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PUBLIC VERSION

Dear Keston

Z ENERGY COMMENTS ON 18 APRIL WORKING PAPERS

1 We act for Z Energy Limited (**Z**). We attach Z's comments on the Commission's 18 April:

1.1 "Working paper – Focus areas"; and

1.2 "Working paper on assessing profitability".

2 As per the Commission's requests (set out in both papers), we have provided confidential and public versions. Confidential information is highlighted in the confidential version and redacted from the public version.

3 Please let us know if you have any questions regarding Z's response. We look forward to continuing to engage with the Commission in the coming months.

Yours sincerely

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Z ENERGY COMMENTS ON 18 APRIL WORKING PAPERS

Introduction

1 Z has considered the Commerce Commission's 18 April 2019 working papers on "Focus areas" (**Focus Paper**) and "Assessing profitability" (**Profitability Paper**, together the **April Papers**). Z sets out its initial comments below.

2 Z acknowledges that the April Papers are "working papers", and the Commission's views are at a preliminary stage and still evolving. The Commission requested only brief comments and accordingly Z has noted key topics and considerations that will need focus early in the Commission's process.

3 Z believes that the Commission will benefit from continuing to engage with the industry prior to the draft report expected in August/September. Given the short timeframes and complexity of the exercise Z expects to be involved during the four months before the draft, to ensure proposals are well tested and refined by the draft. Z will also engage on and after the draft proposal.

4 Z is available to assist, and to make independent experts available to assist, at the Commission's convenience. Z suggests a meeting in mid-June to discuss the content of this response, and the Commission's progress with its analysis and Z's data.

Summary

5 Z appreciates the work the Commission has put in to date. In this response Z:

5.1 encourages the Commission to focus on factors that may affect competition;

5.2 suggests ways and limits to how profitability may or may not be useful in this context; and

5.3 identifies other factors that Z suggests the Commission consider.

Focus of the competition study

6 Z encourages the Commission to focus on what can be done to promote competition in retail fuel markets for the long-term benefit of consumers. Competition study in the Commerce Act is defined as "a study of any factors that may affect competition for the supply of goods and services". The terms of reference use similar language.

7 Profitability may be a relevant consideration but should be placed in its proper context: what can profitability tell us about factors affecting competition? Profitability may be an indicator of underlying factors but is itself an "outcome" (and an outcome at only one point in time) and not a complete picture (in contrast to the Commission's usual regulatory exercises).

8 For example, Z believes that analysis of profitability and returns can usefully indicate trends in retail fuel markets and the level of competition over time. During periods of relatively low returns, investment has been low and participants have exited the

market. When profits are higher, the result tends to be a period of increased investment[1] and falling profits.

9 In general, the April Papers focus predominantly on outcomes rather than factors. In Z's view, direct analysis of factors that may affect competition is the best way to have confidence about whether prices are reasonable.[2]

Complexity of profitability analysis

10 Z agrees that assessment of profitability is difficult, reinforcing the importance of focusing instead on factors that may affect competition. In addition to methodology-specific issues, many of which the Commission has identified, profitability assessment in general will be limited by:

10.1 the availability and format of data from all industry participants (as the Commission highlights in detail from paragraph 47 of the Profitability Paper). The nature of any data may influence the feasibility and reliability of different measures of profitability;[3]

10.2 comparability / differences in the business models employed by different participants. Firms have vastly different investment models and offer different products and services (as covered below). Even taking account of those, isolating the genuine "retail fuel" costs will be a complex exercise and may not mirror the way firms allocate costs or consider their businesses; and

10.3 the changing nature of the fuel industry over time. Z considers retail fuel to be a sunset industry. Industry participants are currently employing vastly different investment strategies.

11 If the Commission does proceed with fulsome profitability analysis, Z encourages staff not to rely on gross margin analysis. Although Z does track gross margins internally, Z does so as a proxy for revenue and to show high level trends. Z does not use gross margins as a measure of profitability.

12 Consideration of net profit margins is more appropriate in any consideration of profitability. Net profit margins subtract operating costs such as overheads, staff and the costs of discount and loyalty schemes. ROCE also takes account of costs but is more limited due to comparability of capital choices.[4]

13 The Commission notes at paragraph 94 of the Profitability Paper that it proposes to place greater weight on the results of firms who are locally owned, and those whose

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1 For example, independent distributors are in the midst of significant expansion. NPD recently established a significant presence in Christchurch. Waitomo has announced plans to build sites in Wellington and Christchurch in 2019. Gull has announced expansion into Wellington (one site) and the South Island (six sites, including a presence in Christchurch). A new independent terminal is also opening soon at Timaru.

