



**Submission to the Commerce Commission
On
Z Energy's Acquisition Application for
Chevron's Bitumen Supply Business in New
Zealand**

Contact

Richard Quinn
Manager Project Services
New Zealand Transport Agency
Private Bag 6995
Wellington

Email: Richard.Quinn@nzta.govt.nz

Phone: 021 844 466

21 July 2015

1. Why We are Making this Submission

Bitumen is a critical product for the success of New Zealand's economy as it enables the cost effective transport and trade of domestic and export goods through its use in the maintenance and construction of roads and footpaths. Around 160,000 tonnes of bitumen are used each year for maintaining and building New Zealand's roads equating to a market value of around \$143 M depending on the exchange rate and global crude oil prices. This is a substantial operation and requires an efficient and competitive bitumen supply and distribution market to ensure a quality bitumen supply at reasonable cost.

The NZIER "Construction Industry Study" found "that labour, capital equipment, aggregate, and bitumen and asphalt were the most important inputs to the construction and maintenance of roads. Bitumen equated to 13% of the national expenditure.

The New Zealand Transport Agency has a direct interest in the bitumen supply market as it funds and operates the 11,000 km State highway network and it co funds 50% of the approximately 80,000 km local roads network managed by local authorities. In essence the Agency and Local Government are the bitumen supply end customers on behalf of the New Zealand motorist.

The Transport Agency has a statutory duty through Section 25 of the Land Transport Management Act to encourage efficient and competitive markets.

Further, In her October 2014 on line report "NZTA Maintaining and Renewing the State highway network - Follow up Report" the Auditor General stated:

4.10 Our second report recommended that NZTA have specific strategies to encourage more suppliers into the professional services market for maintenance and renewal work. We consider that NZTA should also encourage competitive and efficient markets for physical works services.

The Agency is therefore concerned that the Z Energy acquisition of Chevron's bitumen supply business (referred to in this submission as the Merged Organisation (MO) post acquisition) substantially lessens competition in the New Zealand bitumen supply market by creating what would effectively be only one New Zealand bitumen supplier in an effective monopoly situation.

2. Submission Overview

This submission is made in relation to the potential impact on competition in the bitumen supply and distribution market in NZ. It is recognised that the Z Energy acquisition of Chevron has impacts on the wider competitiveness of the petroleum market and that the bitumen supply and distribution market is a comparatively small part of this acquisition. Nonetheless the cost of bitumen represents a sizeable proportion of the cost of building and maintaining roads in NZ and as such the impact of this acquisition on the NZ bitumen supply and shipping component of the distribution market deserves due consideration.

We believe that the Z Energy acquisition of Chevron's New Zealand bitumen supply business is likely to substantially lessen competition because:

- There is unlikely to be market parity between bitumen manufactured at the New Zealand Refinery and bitumen imported.
- The MO will have around 90% market share and is likely to be a monopoly in the New Zealand domestic market.
- The MO is likely to remove the competitive tension of imported bitumen because it will address and remedy the current distribution constraints.
- Z Energy is the only organisation who is accessing its rights to manufacture bitumen through the New Zealand Refining Company. Roading contractors are prevented from accessing bitumen directly from the NZ Refining Company.
- The market has already become less competitive in recent years due to the collapse of Delta in 2013.
- Expansion of bitumen suppliers into the market will be small scale and unlikely to pose a sufficient competitive constraint on the MO as the market is flat and declining and there are high barriers to entry.

These aspects are discussed further below.

3. Substantially Lessening Competition

We believe the Z Energy acquisition is likely to substantially lessen competition because it will cause a transition from a competitive market to a monopoly and lead to those contractors who purchase bitumen for the Agency and local authority contacts being materially and adversely affected for the following reasons:

3.1. There will not be market parity between bitumen manufactured at the New Zealand Refinery and imported bitumen because:

- It is currently not possible to import bitumen into the South Island as the storage facilities only have capacity for distributing domestically manufactured bitumen through frequent small shipments. Viable bitumen imports require large storage capacity of 20,000 to 30,000 tonnes while current tank capacity is around 5,000 to 8,000 tonnes. Remedying this issue will take many years due to the need for obtaining resource consents, land purchase and installation.
- Time lags associated with importing bitumen mean that it's not possible to respond to domestic price changes in a timely manner. It takes around four months to land imported bitumen and can stretch out to seven months before bidding and use occurs in the next road sealing season. Markets can substantially change during this period of four to seven months

Imports have only occurred in the past because the NZ based coastal ship could only physically distribute two thirds of the required bitumen around New Zealand, with imports planned well in advance.

3.2. The MO will have around 90% market share and is likely to be a monopoly in the New Zealand domestic market and be able to influence the bitumen import market to make it unviable.

Prior to the merger there were two bitumen suppliers (Z Energy and Chevron) supplying bitumen out of the New Zealand refinery. Competition between these suppliers ensured the domestic market bitumen bench price was not inflated. We are concerned the MO would have the opportunity to inflate the actual domestic bitumen price to just below the imported price because there would be limited countervailing market pressure. Past market conditions have put the imported cost of bitumen up to 15% higher than the domestic price. When this market situation occurs again, the MO could take advantage of it and the country's roading contractors, the Agency and local authorities will be materially and adversely affected through higher (inflated) prices.

