

ISBN no. 978-1-869456-92-4

Project no. 21.01 43585

**Public version**

# **Market Study into the Retail Fuel Sector**

**Working paper – Focus areas**

**Date:** 18 April 2019

[This page has intentionally been left blank]

## Contents

<b>INTRODUCTION .....</b>	<b>1</b>
PURPOSE OF THIS PAPER.....	1
OPPORTUNITY TO COMMENT ON THIS WORKING PAPER.....	2
<i>Format for providing feedback .....</i>	<i>2</i>
<i>Disclosure of your feedback.....</i>	<i>2</i>
BACKGROUND TO OUR STUDY.....	2
<i>Material we have published.....</i>	<i>3</i>
<b>FOCUS AREAS FOR OUR STUDY.....</b>	<b>4</b>
COMPETITIVE OUTCOMES WE OBSERVE .....	5
<i>Profitability of firms in New Zealand retail fuel markets.....</i>	<i>7</i>
<i>Regional variations in prices and margins .....</i>	<i>7</i>
<i>Pass-through of changes in input costs to retail prices .....</i>	<i>7</i>
FACTORS AFFECTING COMPETITION.....	8
<i>Structural conditions for entry and expansion.....</i>	<i>8</i>
<i>Infrastructure sharing (horizontal) arrangements.....</i>	<i>9</i>
<i>Wholesale (vertical) supply arrangements .....</i>	<i>9</i>
<i>Consumer behaviour and firms' pricing strategies .....</i>	<i>10</i>
<i>Coordinated behaviour among firms .....</i>	<i>11</i>

## Introduction

### Purpose of this paper

1. This working paper sets out the focus areas for our retail fuel study (study). The purpose is to share our thinking on these areas with interested parties prior to publishing our draft report.
2. Our preliminary issues paper stated that our competition assessment of the retail fuel markets will focus on:<sup>1</sup>
  - 2.1 the competitive outcomes in retail fuel markets; and
  - 2.2 what factors are affecting competition in retail fuel markets.
3. In this working paper we describe in more detail the **focus areas for our study** within each of these categories. We intend to examine whether the factors described, or interactions between these factors, are affecting competition in ways that may not be in the long-term interests of consumers.
4. Although the discussion in this working paper has been informed by the submissions received from parties on our preliminary issues paper, it does not seek to respond directly to those submissions. We are continuing to consider those submissions and have been following up directly with the relevant parties. These submissions are available on [our website](#).
5. Given this is not a competition investigation, references to a retail fuel “market” in this paper do not necessarily refer to a formally defined market for the purposes of Part 2 and 3 of the Commerce Act 1986 (Act).<sup>2</sup>
6. This is one of two working papers we have published as part of our study. We have also released a separate working paper discussing our proposed approach to assessing the profitability of firms participating in the retail fuel market.<sup>3</sup>

---

<sup>1</sup> Commerce Commission “Market study into the retail fuel sector: Invitation to comment on preliminary issues” (31 January 2019), at [24]-[26].

<sup>2</sup> Commerce Commission “Mergers and acquisitions guidelines” (July 2013), Chapter 3.

<sup>3</sup> Commerce Commission “Market study into the retail fuel sector: Working paper on assessing profitability” (18 April 2019).

### **Opportunity to comment on this working paper**

7. We are not seeking further formal submissions on the focus areas for our study at this time. However, if interested parties wish to provide feedback on this paper, they can do so by sending written comments to:

Keston Ruxton  
c/o [marketstudies.submissions@comcom.govt.nz](mailto:marketstudies.submissions@comcom.govt.nz)

8. Any written comments on this paper should be provided no later than **5pm, Tuesday 7 May 2019**.
9. Interested parties will have a further opportunity to formally submit on our consideration of these focus areas when we issue our draft report.

### *Format for providing feedback*

10. If you choose to provide comments on this paper, please include your company name, or the name of the person providing the comments, and “Feedback on working paper – Focus areas” in the subject line of your email. We prefer that comments are provided in both a format suitable for word processing (such as a Microsoft Word doc), and a ‘locked’ format (such as a PDF) for publication on our website.

### *Disclosure of your feedback*

11. We request confidential and public versions of your comments, so that a public version may be published on our website.
12. We offer guidance below where interested parties wish to provide information in confidence.
  - 12.1 Where confidential information is included, such information should be clearly marked.
  - 12.2 Both confidential and public versions of your comments should be provided.
  - 12.3 The responsibility for ensuring that confidential information is not included in a public version rests on the party providing the comments.

### **Background to our study**

13. On 5 December 2018, the Hon Kris Faafoi, Minister of Commerce and Consumer Affairs issued a notice requiring the Commerce Commission to undertake a market study into retail fuel under section 51(1) of the Act. Specifically, the study is into any factors that may affect competition for the supply of retail petrol and diesel used for land transport throughout New Zealand.
14. A copy of the terms of reference for the study is provided in the box below.