2 See paragraph 50 of Z's 21 February 2019 submission on the Commission's preliminary issues paper (available on the Commission's market study webpage) for more detail.

3 For example, Z believes its data will not adequately allow the Commission to calculate a ROCE for Z, simply due to the nature of Z's business and therefore the way its data is recorded. In response to BP's ROCE/ROACE "measurement issues" raised, the Commission notes at paragraph 84.2 that it will not seek to allocate shared and common costs where firms have not done so. Z runs a company-owned network with staff and many other costs covered at the head office level and not necessarily attributed exclusively to "retail"; analysis that excludes these costs will be flawed, but similarly any attempt to allocate costs will be a complex and likely inaccurate exercise.

4 Z notes also that different firms will value their capital in different ways. A consistent approach to valuation will be needed.

activities are most focused on the retail fuel markets. Z would like to discuss further the Commission's rationale for this approach. Focusing on factors that may affect competition rather than profitability alone should allow the Commission to consider the role and impact of all firms in retail fuel markets.

Investment decisions and the cost of capital

14 The Commission proposes to use cost of capital to estimate hypothetical "normal returns". Z believes the Commission will benefit instead from greater consideration of real world hurdle rates and the factors it observes are in play in the market. Z recommends for example that the Commission consider:

14.1 fuel firms' own internal WACCs, hurdle rates and investment analyses; and

14.2 investor reports where available, which give direct evidence of investors' expectations where WACC and other calculations are estimates by nature.

15 [REDACTED]

16 Z also believes WACC analysis may be complex and of limited use. The Commission has already noted the different levels of risk across different business models. Even if the Commission produces a WACC range, the fact still remains that different businesses have significantly different risk profiles and cannot be easily compared against one WACC range.[5] The Commission's standard WACC methodology is more easily applied where the regulated entities are reasonably homogenous firms.

17 Returns expectations and investment decisions are also different for Part 4 regulated businesses. Regulated businesses have prices set on the basis of cost. In this world there is limited value in options and flexibility as all investments earn the same return proportionate to cost. Regulated businesses may also have better guarantees of returns. In contrast, fuel firms' investment decisions are made in a competitive landscape. Options are highly valuable given limited capital, and competition and stranding risks that regulated businesses don't face to the same extent.

Key issues identified by the Commission

18 Z agrees with a number of important points made by the Commission, including:

18.1 the limited value in a snapshot of the market and profitability at one point in time. In this context consideration of factors impacting competition is more useful;

18.2 the importance of estimating replacement cost in any profitability analysis that does occur (discussed from paragraph 85 of the Profitability Paper); and

18.3 the choice not to use the New Empirical Industrial Organisation approach in this study (discussed from paragraph 95 of the Profitability Paper).

[5] The breadth of diversity across the 21 retail brands is significant and entirely unlike Part 4 regulated businesses. Retail brands include multi-nationals (like BP, Mobil and Gull), public domestic-only companies (like Z), national private firms (like Allied), regional private firms (like NPD), private "cluster" operators (like PetroChem) and family-owned single site participants.

Additional factors

19 Z believes there are several key factors to take account of that the Commission has not covered in its April Papers. These should be the primary focus of the study as they are important factors affecting competition and highly relevant to the study.

Business models

20 Z suggests that the Commission account for the different business models in the market and the ways in which these are reflected in the competitive positions of the various participants.

21 The Commission notes at paragraph 51 of the Profitability Paper that there are both overseas and locally owned participants, but there are other significant factors that impact competitive outcomes, particularly the level of fixed costs faced by the midstream participants through shared investment in infrastructure assets such as ships, pipelines and storage facilities (terminals). The commitment to investing in this infrastructure reflects into market outcomes in a variety of ways, including:

21.1 a commercial imperative to retain volume to cover fixed costs – this is particularly significant when competing to retain large blocks of volume controlled by distributors such as Farmlands, g.a.s., Allied and NPD as well as supermarkets both with Foodstuffs' fuel offer and dockets offerings;

21.2 an efficient and robust supply chain with minimal duplication of underlying primary distribution infrastructure and a degree of resilience to ensure security of supply. The risk and funding of this supply chain is borne by three participants but utilised by most; and

21.3 universal service offering even to the most remote parts of New Zealand, which supports volume and underpins a comprehensive network offering for commercial customers.