This unilateral effect would not be negated when the market conditions were reversed and domestic prices were higher than import prices because of 3.1 above.

- 3.3. The MO is likely to remove the competitive tension of imported bitumen because it will address and remedy the current distribution constraints.

Shipping constraints in the distribution of bitumen around New Zealand currently assists a competitive market because around one third of bitumen needs to be imported providing a tension between imported and domestically produced bitumen prices.

We understand that Z Energy will be addressing the shipping constraints through the use of a larger coastal ship thereby removing the need to import bitumen.

- 3.4. The MO will be the only organisation manufacturing bitumen through the New Zealand Refining Company because only those with shares in the company currently have rights to do so. This means that contactors are prevented from accessing bitumen directly from the NZ Refining Company, and that the Z Energy acquisition is not a contested sale as Z Energy was the only organisation able to purchase Chevron's shares.
- 3.5. Up until September 2014, the New Zealand bitumen supply market was considered competitive with three bitumen suppliers, namely Z Energy, Chevron/Downer and Delta. Delta solely imported bitumen but was put into Liquidation on 4 June 2014. The imported bitumen supply industry is recognised as a difficult one with high barriers to entry because of the large investment levels needed, significant cash flow pressures, specialist technical expertise required and the high health and safety risks.
- 3.6. There are only a few other small bitumen suppliers in New Zealand, namely Technix and Trafigura. Technix was the original importer of bitumen into New Zealand but got out of the business over ten years ago by selling practically all its equipment to one of the large contractors. Trafigura is a new entrant with a small market share.

4. Defining the Bitumen Market

4.1. The Product

Bitumen used to be a by-product of the refining process in turning crude oil into petrol, diesel and other products. Historic bitumen prices reflected this. For some time now new technology has enabled the bitumen fractions to be further “cracked” into other products, such as fuels. Bitumen prices these days are based on the opportunity cost of “re-cracked” bitumen.

Unlike Australia, bitumen is still manufactured in New Zealand at the New Zealand Refining Company. The Refinery is owned by the four major oil company operating in New Zealand, but only Z Energy and Chevron use the Refinery to process their crude oil into bitumen. The other 3 oil companies choose to “re-crack” bitumen into other products.

Bitumen is further processed by contractors into the following products for roading purposes:

- “Straight bitumen” for chip seals pavements
- “Cut back” chip seals using kerosene
- “Emulsion” chip seals using emulsifying agents to dissolve the bitumen in water
- Asphaltic concrete for structural strength and for creating a smooth paved surface
- Slurry seals

Structural asphaltic concrete, which is less than 10% of the bitumen market, can be substituted in certain circumstances by Portland cement concrete but despite significant international research no substitute has been found for other bitumen seals used to surface and waterproof the road surface. For decades bitumen has proven and continues to be one of the best waterproofing agents in the world.

The New Zealand Transport Agency sets the New Zealand Specification Standard for bitumen used on both State Highways and local roads. The Bitumen Standard (M1) is unique and one of the toughest specifications for bitumen in the world due to the variable climatic conditions in NZ. Bitumen used in New Zealand is less than 1% of the world’s bitumen use making it unattractive for many international refineries to produce bitumen compliant with NZ specifications.

4.2. Supply Chain

Three NZ based contractors currently have the capability to import bitumen directly from overseas because they have storage facilities to do so. However, this has only been done in the past for security of supply reasons and will become unneeded and uneconomic if the MO uses its domestic monopoly position to inflate the domestic price of bitumen to imported bitumen price levels and it resolves the shipping distribution issues

4.3. Customer Type

We believe the merger will discriminate against medium and small contractors because should they wish they do not have the financial, technical or storage facilities to import bitumen.

There are also concerns over the commercial leverage medium and small contractors will have in securing bitumen supply with a monopoly provider.

5. Market Share and Concentration

Currently Chevron and Z Energy bitumen sales comprise around 90% of all bitumen sales in New Zealand with around 66% coming from the New Zealand Refining Company and the remainder imported. This means that after the merger the MO would have 90% of the market share.

As noted above there are also two other companies with the possibility of supplying imported bitumen, however their capacity for doing so is limited due to the barriers to entry and expansion.

6. Competing Suppliers Merger

As mentioned above, we believe there is the opportunity for the MO as the dominant supplier of domestic bitumen to produce unilateral effects by:

- Addressing the bitumen supply distribution issues and therefore removing the countervailing power of imported bitumen because the New Zealand Refining Company can then supply the New Zealand market.
- Inflating the domestic price of bitumen when below imported bitumen prices to make imported bitumen unviable and thereby making excessive profits.
- Market failure due to a lack of parity between imported and domestically manufactured bitumen as described in 3.1

7. Entry and Expansion, Countervailing Power and Efficiencies

We believe that any entry or expansion of bitumen suppliers into the market will fail the LET test because it will be small scale and unlikely to pose a sufficient competitive constraint on the MO because the market is flat and is predicted to decline and currently other competitors are small and have not been able to expand for many years.

We trust you find this submission useful and we would welcome the opportunity to meet and discuss it with you.