the other indication perhaps of some opening comments came from the MTA.

MR BAGGOTT: Good morning everybody, my name is Ian Baggott, Sector Manager Energy and Environment. I've got a brief statement I'll just read out that hopefully explains MTA's position and interests going forward in this market study. I'll start with a bit of a history lesson about MTA.

The Motor Trade Association is an incorporated society that was founded in 1917 and in 2017 celebrated 100 years of trust in the New Zealand motoring community. MTA currently represents approximately 3,600 businesses within the New Zealand automotive industry and its allied services. Members of our association operate businesses including automotive repairers, both light and heavy vehicles, collision repairers, service stations, new and used vehicle importers and distributors.

The automotive industry employs 57,000 New Zealanders and contributes billions of dollars to the New Zealand economy. We currently have around 870 service station members representing all fuel brands and business operating models ranging from corporate-owned corporate-operated to fully independent sites. Our service station members are an important part of the overall MTA membership and we have been working hard to develop additional support services and business benefits for these members.

We do appreciate the opportunity to comment on the market study and to the retail fuel sector, the draft report; and while many of our comments focus on issues reflecting MTA's independent or dealer-owned and operated service stations, we should also point out that approximately half of our fuel sector members are fuel firm corporate-owned corporate-operated sites. It should also be noted that many of the industry have encouraged MTA to speak on behalf of small independent service stations to make sure their voice is heard during this process.

MTA generally supports the findings and analysis in the draft report and is delighted that the report has confirmed MTA's own views and concerns, particularly around the restrictive nature of some fuel supply agreements that our independent members have brought to our attention. We do believe that greater transparency and access to independent retailers or resellers to an active wholesale fuel market is a further key to unlocking the desired improvements in the wholesale fuel market. MTA looks forward to the further consideration of this topic.

We do, however, question some of the broader references to profitability of the retail fuel market in the draft report. These figures were derived from assessing the profitability of fuel firms, i.e. the majors and resellers, operating a vertically integrated fuel supply model. MTA maintains that there is nothing to suggest that the profitability of these figures that were portrayed are being enjoyed by independent retailers who are directly or indirectly tied to a major through a long-term fuel supply agreement.

MTA leaves the final analysis of profitability of the fuel firms to those firms and the Commission. MTA further applauds the way the Commission has engaged these complex issues and identified that the primary issues impacting on consumer prices relate to contractual constraints and other issues in the wholesale market. The challenge going forward is to fully understand the current, somewhat complex retail fuel market operating in New Zealand and look for ways to improve competition at the wholesale level without imposing any unintended adverse consequences on competition in the retail market.

It is our view that change that promotes a more active wholesale market in which retailers can engage as they wish and retailer numbers are more likely to remain the same provides the agility to improve competition. In saying this, MTA recognises the need for certainty around fuel supply agreements for both the wholesaler and the retailer at all stages of running their business.

Finally, in line with the Government's just transition principles leading towards a low emission economy, we trust that any changes imposed by the Commission follows these just transition principles. The significant investment all parties have committed to in providing such a great range of retail fuel outlets needs to be recognised and balanced against better market outcomes when looking to introduce the desired long-term benefits for consumers. Thank you.

MS RAWLINGS: Thank you very much. Those are the introductions that we had prior indication of. I'd just like to check whether there's anybody else that would like to make any opening or introductory comments at this stage? No? All right, we'll move on then a little bit early to our first session, which is going to focus on the retail issues that we have explored in the draft report. And we really wanted to start with this area because I guess these are issues that are most directly visible to consumers, and perhaps with those final comments there it's a good introduction into this area.

So the first topic that we really wanted to look at is the use of loyalty and discount programmes and schemes, and as many of you have acknowledged and the draft report reflects, loyalty and discount programmes have become an increasingly common part of the landscape in the retail market.

Many of you will also be aware that the ACCC recently issued a draft report on customer loyalty schemes and in that report it noted what many of us observe here; and that is that these schemes are ubiquitous in many sectors of the economy, not just in this particular industry that we're looking at, and customer participation tends to be high and these are things that we observe in New Zealand as well.

These programmes can assist, we recognise, in attracting and retaining loyal retail customers and they also assist with the collection, in many cases, of data to help suppliers to develop insights into customer behaviour, and that's something that we haven't explored to a significant degree that I'd like to come back to in this session. Data collection enables, of course, insights to be drawn from customer behaviour and that can enhance segmented marketing and individualised marketing and differentiation of offers made to consumers.

The ACCC issued its draft report after our draft report but we do consider that some of its commentary has some parallels in some of the issues that we've raised in relation to the retail sector here. So we want to just explore some of those a little bit further.

I should note also we didn't include, as you'll be aware, recommendations in the draft report relating to loyalty and discount schemes. We still don't consider ourselves likely to do that in the final report at this stage, but that is a part of what we are looking to explore here and we think it's useful, nevertheless, to unpack some of the issues in this area for the benefit of consumers and those looking at the retail market as a whole.

So we've observed that most fuel retailers do offer one kind of loyalty programme or another and there has been some switching between programmes over time and the memberships of these programmes can run into the many millions of consumers.

We also made the point, we acknowledge that price discounting on its face can be good for consumers. Loyalty programmes are delivering discounts from board prices for consumers and many submitters have generally referenced the positive regard with which consumers hold those benefits, and we reference submissions to the effect that discounting behaviour does evidence a degree of competition at the retail level.

But we also reflected some views that the issue of discounting through loyalty programmes isn't quite as simple as that and may be a little more complex than just the application of a simple discount. So we've sought to explore whether loyalty programmes have substantially replaced direct board competition in the eyes of many consumers and whether direct board competition might in fact provide lower prices across the board than participation in loyalty and discount schemes, and whether that might benefit consumers more broadly as a whole.

So you'll be aware of the potential issues that we identified and the key two were really focusing a concern that perhaps consumers are focusing more on the level of the discount that they receive than on the ultimate price that they're going to pay for the fuel that they acquire, and the second related to price transparency.

So this is an issue that the ACCC also has referenced that perhaps loyalty schemes can reduce price transparency when it becomes difficult for consumers to compare loyalty offers because of the proliferation and the differentiation between those offers, and this is something that we also flagged in the draft report.

SESSION TWO: Retail Price and Product Offer

Discount and Loyalty Schemes

MS RAWLINGS: So perhaps I can start the discussion on this issue just with the question of the rise of loyalty and discount schemes in this country. So as I've said, we obviously observed an increase in the use of loyalty and discount programmes. They've become increasingly common and we'd just like to look at perhaps the reasons for some of that.

And I might start if I could if Z has some comments on this issue. You've noted in previous submissions that there has been this rise in the use of off board price discounting and I just wondered if you could provide us with sort of an introductory view on why you think that increase and use of this form of discounting has taken place here.

MR BAIRD: Good morning. So look it's one of those things where I think it's just an evolution of customer expectation to be honest. So as you said, loyalty programmes exist right throughout the New Zealand marketplace in a number of industries and we've had, or Z through the acquisition of Shell, was involved with Fly Buys so we've had experience with that sort of programme for a number of years.

And what really we've seen with that is that as customers get to that next level of expectation and other competitors come into the marketplace then there's just a need to keep pace with that and to basically evolve the programme, so that's what we've done with our programme.

I'd say to the second piece of that is that we've tried to be very clear with that in terms of making it very simple for customers to understand what the offer is compared to the board price, and also to make a no minimum spend so therefore the complexity or the barrier to entry is quite simple as well.

So we're very aware of the complexity of programmes across the divide being the New Zealand marketplace and that's evidenced in research that we've undertaken. So therefore we would say that we're very consumer-focussed in terms of trying to deliver what consumers want from us and also at the same time being very clear and very simple in how we deliver that.

MS RAWLINGS: Do you think that means that consumers have become more focussed on the benefits that they get under that particular programme offered by each retailer than just comparing straight board price do you think?

MR BAIRD: No, so consumers are very aware of board prices and, look, many - I would say, you know, a large number of consumers actually hold most loyalty programme cards or are members of those anyway, so there's a lot of cross-over between those. And then they're effectively making their first determination a lot on the price and the service, location and other things that the offer or the brand has got, and then the loyalty programme is almost a cherry on the top would be our understanding of what consumers tell us.

MS RAWLINGS: Thanks for that. BP, do you share that same view, have you got other comments you'd like to make?

MS BOFFA: So the reason we have loyalty is that what we look to provide to our customers is a fully differentiated offer. So we like big sites, we have multiple grades of fuel with additives, we've got our coffees, we've got shops, we've got car washes and what we believe is the market leading loyalty programme, and what we're doing that for is to reward those customers that want to regularly use BP, or shop around if they've got multiple cards, as a way of saying thank you. That's what we're using the programme for.

I get your point about the transparency of what the price is versus price board. I guess I've got two comments to say about that. We know that if we're not on the mark on the price board, if we're off by a cent or two we will lose volume. So we have a very strong incentive to make sure that we are competing at the price board.

And to answer the question about do people really know the price they're getting, well, the move that we're making right now in market is to put our 91 discounted price on all our price boards because that is by far the largest grade that we will sell through the loyalty programme so that people can instantly see when they're driving down the street what that discounted price is. We've also removed the minimum on our loyalty programme so enable anyone who comes in to be able to purchase and we have the ability for you to sign up in store and either take that discount at the moment or accumulate if you spend more than 40.

So we're using it as a big differentiator but we're very aware of both the discounts and the price board and the need to be competitive in both.

MS RAWLINGS: So do I take from that that your view is that consumers are really being driven by price and using the loyalty as an additional benefit once they've made a decision based on price, or are they actually comparing benefits available under the loyalty programmes as well in your view?

MS BOFFA: I think they are. Yeah, research that we do tells us there's a range of reasons why people choose a site. Price and location are two of the very big ones, but some people choose purely on grade of fuel. If they've got a high spec vehicle and they want 98 fuel they will search out a site with 98 fuel.

So there's a range of reasons why people choose sites and even within a week people who have to fill up twice might have a very different reason of why they choose one site on a Monday on their way to work in a hurry verses in the weekend when they've got kids and they've just been standing on a sports field and want to get a coffee and a pie as well. We believe there's a number of reasons and what we try to do is explain our various offers to consumers so that in all those need states we're the one that they would think of.

MS RAWLINGS: And you talked about the programme as a reward for customers who make choices based on some of those other things, but the information that we've had is it clearly costs a bit to run a loyalty programme, so what are the other key benefits to suppliers from running the programme?

MS BOFFA: So for us you mentioned in your opening about the data side. So part of what we do is the segmentation of customers so that we can provide distinctive offers to them based on the way they shop with us and the types of products they buy. So part of the investment in the programme is so that we can be more targeted to those customers and give them offers that they want.

MS RAWLINGS: Is that something that you see increasing over time or is that a core part of the programme, the ability to actually identify and segment the customer market and direct offers to individuals?

MS BOFFA: So from our position it is. Being a company that offers a broad and diverse range of offers at our sites, for us it's really important to know why and individual is choosing us, whether it's because of the car wash or it's because of the fuels or something else. And the way for us to do that is by collecting the data. So we find it very valuable to make sure that the various offers that we're putting out, not just the CPLs, are fit for purpose. So we see it as valuable, yes.

MS RAWLINGS: Is that used for targeted advertising marketing as well, or is it more - what you're describing sounds to me a bit more like data analytics than targeted marketing?

MS BOFFA: I'd actually ask if we can move this forward to Friday when we have our session with you getting into this level of detail.

MS RAWLINGS: That's fine, we can come back to that. Perhaps I could just go back to Z on this question of what consumers are basing their decisions on and whether you have a sense of whether or not they're actually comparing loyalty programmes, or really looking at price point or the range of features that have been described.

MR BAIRD: So we would think that they are definitely looking at price as a sort of first and foremost decision point in terms of their purchase. But loyalty programmes are clearly playing a part in that and can play a part in it. And so what we're trying to do with our loyalty programme obviously is not be the decider but certainly be an incentive for customers to come to us.

So the reasons that we want those programmes is if we can bring a customer back three times instead of, you know, three out of five times, five out of five times. That's very valuable for us and we can build a relationship with a customer and actually then the same understanding in terms of understanding their data and how they behave and what's really relevant for them and what's valuable for them we can start to reward them with offers that are more valuable than sometimes cents per litre can be. So for some people a car wash is more valuable or, you know, a discount off a car wash or a free cup of coffee is more valuable than cents per litre fuel discounts.

MS RAWLINGS: How do you really assess that degree of importance among consumers?

MR BAIRD: It's something you do over time in terms of understanding, testing different things and seeing what works and what doesn't. So a lot of experimentation and a lot of understanding about the results of that.

MS RAWLINGS: I think Mike Bennetts at some point has described the element of cost and complexity in the market in these schemes as not being there some years ago and that could potentially cause confusion for consumers. I just wondered if that's a widely held view with Z, whether you are able to elaborate for us on the kinds of aspects of programmes that may be causing difficulty for consumers or confusion or areas that you might have focused on in that regard?

MR BAIRD: So I think where you end up with, I guess there's a range of programmes out there and some are very simple in entry, is almost no minimums etc, there's no sort of considerations or things around them that make them difficult for customers to use. So I think that's an area where there's minimum spends that are in force and things like that, can make them more confusing than others. So again, customers have a choice and they make those choices on the sort of programme that best fits for them.

We've been very much focused around making sure that every New Zealander can participate and therefore no minimum is a big piece of our programme. Others out there don't do that and there's a variety of different ways that competitors offer sorts of programmes and different range of other promotional activity. Some are easy to understand and some not so.

But, again, if you put it in context of the overall marketplace, you know, I always say this, consumers don't go to bed worrying about where they're going to buy fuel and therefore we've got to be as clear as we can in terms of making sure that they understand what those offers are and what they mean for them and the value that they get from them.

MS RAWLINGS: I think MTA have made some comments about the potential for consumers not necessarily to be focused on the ultimate price that they're paying for fuel. What is it that you think is affecting consumer choice in relation to where they choose to buy and is it price or is it loyalty; are there other factors at play which might be strongest?

MR BAGGOTT: I think there's a range. I tend to agree with both Z and BP in terms of the loyalty discount card is ingrained in that consumer experience. It's not just limited to fuel markets, it's across all areas of the retail trade. So we tend to agree with the Commission, it perhaps does mask the true price at the pump and there's probably that social equity aspect of if you don't have the loyalty card you're missing out on that opportunity for that discount.

MS RAWLINGS: I think BP in relation to that latter point, you made the comment that over time perhaps you try to encourage more and more of your customers to belong to these programmes and ensure that they can utilise those prices. I guess that begs the question for us as to why it's necessary to have access to a discount through a programme which is promoted to customers and when you encourage them to join. If the motivation is to encourage more and more to join, why not have a standard price across all customers without that threshold of accessing the loyalty programme to access a lower price?

MS BOFFA: So the reason we have loyalty is part of the diversity of our entire offer. So it's a choice we've decided to make with our strategy is that we want to have a loyalty programme to specifically reward people who continue to use us.

DR SMALL: Do you know whether your customers prefer that arrangement to an arrangement where, for example, all the board prices were a bit lower? I hear what you're saying it's good for you, it suits BP for part of your business strategy, but do you have insight into the way consumers think about that?

MS BOFFA: There is a portion of New Zealand consumers who don't choose us because they can get a cheaper price down the road. So people do do that. The other point around the strategy that we have around our loyalty programme is we believe it's different because New Zealanders can take other parts of their weekly budget and purchase with other retailers who will give them CPLs and they can bring them to our site.

So we believe that's another point of difference with our offer and why we have it is because it's actually about maximising your entire budget on all of your spend and putting that towards savings with fuel.

DR SMALL: So you don't have any particular insight into that preference for consumers? I hear what you said.

MS BOFFA: Yeah.

DR SMALL: Thank you.

MS RAWLINGS: Gull, I wonder if we could ask you about this area if it's something that you can discuss with us now, but you don't offer a programme of this nature and we just wondered if you might share a few views on why that is.

MR BODGER: We don't currently offer a programme of this nature. I guess we've had opportunities, we've been involved with old supermarket docket programmes in the past. If I can just sort of come back a piece, frighteningly looking around the room, Charlie or Maurice you may have longer or similar length service in the industry in New Zealand. But every survey I've seen published in New Zealand or overseas has said "give me the fuel at a fair price" number one for consumer preference. So the board price, the price that people pay is key, and number two actually after that is "don't mess me around, get me out of here and get me back on the road" regardless. Then you come down to other preferences, coffees, car washes and so on after that and you can see the development of our offer is looking at price and speed.

To me the Commission needs to put the ruler over this. You have loyalty programmes, and if I can look at myself buying some paint at Mitre 10 at the weekend I received some points and my comment, perhaps flippantly, to the lady who served me was I can now fly from my bedroom to my mailbox on the number of points that I've got going that far. But that does push some people's boats and yes, I did pull the card out of my wallet and I did use it, so I collected it. And as observed I've probably got cards for all of my opposition here, when I'm on holiday and away from our sites I can collect points there or discounts etc.

The rule of the Commission needs to look at, I think, is the proportion of fuel of the customer that is attracted by an offer that is 6 cents off or displayed on an ID sign that you then don't get through time or whatever from not handing over your piece of plastic. I think it's commendable that some of the oil majors in the room have reduced the complexity of their systems, you don't have to jump on one foot and rub your stomach so much, but I think most are still capped at a certain total number of litres. I could be wrong on that, there have been changes in the last fair while.

So how many people are attracted by that and then don't use it, if that is the major price? I don't know that, you would need to have huge data analytics to get there, and there are some genuine reasons for being in the programme. But if the programmes become there we will have a programme.

MS RAWLINGS: So you're expressing a concern about those who, I guess for me, might fall into two categories, those who simply never utilise the schemes whatsoever but those also who are somehow attracted to the existence of the scheme but still don't utilise it, and I think that's been referred to variously in a baiting kind of a fashion.

MR BODGER: You need to be registered to get the full whack otherwise you only get this, but it's advertised as X cents off on this day then it's less than that that you want to do it but your card's back in the mirror in the visor of your car, you can't go and get it so you throw your 20 bucks on the counter and you walk out. How widespread that is? Dammed if I know, not in that market. But it will be a portion of society.

MS RAWLINGS: I guess that leads to a question about participation in loyalty programmes generally and the numbers associated with that which we have some indication of versus the number of active members that are using the programme once signed up to the programme as well. Can I ask BP, do you have a sense of those two groups of people, are there proportions that might sign up but then never use it again, or inactive members?

MS BOFFA: Yes, there are. I can't tell you off the top of my head what the proportions are, but I do know we have a very active base that do participate.

MR FITCHETT: Can I make some comment on this. So the active base, we have a total of 2.6 million members in our programmes, and over a month there's about a million that are active in the programme and defining activity is very diverse. So we have some that religiously use the programme and use it every week or every time they fill up, to ones that are very much transient so they will come in and out, they will go to various - they'll come to our partners and then they'll move out again. That is price board related as well. They will change their shopping behaviours based on price board.

So the loyalty factor is there, but price board does change them in and out. The fact that they have to go through a progress to join up, so generally there's a sign-up process, whether it's by phone or over the internet or through the phone app. So these people come, choose to be in the programme and they use it to try and improve their price they pay for fuel, so a lot of our customers earn their fuel discounts outside of the fuel companies, so at the Countdowns and Placemakers, the likes of that. So accumulating those fuel discounts outside of the fuel industry is what drives a lot of our cardholders as well to get those extra large discounts that will change behaviour.

MS RAWLINGS: So does that mean that you're expecting that there are a large number of cardholders who are holding memberships of other programmes as well, or is that something you monitor or not so much?

MR FITCHETT: I would say everybody that's in our programme probably has a card in another programme and they engage in and out all the time. They're very fickle.

MS RAWLINGS: Or wise, one or the other.

MR FITCHETT: There are other drivers. So for people to go and join the programme and they are very conscious of price. So a lot of the people using our programmes are conscious of price in fuel. So they're not stupid, they look around, they know where the cheaper sites are, they know the better days to buy. So, yeah, these are - you know, some of the commentary out there you assume people are not that smart, but they are, and the people that use our programme are very price savvy.

MS RAWLINGS: Do you have a sense, though, of - so those are the ones using your programme, but of a proportion of consumers that you're not accessing, say, that may care less or are less savvy or -

MR FITCHETT: So we've probably got 1.8 million who aren't that active in the programme and probably a million odd that aren't. And we survey them to go "Why are you not using the programme?" They just don't care, they go "I fill up where it suits me based on location" or "This is my regular site, it's easier for me", or "I know where the discounters" are so they don't bother engaging in the programme.

So the ones that don't use the programme have other drivers for their fuel purchasing behaviour and it's not always discounted price or loyalty programme that makes those decisions. But those that want to do it, they get in, they join it and they use it, and those that don't, don't.

MS RAWLINGS: That's helpful thank you.