22 The competitive positioning of firms like Gull is in stark contrast and is characterised by optimised distribution around the lowest cost to serve locations from a specific supply hub (e.g. Tauranga) and lower barriers to exit in the event that market conditions change. Distributors' business models also differ compared to the points above.

Quality, innovation and product differentiation

23 Similarly, quality factors and product differentiation more generally are key factors affecting competition. The April Papers make only passing reference to these factors; at paragraph 25 of the Focus Paper the Commission notes: "Although other areas – such as quality and innovation of product and service offerings – are not primary areas of focus, we will have regard to these when reaching our conclusions."

24 Z encourages the Commission to have stronger regard to these factors and the extent to which they impact competition. They are relevant considerations given the terms of reference and meaningful in that they result in diversity of services to the benefit of consumers.

25 Quality, innovation and product differentiation are key factors in the market despite reasonably homogenous underlying products. Relevant features include:

25.1 Fuel grades: For example some participants offer 98 octane fuel at a premium to Z's highest grade 95 octane fuel (although Z considers that its 95 fuel is appropriate for use in most vehicles for which 98 is targeted).

25.2 Location: Convenience is obviously a relevant factor for fuel consumers who are often travelling subject to time constraints.

25.3 Facilities: Firms differ in the nature of facilities offered. Z's offering provides safe, clean, dry and well lit facilities with a comprehensive food and drink offering as well as other products (e.g. carwash and convenience store items).

25.4 Service: Similarly, different firms offer different associated services (e.g. forecourt concierge assistance which Z offers).

26 There are cost implications for all of these features. Retailers like Z have an incentive to pass those costs through to consumers and, in doing so, can explore opportunities to grow margins to reflect the underlying value in the premium offering. Z's investment in its customer proposition was executed by developing a disruptive competitive strategy grounded in extensive customer research.

27 In contrast, some retailers specifically target the most price sensitive customers by stripping the offering right back to its most basic (low cost) form: an unmanned offering with virtually no service component. Consumers are able to price the premium offer and bypass it if it is not considered to represent value.

Relevance of the sunset industry

28 Z recommends that the Commission consider the impact of the sunset nature of the downstream fuel industry as policy responses to climate change drive changes to vehicles and use of retail fuels.

29 Industry participants face real uncertainty on an ongoing basis with a significant divergence of views as to the likely rate of substitution of ICE vehicles with EVs. Already this factor clearly impacts competition, with different investment models in play across the market. This factor impacts Z's investment decisions and likely others'. It goes to participants' willingness to invest even during times of relatively high short/medium-term returns.

30 The transition period will be particularly problematic from the perspective of investment incentives as the scale efficiencies of the industry decline over time. The risk of regulatory error in this environment is much higher than it would be in a steady state and any regulatory intervention would be in pursuit of a perceived problem that is time limited. The Commission will need to account for this factor in its analysis and reflect it in any recommendations.

Additional features relevant to the likelihood of coordination

31 The Commission lists at paragraph 51 of the Focus Paper a set of features that are potentially conducive to coordinated behaviour, but recognises that these features do "not necessarily mean that coordination is likely or sustainable". The Commission proposes at paragraph 52 to consider these features in more detail.

32 Z recommends that the Commission also consider factors that mean coordination is unlikely, if it is not already doing so. The Commission has previously recognised many such factors. In the retail fuel context, examples may include the significant number of independent brands and service offerings, different business models (e.g. with Z being more exposed than others to the global spot price), price setters and decision-makers at different functional levels across businesses, the nature of the wholesale market and the role of imports.

33 Z recommends finally that all factors be considered in their full context. For example:

33.1 In theory a high degree of price transparency and product homogeneity may increase the chances of coordination (although Z does not believe this to be the case in retail fuel). However those factors may also be pro-competitive in other regards, for example in lowering barriers to switching.

33.2 One of the features identified as potentially conducive to coordinated behaviour is the use of shared infrastructure among the midstream participants. The Commission should also take into account the benefits resulting from that shared infrastructure in terms of efficiency, security of supply and geographic coverage.[6]

Conclusion

34 Z reiterates that these are initial points intended to assist the Commission as it develops its analysis and potential approaches. Z looks forward to engaging further in the coming months.

[6] Noting also that Z does not consider that use of shared infrastructure or the other features the Commission is considering result in coordination.