### **Terms of reference for competition study into retail fuel markets**

I, Kris Faafoi, Minister of Commerce and Consumer Affairs, pursuant to section 51(1) in Part 3A of the Commerce Act 1986, require the Commerce Commission to carry out a competition study into any factors that may affect competition for the supply of retail petrol and diesel used for land transport throughout New Zealand.

Matters to be considered in the study include, but are not restricted to:

1. the structure of the industry;
2. the extent of competition at the refinery, wholesale and retail levels, including the role of imports;
3. any factors that may hinder competition between industry participants;
4. the conditions for entry by potential competitors, including independent suppliers, and/or the conditions for expansion;
5. whether wholesale and retail price and service offerings of petrol and diesel are consistent with those expected in workably competitive markets; and
6. features of retail petrol and diesel markets that are not in the long-term interests of consumers.

The Commerce Commission must make its final report for this study publicly available by 5 December 2019.

### *Material we have published*

15. On 12 December 2018 we released our [statement of process](#), outlining the process we intend to follow over the course of the study.<sup>4</sup>
16. On 31 January 2019 we released our [preliminary issues paper](#), seeking responses for interested parties on preliminary issues we may explore during our study.<sup>5</sup> The submissions we received are available at [on our website](#).

<sup>4</sup> Commerce Commission “Market Study into the Retail Fuel Sector – Statement of Process: Our intended process and how you can contribute” (12 December 2018).

<sup>5</sup> Commerce Commission “Market study into the retail fuel sector: Invitation to comment on preliminary issues” (31 January 2019).

## Focus areas for our study

17. This section provides further details regarding the areas we intend to focus on in our retail fuel study, building on the approach set out in our preliminary issues paper. We intend to focus on the areas described in this section to address the matters raised in the terms of reference for the study.<sup>6</sup>
18. Our preliminary issues paper stated that our competition assessment of the retail fuel markets will focus on:<sup>7</sup>
  - 18.1 the competitive outcomes in retail fuel markets; and
  - 18.2 what factors are affecting competition in retail fuel markets.
19. We also noted that following this analysis, we may make recommendations if we consider there may be ways to achieve better outcomes for the long-term interest of New Zealand retail fuel consumers.<sup>8</sup>
20. Our approach is summarised in Figure 1 below.<sup>9</sup> Submissions on the preliminary issues paper did not raise substantive concerns about this approach.

---

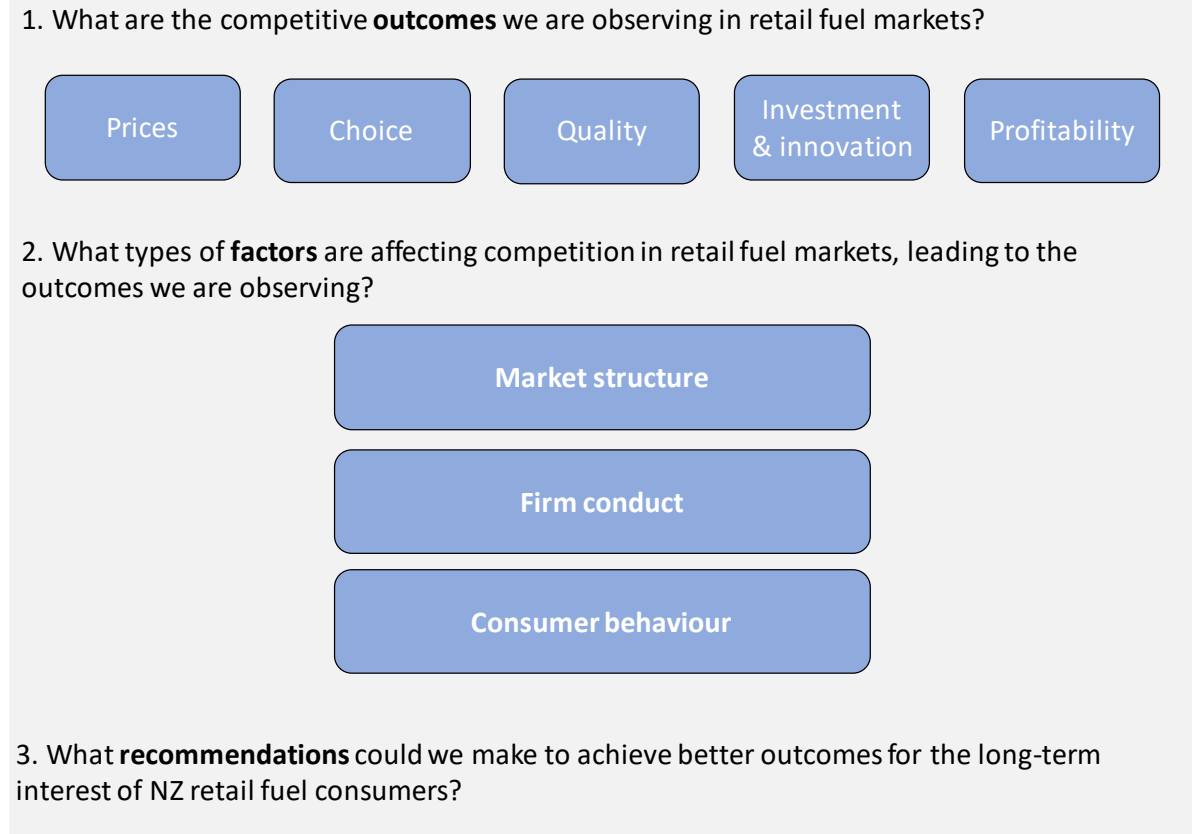
<sup>6</sup> The issues we focus on and investigate may change as our study progresses.