DR SMALL: Could I just - a little bit further on that if you wouldn't mind. So what I've heard so far is you've got about a million active a month and it's the same million more or less, is that right? So it's not that the active users are cycling in and out of your programme and across to other people's programmes, it's more or less the same people? Because you also said you've got a bunch of people who are registered but are not -

MR FITCHETT: Let me put it this way. We can have 15,000-odd people joining the programme every month, our active users don't change, don't increase with those 15,000. So people come and go all the time. So yeah, they change because people change where they live, they come in and out of jobs with fuel cards, it is a moving target. There will be a base that are pretty settled, but it's like a river, they come and go.

DR SMALL: Thank you.

MS RAWLINGS: One of the issues that we explored or mentioned in the draft just related to the actual stickiness of consumers as a consequence of loyalty programmes, so whether, as their name suggests, they actually do encourage customer loyalty or not. And I think the sense of the discussion today is perhaps more that consumers are inclined to multi-home, hold membership of any programme and are perhaps, I think as BP suggested, more inclined to pursue price and then to obtain the reward, in BP's words, or the benefit of membership of the loyalty scheme as a secondary matter.

I'd like to test that a little more expressly whether you think - and perhaps we'll just stay with Smartfuel, whether you think that there is actually a degree of loyalty and commitment to the brand, that is generated through the scheme itself or whether that sort of multi-use is more prevalent?

MR FITCHETT: Absolutely it does develop loyalty to the brand because people do engage. That is a big part of it. But in running our programme and running our rewards offers, we have to be competitive all the time because those people will change if we're not on the mark with them.

MS RAWLINGS: Can I just ask that same question of the fuel companies themselves who might have a slightly different perspective. Maybe starting with you, BP, whether it's a question of really driving loyalty and commitment to the brand or whether that reward that you mentioned is really the key benefit that consumers see in the programme.

MS BOFFA: So we participate in AA Smartfuel because we're hoping that our customers will be loyal to our brand, but actually the reality of what we find is yes there'll be a portion who are. However, active users within a loyalty programme does not mean exclusive users; they shop around. We can see a user through the data that will say they come to you every week and all of a sudden they're gone and then they come back, but they might only buy once a month. They are shopping around, people move about, what they're after changes, and price board matters, location matters, other offers matter.

So I think the key point we'd want to make is we want people to be loyal, but what we actually find is that active participation does not mean exclusive participation and that's why we need to compete on the price board and with loyalty.

MS RAWLINGS: Thanks for that. Z.

MR BAIRD: So we'd agree completely actually. So consumers have very, very high expectations continuing all the time. This is an important piece of what we do and an important piece of the puzzle for us in terms of other competitive offers that make us attractive to consumers. So it's, as I say, an important piece but not the only piece.

SESSION TWO: Price Board Advertising

MS RAWLINGS: I think this is perhaps a useful segue on to just talking about price transparency and board prices themselves. And so I think AA have referenced a 2016 survey in which you found that a high proportion of responders might prefer to see 95 and 98 octane prices displayed on boards. That's a few years old now; is that a consumer demand that you think is still prevalent?

MR STOCKDALE: Yes, we do. It's one of the key issues that's raised by motorists with us in terms of fuel pricing is the lack transparency for premium fuel. So the survey that you refer to dates from 2016. We haven't updated it, but back then we asked our members, a random sample of our members, did they keep an eye on the price boards and 76.6% said they did, so clearly there's a lot of people who do use those price boards. They are obviously very useful and that makes sense because they're a voluntary advertising, it's not mandated and yet virtually every service station has them. So clearly there is value to them otherwise service stations wouldn't be advertising their prices on their price boards. The problem is they're not putting one of the products on the price board.

So we also asked our members should the service stations display that premium product and over 81% said yes, they should. So as far as we're concerned that's a mandate for change and that's why the AA has been saying we would like to see all fuels that a service station sells publish those prices on the roadside price boards. We note that in two Australian sites they mandated that and we believe the same should apply in New Zealand.

MS RAWLINGS: And at the time of the draft there was starting to be this move toward publishing discounted prices as well which we've heard about today, so the lowest price available on regular fuel using a loyalty programme or other discount. Have you got a view on that?

MR STOCKDALE: One, it's a little bit ironic because we've been told by the industry that there isn't space to display all fuel prices on their price boards or it's not that easy and they want to display other information and now we see this move, so there is room to display more prices because they're doing that. But that is a good thing because it's providing more information to consumers and it is helping them compare prices. So we applaud that, we want to see that for all fuel grades.

MS RAWLINGS: Do you have any concern in the context of the conversation that we've just been having about a risk, say, that having a full board price for standard fuel and a discounted price may just emphasise the level of the price for consumers rather than the actual price that they're going to pay, or do you think that's simply information that's useful to consumers?

MR STOCKDALE: I think on balance it's useful because it does help people compare prices. You know, depending on if they've got that loyalty scheme.

MS RAWLINGS: Thanks for that. Perhaps I'll give you, Z, an opportunity - you've been supportive of display of both sets of prices - just a comment on the suggestion that it is difficult to include further information on price boards and whether that's still the position or whether you've moved on from that?

MR BAIRD: No, so look historically it's always just been a thing around trying to keep those boards as simple as possible. And so, you know, back in the day we've done a lot of research in terms of how many messages consumers can take in so that's kind of driven it, and obviously 91 and diesel have been the predominant grades therefore that made sense to advertise the prices of those. But we agree, we're open to putting 95 on. It's not simple in terms of there will be a cost and obviously a rejig of how that will all occur and we would want to be very clear in terms of the way we would do that to make sure we're very clear in terms of what those prices are. Even today our 91 Pumped price, which is our loyalty programme price, is at the very bottom, so that we're leading with the correct pricing sort of hierarchy, if you like, so consumers are very clear on that.

But we would think over time consumers would start to pick out the grade they're most interested in and key into that, so we're quite relaxed about the ability of consumers to understand from that perspective in terms of what price they're looking for they can quickly connect with.

MS RAWLINGS: Given the comments that you've made before, or the comments referenced back to Mike Bennetts about the complexity of some of the loyalty offers, do you think it's realistic that those discounted prices can be displayed in a way that is clear to consumers and doesn't mislead them about their ability to utilise that particular price?

MR BAIRD: Yeah, I think we've done that with our panel that we've got now, so we did quite a bit of research around that with consumers to make sure they did understand that. We had a couple of goes at it to start with, so we know we're way better than we were because the starting position was not very clear to them.

And so to that point I think we have been, and I think that's an important piece. So the earlier conversation around do consumers understand the price they're actually paying, then that's very clear to them that that's the price they would pay under those circumstances.

MS RAWLINGS: Maybe I'll just turn to BP then in relation to those same comments about the feasibility of including price points and the extent to which consumers again will really understand their entitlement particularly to the discounted price point.

MS BOFFA: Yeah, I'll start with the premium fuels. I'd like to put in so people have got the context. So at our standard retail site 55% of the fuel we will sell is 91, the next fuel that we sell the most of is diesel which is around 27%, so the balance being 18 is what we sell of premium fuels, so it's by far the smallest portion of what people actually come to buy from us for. So the reason we have diesel and 91 on the price board, 85% of customers want that so we put that on.

The reason why we're struggling with putting this idea of putting premium fuels on the price board is that not all premium fuels are the same and we see that because we have two premium fuels, we have 95 and we have 98 at some sites and they have different prices because they cost different amounts. Then I'm aware we've got other competitors across the market who have the equivalent of a 98 octane but they're using ethanol blend, so it's a different product from my pure 98 octane. And then there's another competitor who takes a 95 and puts an additive in it to boost it to 100.

So by putting a premium price on a price board I have concerns customers are going to be even more confused because you can't actually compare them all, they're all different. 95 is different from 98, which is different to 98 with ethanol, which is different to a 100 made off a base 95. So we have to get all that messaging on to our price board so that people can fairly compare what a premium price is.

So my belief is that there's other ways that customers are informed about premium fuels, they exist today and I think they'll get even more prevalent. Gaspy, by way of example, is an app that people can use to see what premium prices are and they can clearly see what those are by grade. So I think there's possibly other ways that people can find that information, because our research also tells us that generally speaking premium fuel buyers are more engaged in that purchasing decision because they generally have cars or they're an individual who wants to get higher performance from their car so they search for those products and they're aware of the differences that they give them.

So we would want to understand more about how we would do that so as not to create confusion for people as they're driving down the road as to what price they're actually comparing in terms of apples to apples. We do obviously have our price on all of our pumps so when you're on the site before you lift that nozzle you do know what you're putting in as well as the supporting information about our grades and what benefits you'll get. So that would be my comment around premium fuels.

The other question was, sorry?

DR SMALL: That was very interesting, thank you. So you made the point that your premium fuel, first of all you've got two grades, and secondly, your grades are not comparable to other people's grades of, say, 95 for example?

MS BOFFA: 95s are similar but we don't have 95 at all our sites. So I have some sites with just 95, some sites with just 98 and some sites with both those premium grades, the mixture.

DR SMALL: Right, I mean if I could take you back to your earlier comments, this sounds consistent with BP's general strategy, which is to provide highly differentiated products and people can make their own choices.

But don't they do that on the basis of what you're offering? So, for example, it's not clear to me why this would be an issue in terms of whether there's a difference between your 95 which doesn't have ethanol I think and someone else's 95 which does have ethanol. Isn't this a little bit like maybe the car washes are slightly different or something? Is it something that you need to communicate to people, to consumers through this messaging on the price board, or is it something that relates to the product that, as you've said, you have these very differentiated products and people kind of understand those products. So any comment on that?

MS BOFFA: So it's more around people comparing a 98 to a 95 because there is a cost difference between those two.

DR SMALL: Okay, so that's the issue mainly.

MS BOFFA: Yeah.

DR SMALL: In some stations you'd have both I presume?

MS BOFFA: Yes, we do.

DR SMALL: So that would be two extra prices, right.

MS RAWLINGS: I'm conscious it's probably time for a bit of a break some morning tea, so it might be -

MR PARHAM: Sorry, can I just jump in there just before we stop for the break?

MS RAWLINGS: What I was just going to say, if you don't mind, is I think we would like to really hear what Gull and Waitomo have to say about price board displays; so if I suggest we take the break now and then come back with looking at submissions which I know that you've made suggesting that this sort of display maybe is not that productive for consumers and we can pick it up at that point if that's okay. So we'll take a break now and head back in here around 11.15. Thank you.

Adjournment from 10.50 am to 11.15 am

MS RAWLINGS: Thanks everybody. Perhaps we'll just kick off again. We were talking about the issue of display on boards I think, and we'll start with Waitomo perhaps.

MR PARHAM: Thank you. I guess following on from the conversation before the break just around the advertising of 95 on price boards. For us we sort of see that as a waste of time and just noise. As a low cost operator, and probably like anybody else in this room, we've got scarce resources and that's people, time and money. So by doing this it's going to suck up our bandwidth where we could actually be opening another site, bringing a bit more competition and choice to some markets.

So on that sort of perspective we don't see it's necessary to put 95 on the price board. I think, as has been mentioned by other participants in the conference, the pricing is clearly identified on the pumps and also there's ways through the price comparison app Gaspy that you can see 95. So people can actually make their decision before leaving home and when they're making their journey on the way home.

Probably the other point we wanted to flesh out is the issue that we see is more of an issue is that showing the discounted price on the price board. You know we see that as bait advertising. We've got no issues with the loyalty programmes per se, that's part of the landscape and part of what consumers want these days with personalised messages. I think we're all cognisant that we've moved from a world where there was one message going to a million people, now it's a million messages going to a million different people. So that's part of the data, the insights and the segmentation, and that's about the offer that you have as well.

But we really see the bait advertising, as we term it, just lures people in unsuspecting, there's strings attached. Research I've seen, on average people view a sign 1.3 seconds, and so when you're driving along you may not necessarily understand that that is the actual price you're going to pay, so you've got to do other things such as swipe your card or register or do whatever to get that discounted price.

So that's why we think that's the major concern around the price board and the price board advertising. It essentially just lures customers in on a premise on a price that potentially they may not be eligible for. We just call out some of the ACCC work done in Australia. They've looked into this issue extensively and we also note that several States in Australia have banned that discount pricing. That's all I have thank you.

MS RAWLINGS: Do you think, though, that if the terms of those programmes are sufficiently simple, Z's talked a little bit about simplifying the requirements for entry, we've heard a little bit about minimum spend for example, are there other things that would need to happen to prevent those concerns of bait, or misleading sort of display for you, or would simplified terms be sufficient to bring value to that display of discounted price?

MR PARHAM: I just don't think you can advertise them on an ID sign basically. When you're driving past, there's a lot of variabilities going on when you're driving down the road, so just trying to read something to see Ts and c's or trying to see the small print you're not going to see that. So where the actual terms might be, you know, simple when you're in the store, you know, a lot of our customers especially that we get feedback from, they're always drawn to the lowest price, and I know personally myself driving along I'm drawn to the lowest price. I see that, then I understand actually that's the specified discounted price. So because we're obviously out in the market observing, because as a low cost discounted per se we need to be on the market and if we're not then our customers will go elsewhere. So we're very cognisant of that price.

DR SMALL: Sorry, can I just follow that a little bit further. So I'll confess, I'm not someone who has a whole lot of these cards in his pocket. If I saw one of those boards that had a 91 price and then a discounted 91 price and I foolishly drove in thinking I was going to get the discounted 91 price I might feel a bit annoyed, but if at the counter I was able to easily access that discounted price simply by saying I came in because the discounted price was shown, and then they would, I don't know, whatever the - give me a card or give me the discounted price, would that make it better?

MR PARHAM: They're still lured into the site in the first place.

DR SMALL: You have been lured in but you've also got the price that was advertised if that was guaranteed, would that assuage your concerns or not?

MR PARHAM: Not really because I think it's still advertising that price that there's still strings attached and that's basically our concern, there's always going to be strings attached.

DR SMALL: Thank you.

MR STOCKDALE: Can I make another observation about displaying fuel prices. So another complaint that the AA receives is from people who thought they were going to buy 95 octane petrol and ended up buying 98 octane petrol. So we heard earlier on that not all premium fuels are the same and that's quite right. And it is confusing, and typically the price differential between 91 octane and 95 is about 9 cents a litre and then it's another 8 cents for 98 octane. So a 17 cent differential.

And people might have intended to buy 95 because their car requires a premium grade. 95 is pretty common as the premium, minimum, but they didn't intend to buy 98 and they've ended up spending an extra 8 cents a litre because the price was not advertised and they only knew that they were buying a premium fuel and they didn't realise it was the extra grade. If the price was advertised on the price board and there was a 17 cent differential, they would look at that and say that's a lot more than 91, that's not what I normally pay, and they might have seen another service station who sells 95 and saw that it was only a 9 cent differential and that's where they would go.

So our view is that there are people spending more for premium petrol than they need to because they're buying the wrong grade. If the price was displayed on the price board they would be able to shop around, those prices would be transparent. So that is another reason why we think the premium fuel needs to be displayed so that people know what fuel it is they're actually purchasing and the price will help them determine that.

MS RAWLINGS: Thanks for that. I think we'll come back later in the session to the question of use of fuel which is an important point that you raise as well about consumer differentiation between the grades that they actually need. But that connection to the disclosures is useful thanks.

I think Gull also has shared some of Waitomo's views in relation to display of premium prices on boards. Can I just ask you to make a few comments on the issues raised?

MR BODGER: I will, if I could just talk about customer complaints for a moment. Surprisingly our business is not perfect and we make mistakes and we work at both extremes of the bell curve and I suspect all the oil industry is here. To put this into perspective, during daylight hours a Gull customer, that's a Gull customer - and I calculate we've got 7% of the gasoline market in this country - hangs up a nozzle every 30 seconds. So people use us and the industry continually, and if there's a problem Facebook, e-mail even the old-fashioned phone call they complain.

I think there needs to be some perspective brought here. In my time at Gull in the 13 years, and I am very close to the customer base because there's not very many of us, and the complaints, we have not had an issue with people complaining about the lack of a premium price on the price sign, or to my knowledge that we've had a complaint that they came in to get 95 and they got 98. That includes us transitioning from a 95 octane to a 98 octane. I would be concerned if we opened the walnut with the sledgehammer here Commissioners.

On the sign basis; all oil companies in this room apply for resource consent for their service stations. That includes in this modern day a square metre of signage that is permitted at each site and if you have historical rights you'd better not put up a major billboard without further resource consent. So either through existing use or actual consent you have a certain square metres. I still believe in choice, and this is a country of choice, and us, be it an MTA site, a Gull site, or a Z site, can we not choose what advertising material we put on our limited real estate, and I believe that that is a very important point to make.

I'd also urge the Commission to pick up on Z's point and perhaps take some specialist advice along the lines from advertising consultants that less is more. If we go to some extremes that I have gleaned or read that BP retailing four grades of petrol and potentially four grades of fuel and therefore eight discounted grades or fully priced grades, I'd defy anybody, and Simon's 1.3 seconds, to actually pull out the price that you want to know. And our value of sales would be very similar to BP's, it is 91, it is diesel and then down the bottom it is premium. So we put up the price that people want to know.

If this was an issue of major concern that would require a Government to legislate change, is bread and milk not more important to New Zealand Incorporated than the price of premium gasoline if you were going to take that choice away? The everyday price is supplied and it is available on many media. Gaspy, it is good to see you here being part of the conference. Public notices still arrive but we don't have to put our prices into public notices, where are we going to be in 5 years, 10 years' time when we're communicating price to people and we may have gone to the point of legislating to say you must have this type of sign up? Do we need to be there and let us get there with the information.

Our figures and I believe we build sites and do things much more efficiently than large corporates. We've noted $7,500 to put up a sign in Auckland advertising premium. I'm very happy for the Government or for others to pay that price rather than us recoup that from the motorist, and I draw you back to the eight ladder signs on the price board of every price being displayed.

People also make a vehicle choice. In general people who are economy shoppers who look for budget will choose their car to run on either 91 or diesel, and they will look for that and the people who run on diesel generally factor the RUC component of the total cost per kilometre into that. Those are the people who are observing the prices of the 91 against the premium.

LPG, Adblue are also related products. Should they also be included in the legislation to do that? Adblue will be an important part of the quasi fuel mix going forward for New Zealand so we are adding more and more complexity in New Zealand to a simple process which is all about choice of what we have been consented to put in there. And I put it to you we are looking to solve a problem that is for people who have pulled on to the forecourt, and I believe all of my competitors clearly display a price sign on every premium pump and every LPG pump and every Adblue pump in the country that is there. You can see it out your car window and if you do not like it you have wasted 30 seconds of your life. And I believe that that is a fair price to pay compared with the industry being able to choose for what it can put on its real estate.

MS RAWLINGS: Can I just pick up that final point there because it is something that interests me in the support of pump price, and we'll come back to Gaspy and other forms of price comparison. But in relation to display on pump price, I think you've said that you think that people have already decided where they're going to buy their fuel before they get you to.

MR BODGER: A lot of people will have in this modern day.

MS RAWLINGS: And that pump prices can give you obviously a view of what you're paying before you lift the bowser, but is that in your experience an effective means of sort of price information and comparison for consumers? I guess what I'm asking is, using your example, do people really pull up, look at the price and drive away, or once they're there they're there?

MR BODGER: Yes, you do see them drive-away. They may have left their wallet at home, but people do drive away. And people notice the difference in our premium pricing which we peg. We see honestly to our 91 price, so we lower our 91 price, our premium price lowers. We peg that and there can be significant price differentials between our premium price and our competitors either 98 or 95 price. And people comment that to us.

MS RAWLINGS: So I think am I right in saying when you talk about the cost of installing it that you have installed one board as sort of a pilot with the premium price?

MR BODGER: Yes, by our choice we have taken down other advertising and by our choice we have put that up and we are looking at doing another one by our choice. And we would like to retain that choice to put up Fruju ice creams should we want to do that into the future.

MS RAWLINGS: I understand your choice about the freedom to make those decisions for everybody. I just wondered if there was any observation of your experience of having trialled that that you could share with us and do you think it's -

MR BODGER: I would share that in our Thursday session.

MS RAWLINGS: Fine thank you, that would be helpful. Can we just look actually at the other - if I can just ask you about that issue of what is driving consumer choice again. Is the issue really with just based on the proportion of fuel that you're selling so you think it's helpful to display standard and diesel pricing on boards without premium, or do you think that's still influencing some degree of consumer choice?

MR BODGER: Again, we work at the bell curve and consumers make decisions all the way around there, and for all sorts of different reasons. We like the clarity of two prices, two prices which, due to the tax regime in this country, are generally easily distinguishable. Like often there's a 2 unfortunately in the Auckland 91 prices at the moment and there's a 1 in front of the diesel price. So the customer can - and I'll take Simon on it here - for 1.3 seconds work out which one he or she wants to look at and they in general have a car that runs on that and for the others, yes, there is a price on every fuel pump. Or if there's a competitive advantage, one of the competitors in the room may wish to display that and some do.

MS RAWLINGS: Maybe we'll come back on Thursday to talking about what those competitive advantages might be it sounds like.

Just in relation to MTA I think we've had some support of putting all prices on boards. I wonder if we could just maybe explore that a little bit further. There's quite a divergence of view in the room clearly.

MR BAGGOTT: I get AA's point, I get everybody's point really. We were in Melbourne last week and we got to visit a few service stations over there where they do have all prices displayed on the board and I must admit it was quite confusing. But in saying that, the conference that we were at, one of the presenters did do a presentation in terms of consumer behaviour. They did make a point of saying that premium fuel customers tend to be more loyal. So I just throw that out there in terms of opportunity and leave it at that.

MS RAWLINGS: And I think let's move to the Gaspy position on this price display because you've expressed some support for the display of premium fuel prices but not so much post-discount prices. Can you tell us a little bit more about that position?

MR GREEN: It really comes down to preference. Certainly if all the prices are displayed it suits us, but it suits us from a, you know, from a business who has a community of members, you know, it's convenient, it would be more convenient for us, whether it's necessary is a different sort of a question I think. And I think it also, it is dependent on the provider, the fuel provider in terms of reputation and how they think they are, or assume they are viewed by the public. If they want to put - like any sign, if you went out the door there today there might be a sign advertising something with an asterisk behind it and it's the risk of the consumer to try and figure out what the details are there or not. But it's really a case to case basis and for us, you know, enforcing a road sign would basically just be a convenience in terms of collecting data, but whether or not it's necessary, I wouldn't like to comment.

MS RAWLINGS: Would it be fair to say your view's more connected to your crowd source information because your people can observe the prices more readily and feed them back into the app, is that -

MR GREEN: That's true. We always encourage our members to upload and confirm prices from the actual pump, and I would agree that all the actual pumps have the price on them, because for a long time now the boards have come and go a little bit. Sometimes there might be a fuel price change and the board hasn't been changed for just obvious manpower reasons or all sorts of different reasons. There could be an electrical problem with the board and it puts out of spec, so we encourage all our members to upload prices and confirm prices straight from the pump.

But again, things have changed. There were things - everything used to be 0.9, now it's 0.7, then it's 0.2. So as a software technology firm, for us most of these subtle changes are just challenges to find interesting ways to, you know, work around and make or break deals.

And I also would add that, you know, the premium price is always available on Gaspy at all times as well, and that if you opened the Gaspy app we don't show all the prices either, you still have to select the type of fuel you want as a preference to get shown it. So if you were to enforce that it would also probably enforce us to constantly, you know, to show every single price on the screen as it came up, which would be a real burden to the visual flow and the usability of the app as well.

MS RAWLINGS: So that may answer another question that we had really, was whether, given the nature of discussion about premium fuel this morning, you have access to data about the number of people using your app who are actually looking for premium fuel prices versus standard prices. Is that data that you're able to access from that selection process?

MR GREEN: Yes, it is. We have a very robust data field and we have a data analytics partner, Datamine in Auckland, so we're thoroughly over all our data. We have 409,000 members and we're very singularly focused. We're just about fuel price, we're not selling milk or anything else, car washes, none of that, it's just what is the price of fuel and our accuracy is incredible. And yes, we do, it's just a matter of working with Datamine to pull those numbers.

A lot of people have used the word complex or complexity. For us as a software firm we just work in logic and numbers and for us to access the data on who's using what and who's purchasing what and where the actual interest is in analytic logical terms, you know, it's an e-mail to Datamine to say "show us those numbers please". And we currently have those numbers.

MS RAWLINGS: Thank you. We want to talk a little bit more about other methods of price comparison, but before we do that, given the diversity of view and the range of discussion, I might just see whether anybody else wants to comment further on just this question of board display of either premium price or post-discount price and whether our focus should be different in relation to each of those. Can I just ask?

MR BAIRD: Probably one of the comments we would make or I would make is I think - Lindis referred earlier in his opening statement about the unnecessary sort of mystery that surrounds this industry, and I think this is just one of those areas where we could clean it up, tidy it up and display it and be done. And I think there's a couple of reasons for that.

One is, notwithstanding some of the debate and the cost and some of the issues around it but it can be done, and there is definitely a growing, small but growing demand for 95 as that car fleet of New Zealand upgrades. So I think it's one of those things that we should embrace and seriously think about.

But I think it needs that the industry needs to agree to do it, so again we demystify the thing, and that there's a clear hierarchy of how that occurs so that consumers get to see that when they've got that 1.3 seconds - sometimes it's a bit more actually but never mind - that they can actually pick the price that's right for them. So they know the grade they're looking for, they know the car and what grade it should use, therefore they could get that sign, and I think it clears up a lot of things and makes life a lot easier for everybody.

MS RAWLINGS: So should we take from that comment that your view is everyone should be doing the same thing to enable consumers to compare apples with apples, or are you a supportive of Gull's proposition that we leave this to participants in the industry to determine what they best for their own business?

MR BAIRD: I think when it comes specifically to the fuel pricing piece, and we're really talking, you know, that pricing panel, that's mandated in terms of that's how it occurs and there's a clear hierarchy of how it occurs. There's still room on the panel, there's a brand sign, there's store panels, there's other things that can go on there or be forfeited if that's the case to make sure that that sign's very clear.

MS RAWLINGS: Can I just put that same question to BP just to end this discussion perhaps?

MS BOFFA: So we disagree. Our view is that it should be up to individual competitors within the market based on their strategies of how they're differentiating their offer. As I've mentioned, we have a very diverse offer. I want to be able to put crispy creams on my MID, I want to be able to put on that I have ultimate fuels which have extra additives in them. I want to be able to put that I have a coffee offer called Wild Bean. I will need to remove those if I'm going to be required to put all prices on to the price board.

MS RAWLINGS: Thank you. Hand up over here I'm told.

MR STOCKDALE: Sorry, if I just might reiterate, the number one reason that people go to service stations is to buy fuel. Yes, they do sell other products but that's the one thing they have in common; they're selling fuel, that's what people are going for. It's their core product, the price should be displayed for their core product and not for other products that are much less important to the reason for people going to a service station.

MS RAWLINGS: Thank you. If we go back to other forms of price comparison and tools, I think that would be useful. We've expressed some scepticism in the draft report about real-time pricing for consumers and price comparison apps and the like. Just because there is mixed feedback on their use overseas and significant concern about their ability to, in the process of improving price transparency for consumers, also obviously improving any conditions for coordination between participants in the industry as well. So we do ask for comment on the effectiveness of price comparison apps in particular and nobody really embraced that invitation in submissions.

So we did just want to explore it here just to make sure there either isn't any comment or just to canvass some views on that. But I think if we start by going back again to Gaspy, it is really helpful to have you here thanks. You've got around 400,000 subscribers to your app and your service, and I just wondered if you could share your perception either reflected in that number or more generally of consumer demand for the ability to compare price as a general principle. Are people actively contributing to the price display or are they really searching for the best price as well?

MR GREEN: I think it's a highly active market for us. Definitely in comparison to anything else we've done as a software firm developing apps it's easily the most active. We see that fuel price is a bit like weather, you know, it's a barbecue conversation, everyone's talking about the price of gas or weather, so from a story-telling point of view, which obviously relates to Gaspy, good guys/bad guys, that's a large part of how the community works is that you're assigned this role as a spy and you're spying on big oil and, you know, that's a big part of how our community actually exists, how we encourage people to collect data and share it with each other.

But people are fascinated by the price of fuel, it's just one of those every day conversation points. And we do see - you know, there are very obvious trends over time. But having said that, we have what we would call super-users, and these are just obsessive, crazy users that just really embrace the idea of being a super spy and, you know, finding out everything and we have other rewards in there like badges and special missions that they go on to encourage them.

Then there is a large chunk of people that just want to know what the price is. So they will use the app on a regular basis but they don't actually contribute much, so they take but they don't give back. So, yeah, the people who use Gaspy, it's quite a range of people ranging from kind of just using other people's work, to embracing the gamification, if you like, of the app and feeling like you're part of a social justice kind of community or something like that.

MS RAWLINGS: Can you give us an indication of the rough proportions of people that are sort of taking but not giving, as you put it?

MR GREEN: I couldn't off the top of my head because we're a software and analytical company, I really like to be really specific on numbers because we can. But I could certainly give you those numbers in the future.

MS RAWLINGS: Thanks. Another question I think we had was just around the impediments that you see in growing the use of the app. If there was a magic wand and you could have something to make the process of gathering information or providing information easier, what would those things necessarily be?

MR GREEN: I think one of the challenges for us as a small business in New Zealand, we're a small software company based out of Tauranga. Gaspy is just one of many things that we work on, it's not our sole product. It is very limited income, without compromising its transparency. And obviously to maintain service speed, you know, for instance if someone says something about gas on the news at 6 o'clock that's, you know, anyone here who runs any kind of app, that normally requires like an Apple team to not crash. We have a small firm and also we're dealing with this huge behemoth community that is growing up around us that we are trying to keep the service going for. And we have provided this service now for four years for free, and we've had a lot, you know, we've collected so much of this data and information we're happy to share with others about.

So getting support, whether that's commercial support or Government support, in the future would be really useful to us. Also we've seen changes to how we outwardly face. When we started off we were very committed to our story line, which is a necessary part of it, you know, the good guy/bad guy because we had zero marketing budget, and that worked really well for us to get us off the ground as a start-up business. I think like the other day we were the second highest rated app in New Zealand, which in itself is a success story for a technology company in New Zealand.

But as we've got bigger it's become more about - we've become more everyday. People just use Gaspy to find the price, people are less interested in some elaborate story line, we've just become a trusted price comparison. And I think long-term that's where we would like to continue to sit, we'd like to be able to provide transparency on all prices and work towards being able to work with some of the other people in the room to maintain transparency would be good, and I think it offers a real solution to some of the issues we've talked about today.

MS RAWLINGS: What would that require? Are you a supporter of sort of real-time pricing information both, I guess, as a concept and realistically as a feasible option?

MR GREEN: Absolutely. We are a private enterprise, and like everyone else here we're tasked with being profitable. Our business depends on accuracy, we have excellent accuracy now, it's crowd sourced, which again if you come down to statistically speaking is incredibly accurate. Often people talk about crowd sourcing in a flippant sense, but if we're sitting at roughly, normally about 97.8% accuracy, it's kind of like suggesting that 400,000 people are wrong and you're right. So, you know, the power of a community is very big.

But having said that, obviously the goal of having 100% transparency all the time, particularly in rural communities, would be ideal. But to achieve that realistically we'd have to have some form of understanding or partnership with fuel providers so that we could upload the details as they came about, so we weren't waiting to find out what's happening with the fuel pricing.

MS RAWLINGS: What's your sense of your coverage? So you mentioned rural communities in particular, it seems to make sense that in less populated areas you're counting on having one of your passionate -

DR SMALL: Yeah, absolutely.

MS RAWLINGS: - assessors of price to feed into the app. So what sort of coverage nationally do you have?

MR GREEN: We have 100% national coverage. There's some obvious black holes; West Coast of the South Island especially in winter, you know, Great Barrier. So all the black holes, I suppose, are the obvious ones. So I'd say we are servicing the mass majority of the market in a really tangible way. And so if you think about, say, how accurate we are in Auckland or Wellington versus how many members are using the site versus how many people happen to be driving past Haast, not many people are falling out of the loop, so to speak. But having said that, we're interested in moving towards 100% accuracy, we want to have 100% accuracy for our members, so it's always accurate.

MS RAWLINGS: We've heard a lot this morning about accuracy and consumer ability to determine actual prices in that context of discounting and loyalty. How much of a difficulty is it for you that there are different terms and conditions and entry points into these schemes and discounts?

MR GREEN: We've really approached it as - embraced it really into our gamification. When we first launched we didn't include loyalty cards discount services and it was immediately one of our most requested additions to the app. So the way our app grows is again it's community-based, so whoever demands the most in terms of a new service, like we want a discount calculator, that's what we do next. That's how we manage the hierarchy of our next task and our next updates.

So early on we added a discount calculator which you can put in any of the existing fuel card or discount offers that are in this room now and it will automatically translate and produce for you the best price, including whatever discounts, even multiple discounts, and give you the best price in your area or whatever suits you. So we've just built technology to kind of have our cake and eat it too, if you like. Because whether or not it's a good idea is not really our area. We just want to make it easy to see, make it clear.

MS RAWLINGS: So in building that discount calculator, do you struggle with maintaining accuracy in relation to the terms and conditions of different programmes, or do you think that you're pretty accurate on that as well?

MR GREEN: We're pretty accurate, very accurate. But, you know, we are very reliant on our community of members, and so when things change we rely on correspondence from our members to tell us like if a station opens or closes, if a discount card changes. Some of the fuel providers in this room would send us information in advance and let us know, which is actually really helpful, incredibly helpful. But generally things even up pretty quick.

Again, since we got over about 100,000 just on volume everything evened up because it's just a probabilities thing. Once you have that many people and we have a very vocal audience. So like, for instance, if a petrol station closes down, it's not uncommon for us to have 1,000 e-mails within an hour telling us, you know, "Headquarters, a petrol station's closed down, tell all the spies". So it's fairly active in that way, people are very forthcoming.

MS RAWLINGS: I think it's really useful background, thank you. I think BP has submitted in favour of this sort of tool for consumers. I wonder if you could just comment perhaps on what you see to be the interrelationship between display of board prices, for example, as a tool for consumers versus the use of apps. Is there a sort of direct and important relationship, or do you see them as perhaps substitutes for consumers to be using for price comparison purposes?

MS BOFFA: Our view is that, well, all customers are different, when they need to buy fuel they'll all think about it in different ways and we recognise that there are groups of customers where a crowd source app like Gaspy is exactly what they want, they want to know quickly on their phone where the best price to go is for whatever their products they're after. And then there are others who as they're driving down the street want to see on the board or they want to combine loyalty.

So our view is choice, choice is the right thing to give consumers and let them vote with their feet or the car and go where they want. So yeah, we support crowd source apps like these alongside price boards and loyalty.

MS RAWLINGS: How feasible is it to think about sort of real-time price information fed through to a tool like an app or some other price comparison tool that could be made accessible to consumers?

MS BOFFA: It is feasible, but I'd rather talk more with you on this on Friday if that was okay.

MS RAWLINGS: Sure, thank you. Z can I just test whether you'd like to share some views on this?

MR JONES: We view this in terms of our submission was how we thought about it and shared our views was in the monitoring section. So we support it, we support that there should be monitoring of fuel prices, we'd previously suggested - I think it was post the MBIE study - that the industry should provide transactional data to ensure that fuel prices and margins are generated accurately and people had that information available, both consumers and the Government.

Hearing the product development with Gaspy I'm not sure we want to cut their lunch, but I think there could be room for both systems, because I think accuracy of that data matters.

MS RAWLINGS: I think both MTA and AA have submitted in support of this kind of tool, AA particularly in favour of real-time pricing. I just wondered if you wanted to comment further, just having heard some of these comments from Gaspy or from others?

MR STOCKDALE: We certainly support, I think, doing further investigation into this. Obviously other jurisdictions have done this to varying degrees of success. So I think it's something worth looking into in more detail, but there is value to motorists from having that price transparency and apps is another way of providing that.

MS RAWLINGS: Do you have that concern that there would be still a section of consumer group that just would never use a tool of that nature, or do you think it might be something that would grow in demand?

MR STOCKDALE: That's a reality and other jurisdictions have shown that in fact the utilisation can be quite low. That's something that maybe can be improved. The AA can possibly have a role there. But it's an additional option that previously was not available. At the moment we've got a crowd sourced app, we never used to have that. Real-time information would just be an improvement. It's optional but it's better than what we used to have, which was we didn't have that option. So people choose to use it great, but not everyone will, but those that do are better off.

MS RAWLINGS: Have you done any work to date on sort of preferences or potential use by your membership of something like that? Have you looked at it at all with AA members?

MR STOCKDALE: Yeah, we've done a little bit of research on that and there certainly is support from our membership for having real-time pricing through an app.

MS RAWLINGS: Thank you. I think we talked about this a little bit in your earlier comments, Gull, but I just wanted to check whether you or perhaps Waitomo have anything more to add on this question of app use. I know you've said that you think it's a more useful way of people to plan in advance rather than trying to rely on board price or pump price. Is there anything else you wanted to add?

MR BODGER: Just to comment several years ago informed sources approached us about attempting to take an EFTPOS unit interchange system that is used in Australia and bring that to New Zealand to tell people what pricing was at service stations and therefore when it changed. We declined to be involved in that system and similarly we've - no disrespect - we've declined to actively engage directly with Gaspy. It's there, it is developed, congratulations, 400,000 people by itself without any intervention, giving information to consumers who want it.

MS RAWLINGS: Obviously we're very keen to understand a bit more about your reasons for that, but would you prefer to explore that at a different time?

MR BODGER: Yes.

MS RAWLINGS: Anything else to add? I think that's probably our questions on this issue, but I'll just test whether anybody else has got anything they wanted to add before we move on. I think we've talked a little already this morning largely through your comments, BP, on other aspects of product and service differentiation which are obviously important. It is an obvious development in the market that there has been increased differentiation in the offering by various retailers and that consumers appreciate that. We've noted in the draft, of course, a concern that product differentiation could be more a response to high margins that we've observed, and we'll talk more about profitability this afternoon.

SESSION TWO: Differentiated Service Offerings

MS RAWLINGS: But I think if we wanted to explore just a little bit more the role of service and quality in consumer decision-making and in competition essentially. So we've had a little bit on that from you BP this morning but maybe I'll start by just seeing whether there's anything else that you wanted to add more specifically in that context of the idea that perhaps that service differentiation has been occurring in lieu of direct board price competition.

MS BOFFA: So our view and what we do, we are competing on the price board and we're differentiating the service; the two go hand-in-hand. I made the comment earlier, we know from experience and from data that if we are more than a couple of cents off the price board, we lose volume, and we're not here to lose volume, so we compete on the price board, and then we've chosen as part of our strategy to have a fuel service offer with multiple things and reasons why people might choose us. I can go into detail on those again if you want but I've kind of covered them off.

MS RAWLINGS: I think on the differentiation itself we've probably heard from you this morning on that. Just to the extent you feel able in this session, I think we're interested to explore a little bit further how much of a constraint you feel that unmanned sites are and the prices offered perhaps by those sites on that full service offering and the relationship between those offerings, and I'll also ask others too, but if you had some thoughts on that to begin with that would be helpful.

MS BOFFA: Yeah. What I can say here, we have experience when an unmanned site opens across the road or beside us, and assuming they are a low cost operator and therefore pricing accordingly, we need to react on the price board to ensure that we retain our customers. When these sites are opened further away from us a number of things can happen, depending on roading, depending on the number of other sites around us, whether our site is a go to work site or a go home site - people buy differently in the morning from the afternoons - all those sorts of things come into play. But generally speaking, if we're sitting off the price by a couple of cents we will see an impact and our customers will tell us.

MS RAWLINGS: Does that mean that the extent of collocation or the geography is influencing the extent to which those other factors that you mentioned might influence consumer decision-making? So it sounds a little like the closer those sites may be the more you think consumers are looking just at price rather than at the other offerings as well. Would that be fair?

MS BOFFA: We see different things with different customer groups. So we get a range of customers who come across our forecourt, some that all they want to do is be in and out super fast, they don't want to interact with the person, in fact they want to do it on their phone to be in and out very quickly. Those are the ones that can just as easily go and do that at an unmanned pay at pump site. But we also have a number of customers who use us to buy their coffee, their cigarettes, their milk, their morning tea, their lunch and those ones will react differently, but we may see the frequency that they come to us drop off, in the sense that they may go somewhere else on a Monday but come to us on a Friday or a Saturday. So we do see changes. People do look at the offers differently based on what's going on for them that day and what their priorities are.

MS RAWLINGS: Just given that feedback has reoccurred, I'm told the feedback is worse when mobile phones are near the microphone so maybe if everyone can have a little check that would be helpful. I think John had something he wanted to follow-up on.

DR SMALL: Just to follow that, that was a really interesting comment, thank you. So what I took from it was that, yeah, location and proximity is really important between your sites and a competing site. But I'm just interested - and I appreciate your point about different customer groups behave differently.

I guess we're looking from a competition point of view, we're kind of interested in the average effect which I would summarise as being in your board price, and you may recall it in our report we did look at some new to the industry sites, we found it a little difficult to detect strong impacts of new site openings on existing stations. So quite interested to hear your comment that if an unmanned site opens really close to one of yours then that does, I think I heard you say, lead you to react on price. Would you be able to share some of that information with us at a later date, because we'd be pretty interested in that?

MS BOFFA: Yeah, absolutely we can start on Friday.

DR SMALL: Thank you.

MS RAWLINGS: Perhaps we'll just canvass the same sort of material with Z as well just in relation to your perception of the impact of unmanned sites on the full service offering.

MR BAIRD: Yeah, so unmanned is a segment out there and it's great competition, it gives consumers choice. We think there's a definite segment of consumers that are starting to use unmanned and that's great. We also think there's a segment, and we know there's a segment that want a full service offer and want the things that go with that that we provide, be it, you know, car washes, coffee, forecourt concierge, the whole range of services that we also employ as differentiators in the market, and in doing so are reacting very much to consumer needs and consumer wants.

So we would see our business as very much as a sort of a fuel business and a convenience business in that sense, and equally both have got great opportunities to satisfy consumer demand.

I'd say the other piece of that is we have a lot of customers that just come to the convenience store only, so we also have a bunch of people that come just to shop with us for convenience and not buy fuel. We see consumers moving around the total market depending on what's going on. But definitely fuel price is a big determinant, location of the site's a big determinant, ease of getting in and out, the service that's offered, they're all components that make a big difference and definitely if an unmanned site opens up, or any site opens up across the road from an existing site, it definitely takes volume and you've got to compete hard for that customer.

MR JONES: I think the other thing I would add, in our reports or our submission to the MBIE fuel study in 2017, we did some analysis on this and shared it with MBIE in terms of the impact of unmanned but new entrants more generally. So I think if that's not publicly available information we can make it and we'll share it with the Commission.

MS RAWLINGS: We have some submission that if others didn't have some service proposition then they might not match competitor pricing if they - let me put that differently. That with a greater service offering it might not be necessary to match lower pricing either by an unmanned site or simply lower pricing across the board.

So again, this is going to this question about the value of service, a higher service offering versus unmanned sites, and whether that's dictated by geography as perhaps BP suggested more strongly than other factors, but do you have a view on that?

MR BAIRD: Look there's definitely sites where - with a full service offering there's a differentiator there, right, that consumers sometimes are prepared to pay a little bit more for, and it can depend on a whole lot of factors. But again, I think what we see play out is there's - you know, literally every site we operate is priced separately, differently and it's range of factors that go into the mix to decide what that should be.

MS RAWLINGS: I think that's the flavour that, perhaps that discussion from BP's had as well, that there may be - it's not a generalised issue about the effect of an unmanned site across the road. Even within a geographic location you might have other factors that would determine whether a particular site reacted in a particular way. Is that fair?

MS BOFFA: Yeah, that's fair. And the other point being that it may be a distance away and then someone else reacts and someone else reacts, it's very fluid and there are a number of factors that impact it.

MR BAIRD: To give some colour perhaps, we just built, for want of a better term, but opened an unmanned site in Alexandra which was a full manned site prior, so it's a bit of an experiment for us. The feedback we got was actually really interesting in terms of we actually have lost volume and the customers have told us that they valued the service, they valued the rubbish bin, the bathrooms, the store. So there's a whole raft of stuff in there that definitely points to the fact that there's segmentation happening in the marketplace and consumers have choice and they're making those choices.

DR SMALL: This is a really interesting conversation. If I could just sort of bring it up to a slightly higher level of generality. I guess one of the things I'm kind of getting the sense of is that you're telling us that in the retail space these markets are actually highly differentiated, that what works, what affects your pricing decisions varies according to who's nearby, whether it's a go to work or a come home from work site, how many people of a different type might live in each location.

So would you agree then with a general proposition that I'll just put to you, it's a bit of a wildcard; that this means that at the local retail market level there's a range of different competitive intensities, some of them are much more intensely competitive than others? Perhaps we'll start with Z.

MR BAIRD: Yeah, absolutely.

DR SMALL: Thank you. That was one of the underlying themes, I think, in our report, so thank you for that. BP would probably agree?

MS BOFFA: Yes, and we're happy to talk more on this on Friday.

DR SMALL: Cool, thank you very much.

MS RAWLINGS: Let's move away then, I think, from the competitive dynamic unless there's anything that perhaps Gull or Waitomo might like to add to that at this stage.

MR PARHAM: I support what everyone has said, in that there's customers who are on different shopping missions every single day and some days they come to us, sometimes they'll go to BP to get a Wild Bean coffee or they'll to Z to get a pie nation pie or they'll go to Mobil to get their Smiles rewards.

So it changes every day, it's obviously very important in the market you operate and your site selection and how that's built; access, visibility, you know, that's very important. And that's where the offers are probably important as well, and what, you know, the brand is known for. So is it full service, is it concierge, is it the coffee.

And I think that's what they've got to resonate with their customers for. We're sort of a quick in and out quality fuels and that's who we target in our customers. And the competitors in the room have headwinds. We all know that minimum wage is going up. Probably 80% of what's sold in the C store is nicotine, caffeine, fat or sugar and there's definitely headwinds in that. So it's a diverse market with diverse customers, so just to agree with your comments.

MS RAWLINGS: Thank you. Anything else to add at this stage?

MR BODGER: Dangerously I think you've got the oil industry agreeing to something.

DR SMALL: It is isn't it, yeah, a bit scary.

MS RAWLINGS: Let's come back to some of those issues in a bit more detail, I think, towards the end of the week with each party will probably be quite valuable. I just want to go back now to talking - we've talked about premium fuel in terms of display and we had a little bit of a mention in relation to the use of premium fuel in circumstances where that may not be needed for consumers and this was an issue that we raised in the draft report. It seems like there's a few layers to this. One was the use of premium fuel rather than regular fuel and the other is in relation to different grades of fuel.

But I just wanted to check with AA actually that this proposition that consumers may be using premium grade fuels when they don't need to and whether there's anything that you wanted to share with us, or information that you've gathered on that point that we don't already have that hasn't fed into the draft just as a check on that I guess, or any other view you might have on it that you wanted to share now?

MR STOCKDALE: Well, yeah, you've also referred to this in the report and I think there's some takeaways from that, and yeah, there may be need for improved education and you've made some recommendations, particularly around if we can display the octane rating inside the fuel flap, it's not as easy as that. The challenge we have is with used imports where the information is not readily accessible. So it needs a little bit more work.

But, yeah, anecdotally some people are filling up on a fuel that they don't need, a grade that they don't meed. The caveat that I would add which perhaps wasn't covered in the draft report is that we wouldn't want people to put in a lower grade of fuel than their car requires. So there is a risk that people - sorry, there will be people who are choosing to put in a higher grade than they need or accidentally, and there's absolutely no harm in that. There is harm in putting in a lower grade of fuel than the car requires. Over a long-term that will cause engine damage.

So there does need to be clarity. It's absolutely okay to use a higher grade but we want to discourage people from thinking oh I can just put 91 in, it will be okay. It won't be. So having the right information is critical.

MS RAWLINGS: So that's your concern in relation to imported vehicles it seems, that if the information is not available with the vehicle itself and is subsequently inaccurate then we risk that kind of damage being done.

MR STOCKDALE: That's right. So a suggestion was maybe that information could be collected as a warrant of fitness. I don't think that's going to be a reliable source, we have to get it from the engine manufacturer, the car manufacturer basically and maybe the importer, particularly if it's a used vehicle can be responsible for sourcing that. This needs more analysis to actually come up with a solution, but doing it at the warrant of fitness is not going to be reliable.

The AA ourselves, we get people contacting us - this is one of the common queries that we receive through our motoring advice team in Auckland. We actually have an online Q&A, it's called "Ask the AA", and people often go on there with a question saying "I've got a 2005 Honda Fit which is a used import, what octane rating should I be using?" And our experts will reply if it's a New Zealand new car or if it's an engine that we have the specifications on we're able to respond and say our advice is that this only needs a minimum 91. Often the response will be this is a Japanese import, we don't have the specifications for that car, we can't answer this question. And we try hard to have that information, so it's not that easy to give that clarity. And that might mean people then choose to use 95 as a safe option because they don't want to risk this engine damage.

MS RAWLINGS: So when you expressed the view that there may be people using premium fuels that don't need to, is that a comment directed across the whole range of motor vehicle users, or are you primarily concerned with those using those import vehicles where we just don't know? So what I'm getting at there, are most of those who may be using premium fuel unnecessarily likely to be in that category where we have difficulty determining what they should be using, or is it an issue that runs across the board?

MR STOCKDALE: Certainly it will be that, but it will also be the other scenario I mentioned, which is where they have put in 98 by mistake when in fact they only wanted 95. They knew they wanted a premium grade, minimum 95, but they put in 98, which very relatively few cars in New Zealand do need 98 as a minimum. Whereas there are a number that do need 95 as a minimum. And that is because cars, typically from the European market, 95 tends to be the minimum regular grade if you will and then they have 98 as premium. In Japan it's 91 that's the regular and 95 that's the premium. So we have this mixed fleet in New Zealand. But actually relatively few cars need 98 as a minimum, but people are using it when in fact their car only needs 95.

MS RAWLINGS: So the 95/98 split is not something that we really addressed previously, but have you got any particular suggestion for solution for that issue?

MR STOCKDALE: In terms of?

MS RAWLINGS: How we might educate consumers better.

MR STOCKDALE: Put it this way, it's something that the AA is going to put some more thought into. We did do some publicity on this issue about ten years ago where we conducted a fuel economy test where we had a designed route using the same car, the same driver, the same route, so we tried to keep everything, so there was as little variation as possible and we showed a difference in fuel economy from using different grades. But that was just to inform people about the relative cost of using different fuels. But again we had to clearly state you need to use the minimum fuel that the car manufacturer requires and that can be a bit of a challenge.

MS RAWLINGS: Can I just ask others about your perception of the extent of this potential issue of people not understanding the minimum fuel requirements, maybe start with BP?

MS BOFFA: So our position is that generally we think people are well-informed about what fuel to use. I take the point about second-hand cars and whether they actually have that written on the inside flap or they can determine that from the instruction manual. The advice we tell our staff at our stores when people do ask is to look at the fuel flap, look at the instruction manual, at that point refer the person back to the person they purchased it from and/or ring the AA. But that happens - sorry Mark.

It's not a common occurrence. What we tend to find is that generally people know what products they want and it's more about explaining the differences between 95 and 98 where we say there is a difference between those two products, that users will get different benefits, although that is subject obviously to the type of engine, the way they drive and a number of other factors.

MS RAWLINGS: So what are the steps that you take to try to share that information with your customers?

MS BOFFA: We have pamphlets, we have stuff on our website and we do advertising campaigns around that as well.

MS RAWLINGS: Do you have a sense of the extent of interest that consumers have in that sort of information? Obviously you think there's enough to publish the material.

MS BOFFA: Yeah, research tells us there's about 10% of the population who are absolute die-hards, love the high octane products and will go out of their way to find them because their car is their life and they want those enhanced performance benefits. So there is a portion of the population who are very engaged. Then there's a portion that needed higher octane because they might have a European engine or something that requires them to be 95 plus and then there's the rest.

MS RAWLINGS: Z, do you have any thoughts on the extent of this issue?

MR BAIRD: We only sell 95 so we don't sell 98. To that extent we don't see the issue. I agree, it gets very complex and we would also refer customers back to the AA. It's a minefield in that sense.

MS RAWLINGS: Does that include the distinction between using regular or premium fuel in itself rather than the 95/98 issue, but the extent to which you think your customers are drawing correct distinctions or might need more information?

MR BAIRD: I think it's at the margin to be honest. I think the majority get it and most of them are pretty good, but there's definitely some - and they tend to be more of some of the Japanese imports not the weirder, for want of a better term, but the more obtuse models, right, otherwise most of it's relatively simple and understood.

MS RAWLINGS: Have you got any specific sort of education or initiatives that you undertake to try to deal with educating people on fuel type?

MR BAIRD: Predominantly website and from-time-to-time in the past we have done advertising around 95.

MS RAWLINGS: Anything on this issue for you Gull?

MR BODGER: I think it's a David Crawford, David Vincent motor vehicle need to be in the room to solve this, but again picking up Mark's point, if you are minimum 95, do not trade down your octane because it will end in tears. But again, going to the consumer research of complaints, we don't get many people complaining that the car has blown up because I was running on the lower octane. I think - and it is a think - but picking up what Andy said, the consumers are generally well-organised and well-educated if they have that vehicle. There is a certain bogan centred piece of society that will take the higher octane regardless because that is their choice, you know, you can choose this coffee or that coffee, so that is their choice.

I think the thing to look at too is the most trusted people on recommendations is Mark and his organisation where it's probably well-founded, but also your local mechanic is generally well-trusted and at times that cannot be well-founded, that that person may always recommend the higher octane because then you can never be wrong. If you are unsure and you always put in the higher one your car will continue to go as per normal, and often that, I believe, would be the advice from the mechanic. And it's how you get that education into the polytechs continually out, how you do it for the multiple marks and models that we get in here and the age of the fleet. Damn difficult.

MS RAWLINGS: But there's a risk element, I think, is what's come through too in terms of who's giving the advice, because the more conservative option will be more appealing to those giving the advice no doubt.

MR BODGER: Gull will give advice around the quality of our fuels, we won't give advice about your engine because you have bought that engine from somebody else, be that second-hand or new or whatever. You need to sort that out with your engine manufacturer.

MS RAWLINGS: Thank you. Anything to add?

MR PARHAM: I was going to say probably the main questions we get around our fuel is does it have additisation or is ethanol blended in it. So those are the main questions, and ultimately we are dealing in retail here where largely a lot of people know what they need but they buy what they want. So it's quite different sometimes, but I've just noted down an educational initiative where I'm going to refer people to the AA.

MS RAWLINGS: Perhaps we'll leave it on that note. I'll canvass whether anybody -

MR GREEN: Could I just add to that?

MS RAWLINGS: Yeah, thank you.

MR GREEN: Education, it depends on who's role is it to educate and on what. I think technology has a real opportunity here to provide that education, particularly if it sits outside of private business, as most education does in NZ already. Things like, you know, I'm a solution focused person and as are my colleagues, when I think things like trying to describe or define the difference between fuel types my mind immediately drifts to we already have a 91 button, you push the button, it defines what 91 is, it goes to the scroll list and it lists in alphabetical order all the current makes and models and you scroll down with a search button to your thing and it tells you without doubt from the manufacturer that your vehicle takes this thing. This is just a technology solution. It is relatively easily implemented.

But again, motivating private business to bother is not really necessarily, you know, what they need to do, it's not a core business, but I suppose I just wanted to say there's some fairly easy opportunities and easy wins using technology to educate the public.

DR SMALL: But you're also saying that in this case it's not easily monetiseable, did I hear that right?

MR GREEN: I think most things are easily monetised with a bit of creative thinking. It's more of a case of what you do for what return you get, like in any business.

DR SMALL: Yeah, sure.

MS RAWLINGS: There are a range of potential options without being limited in this room to initiatives that might be considered as options that necessarily need to fall on those who are here. So it is a helpful perspective, thank you.

MR BODGER: Could I just add one thing. Most motorists choose their octane once every four, five, seven years when you choose your vehicle. You choose your brand of fuel weekly, well I'd like it to be daily but not quite.

MS RAWLINGS: Thanks. I think we might break there for lunch. There are some issues raised in the draft report in relation to the relationship between margins and discounts which fall sort of in this retail area but I think what we might do is carry that over to a wrap in with a general profitability discussion that we've scheduled for this afternoon in any event. And I think lunch was scheduled for 12.30, so we'll break now and we'll return at 1.40.

I'm conscious that there may be some in the room who just were attending for this morning, so if that's the case, thank you again for your time, and also if there are others who were coming a bit later for the profitability discussion which we're probably starting a little earlier than anticipated now, if that creates attendance issues for anybody please do just let us know over the lunch break and we can see how we can accommodate that as well. Otherwise please see us back here at 1.40. Thank you.

Lunch Adjournment from 12.30 pm to 1.39 pm

MS RAWLINGS: Welcome back everybody. We're going to turn this afternoon to a discussion on first of all just some aspects still relating to discounting and the correlation between growth in discounts and growth in margins over time and then a broader discussion on profitability and aspects of that.

So I'm going to hand over to Commissioner Small who's going to lead off that discussion this afternoon.

DR SMALL: Thanks, Anna, and welcome back everyone. The first topic is really a hangover, as Anna said, from the previous discussion and then we'll get into profitability as such, at least as we've prepared for it. And just to give you a preview of where that discussion's going, we'd like to talk in terms of the general profitability session, we'd like to talk about our overall approach to this topic and then in more detail about importer margins, we've got some issues about the business cycle to discuss, average returns on capital, Tobin's q, incremental returns on capital, persistence of profits and participant behaviour in response to return expectations, so we should be done by afternoon tea time. Seriously, there's a bit of meat in here and we're looking forward to a really useful discussion. I will introduce that profitability session more generally in just a minute, but let me just start with prices and margins.

SESSION THREE: Profitability

Price and Margins

DR SMALL: I think there may have been possibly a little bit of confusion in terms of - whether we wrote it vaguely in the report or it was misinterpreted - but in the report we talked about two ways in which we saw a connection between the level of discounting and the level of importer margins. And so one of those was and by far the most important one and the one that we are most interested in is this kind of long-term pattern.

We had a chart in the report around para 7.27 in the report just showing the growth over time in importer margins and discounts. That used MBIE data, and we recognise that that's not perfect data, but we wanted to explore just with you what's driving that, what your interpretation is of that long-term correlation. So that's really what I'm interested in now. But before we get to that, we also did some econometric analysis at the back end of the report which was by far - it was a very different style of analysis and it looked at - I'd characterise it as fairly short-term correlations, i.e. days at a time between changes in margins and changes in discounts, and that showed a sort of slightly, well, vaguely interesting pattern but there's all sorts of issues with any econometric model, of course.

We're not putting much weight on that, but I raise it now because I think it may caused a little confusion perhaps among readers of the report. But I'm happy to talk about that if you want to, but the key point is how do we interpret this long-term pattern.

We said a few things about it, we said we thought discounting was sort of a symptom of higher margins and we noted that historic correlation in that regard. And so I think my main question really is for BP, I think, because BP submitted that this is inaccurate and that - I'll quote your submission. "In relation to the Commission's analysis of board price margin and discounting, BP considers that the basis for this analysis appears to be inaccurate. The data does not reflect BP's views of discounts and margins".

So I just would like to understand a little better please, if you could, what you mean by that, where the inaccuracies are, and what we should take from that?

MS BOFFA: I've got that paragraph in front of me, so what we're referring to there is that earlier in the report where you've got an infographic talking about importer costs and importer margins for premium fuels. We've also put in our submission that we believe that that's incorrectly been attributed and related to the product quality adjustment costs, that those have been put into importer margin as opposed to importer costs.

We can go into more detail on it on Friday, but we're unsure as to the data that's been presented here and our speculation is that perhaps that same inference has come through into here.

DR SMALL: Okay, thank you, that's helpful in understanding your submission. Just on that, that question of the costs, I noticed your submission on that point saying that the quality adjustment costs were a good deal higher than we thought they were. Can I just ask you if those have changed over time, those quality adjustment costs to your knowledge?

MS BOFFA: Yes, they have.

DR SMALL: So you've got some information on that that you can provide us?

MS BOFFA: Yes, we can talk more about that on Friday.

DR SMALL: All right, has anybody else got, I guess, a framework or a theory for why discounts seem to have - I mean accepting that maybe the strength of correlation is perhaps not as high as it might appear in those charts, does anybody dispute, first of all, that there is correlation between the increase in margins and the increase in discounts? I mean we generally - our view of the data, admitting that maybe there are some adjustments to be made, our view seems to be that these things have grown together and levelled off together.

MR JONES: What I'll do is I'll ask Andy, my colleague who runs the retail business, to answer that one because he, I guess, lives it every day so probably the observations of what shows up on a day-to-day basis. Over to you.

MR BAIRD: It's an interesting question actually in terms of - I would put it down - it's almost like - it's probably not answering the question directly but it is a factor of competition in the marketplace I think that - I don't think the two are related as such. I know you can show a graph that shows some relation, but the reality in the marketplace is that that is just heavily competed in a sort of, as we talked about earlier this morning, around site-by-site, on a site-by-site basis in the market area. And so that's probably the focus that we would have from a retail perspective, is that we're just focused on the consumer, making sure we're giving them great value and doing the right things by them and that just is a consequence of that.

DR SMALL: Right, because I mean we did pose this question in our statement of preliminary issues as well. I think we put it in a fairly open way as to it seemed a curious stylised fact to us that both these things were growing together and we asked for your views as to why that might be and we didn't really get any. So let me put it around the other way and say well, supposing we're talking about, as BP argues, a business cycle that was low, that went down and then came up, and now I think the theory is it's peaked and is on its way down again. We'll get to exactly how we date that business cycle shortly, but would you agree that if that's the case that the level of discounting, what do you think will happen to it on the down swing of that cycle?

MR JONES: I can understand the view that as margins increased competition increased and its expressed in discounts. What I can say from the Z data is what's evolved in the last 18 months to two years, that decline in margins is more driven by a decrease in headline observable price than it is an increase in discounts.

So what happens next I don't know, but in terms of the ability to compete with discounts, I could speculate, and it would be speculation, that it would diminish because the bigger decrease in margin, in particular in the last 12 months, has happened because headline prices or headline observable margins, probably best approximated by the MBIE data, has decreased more. So that's speculation.

DR SMALL: That would be my guess as well. Simply from on affordability point of view, if your margins are getting squeezed then there's basically less space to discount.

MR JONES: Yes, yeah, and that data's available and we can make it available to the Commission in terms of more recent, because I think that effect is more observable in the last 18 months, so -

DR SMALL: Did you want to make a comment Mr Bodger?

MR BODGER: "Mr Bodger", thank you.

DR SMALL: Sorry, Dave.

MR BODGER: He was my father, he was a school principal. BP's opinion is not alone. You go back early 2000s the market was shocking. People were selling out and leaving New Zealand. There is one evident that left and there was significant rumours of another one that was actively on the market and close to leaving at that point in time. There was close to nil or negative profitability in the business and nobody was investing.

So it's a longer term, there's a longer term view that, yes, we have come here and we are somewhere here, I don't know where, but yeah, there have been some horrible times in the past.

DR SMALL: I certainly agree with that, that's clear in the data I think. I was more interested in the way that discounts activity and the size of discounts seem to move, comove and correlate with margins. But I think if anyone else has got any comment on that I'd be keen to hear it.

MR FITCHETT: Maybe I can add some perspective to that because - I'm not involved with the margin side. We run a programme which we have oil companies as partners amongst other retail partners who set their discounts as they go. If you think when we started, we started back in 2011 at 4 cents a litre with one of our fuel partners, and the logic behind that was just to match the supermarket docket schemes. There was no other science behind that, it was spend $40 and get 4 cents a litre.

And that's basically where we started and we had two fuel partners and one moved their offer up from 4 to 6 cents because they wanted to get more of our base shopping with them and hence they moved and it's essentially - that's what sort of has driven the 4 to 6 cents and where we got to 6 cents every day was them trying to get more of the customers coming to them as opposed to another fuel company. Look now we're 6 cents every day and, you know, they do do the 10 cent things.

But for us it wasn't - that was in a lower margin world, but it was more those two fighting for share of customer and off the back of the supermarket docket programmes, who weren't in it, one of our partners, to try and get that compete in a market where they weren't in a supermarket docket scheme, so if that helps with some context.

DR SMALL: Yeah, it does help. Thank you very much. That's probably enough for now I think on that point, unless anyone else wants to raise it.

SESSION THREE: Profitability

DR SMALL: So let's go to profitability as such, and before we get into it I'll just make a few preliminary comments. Obviously this was a matter of some interest to us in our draft report. I think we've said repeatedly in the draft report and prior to that that profitability will always be an imperfect indicator of the strength of competition, and similarly I think we'd all agree that any particular, well, measures of profitability generally are themselves subject to error and imperfect in various ways.

So the purpose of this session really, though, is to test our analysis and your comments so that we can better understand what you're telling us and so we can improve where we need to in the final.

We have found the submissions very helpful on this topic area, both in probing our analytical methods and the inference we draw from them and also in spotting inaccuracies in our work, and we appreciate that and we take that on board and we'll be making those adjustments as we go forward.

But at this point we'd also consider that some submissions on some issues are themselves a bit inaccurate, or at least that we don't fully understand what you're trying to tell us, and so what we'd like to do in this session is to deepen our understanding on what you're saying. So we're going to be asking you to go a bit beyond what you've written in your submissions, which we've carefully read, so that we can better understand the points that you're making to us. So we're really here to listen.

So because the analysis that we undertook used a range of methods, many methods, there's lots of topics that we could discuss here. Fortunately some topics don't need to be covered, either because submitters made no challenge to our work, and I doubt there'll be many tears shed to learn that the cost of capital falls into this category, or in other cases because we fully understand what you've told us. So just because we don't cover something in this session doesn't mean we're not interested in it.

Okay, so as I said before, we're going to start with the overall approach and our overall approach to profitability, we did actually publish this back on the 18th of April, and at that stage we proposed a range of measures and information sources. We noted that these were indicators of profit and we tried to place the relevance of those indicators into our broader competition analysis.

We foreshadowed the use of backward and forward-looking measures and looking at many firms which participate in the fuel industry. So we got some constructive feedback on that overall approach and we tried to accommodate that in our draft report.

However, now some of the submissions we've recently received criticise the overall approach and specific aspects of it. But there are not, to be honest, very many positive constructive alternatives suggested, so we'd like first of all to give you an opportunity to tell us at the overall level how we should have done it and how we should do it for the final.

So perhaps I could start with Z's comments. Z's submission characterised our approach as being a light touch method which seeks indications only rather than to perfect the analysis, and Z also said that multiple shorthand approaches do not verify a concrete overall view.

So perhaps I could start with Z and say, is it possible, in your view, to properly assess profitability in a market study, bearing in mind this is a one year process, one industry, we're not talking about Part 4 regulation, we're looking at profitability for the purposes of drawing inference about competition. So do you think it's possible or should we just not have done it?

MR JONES: In terms of the exploration of this topic, we've got Jeff Balchin with us, who's an advisor to Z, who will make his comments available to the Commission as well because I'm sure he'll have some useful comments. But from the Z perspective, yes I think we necessarily need to do it and this process of investigating where we have a different point of view to the Commission, and legitimately so in some pieces; we'd also say that under the reasoning of the intent of some of the analysis I think we've got something to contribute, so this is the forum for that.

Also I think some extension of the analysis. In particular, I understand that a key test is for markers to be found to be less competitive than they otherwise should be, is that returns are excessive, they persist and are likely to persist. I think just extending the analysis actually informs that conclusion substantially.

So I think there's some additions and modifications that can be made that recognise the inherent difficulty but would ensure that we get a more, I don't want to use the word accurate, but more satisfactory analysis.

DR SMALL: Thank you, so you're not saying that we should just pick one of these methods and focus on that, or two of these methods and perfect them, or are you?

MR JONES: So if you looked at, say, the ROACE analysis and the margin analysis, they each form part of the picture and, for instance, if I look at the ROACE analysis or the margin analysis there's the completeness aspect to it that I think we should pursue that will complete the picture.

In terms of the Tobin's q analysis, I think there's elements of that that I think is worthwhile, subject to the same interrogation in terms of more information we can bring to the table to clarify that analysis, but more broadly I'd leave comments on Tobin's q to Jeff and ask for his comments at this point in time.

DR SMALL: Sure, we are going to come to Tobin's q and we are going to dive into these methods in depth. I'm just really at this point trying to understand the broad point. And I think what I'm hearing you say, but please jump in Jeff if you'd like to add to this, I think what I'm hearing you say is that you don't object and perhaps might even support the use of a range of measures. So your concern really is that there's some weaknesses in the application of some of the methods that we've used?

MR JONES: I think there are some weaknesses, acknowledging the time pressure of the Commission. There's also some information that was not available to the Commission or a perspective we can offer that, so I'd point to a completeness is something that we should pursue in regards.

Also there's a view of absolute profitability, but acknowledging the importance of this discussion to stakeholders, there's a relative assessment of profitability that I think we also need to pay attention to, such as comparing our returns with other companies. So I think we need to pay attention to that. So yes, we do need to pursue it and I'd point to a completeness of the analysis is important.

DR SMALL: Thank you very much. I hear what you're talking about regarding comparability, I notice you made that in your opening comments as well. I agree with that, that's fine, thank you.

What about CRA, is Jennifer -

MS FISH: Jennifer Fish here.

DR SMALL: Would you like to make some comments on this at the overall level because you're also -

MS FISH: Sure, I am happy for there to be a range of measures. I think that's appropriate because no one measure is going to be perfect and measuring profitability is exceptionally difficult. Identifying whether prices are above a competitive level on the basis of a profitability analysis is even more difficult, because the profitability analysis alone might not tell you that, depending on how it's done. I think any measure that you apply has to be conceptually sound, it has to be applied in the manner that addresses what it is you're trying to conclude from it, and I think any conclusions that you draw need to recognise the limitations of that measure and how difficult it is to measure.

DR SMALL: Thank you very much, I don't think we'd disagree with anything there, thank you. Perhaps the only party who did actually propose an additional measure was Garth Ireland and who, through several submissions, has outlined how EVA could be used as an additional measure. Garth, could I invite you please to briefly outline what you see is the advantage of this approach and any other sort of relevant comments to our overall strategy here.

MR GARTH IRELAND: Thank you. Now basically I start off from a value-based framework which essentially adopts NPV discounted cash flow as the framework. Which is emulated by the Commerce Commission in regard to Part 4 regulation and in that case it deliberately, just as an example, sets out to set revenue at the net present value equals zero, or alternately in any one year, over a 5-year, somewhere along the line that the economic return in that year or in all of the years equals zero. And the zero comes about because the earnings would be risk adjusted in the sense that the normal return would be such that the business return less the capital charge would be zero. So in that case the investors's earned his rate of return.

So that naturally fits into the fuels area. In that case the constraints are different. In other words, you can maximise value or someone can put limits on it, but at least you need to understand all those workings as best possible and I think out of that will come a reasonable solution.

Now there are many ways of getting there and many substitutes and surrogates and, for instance, I just noted the dimensions that you've got to handle is positive changes, negative changes, ups, downs, backward, forward, fast, slow - so this there's a speed element - stable, cyclical. So all of those dynamics are at work here. And I think a number of approaches around the basic cash flow methodology enables you to get to a position where you can make a reasoned decision.

DR SMALL: Thank you very much. I was particularly taken by your approach, it was very interesting indeed, and obviously this is not a Part 4 analysis and we just don't have the resource to conduct that level of exhaustive inquiry in this context, but nevertheless I think I would agree, it's useful to think about that as a concept in this context.

So I guess I'd be keen to hear from others, first of all whether you've seen Garth's submission, and secondly whether you think that that's something that we should pay more attention to in the future. And maybe we'll start over at this side, I don't know who wants to answer for Z.

MR JONES: I think there's substantially more benefit in this process for completing the analysis that was started and having it be informed by our submissions in this process. I think that's where the most benefit's from in terms of this process.

DR SMALL: Rather than?

MR JONES: Rather than swapping horses and changing the analysis. I think we need to finish what we've started would be my sense of it.

DR SMALL: All right. Would you like to make a -

MS FISH: I have to admit I haven't read Garth's submission yet but I'm happy to provide some written comments on it within the next two weeks if that's helpful.

DR SMALL: Thank you. I want to be reasonably complete here. I don't want to exclude people who have got a view on this, so please do signal if you - I realise this discussion is probably going to get a little arcane as we go along but please do signal and let me know if you -

MR BALCHIN: John, could I just make a comment?

DR SMALL: Yes.

MR BALCHIN: In my view there's not a lot of daylight between economic value-added as a concept and a ROACE-type analysis, the EVA is probably just a more sophisticated way of bringing together multiple years. What's critically important, and whether there will be disagreement and where people may disagree with what Mr Ireland has done are the inputs that go into the analysis, in particular the opening values, whether they're book values or acquisition valuables or whether a proper replacement cost, and what's assumed to be the residual value at the end of the period, and to what extent, for example, issues like stranded asset risk are fully reflected into those closing values. So I think as a concept I don't think there's a lot of difference, but I think it doesn't overcome the difficult issues you already have to face with, say, a ROACE-type analysis.

DR SMALL: I'm sure we'd agree the inputs are absolutely crucial, but Garth please comment on that.

MR GARTH IRELAND: The framework provides for three different approaches to ascertaining excess returns. Now what I did, very explicitly, said my measure is an investor's measure. That means what is the cash flow return on cash invested, which means a lot of accounting adjustments get wound out on that basis, so that's 100% consistent with NPV, all cash.

The second approach, which is alluded to in various analysis, although I think it's slightly confused and needs to be sorted out, is that you can then define, say, capital excluding goodwill, which effectively is a business approach whereby you're saying that irrespective of the takeover or acquisition premiums, if you like, the businesses are combined together and the operating business is just moulded and just remeasured, if you like. And the third one is the new entrant test, which again is a different definition of capital and I think it is a little bit confusing.

Now I suggest that the history is done on an agreed basis, if you like, and mine is cash invested and see how it evolves. On the new entrant test there's a lot of work done on that and there’s a lot of disagreement. Now I just don't know but that's something that's there. And also just the business approach, you might do that as another alternative because that particularly relates to Z who pay premiums for a business that didn't really change underneath, there were synergies and so forth. So I think that my framework enables all those parts to be reconciled.

DR SMALL: Excellent, okay, that sounds like a good foundation to kick off from, thank you for that and we may well come back to you when we get into some of those issues.

SESSION THREE: Margins

DR SMALL: So that's the overall approach. Now the next thing I thought would be useful, I've tried to order these in a reasonably logical way, is margins. Perhaps as a starting point, we've talked about margins earlier in the conference already, a lot of discussion in the submissions about margins.

I think as a starting point here I'd like to quote CRA whose submissions says at page 1 that margins are not a measure of profitability and provide little information on whether returns are excessive or competition is effective.

So I'm trying to reconcile that statement with a series of quotes that we had in our draft report at paragraph D6 which are quotes from firms that do seem to indicate that firms see margins as a measure of profitability. And I'll just give you a few to give you the flavour of it, because really my question is whether or not these are in any way informative.

June 2012, analysis prepared by one fuel retailer said, "However, there may be a risk to us should a new fuel retailer enter the New Zealand market attracted by current high margins". And went on to say some other things. Another fuel retailer strategy document from a year later 2013 said, "Fuel margins are currently at an all time high. While New Zealand is a stable market, such high margins will attract new entrants or sustain discounting of margins". And there's a few more there as well.

So these statements led us to believe that firms actually do look at margins and consider them an indicator, not a measure, but an indicator of profitability. So would you agree that they are an indicator of profitability?

MS FISH: I think they're relevant to profitability, they're just not an actual measure of profitability, and our comments were specifically in relation to the importer margins that have been reported which don't include all costs. Cost margins are relevant to profitability, they're just not - our point was they're not actually a measure of profitability. So if you see margins increasing, that is a place to start and wonder what's happening, but it's not the end of the inquiry. And our point is that you can't just look at gross margins or importer margins and make any conclusions from a trend in that as to whether retailers are making excess profits.

DR SMALL: All right, so -

MS FISH: I'm not saying margins are irrelevant, they obviously are an important component that goes into a company's profitability.

DR SMALL: All right, so they're one of a range of indicators of profitability but they're not a measure is, I think, what you're saying.

MS FISH: You could use it in conjunction with a measure of profitability to kind of confirm your results, but our point is you can't rely on just an analysis of margins alone to draw conclusions about excess profits in the industry.

DR SMALL: Yeah, I think we'd agree with that. I think Z would agree with that.

MR JONES: Yeah, nothing else to add to that.

SESSION THREE: Business Cycle

DR SMALL: All right. Very good. So that brings us I think - that was easy - so with margins as an indicator of profitability, I want to talk now about the business cycle. And the reason for doing this. Of course is that whilst we gave some estimates of return on average capital employed that go back to 2004, there was also a reasonable focus in our report on returns over the last decade, and BP in particular have in several places argued that we've neglected the impact of a long business cycle and that this has led us to incorrectly suggest that fuel firms have been making excessive profits and CRA makes similar arguments.

So I think we can probably, for the purposes of this analysis, unless you object, use the margins as an indicator of the cycle. I think this is actually what you yourselves have done in your submissions, you've looked at the margin graphs that have gone down and then gone up and levelled off and you've said that looks to us like a business cycle. I think that's where you're coming from but please correct me if I'm wrong.

MS FISH: Well, it's more that we see the business cycle as a period where entry is occurring in response to higher margins and higher profits followed by a period where we see a decline in margins as a result of competition as a result of that new entry, we then see exit happening as a result of those depressed margins and profits, two separate things, and then we see kind of an upswing. So I see a business cycle as a cycle that involves investment, contraction, investment. It just coincides with the margin diagram that you've provided in the report.

DR SMALL: So when you talked about the business cycle and developed your views on the business cycle, are you saying that you looked at patterns of investment and exit rather than margins?

MS FISH: Well, they kind of go hand-in-hand. We saw a period of deregulation, a period of instability, we saw a period of kind of relatively stable slightly inclining margins for a period of about six years, then we saw entry and substantial entry with Challenge and Gull. We saw after that margins fall in response to competition from that entry, we've seen contraction, and we're now seeing a process now of recovery up to the current point and we're seeing kind of new entry in response to that.

So I think the two things go hand-in-hand. We can see the change in margins and we can understand why that occurs because of entry and exit decisions over time.

DR SMALL: Right, so those margins are actually a good indicator. And so the drivers of that business cycle then, you would say - I mean obviously we're keen to see, first of all, how we date it, which is a big issue in macroeconomic business cycles, and then secondly what's driving it, and then what are the implications for profitability analysis. So would you say that the - shall we look at the margins graph for this point since we seem to be agreed that they're telling us much the same thing. Where can I find the margins part.

MR GROOT: Chapter 3.

MS FISH: I think it's figure 2.4.

DR SMALL: Please sing out anyone who finds it before I do.

MR GROOT: 2.41.

DR SMALL: 2.41, thank you, page 28. Okay, so have we all got that, page 28? High margins before deregulation. A slump at deregulation and then - I mean talk me through it, how does this cycle work and where's it going from here?

MS FISH: I would say that there was a period of instability after deregulation.

DR SMALL: That takes us to where, about 92?

MS FISH: Which takes to us about 92 then we see a period of kind of greater stability between, say, 30 and 40 cents per litre. We understand entry occurred in 1998, so that indicates that margins remained - it took six years for margins at that level to encourage new entry. And then we see competition competing away those margins for a very long period through to around about 2010.

DR SMALL: Yeah, 2008 I think is the bottom.

MS FISH: 2008 is the bottom, yeah, with recovery happening maybe around 2009. And over that period of time we saw a lot of site closures, we've seen 25% of retail sites, I understand, close during that period as margins were tightening with most of that contraction happening in that latter period of 2005 to 2010. And then we've subsequently seen an increase in margins over the last 10 years which has been accompanied particularly in the last kind of couple of years since 2016 with entry by independents.

So I take from that that there is a long cycle, these are long lived assets, investment decisions are not taken lightly. It's taken quite some time in the beginning after deregulation for margins to be stable for that to encourage new entry, that new entry has encouraged competition and margins to be squeezed, and that has lasted for quite a long time and encouraged contraction, encouraged people to leave the industry, and we're now seeing a recovery period.

DR SMALL: I see. So the downturn, the downswing in that post-deregulation cycle was due to Gull presumably entering in 98 and then -

MS FISH: And Challenge and then I think maybe Liberty came later.

DR SMALL: And Challenge which subsequently exited -

MR BODGER: 18 months.

DR SMALL: 18 months later, yeah, so perhaps not a big effect from Challenge. And so what you're saying then is that it was Gull that put these margins on the down slide and that continued until 2008. What happened then in 2008, how did that - I'm trying to understand how they turned up actually, how did margins start to recover?

MS FISH: My understanding is that people thought margins were unsustainably low.

DR SMALL: Yeah, they might have thought that but how did they get them up? I mean I can see your point that if you're at the peak of a business cycle and then someone aggressive like Gull comes in that might drive margins down, but I'm struggling to understand how we get out of the trough.

DR WALKER: Didn't you indicate before that the margins rise when firms exit, so what's the exit that's happening to drive the rise in margins?

MS FISH: So my understanding is that there are around about 400 sites that were closed during that period of time.

DR SMALL: That's retail sites, okay, so you're saying the entry of an importer was what brought it off the peak and it was the exit of retailers that brought it off the trough.

MS FISH: There's exit of retailers, also decisions to invest in the industry and provide higher quality product.

DR SMALL: Are you talking about Z here, because they didn't come in until a couple of years later, I think.

MS FISH: So my understanding Z entered in 2010, I'm seeing quite low margins through to that period.

DR SMALL: I think margins had been rising before you arrived, hadn't they?

MS FISH: Mmm-hmm.

DR SMALL: That's our information, I think, is that margins had come out of the trough before Z entered and then Z came in with the view of providing higher quality and getting higher margins.

MR JONES: My knowledge about margins are better post being here with Z. The lines are pretty squiggly, I think. In terms of a trend it is somewhere around that period. Yeah, that's not something that we would conclude about margins improving before Z entered the business or the industry.

DR SMALL: But certainly afterwards.

MR JONES: Yes, in terms of the analysis that's been shared from exit from the industry and entry into the industry they are some of the catalysts for those changes for sure.

DR SMALL: Right. Okay, so the reason this matters, of course, is that you're saying that we should have taken our profitability analysis back further than we did. I think that's the BP's argument.

MS FISH: Well, subject to - I can understand there are information limitations to that. What we're really saying is that whatever time period you use just keep in mind what had come before.

DR SMALL: Yes of course.

MS FISH: If you're using a truncated analysis that only goes back to, say, 2010 or 2008, or if you're looking at margins over a much shorter period of time from that 2014 to 2019, 18 period, just be very cognisant of what came before that, that we've had a very long period of low margins and that's relevant to your analysis of profitability, these are the long lived investments.

DR SMALL: Look I think we'd definitely agree with you on that and we'd probably also say that's what we've tried to do. We did go back to 2004, which you know on the margins chart or on the story we've just been discussing, was well into the slump. I think you said that was when all the stations were closing. So if I look at figure 3 in the CRA submission, which was on your page 18, and you've got there disaggregated return on average capital employed for the major firms going back to 2004, I think this uses our data actually, but I might be wrong.

So if I look at the upper end of the WACC range, which really we only estimated for the last few years, we didn't estimate it back further, but just taking that as an example and the annual weighted average of the majors, which is the grey line, then it looks to me as though - correct me if I'm wrong - it does look to me as though the weighted average of the majors returns were in excess of at least our estimate of WACC in 2004, 5, 6 and 7 and in fact in every year except for 2008. Would you -

MS FISH: When compared to your WACC estimate for 2014 to 2019 I think there's an acknowledgement in your report that WACC was higher in previous years.

DR SMALL: Yes, I agree with that.

MS FISH: Also all of this analysis is based on historic cost estimates.

DR SMALL: Yeah, so we're going to get into the calculation method, but I'm just really trying to - I guess I'm trying to understand whether going back to 2004, as we did, is enough to address your business cycle concerns, assuming that we do it in a correct way, which we're going to get to in a minute.

MS FISH: You haven't really given - sure there's a plot of that in your report but no real consideration for what that means in the context of your analysis of returns from 2014 to 2018, which is where you're really focusing your analysis of whether returns are excessive.

DR SMALL: So that's the period over which we estimated WACC. I take that point. But would you agree on the basis of both the margins chart and your figure 3 that 2004 is an okay starting point taking into account the business cycle? Or would you say that, even if you did it very well and accurately, that starting in 2004 would be starting too late? It looks like it captures the trough is what I'm saying and several years before the trough. So I'm asking you whether you think that that would be - feel free to disagree.

MS FISH: I think there would be value in going back further if you had the information.

SESSION THREE: Average Returns on Capital

DR SMALL: Okay. All right, okay, thank you for that, we'll leave that topic there and turn to average returns on capital which is - I don't know how we're going to say this word - return on average capital employed, how did you say it before, ROACE?

MR JONES: Returns.

DR SMALL: If we say returns can we take that as meaning ROACE? Good. Z, you've submitted that returns are not a reliable methodology for assessing excess returns. On the other hand, we do understand that a number of fuel firms domestically and internationally use this measure to assess financial performance and we reported that in our draft report. And in fact the fact that firms domestically and internationally, fuel firms, do use this measure is one of the reasons that we included it.

So I guess the first question is, assuming that you did it right, did this calculation correctly, is this a suitable measure of average returns on capital over time and if not what is?

MR JONES: So as one measure it is a useful one. In particular observing one entity over time. So I think that's the criticality.

DR SMALL: Okay.

MR JONES: So when we compare, say, between sectors or between companies, we need to apply, I think, more diligence in the use of ROACE. So it comes with those very real limitations, which to a certain extent can be overcome. So observing one entity over time is more useful than a point in time estimate or between companies or between sectors.

DR SMALL: Thank you, that's helpful. Okay, but I've got another one for you Z. So going now to the definition of how we actually implement this measure. So you said in your submission that - and this concerns non-fuel income, which you have some of obviously - and you say that this undermines the ROACE findings, yet you also say that you run a company-owned network with staff and many other costs covered at head office and not necessarily attributed exclusively to retail analysis, an analysis that excludes these costs will be flawed, but similarly any attempt to allocate costs will be highly complex and likely inaccurate.

So you're saying we've got, essentially, at least a two product firm, we've got fuel and non-fuel, we can't include the non-fuel income because that undermines the ROACE findings, but neither can we back it out because that requires allocation of common costs. So could you help us to find a way through this?

MR JONES: Yeah, so I think we can in providing potentially more data so you get to see the size of that. I think the point in particular, though, is that if we're including revenue and income from activity other than selling fuel, and we include that revenue to substantiate conclusions that returns are excessive and likely to persist, that's when I think it starts getting tricky. So I think it's an acknowledgment that there is a substantial part of, I know my firm's returns, that come from selling things other than fuel, but for the purposes of the draft report have been included as if they were fuel. That's the most important thing.

DR SMALL: Right, I understand what you're saying. In fact, in your submission you in fact suggested that including these non-fuel activities materially increased your ROACE. I'm not asking you to divulge information that's not publicly available but, you know, it sort of indicates you're making more money on pies and coffee than you are on fuel.

But irrespective of whatever is going on there, your claim regarding the fact that these non-fuel activities increases your ROACE, that must depend surely on some allocation of common costs that you've got in mind when you make that statement.

MR JONES: Yeah, so we did complete that analysis for the MBIE review and it does an allocation of costs, yeah, we know that, and that does come with some difficulties. We do know, however, that the actual costs of operating a convenience food store network in particular, they are incremental to the core business of running fuel and that's reflected in what we think are quite sensible allocations. So yes, you can do it but -

DR SMALL: When you say they're incremental, does that mean there's not much extra capital involved?

MR JONES: So in terms of the analysis, if you look at the extra effort to sell fuels from a location, if that location is there with parking, a building, all the site works etc, yes, it is incremental.

DR SMALL: Won't the building be bigger at least to house the retail products?

MR JONES: I think in terms of different size footprints the average convenience food store could be somewhere between 60 and 80 square metres. So a lot of that provides for just movement of consumers to sell the high margin products is not - it doesn't have to be significantly larger to augment the profitability of the site.

DR SMALL: Okay. So do I take it that from your earlier comment that you would be willing to share with us a break-down so that we can better understand this for your own business?

MR JONES: Yes, we would, including the analysis that we provided to MBIE in 2017.

SESSION THREE: Revaluation Gains

DR SMALL: Excellent, thank you very much. Okay, that's great. There's more of course. So let's talk about revaluation gains if we could because, again, Z challenges the inclusion, so we've included revaluation gains in our estimate of your returns and you say that this is wrong and that it overstates your returns.

So I take it from that that you don't contest that you've had revaluation gains, but my question is, really, if the gains are not included in your returns, these revaluation gains, then who owns them, who does own those revaluation gains?

MR JONES: Yeah, so in terms of who owns them it's included on our financial accounts, you know, the owners of the firm. One of the, I think, important distinctions, though, is in terms of that it's classified as returns that are available to shareholders, they're not something I would distribute as a CFO as part of our dividend policy, for instance. So I don't include them for the purpose of being able to distribute to our shareholders and I think that's an important distinction.

DR SMALL: So that means you're retaining them for some other purpose, possibly investment. But what you're saying is you're not passing them out as part of the dividend. But mustn't they necessarily increase the value of your company and won't the investors in your company have, for example, a revaluation gain on the share price? Not a revaluation gain but an appreciation. It's going to go somewhere, isn't it, it's going to show up somewhere in the earnings or income that your investors get.

MR JONES: I haven't seen that in the revaluation exercises we've done and they're made public and we've disclosed them. Secondly, we're not in the business of trading property, so it wouldn't be the expectation that, say, other businesses who are in the business of that would, you know, that they would be made available to shareholders. We don't see that as a material change on the value of our company in the eyes of our investors.

MR GROOT: Just following up on that, it does presumably give - if an individual site, for example, or some of your sites are appreciating in value, that does presumably give you the option to look at alternate uses for those sites, i.e. not continuing to retail fuel from them but looking at selling them?

MR JONES: Say again?

MR GROOT: If you're achieving valuation gains on particular sites, individual sites or groups of sites, sites in a region, for example, that presumably does give you option value in terms of whether or not you wanted to continue to use them as fuel retail outlets or to look at alternate uses?

MR JONES: Yeah, exactly. So for the purposes of identifying the best uses of capital yes, it does. To include the revaluation of property as income for the purposes of assessing returns to fuel retailing, and substantiating the findings, that's what Z disagrees with. I can understand the perspective that it does create option value and gives us a sense of higher alternative use, but for the purposes of the findings in the draft report that's something Z has a different perspective on.

MR GROOT: But land does generally appreciate in value.

MR JONES: Sorry, is that -

MR GROOT: Land does generally appreciate in value.

MR JONES: Yes, as do rents and other costs associated with it, yes.

MS FISH: Can I just add something to that?

DR SMALL: Please do.

MS FISH: Whether or not you include revaluation gains I think really depends on the purpose for which you're doing the analysis. If you're looking at the analysis for the purpose of just determining what returns has Z made on its investment, then yes, but if the purpose of your analysis is to ask are retailers charging consumers too much for fuel, is this an indication of excess prices or prices above a competitive level, and you've included revaluation gains which are gains that come about not because of any charging of any price to consumers, then you really I think need to consider the relevance of including those revaluation gains for the purpose for which you're trying to use the analysis.

DR SMALL: Yeah, I take your point. Yeah, so I think this is something we're going to obviously reflect on. We're just trying to test your views on why you think we shouldn't include revaluation gains. Obviously in most parts of the economy, share market investors and any business investor looks not only at the cash return but also at the capital appreciation. And obviously whether or not you get that capital appreciation depends on your business model, whether you're leasing the assets or you own the assets, so there's all sorts of factors that go on in here. But it seems to us that - it seems to me at a general level at this point that capital appreciation is a form of income.

MS FISH: I guess the point is does the fact that I have an appreciation in my capital base mean that I should charge consumers less for the service that I'm providing. So if the outcome of including revaluation gains is that I get a higher estimate of return on capital employed than I otherwise would if I didn't include them and I'm trying to infer from that that prices are too high, that there's some uncompetitive outcome, you have to ask yourself the question of well, one, does that return relate to prices being charged to consumers, if it's a revaluation gain it's actually not a return that comes from the charging for the service being provided.

DR SMALL: No, it's -

MS FISH: And also if I've made that revaluation gain and I've earned returns higher than otherwise expected or that seem reasonable, does that mean I should charge consumers less for the service that I've been provided because I have made perhaps an unanticipated gain on the value of my land, or even if it was anticipated, should the fact that I've had a capital gain mean that I should charge consumers less in order to get down to a return that equals my average weighted cost of capital.

I'm not sure that conceptually makes sense to include it and then draw an inference that there's been excessive pricing. I think that process needs to be thought through in terms of the rationale for including it and what you really should draw from it.

DR SMALL: I agree it needs to be carefully thought through and I hear what you're saying and so thank you for that. Maybe we'll move on. I'm mindful of the - seems like this is going ridiculously quick because we're due for a break shortly and we've still got material to get through. So perhaps I could go back to Z because we were interested in the standard methodology that you've got for estimating your ROACE.

Can you tell us more about that, is it published or documented somewhere? I wasn't aware that the - we've obviously gone through our own method and you've criticised aspects of it, but you've said that you yourselves have a standard methodology. How standard is it? Is it standard to Z or is it something that you can refer us to?

MR JONES: We can provide all details of those workings to the Commission, indeed publicly, because we think it's an orthodox approach to a ROACE calculation. Orthodox in the matter of that's what we understood how Shell and Chevron may have done it in the past. So it's not something that we look at and, as CFO, I look at all the time, it's a measure that's useful for one company or one organisation over time. So we think there's a way of doing it and more than happy to share the details or in fact go through the differences here.

DR SMALL: Okay. Could I ask you in particular about the reason that you say that assets that you lease, that the capital cost of assets that you lease should be included in your capital, and I've got the same question about terminals too just to let you know.

MR JONES: There's a couple of perspectives on why we believe you should include those, more than a couple. One is that's a choice of whether we lease or own those assets. So it's almost a financing choice. The obligation is still there, the long-term obligation in terms of being able to occupy a site, so whether it's leased or owned. In terms of accounting standards, I think it's well-established now that those leases do represent the obligation or capital. And -

DR SMALL: While you're thinking there, sorry, before we go on to the next point, so your lease terms, though, won't be in perpetuity, will they?

MR JONES: No, they're not. No.

DR SMALL: No, so you're saying, just so I'm clear on it, if you lease a retail site somewhere, say for a 10-year period or something like that, then what you're saying, I think, is you're obligated to pick up that rental payment every year for 10 years and so in that sense it looks a bit like capital. I think that's -

MR JONES: Yes, yeah.

DR SMALL: So you're saying then that even though your lease is limited to 10 years, the full replacement cost of that site should be booked as if you had bought the site rather than as if you had leased it for a defined period of 10 years?

MR JONES: Yeah, so I think the more complete description of our analysis is consistent with the accounting standards. So we not only recognise the right of use assets, in our earnings we also provide for the tax adjusted lease effect. So we've provided both sides of that one and we think that's the orthodox way that businesses are looked at now, and that's something that a new entrant would be confronted with. So we've included both sides of that equation.

MR BALCHIN: Can I just chip in there.

DR SMALL: Yeah.

MR BALCHIN: It comes down to the objective of the measure and what Z's arguing for is -

DR SMALL: It does, yeah.

MR BALCHIN: - our objective is to test the situation of a new entrant into the industry and test the returns it would make. When you're doing that assessment that should be independent of how anyone finances, and whether you lease an asset or whether you debt finance the asset and own it. Accountants might treat those things differently, but at the end of the day you have an asset that is employed to generate a revenue stream. From an economic point of view there should be no difference arising from that financing choice. A new entrant would need to generate the same income stream, would have to have an asset under its control, so would have to essentially employ an asset that has a cost.

DR SMALL: I might be missing something here. Why is a new entrant relevant to this? We're talking about Z which is already there.

MR BALCHIN: I'm relating it back to the purpose that I assumed we were doing this analysis, which is we're testing whether Z is making monopoly rents by looking at its accounts, but we're testing that against the standard of how a new entrant would fair.

DR SMALL: Why are we doing it that way? Why is that the test?

MR BALCHIN: That's how the Commission has explained the test, as I read it. But I think it should be the test if it's not, because that is the test of whether - if you're trying to infer whether there's workable competition and if one of your indicators of that is whether a new entrant would make rents to enter this market then it should be framed around that, and anything that doesn't do that is actually giving you false information.

DR SMALL: I think that's an argument in respect of Tobin's q but I'm not so sure it's an argument in respect of ROACE, to be honest, so invite you to reflect on that.

MR BALCHIN: With respect, I think you can do a ROACE calculation to perform a similar analysis to what you do with Tobin's q and that is precisely what you should be doing.

DR SMALL: You can, but they'd be telling you the same thing. I thought what we're trying to do here is to look at this from a range of different angles.

MR BALCHIN: But if one different angle is focused on answering a different question, then it's -

DR SMALL: Isn't that the nature of different measures? Margins are looking at a different question.

MR BALCHIN: Margin is a trend, that's why it’s useful, it adds to a snapshot.

DR SMALL: Exactly, it's a different thing so it's for a different purpose. Maybe this goes back to the overall approach. I'm genuinely interested to understand why you think that the ROACE and the Tobin's q should be both aimed at assessing the potential for entry.

MR BALCHIN: Even if you are looking at the situation of Z, the question is still - it's still desirable to do the assessment of Z's returns in the way that's independent of how it's chosen to finance its business. So whether it leases assets or whether it buys assets, we should be looking at pre-financing decisions. That's the Commission's standard approach when it comes to Part 4 regulation and it's a desirable thing to do here.

DR SMALL: Perhaps I should go and reflect on this. Carry on.

MR JONES: In terms of the our ROACE calculation it's orthodox in terms of it's consistent with how a lot of people would expect it to be done given the latest changes to accounting standards, which reflect that, yes, Z could increase its capital base of owned assets by reversing some of the financing decisions we've made. But to myself in my role how is that any different in terms of our fundamental economic position in terms of the cost that we incur as a business? So there's nothing surprising about our analysis when we show you the method we've used. I'd describe it as kind of orthodox and consistent.

DR SMALL: Yeah, okay.

MR GROOT: Lindis, just picking up on that; you made the point before that ROACE's most usefully looked at one firm over time. One of the things that sort of influenced how we dealt with leases was the fact that we were also trying to make comparisons across firms, other New Zealand firms and the international firms. So you've published some information about, and in your submission, the value of capitalised leases. But just interested in your thoughts of how we should deal with that issue in respect of firms that haven't provided information around capitalised leases.

MR JONES: Within the sector, sorry, or more -

MR GROOT: Yes, primarily, yes.

MR JONES: So in terms of the information that's from participants in this study, I think you've got the ability to ask for that information and have it generated. I think in terms of if you look across sectors to compare returns based upon a ROACE measure with a risk that go there, I think that analysis could be completed and proxied for and indeed our advisers have done it. And it's an estimation.

DR SMALL: I think it's time for coffee. We'll have a -

MS RAWLINGS: I think we'll take a short break now but we had originally intended a half hour, but I think maybe 20 minutes and just reconvene at 3.15, that will give us a bit more time for the afternoon. So if we meet back here at 3.15 please.

Adjournment from 2.53 pm to 3.14 pm

DR SMALL: Good afternoon. Okay, so I think we've got through until about 4.30 to complete this session. I think we seem to be on track fortunately. I just want to finish off on that last point that we were talking about, which was the capitalisation of leases and I think - I might be wrong on this, but it's a question for Z. One of my colleagues informed me while we were having a cup of tea that perhaps your methodology doesn't require the full replacement cost of those leased assets to go into the denominator but that it instead requires the time discounted lease commitments, which is different to the full replacement cost. Is that correct do you think? Just a question for you, if this is true then my concerns are substantially allayed because it would be your lease commitments discounted by your debt value.

MR JONES: In terms of our analysis, which we'll share with you, we have included the discounted value of -

DR SMALL: Of your lease commitments over the period of the lease?

MR JONES: Yes. So consistent with the analysis that you would see under the relevant accounting standard. Not that we think accounting standards are always the answer for economic analysis, we think this one actually has some sense.

DR SMALL: Yeah, so we were previously, before we went and had a nice cup of tea, I was under the impression that you were arguing for full replacement cost. So it seems that perhaps you're not, that instead you're arguing for those discounted lease payments, which would be fine from my point of view.

MR BALCHIN: Could I just make a slight qualification to that. This was an issue that crosses over with Tobin's q because the same issue arises there, which is what goes into the denominator of the Tobin's q calculation. In principle it should be the cost of the replacing the assets should go into the denominator in both cases because that's the indicator of the assets you need. Something that I addressed in my report was that Z doesn't actually have that information to hand. All it has available to hand is the present value of the lease payments, so that was done as a second best. One would expect the replacement cost of those assets would be somewhat higher if the assets are part way through their life. So there's a question about what's practical versus what in theory should be done.

DR SMALL: We're going to come to Tobin's q in a minute. To be full disclosure, I disagree with your argument that these things should be done on a same basis because I think they're for different purposes, as I tried to make clear earlier. But I hear what you're saying and I think I hear that what Z is doing is to include the capitalised lease payments, the net present value of the lease payments essentially.

MR JONES: Yeah, so absolutely, that's the discounted value. For the purpose of being straight, our adjustment in terms of fair value for terminals is not, though, that's the full replacement cost and that's, I guess, where we - you have a perspective and we have a different perspective, but to front run that conversation.

DR SMALL: I thought I might tackle that under Tobin's q where it comes up.

MR JONES: Just to be clear, though, we made that adjustment, and you'll see when we send you the data, in our ROACE analysis as well.

DR SMALL: Marvellous, thank you. All right. And so just finally on that, decommissioning and restoration costs, you say that that also should be included?

MR JONES: Yes, I can explain my perspective of it, it's a cost that we incur, it's funds that we set aside for the purpose of tidying up sites, and it's a relatively certain base, it's known to what standard they have to be cleaned up. This is well-known in the industry of the sorts of things that you need to do and it's well-established practice. And I think not providing for that in our returns for me, I guess, as one of the officers of the firm, to not provide for cleaning up after yourself doesn't seem fair or reasonable.

DR SMALL: This isn't the case where you're exiting a site, is it?

MR JONES: Yes, the way we account for that is there's an expected life time for all the sites and we have some sense of what the costs would be. That's based on analysis site-by-site and the sort of things that we find when we clean up after ourselves.

DR SMALL: So does that mean that even if you're not exiting you're booking some of these costs because you eventually are going to exit.

MR JONES: Yeah, so there's an expected life time of each asset and the provision reflects that expected lifetime of that asset.

DR SMALL: So the working assumption is that you're going to exit every site essentially?

MR JONES: Yeah, essentially, and some have much less economic value because it's the present value of those terms. So that could be 20 or 30 years away.

DR SMALL: Sure, they'll be way discounted.

MR JONES: Yeah, yes.

DR SMALL: Yeah, that's right. It's interesting for me, though, as a - I see Garth smiling over there, would you like to make a comment?

MR GARTH IRELAND: I was just going to say, in the economic model one would reverse that entry because the cash hasn't left the business. So when the cash leaves the business it will enter all the accounting framework, so that's from the economic point of view. So you reverse provisions to reflect the money in the business, if you like, and so that applies to fair value adjustments, applies to all those non-cash entries, employment provisions etc.

DR SMALL: Thanks for that, that's helpful. Do you want to comment?

MR BALCHIN: I would challenge the economic point. These are costs that will be incurred.

DR SMALL: Only if you do exit.

MR BALCHIN: If you do exit, when you exit, and they need to be accounted for at some stage, and it's no good accounting for them after you've exited because they're not - in a sense you've left the industry and there's no revenue to recover those costs. Accruing for decommissioning costs is not something that's unusual, it's something that's done for regulated businesses where there is a finite life to the asset. Gas pipelines in Australia are already starting - there are some of those pipelines already factoring into their prices the decommissioning costs because they don't expect to survive post (inaudible).

DR SMALL: I understand the point you're making, but it's a non-cash cost, it's something that you expect to be realised at some time because you'll eventually exit the site and so you book it now.

MR BALCHIN: That's right.

DR SMALL: But you don't take the same approach to revaluation of the land, do you, that's also a non-cash non-realised - have I got this wrong?

MR BALCHIN: Revaluation of land is a book entry rather than an actual cost. This is an actual physical cost you're going to realise some time in the future. I think the -

DR SMALL: So is the revaluation because you are going to exit so you are going to get the money.

DR WALKER: At the same time.

DR SMALL: At the same time, yeah.

MR BALCHIN: Well, we don't know. I mean a lot of the assets, if we're talking about retail sites, a lot of the assets are sunk assets literally. The tanks and the pumps are not useful for anything else, so you're not going to realise that amount. So Z's point is there's quite a nebulous relationship outside of regulated businesses between the asset value and prices and revenues.

DR SMALL: Okay.

MR JONES: I get the potential equivalence between the asset revaluation for the land and for providing for cleaning up after we've left. This provision exists for all sites we operate at whether we own them or whether we lease them. It's a function of conducting the activity of retailing and wholesaling hydrocarbons and the analysis that we do is site-by-site and it's specific for each condition. So it could occur as equivalent, but I think it's different.

DR SMALL: Even for leased sites. So somebody else owns the land and you lease it, you book the remediation costs on that as well?

MR JONES: I think it's based on the reasonable expectation if in the act of conducting you make a mess you tidy up after yourself, it's that simple. It's a reflection of the business activity we take from day one, there's a reasonable expectation that we need to clean up afterwards.

DR SMALL: Do you think that's reflected in the contracts or is it just something that Z feels it should do?

MR JONES: There's an obligation under law and regulations to support the level of clean up, how you conduct it and there's significant precedent within the industry which all the participants in this room would know about.

DR SMALL: Okay, thank you very much, that's helpful.

DR WALKER: Just you said that this clean-up cost is site-by-site, so like does that mean that you sort of have an estimated life for different sites that might be different one site to another because you think this site's only got a certain life, or how do you decide that?

MR JONES: So the basis is that we don't just make some provision for all the activity that we have, we actually look at the network that we have, the terminal sites we have, and in some instances it even goes down to the nature of the assets that are there and the nature of the site that we occupy. That's just based upon previous experience. So yes, we do it site-by-site. Discounted. So implicitly that requires us to have a view of the future. I think the key point with it being a discounted point of view that reflects the present value of those future costs. If it's a long time in the future we don't incur massive costs now, we think it's a very -

DR SMALL: I understand, and the fact that they're so deferred means that when you discount them they're not very high. It does also mean you need an estimate of that exit date too, doesn't it.

MR JONES: Yes, we do, and that gets reviewed - I'd have to confirm this one, but my expectation is it gets reviewed up and down as things change.

DR SMALL: Okay, that's interesting.

MR JONES: But tanks typically don't get younger year by year, so it typically goes one way.

DR SMALL: We're going to get to tanks in a minute. Thank you very much.

DR WALKER: Actually, sorry, a double follow-up. So you're saying tanks don't get younger or whatever, but presumably you might replace the tank rather than exiting.

MR JONES: Yes, we would, and under that instance - looking to Sam beside me. There are occasions where that provision is applied to that tank. I would have to confirm that whether there's been precedent. In a large terminal if there was a clean-up associated with that site and there was a provision identified for that site, which there would be, there could be the occasion where that provision is reversed. I'd have to confirm that that's happened in the last 10 years, but I'd expect that to be the case and outside my boundaries of knowledge in the room right at this point in time, but I think it's a reasonable expectation we can confirm.

DR SMALL: Yeah, we can sort that out later thank you. All right, so that's the end of that. I should just say since this vexed question of the new entrant has come up a couple of times; we see this ROACE analysis as being essentially backward looking, what's happened and what's happened in an individual business. Tobin's q, which is the next subject, is a rather different measure and so it's the ratio essentially of the value of the firm to the value of the firm's assets. Both of those things are subject to important measurement issues.

SESSION THREE: Tobin's q

DR SMALL: So that was the next measure we're going to look at. We had a number of submissions on this and I'm going to come to CRA for comment on this as well as Incenta. I'll start with CRA. So CRA submitted that, amongst other things, our estimate for q for Z Energy - remember, well, if you don't remember, we only did q for a few firms for which we had data. So focusing on Z Energy's estimate of q, or our estimate of Z Energy's q, CRA submitted that that was unreliable given the choice of share price on a single day, and its submission then went on to estimate q for Z Energy using share prices from January 2018 to September 2019. There's a graph of Z Energy's share price over time at figure 2 on page 13 of the CRA report I think, if my notes are correct. Yeah, there it is.

So in essence, once you've got the number of shares - and I accept we got that wrong - once we've got the number of shares, the value of the shares on the market is essentially our top line market valuation of the company. And as you can see from that chart, and as we all know from reality, share prices do move around quite a bit. So we accept that market values are volatile and therefore q itself will be volatile. And so it's reasonable, we think, to ask whether the value that we used was unrepresentative or in some way biased, accepting that there's some volatility there.

So question for CRA. You've identified three points on your chart, one at 31st of March 2018, one at 5th of November 2018 and one at 31st of March 2019. We used the last date for our estimate. Looking at that chart, do you think we should have used a different one? Which of these three points, if any, do you think we should have used?

MS FISH: I actually don't think Tobin's q should be used as a measure.

DR SMALL: Okay, it's a broader objection.

MS FISH: Two main points about Tobin's q, one quite significant point which I'm sure we'll get on to is the relevance of contracts acquired and whether they should be included or not. Separate question is whether Tobin's q is a robust measure, given that in the numerator you have to define what the value of the firm is. For Z Energy you're using the value of the share price, and the point is that that's quite, from this chart, quite volatile and quite volatile over a longer period and it is trending down over time.

You've used a particular measure as at 31 March. You can see share prices are around that level for the couple of months before and a couple of months after. I think my point is, is that we actually don't know what it's going to look like in three months' time, four months' time. What is it really telling us to take a particular point in time to evaluate whether we think that investors are factoring in some form of monopoly rent being earned.

DR SMALL: Okay, so you object to the measure per se and we shouldn't use it?

MS FISH: I just think it's not a particularly reliable measure and it's very difficult to measure.

DR SMALL: So you're saying essentially we shouldn't use it?

MS FISH: Mmm-hmm.

DR SMALL: Okay, but you wouldn't be arguing, for example, that either of those other two points that you identify -

MS FISH: I'm not saying that either of those other two points are preferable points to the points that you've chosen, I'm just saying it's not a particularly reliable measure because share price movements are going to give you very different estimates of q at different points in time, even in a very short space of time.

DR SMALL: Yeah, that's right. So your estimates of q there, you're not suggesting -

MS FISH: I'm not suggesting you adopt those estimates of q, no.

DR SMALL: Okay, thank you very much. So Incenta, Mr Balchin also made the same point, or a similar point but in a different way; that q, properly estimated, would be expected to vary considerably over time, and as I just said I think we agree with that, obviously.

However, we're interested in figure 1.1 from your submission, which I think you rely on to some extent or you do rely on to some extent, and which shows the estimated average q for firms in the S&P 500 from 1964 to 2017. That graph uses data from Peters and Taylor and was the basis for their article until the journal of financial economics.

I think what you suggested in relation to that chart - perhaps I'll just get it in front of me here before I go further. So the chart looks like that and I think what you suggested was that there's been a rise in q, that there was a bit of a boom or some weird peaks, one in 1982 and one around 2000 which I think you attributed the dotcom boom.

MR BALCHIN: That's right.

DR SMALL: But you indicated that you think there's a rise in q due to an increase in intangible assets. I think that's what you said.

MR BALCHIN: No, no, let me - if that's what you took I gave you the wrong impression because the recognition of intangible assets actually brings the curve down, not up. Can I first start by making clear my view that I don't think q is a particularly useful measure, I think it's way too noisy. The reason for that is that financial markets move so much more quickly than what product markets do. So there's no reason one would ever expect them to be equilibrated at any point in time. As you can see from my quote, that was a position that the Commerce Commission in fact put back strongly to me around a decade ago when I was trying to rely on the theoretical relationship to argue how assets should be valued.

What we were trying to get out of figure 1.1 was that in addition to the proposition that things are noisy, is we also think there's a reason as to why you would expect q to be quite elevated for all firms at the moment. That is associated with the very low interest rates we have at the moment. What we see, and I'd have to say I haven't found sort of a very good published economic analysis of this as yet - mind you it's over a short period - what we think has happened is that very low interest rates have flowed through quite quickly to market values but product markets, i.e. real investment decisions by managers, haven't fully reflected those drops in interest rates. There's certainly anecdotal evidence for that. The Prime Minister of Australia is haranguing corporate Australia at the moment for not dropping their hurdle rates and lifting investment to help it win the next election. But that's our view.

And for a company like Z Energy, which is one of the higher yielding stocks on the New Zealand Stock Exchange, you'd expect that that emphasis would be magnified by the clientele effect, whereby retirees who traditionally might have had a lot of money in Government bonds and other fixed interest, have switched over to higher yielding equities to try to boost their returns.

So just to recap the two points we're trying to make is we think q's likely to be inherently volatile anyway, and secondly, if you were to do the exercise today the baseline against which you would compare a q for a company against would probably not be 1, it would be something above 1, reflecting this recent differential effect of low interest rates on the financial markets compared to product markets.

DR SMALL: Right, okay. So you're saying the same thing as CRA in the sense that we shouldn't really be relying on this measure at all, I think, because it's too volatile, I think that's what I heard you say. Then your second point is that it's likely to be higher because of low interest rates?

MR BALCHIN: Yeah, so what I'm saying is it's likely to be high for all firms.

DR SMALL: Are you suggesting that these are reasonable estimates of q?

MR BALCHIN: They're estimates we've obtained from the author of that study and from a dataset that's produced by the Wharton school of finance. I should say, the early 80s number was something that's influenced by outliers, that's the average across the S&P 500 if you take the median of that early 80s peak, so it's much more subdued.

DR SMALL: Yeah, exactly.

MR BALCHIN: So I'm not entirely sure what caused that. As you appreciate, we didn't have a lot of time to prepare on Tobin's q.

DR SMALL: No, I appreciate that. So I appreciate the effort.

MR BALCHIN: But the second hump is the dotcom boom and bust, and that is something that had a sort of well-documented effect on financial markets.

DR SMALL: Yes indeed. I guess the thing that struck us about this was that we struggled to estimate q for a few firms and we tried quite hard, and you've managed to produce an index from a reputable author that's for 500 firms over decades. And so we went and had a look at the method, and I mean it's not a great example of a q methodology I have to say. One of our real problems was estimating replacement cost, as you know, or depreciated replacement cost. Are you aware of how they did it?

MR BALCHIN: No, I'm not.

DR SMALL: It's essentially book value, net book value. So that's a shortcut that enables you to do it for 500 firms over many decades. But, you know, I think it's -

MR BALCHIN: That is not how the author's describe the method, they describe in their journal article as a gross replacement cost. Can I get back and confirm that because I'm not 100% sure that's right.

DR SMALL: Yeah, let's get back to each other on that, so you wouldn't agree that the use of net book values would be reasonable in there, would you?

MR BALCHIN: No, if I did I would have used New Zealand data and produced an average q at the moment of about 3 which I've got to say I don't believe.

DR SMALL: All right, thank you for that. Now I'd like to just raise this terminals point, which has been discussed a couple of times, and both Z and yourself say that the depreciated replacement cost of terminals should use economic depreciation, and your report says that economic depreciation is zero because the terminals are maintained in an as new position or something of that sort. So have I got you right on that?

MR BALCHIN: So there were two parts. The service potential of the terminals doesn't decline over the life, they're maintained in an as new position. But the second part is that the terminals that are there now are unlikely to be replaced, they'll survive the life of the retail fuel sector, so that's the second part.

What I did say is that for assets of that type the economic depreciation - so the economic depreciation is given by the difference in the cost of using an old asset compared to a new asset, and for industries where assets need to be replaced then a new asset is always better than an old asset because the latter you can replace at a more distant point in time. So there's the time value benefit of a deferred replacement. But if you're never going to replace the asset because the industry is likely to have a sunset before the end of the current lives of the assets, then that benefit from the old asset disappears.

DR SMALL: So your argument, essentially, is that these assets are as new and that Z's maintenance policy is such that they'll remain in perfectly good condition right through to sunset and will never need to be replaced?

MR BALCHIN: Yeah, I did say that that was the assumption I adopted given the space of time allowed. There was not time to be do a proper estimate of -

DR SMALL: I appreciate that, but it is also consistent with what Z argues in its submission, isn't it, that terminals should be valued at replacement cost, i.e. that the depreciation is zero?

MR JONES: For substantially the same reasons as Jeff has outlined. So with slightly more knowledge of those assets and those locations at replacement cost is a more appropriate valuation for those assets.

DR SMALL: Okay. There's going to be some interesting questions about terminal investment tomorrow, but for now I guess I'm interested to gauge your confidence in that proposition. I mentioned before that you've obviously got some idea in your head about when sunset is, when these terminals are no longer going to be used, and interested to know how you can be confident that these terminals won't ever need to be replaced.

MR JONES: It's not about guessing the future but I think what's the most reasonable view of the future. And if we look at the life of these assets when sensibly maintained, and external commentary around potential demand for hydrocarbon in this country using the BEC scenario, I think is probably the most valid up-to-date and referenceable data. On that basis you get to a conclusion I think where Jeff's conclusion is reasonable, that actually these terminals and tanks will be the ones that will be here in perpetuity. As an assumption in the period that we've had to work I think it's a very reasonable working assumption.

DR SMALL: Okay, thank you for that. Back to Incenta. Incenta proposed an additional allowance of $150 million for intangible assets. That estimate was based on an assumption used across companies from all sector groups that internally generated assets are 30% of selling general and administrative costs. So I guess I'm interested to know whether either of you are aware of any estimate of the value of such intangibles as it specifically relates to the retail fuel industry as opposed to a cross-section of firms, or are you just saying this is a reasonable proxy because it's there?

MR BALCHIN: Yeah, no, I'm not. I've become aware since writing that report of another study that's actually tried to econometrically estimate the intangibles share.

DR SMALL: For?

MR BALCHIN: For different sectors. The ones that have been published, none where a retailer fuel provider would easily sit into. There is a sector called consumer which, rather than the estimate of the percentage of annual sales general administration, that's an intangible investment, is 20% rather than 30%. I think that probably understates the position for a retail fuel supplier because a retail fuel supplier also have sort of a large logistics function which your consumer-type activities don't have. And that econometric study actually confirmed that 0.3, that 30% is not a bad estimate. The number they came up with across all firms in their sample was 28%. So that confirmed that.

I should also put on record that my estimate did slightly understate the intangibles that would come out of that simple calculation. I sort of mistook the 20% as being a straight line rate of depreciation, but the literature makes it clear in the subsequent estimate that it's a geometric rate. So if you apply a geometric rate you end up with a higher stock in a perpetuity model.

DR SMALL: I was going to ask you about the depreciation because your assumption was five years straight line. So essentially these intangible assets wear out pretty quickly. And they're constantly being replenished, as I understand it through this, well, however it actually happens in the company, 20 or 30% of this cost category seems like a fair estimate in your opinion of the rate of replenishment.

MR BALCHIN: Yeah, it does, to my mind. It's kind of different across the sectors, that's what the subsequent study showed. But if you think about all the things modern firms do, they invest in human capital, they invest in customer relations and networks, they invest in brands, they invest in organisational capability, they invest in databases. These are all extremely valuable things but to accountants they're operating expenditure and they're obviously not, they're capital. But you're right, they wear out quickly, if you don't keep on investing in your customers they forget you, as consultants well know.

DR SMALL: It's a good thing they wear out. No look, so but on that wearing out, and bearing in mind that what we're doing here is, as I've said before, this is a context where I do think the new entrant hypothesis is relevant and one you're familiar with and keen on; do you think it's necessary actually for a new entrant to have all of this rapidly depreciating capital at the entry date, or do you think it might be equally, or near enough, a reasonable business strategy to take the same approach that the incumbents do and just start tipping in this 30% of this category every year after entry so that this capital builds up over the first five years rather than it necessarily has to be there at day one? What's your view on that?

MR BALCHIN: I think there's a consistency point. When you measure Tobin's q you're measuring revenue and expenditure that Z as an incumbent incurs. A new entrant wouldn't start with intangible capital, they wouldn't start with the same revenue stream on day one, they wouldn't start with the same operating expenditure on day one, they would have to build up their intangible capital over time, that would be revenue -

DR SMALL: That's going to affect the numerator and the denominator.

MR BALCHIN: Yeah, so I think assuming that the new entrant can instantaneously morph into an incumbent is probably a slightly conservative assumption. A new entrant is probably the slight disadvantage to that. The reason why you build up intangible capital is it generates more money or reduces more expenditure or both than the cost.

SESSSION THREE: Contracts Acquired

DR SMALL: Okay, thank you. Now I come to the piece that I think CRA's been waiting for, contracts acquired. And I think both Incenta and CRA take issue with our treatment of contracts acquired. Since we're already going with Mr Balchin we'll carry on that way.

The Incenta submission states that, "Chevron created physical assets and struck contracts that recovered their cost. While the legal title was transferred to the counter-party, which is why they're not reported as a tangible asset on Z's balance sheet, the economic substance is that Chevron, and subsequently Z Energy, remained the asset owner".

So my understanding is that the underlying physical assets, which you connect to this, are actually connected to the bulk supply contracts at issue here, which go to independently-owned Caltex-branded stations. So in other words the physical assets didn't get transferred.

So can I ask you why you think the economic substance of these transactions is that Chevron and now Z Energy is the asset owner, or are you not talking about the underlying physical assets which you seem to be? Help me out here, or maybe I'm not explaining myself, in which case tell me.

MR JONES: So in terms of what actually happened in terms of those transactions, that's as I understand it. So there was sites that Chevron divested to independent business people and there was an exchange of value, in instances that we're aware of, that literally the value exchanged, or the consideration, may have been a dollar. So the occupation of the site was granted to the independent business person and the value exchanged was a commitment to buy fuel for, you know, a decent period of time. We consider that to be the fair value exchange. Such that while we don't know the replacement cost of those assets, we know what those assets are, and if we were to replicate building those sites, our estimate is that the kind of value is about $400 million. So there was a fair value exchange and to kind of expunge that from -

DR SMALL: But you won't ever do that because they're owned by these independent Caltex dealers, aren't they. So is your argument essentially that if Chevron had behaved differently and that it owned all these sites instead of selling them to its dealers, then when you bought Chevron you would have bought the physical assets and that's what they would have been worth and so they'd be on your balance sheet; am I getting that here?

MR JONES: I think that's a legitimate counterfactual. If we abstract out of this industry, if there's long-term contracts that are invested into by a company and they're not included and the costs associated with those contracts aren't included, that's a useful consideration as well. But in terms of the exchange of value, that happened when Chevron sold those assets to those independents we believe was a fair exchange of value. It just wasn't often, in any case as far as I'm aware, recorded on the Chevron balance sheet, because in some instances those assets had close to zero value because they were of a historic cost.

So in terms of the actual exchange of value, that quite clearly did happen and that's what we purchased. We purchased the right to supply those contracts based upon that exchange of value, that fair exchange of value a few years prior.

DR SMALL: All right, thank you. So this, I think, brings us into what CRA said, which was that if these contracts had not formed part of the deal, the prices that Z Energy paid would have been far lower. I think we'd agree on that. But then you go on to say, "Contracts that provide certainty over fuel supply have valued precisely because they avoid the capacity to be unused for any lengthy period of time". That might be what Mr Jones is getting at here, I'm not sure, but we'll come back to you in a minute if it's not.

A question for CRA. If the value of the contracts is to avoid capacity being unused, then why is the value of the contracts, which is 433 million, considerably in excess of the value of the physical assets, which was 248 million, particularly when the life of the contracts, which is 13 to 21 years, only covers part of the remaining life of the physical assets?

MS FISH: Well, I think the value of the contracts that Chevron had were for immediate supply of what I assume would have been a large portion of the capacity of the terminals. When you purchase a business that has 10 terminals and very few retail sites you want to be assured when you enter that you can supply from those terminals on day one and you're not going to be at risk of being without supply for an extended period of time. I personally don't know how long it would have taken a new entrant, if a new entrant had purchased the terminals without any contracts for supply, how long it would have taken them to replace those, but there are immediate cash flows in year 1, 2, 3 that are discounted quite heavily. So I can see that the value of having contracts in place for multiple years is quite significant when you're purchasing assets of that magnitude.

DR SMALL: Okay, let me ask you a hypothetical. Suppose that these contracts essentially allow the earning of significant excess returns, suppose they did. What would your attitude be to the way they should be treated in this analysis?

MS FISH: In that case I don't think an analysis of Tobin's q helps you out at all. If you observe that Z is purchasing Chevron, Chevron has physical assets, it has contracts for supply, you recognise that there is value in those contracts to supply, it could be that those contracts for supply were struck at very competitive prices over long-term, that was a commercial negotiation and they have value because it means I can supply from those terminals on day one. So one circumstance is that there could be no monopoly rents, completely competitive market, dealers had a choice as to whether to engage in those contracts or not.

DR SMALL: Right.

MS FISH: Another circumstance could be that dealers didn't have much choice, there was some agreement that there would be some monopoly or there would be some monopoly rent component. So the value of the contracts in that case would have some monopoly rent component. The reality is you don't know of the 433 million what portion is monopoly rent and what is not. In that case, whether you include it or exclude it assessing Tobin's q isn't going to answer your question was there monopoly rent or not. Your decision about whether there was or not, your decision what portion to include or exclude when you put it into a Tobin's q calculation gest you to an answer that equates to your assumption. So if I assume it's all monopoly rent, the whole 433 million was monopoly rent therefore -

DR SMALL: You'd still put it in.

MS FISH: No, no, I'm not saying I would still put it in. If your assumption is that it was all monopoly rent then you would decide not to put it in, you would say that would be inappropriate and you would get to a Tobin's q of 2 and you would conclude from that analysis that there was monopoly rent. Your conclusion is defined by your assumption whether to include or not.

So I think if you don't know whether the fair value of those contracts as valued at the time included monopoly rents or not or what proportion, then Tobin's q is not going to answer your question. I think the way you have done it is defining the answer to the question based on the assumption you have made. The Tobin's q's not telling you anything, it's just confirming your assumption that you've made in making that calculation and then that carries on through to the calculation of Z's Tobin q when you exclude the amount.

DR SMALL: I hear what you're saying and that's very, very helpful thank you. I appreciate that. One of the things I take from it, amongst the rest of it, which was useful, is that you wouldn't recommend putting them in if you knew that they were monopoly rents.

MS FISH: I think you'd have to have evidence that there were monopoly rents -

DR SMALL: Yeah, that's right.

MS FISH: - and it consisted of the entire amount to exclude the entire amount.

DR SMALL: That's right, if.

MS FISH: So unless you have evidence as to -

DR SMALL: I understand.

MS FISH: - what portion, one, whether there were monopoly rents and two what portion were monopoly rents, either way, you don't need Tobin's q to then figure that out because, again, your assumption about what portion is monopoly rent is defining the result of your Tobin's q analysis.

DR SMALL: I hear what you're saying, thank you very much, that's really helpful.

MR JONES: Excuse me, I could offer an opinion to the extent to how you would assess potentially whether there were monopoly rents.

DR SMALL: Good, thank you.

MR JONES: So we've got the benefit of hindsight. If there were monopoly rents that were going to be sustained, what we do know is that margins have declined since that period to where they are today.

The other point I'll note, and I can't recall exactly where it is in the report, but as I recall it there was a justification that there were monopoly rents being captured and that was reflected in the share price or equity markets reaction to the announcement of the transaction.

DR SMALL: Yeah, we did make that point.

MR JONES: As I recall it being in those moments and if we go back and look at the analysts' coverage of the time, the value of that deal was attributed significantly to the cost synergies that were available due to the competency and capabilities of both businesses being brought together. Our own business case had no contemplation of increasing margins and contemplated the value arising from that entirely additional value from cost synergies.

DR SMALL: On the cost side.

MR JONES: Yeah, so that was our internal contemplation and that was evidenced in what's happened and that was how informed external commentators thought of it as well.

SESSION THREE: Hurdle Rates

DR SMALL: Excellent, thank you for that, that's very helpful. All right, that's the end of Tobin's q. A couple more topics. Relatively briefly I think on hurdle rates then I want to talk about persistence of profit and another small topic.

So we estimated hurdle rates - sorry, we didn't estimate them, we asked you what your hurdle rates were and you told us, thank you. And we also had a look at the out-turn rates of return on incremental investment, and we made some comments about hurdle rates being fairly high and CRA submitted that this was perfectly reasonable and that firms in competitive industries set hurdle rates for new investment of 15% or more. And short pay-back periods and referenced a really interesting paper by Jagannathan and co-authors that backed this up.

So obviously we went and had a look at the paper, and one of the things I was struck by was that it was based on survey data with a very low response rate frankly, 4,600 firms were asked, and about 100 replied. Does that concern you at all and what about the other thing that the authors noticed which was the sample tended to be biased towards large manufacturing firms? Do either of those things give you cause for concern?

MS FISH: I guess we're not really relying only on this paper, this paper refers to many other studies that have been done on this issue that have come to very similar results. There's also a study by the Reserve Bank of Australia.

DR SMALL: Exactly.

MS FISH: So I would say - I don't really have any particular comments to make on the particular survey design or survey responses, it's not unusual to get a low number of responses to surveys. But I think kind of we go back and review the many studies that have been done on the issue, it doesn't seem to be uncommon that hurdle rates are set significantly above WACC.

DR SMALL: Okay, thank you. I agree, the RBA paper was also interesting. One of the things the Jagannathan paper said was that firms that use - I'm trying to match this up with the New Zealand fuel industry - said that firms that use high discount rates describe themselves as facing operational constraints but not financial constraints. They have strong balance sheets, low leverage and large cash holdings. Help me out, do you think that's consistent with what we see here? Or do you think maybe that's not a necessary thing for having these sort of hurdle rates? What do you think?

MS FISH: To be honest I'm not sure whether that's consistent with what we're seeing with retailers here. But I don't think that their findings were restricted to those particular firms, I think they were just saying that those particular firms were kind of more likely to set higher hurdle rates.

DR SMALL: That was the characterisation of firms that use these higher rates. Okay, more generally stepping away from the papers, this might be something Mr Balchin wanted to comment on as well. We certainly accept that firms facing irreversible investment decisions under uncertainty might well set a high hurdle rate to guard against the risk of capital loss. So that's the sort of general real options theory of investment, which hurdle rates above the cost of capital are very consistent with that.

I'm trying, I suppose, to line that up with what we see here in the retail fuel industry, which is first of all firms know the industry pretty well, this is not new territory for you. Secondly, I think relative to the overall scale of the business these are fairly small investments, a few million here and a few million there, next thing you know you're talking serious money.

Thirdly, it's a similar and relatively simple model, which is building new sites, and fourthly, and it's not clear that they're irreversible.

So I'm trying to line up relatively high hurdle rates with those facts and struggling to be honest. So it might be something that BP themselves, rather than advisers, or Z might like to comment on? Are these risky irreversible investments, I guess is what I'm asking, or is it fairly normal business? Or am I asking the wrong people perhaps? Maybe I should be asking Waitomo.

MS BOFFA: I'll go first. Yes, there is a level of risk with these investments. You're talking about the new build sites, right?

DR SMALL: Yeah, the main investment is in retail sites.

MS BOFFA: Yeah. Well, a portion of our investment, yeah.

DR SMALL: Okay.

MS BOFFA: It's nowhere near even half of what we invest every year, just to be clear, in new retail sites. The rest of our capital goes into pipelines, it goes into maintenance, it goes into terminals.

DR SMALL: Okay, but what we looked at here and what we commented on was new builds, yeah.

MS BOFFA: Yes, there is risk attached to that. So what we tend to do with our new build sites is we are looking at new locations. So roads are changing, new subdivisions, communities are being built, changes to highways. And there's risk attached to some of that in terms of getting it right. And you're not doing this in a vacuum. One of my competitors could be very well looking at the same thing. My business case might be based on X, but if someone goes and puts a site up the road from me it's all over, or they decide to put a median barrier down the middle of that road two years later, my turn in rates reduce by half. There's a whole bunch of things that can go on that there is risk attached to these, from our perspective.

When we're looking for these sites, these are new sites in new areas. What happens to the rest of the network is often people stop using other sites and the accounting of what this does to the base business, not all of my sites return the same as a brand new, new build highway site. So we invest in A plus sites, but I've got a hell of a lot of Bs and Cs and Ds in my network as well which will return very different returns to those higher ones. So there's risk and there's very different profiles.

DR SMALL: I see.

MS BOFFA: The other point is as a multi-national I'm competing for my capex against a number of other projects. So I do have higher hurdle rates in competing for that capex.

DR SMALL: That's something that comes from head office presumably, or it's a constraint on BP's operating businesses around the world obviously.

MS BOFFA: We compete for capex, there is not an endless supply.

DR SMALL: That's interesting about the possible cannibalisation of other sites on your own network, I hadn't thought of that one, thank you.

MS BOFFA: The whole network is constantly under threat. Things are changing all the time.

SESSION THREE: Persistence of Profits

DR SMALL: Right. Okay, thank you. I think I can leave that there. So staying with BP if I may, and regarding the persistence, I guess, and longevity of profitability, so your submission highlights the importance of new entry to moderating margins and profit. We've just spoken about your own business cases for new sites, but thinking even beyond yourselves, to your competitors, do you think the conditions for new entry are favourable both - I want to divide this between both retail where there seems to have been a lot of activity, and importing.

MS BOFFA: Can you repeat that please?

DR SMALL: Yeah, I'm just asking you for a general comment on the conditions for new entry at the retail level and at the importer level. There seems to be a lot of building of new stations going on, so presumably that's an attractive line of business, subject of course to capital constraints from yourselves and wherever. So would you agree that those conditions seem favourable for retail investment? The new sites are fairly profitable generally, out-turns are good and -

MS BOFFA: We and others are putting down new sites, yes.

DR SMALL: Yes.

MS BOFFA: I don't know how favourable theirs are, all I can say is my ones and I build a very expensive and a very big site. I'm not building a small low cost operation. So they're very different, I wouldn't want to speculate on whether they're meeting their hurdle rates or whatever, but people are investing.

DR SMALL: Yeah. Notwithstanding the fact that I think - certainly Z and I think other people would agree that, you know, this industry might not be around forever, it certainly seems at the moment that there's quite a bit of new retail investment, even though we might think there's a sunset coming at some time.

MS BOFFA: So my comments earlier, we look predominantly at sites in new areas, new roads, new places, where we believe demand is coming.

DR SMALL: Okay.

MS BOFFA: Despite the fact the market is declining on volumes. So people are moving, do you know what I'm saying? There's new roads being built.

DR SMALL: Exactly, so there's domestic economic growth and population growth and so on and that provides the opportunity for offering new retail sites and that's business that's worth chasing.

MS BOFFA: The point I'm making is that in a flat market, so there's no additional volume being added into the market, it's flat to declining in motor spirit, right?

DR SMALL: Yeah.

MS BOFFA: But what we look for are locations that are not serviced because they're new.

DR SMALL: I understand.

MS BOFFA: So there's a new expressway being built and people need to fill their cars and so we will put a service station near there.

DR SMALL: I understand what you're saying, that goes towards the importance of location of these sites, doesn't it. What about terminal entry, though, because, you know, in your argument about the business cycle that we talked about at some length earlier, I think we agreed that the biggest slump in the business cycle was attributed to Gull and possibly Challenge for a short period of time, which is new importer entry and that seemed to be the thing that really dragged those margins down. I think there didn't seem to be any objection to that.

I guess my question is, how is that going to work in the future? I know we all know that TOSL's building in Timaru, although the success of that is yet to be proven, do you think that the - I suppose I'm asking about whether you think there'll be another one, or whether you think, you know, that, for example, Z's attitude to its terminals, which is that we're never going to build another one of these terminals because these ones will see us out, the industry will be dead before the terminal is, do you think that's kind of an overhang on new entry at the importer level?

MS BOFFA: So my view is that TOSL have spotted an opportunity, they believe that they have got a strategy and a business case that will work for them and they're going to compete, they're going to compete in a relatively small market being the South Island and that will put pressure on all participants in that market. They obviously believe they can access customers and in my mind that is a classic example of a competitive market working. Somebody sees an opportunity, they're investing big money to go after it and things are changing as a result, and will change.

DR SMALL: Okay, that's fine. Thank you. Do you want to comment on any of that, whether you think there'd ever be another TOSL?

MR JONES: No, I guess I'm struck by - so asked to speculate on the number of import new entrants and how that relates to the number of new sites. I think one of the observations would be the factors that enabled those new sites to be built and that competition to be enhanced have existed and still exist and will continue to exist in the future. So the parallel between more import competition, it's hard to speculate on what happens, but I can point to factors that caused those new sites to enter the retail market and competition to go up, margins to go down and returns to go down over the last two years; those factors are still there now, they have been there and they'll be there in the future. So in terms of speculating will there be new imports? I just don't know.

SESSION THREE: Lead Times

DR SMALL: That's fine. Thank you. Okay, so let me just - I'm pretty much done actually. All I really want to know now is about lead times. So obviously, and I'll refer back to the start of our profitability attachment appendix D, and I cited some of those comments earlier in the session, comments from yourselves essentially about the prospect of new entry in the light of the margins data around 2012 to 2015.

So it's obviously important from a business cycle and competitive point of view to understand how long it takes to get in to these markets. We've got a little bit of information, I suppose, from TOSL, but could you give me an indication of the lead time required to build a new retail site? How long does it take from spotting an opportunity? There's a consenting process, then there's contracting and getting everything in place. Does this vary so much across sites that there's no guidance you can give us, or is there some kind of standard that you'd care to have a stab at? Mr Bodger looks like he's got something to say.

MR BODGER: I think Z have made some public comments about 18 months to two years. We would echo those. A lot of it comes down to the competence of the local body that you're dealing with and their enthusiasm for investment in their area or their want to be pedantic. That's the key one. Spotting a site can be, depending on what you're doing and where you're going, can be varied.

If you see a piece of land that is currently housed next to a kindergarten you would expect to be going through the Environment Court if you wished to take that length of expenditure. If you take a piece of commercial land that has access on to the main road and it's not a State Highway and you've dealt with the Council before and they're reasonable it will be a lot quicker. It's horses and courses all over the place. But ain't quick. And frustrating, if I could put a -

DR SMALL: Yeah, the Council consenting process I imagine must be -

MR BODGER: Pathetic.

DR SMALL: - teeth-grindingly awful.

MR PARHAM: I just also say it's costly as well. You know, going back to the timelines, we've got a site that we opened in Upper Hutt, I refer to it as the unicorn site because it took nine months, because it doesn't happen anywhere else. Nothing gets cheaper, finding a site's harder. Every consent you go through you need a traffic assessment, you need acoustic assessment, you need visual lights bills etc, so harder and harder every single time. And as you go to that investment, there's things you don't compromise on as a business around environmental wet stock management and vapour recovery etc.

So you're looking at 18 months to two years, especially if you're looking for new sites. If you look at a lot of the legacy sites that are out there today they wouldn't be able to get consent in today's environment. With a residential boundary in a sort of residential area, those sites, they just wouldn't fly, you'd just give up because it's too complex and too costly.

DR SMALL: So just to pursue that, so does that mean they don't have to be closed down now, but if they were trying to start up again it wouldn't succeed or it would be very, very costly and time-consuming?

MR PARHAM: Yeah, I think if they were dormant for, I think is it over 12 months where your existing use rights expire?

MR BODGER: 24 I think.

MR PARHAM: Yeah, so that's where if you've got existing use rights that's good but, you know, it comes down to zoning. And there's some councils that are a lot more difficult and pedantic than others. And then you have to actually take into account the NIMBYism, the neighbours who, you know, just don't want a service station next door, even though they're on commercial land, you're on commercial land, you're in a commercial area, just because they don't want a fuel stop next door, they'll just ring up their lawyers because they can. So that slows down the whole process and ultimately there's the cost of building a site but then there's a cost of time where you're not operating and also you're not bringing that competition and choice in the market as well.

DR SMALL: Okay. Would it be fair to say - I know that BP has made some comment on the fact that a lot of these new sites that non-majors are building are on main roads, but is it much more difficult to build in metropolitan areas than non-metro?

MR PARHAM: Depends if there's a cycleway, I guess. That's always going to get in the way if there's a cycle lane, but as long as it's zoned correctly it goes back to the acoustics, the traffic and what's required under all the different plans.

DR SMALL: But those constraints would tend to be stronger in an urban area presumably.

MR PARHAM: Yes.

MR BODGER: From our point of view I think the constraints are human being-specific at the Councils. In Auckland we deal continually with intermediate planners and I'd like to send Auckland Council an invoice for education and you educate each person and you move on to the next one with the next site. In more rural areas you deal with consenting officers who it's not their full-time job or this is their first service station, and you can get some significant delays again in education as to what, not just Gull, but the industry is actually putting under the ground and how safe it is. And really there's a lot of cookie cutterism there and it has been approved there there there there there, but you go through a process of assurance to the people that have to write the certificate. And that, I think, is really human being-specific, and there's a risk aversion in the councils to actually say yes to anything because it comes back and bites them, I guess.

DR SMALL: Yeah, certainly familiar with that. Either Z or BP want to make any comment on that?

MR JONES: So in terms of how hard, it feels like defer to the room because we haven't built that many sites. But observing the effect of the number of sites that have been built we can look at the number of sites that have been added to the industry in the last three, four, five years and I think that's quite an appropriate measure for how buildable are sites in this industry. There's no reason to believe that's going to change, the factors or the conditions, the planners will still be the planners, the conditions will still be the conditions, the ability to get supply haven't changed. I don't think there's any reason to believe that rate of build of new sites will change, I think that's an important distinction. That's from an observer as opposed to being part of an organisation that is building sites at this point in time.

DR SMALL: Yeah, fair comment, thank you. All right, I think we're exhausted, so to speak.

MS RAWLINGS: That brings us to an end of the sessions for today but I think just before we close that off I'll just see whether there's anyone that had any final comment on what we've discussed today that they wanted to just close the day with.

MR JONES: Thank you for the opportunity. You often reflect upon was it worthwhile in terms of the contributions we made. There's one period I chose not to talk about, it's in regards business cycles. Partly a personal aversion for not getting that part of my economics degree or understanding them. But the focus of that discussion seemed to be on whether should we start in 2004 and the consideration. I'd just encourage the Commission to look at the other end, ie what's happening now. It's quite an academic point to think when did this cycle start.

It's interesting to look at the conditions but I think it's really important to understand what's happening now at this end of the business cycle and how does that inform an assessment of competition. So thank you for letting me have my say.

DR SMALL: Thank you for that comment, that's extremely pertinent.

MR GARTH IRELAND: I came today prepared to address the issue of persistence of excess returns which is the forward market and in my various submissions I've been accused of being backward looking and what have you, but this is my opportunity to look forward to be helpful and so just a quick say.

My tables A, B and C address this issue. And if we look at what the market is saying and linking that back up into the company's accounts, and this is Z, there's information. And further, what it's actually saying is that the market expects negative excess profits, and I've quantified them at 400 million, as implied by today's share price. Now the things set out, in my submission.

However, the thing that's not there that I think would be helpful is that the research reports from the brokers, and I think of one in particular who has reported about five times this year so has been a continuous update, continuous stream of new information, has a full balance sheet, full P&L, full discussion on margins, very complicated with replacement costs and historic cost.

But I would suggest that what you should do, or could contemplate doing, is trying to understand what the market is saying because there's real money being put there, and that's providing new information because you have to be quite confident that you have a handle on where the market's going because the downside of getting restrictions, if you like, that are inappropriate can be quite substantial. I'm not going to do it but you do it.

MS RAWLINGS: Thanks very much. And of course there is the opportunity to discuss other issues as we digest the day's discussion, no doubt people will have other thoughts, and of course there's a further opportunity for submission in our second round of submissions after the conference, so we'd encourage you to reflect any additional thoughts that you have in those submissions at that point.

I'll close up today just with a couple of other observations. One is that in the course of discussing wholesale supply agreements tomorrow, we noted the MTA submission that one possible option for addressing some issues identified in relation to wholesale supply agreements may be applying or extending the broader protections and regulatory forms happening in relation to unfair contract terms into our business to business space and that they might have some relevance in this industry.

There was just one mention in the MTA submission, it is actually an issue that we had considered that's not reflected in the draft report so much. But what I wanted to do was just draw people's attention to the fact that today Ministers Faafoi and Nash have announced policy decisions relating to unfair commercial practices following a round of submissions on the discussion paper, and that includes extending the Fair Trading Act's unfair contract term provisions to standard form business arrangements with a value below $250,000. And with an expectation of that threshold in mind we had parked, and given the uncertainty in the process, we had parked that issue in relation to our draft.

But there is also proposed a regulation-making power that will allow for clarification of the scope and value of the arrangement, and of course the next step in this policy discussion will be for the drafting and preparation of a bill reflecting the proposed unfair commercial practices law.

So I just wanted to bring that to people's attention. If you were thinking of the issue raised by MTA or you wanted to consider the policy decisions in greater detail they're available on MBIE's website, and obviously some discussion here would be useful tomorrow. The timeframe may not allow for that but you may wish to consider any impact that those proposals could have on our discussion relating to wholesale supply agreements in due course as well.

Obviously, again, that's not your only opportunity if you wanted to consider that and come back to us in post-conference submissions, but if there was going to be some discussion tomorrow or comments people wanted to contribute that would be obviously useful in this room with everybody here.

So we have a 9.30 start again tomorrow. I just wanted to reiterate, as you will have seen from the agenda, that the venue is not here tomorrow, it's at Rydges, so I'm sorry about the change, but I'm also very keen to avoid any confusion about that so that we're all there in order to start at 9.30 tomorrow, and we really look forward to that. And let me just reiterate again our thanks and gratitude to you all for being here today in what's been a really productive discussion and just an invaluable opportunity to have everybody in the same room together. So we'll look forward to seeing you again tomorrow morning.

Day 1 hearing concluded at 4.33 pm