<sup>7</sup> Commerce Commission “Market study into the retail fuel sector: Invitation to comment on preliminary issues” (31 January 2019), at [24]-[26].

<sup>8</sup> Commerce Commission “Market study into the retail fuel sector: Invitation to comment on preliminary issues” (31 January 2019), at [27].

<sup>9</sup> This diagram is based on the approach described in paragraphs 24-26 of our preliminary issues paper.

**Figure 1: Summary of our approach to assessing competition**



21. The areas on which we intend to focus our analysis of *competitive outcomes* in retail fuel markets and *factors affecting competition* are described below. We have identified these focus areas based on our review of submissions on the preliminary issues paper, discussions with stakeholders, and initial work undertaken on understanding the characteristics of the markets we are studying.
22. Our assessment of competitive outcomes and factors affecting competition will consider expected future demand for petrol and diesel.

### **Competitive outcomes we observe**

23. We intend to focus our analysis of *competitive outcomes* in retail fuel markets on three main areas. These three areas primarily relate to the “profitability” and “prices” boxes in Figure 1 above.

#### **23.1 Profitability of firms in New Zealand retail fuel markets:**

Are profits for New Zealand fuel market participants consistent with those expected in workably competitive markets? How do the returns being achieved compare with other New Zealand companies, international fuel companies, and the cost of capital?



### 23.2 Regional variations in prices and margins:

How do prices and margins differ between geographic regions throughout New Zealand? How does the presence of certain competitors, such as Gull, affect competitive outcomes? Are factors potentially affecting competition more significant in certain regions?

### 23.3 Pass-through of changes in input costs to retail prices:

How do changes in input costs, particularly the cost of imported refined fuel, affect retail prices? Have pass-through rates changed over time? Do pass-through rates differ for cost increases and decreases?

24. The choices available to, and made by, market participants are also an area of interest. However, we intend to address this topic in our assessment of factors affecting competition. Example questions about choice, and the factors they are relevant to, are listed below.

24.1 What choices are available to importers, resellers and retailers, and what constrains those choices?<sup>10</sup> Does this adversely affect consumers? These questions are particularly relevant to our focus areas *Infrastructure sharing (horizontal) arrangements* (see paragraphs 39 to 41 below) and *Wholesale (vertical) supply arrangements* (see paragraphs 42 to 46 below).

24.2 What influences the purchase decisions made by consumers? How are their decisions affected by the availability of information, and by the loyalty programmes offered by many retailers? These questions are particularly relevant to our focus area *Consumer behaviour and firms' pricing strategies* (see paragraphs 47 to 50 below).

25. 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. Some of these areas will also be addressed in our assessment of factors affecting competition. For example:

25.1 the level of investment and innovation is relevant when considering the reasonableness of returns earned by participants in New Zealand fuel markets – the combination of investment and returns should reflect consumer demand; and

25.2 differences in the quality of product and service offerings is relevant when considering consumer choice and behaviour under our focus area *Consumer behaviour and firms' pricing strategies* (see paragraphs 47 to 50 below).

---

<sup>10</sup> “Reseller” refers to a purchaser of fuel from the major fuel firms on a wholesale basis, who on-sells that fuel: in bulk to commercial customers; and/or through their own network of truck stops and retail service stations.

*Profitability of firms in New Zealand retail fuel markets*

26. Evaluating the profitability of firms in New Zealand fuel markets is a focus area of our study. By profitability we mean the scope of firms' profits relative to the size of their business; for example, the amount of profit relative to the amount of fuel sold, or to the amount of investment that has been made in the business.
27. Given the complexities associated with assessing profitability, we have published a separate working paper on our proposed approach to assessing profitability in New Zealand's retail fuel markets. That paper is available on our website at <https://comcom.govt.nz/about-us/our-role/competition-studies/market-study-into-retail-fuel>.
28. The profitability working paper explains in more detail:
  - 28.1 why we propose to assess the profitability of firms supplying fuel to the retail markets;
  - 28.2 what conclusions we might draw from this assessment and the potential limitations on these conclusions; and
  - 28.3 how we propose to assess profitability.

*Regional variations in prices and margins*

29. Variations in regional prices and margins will also be analysed. Differences in regional prices are a well-identified feature of New Zealand fuel markets.
30. We will seek to understand this dynamic. For example, do prices and margins differ depending on which competitors are present in a region? Does shared control of, and restriction of access to, key infrastructure affect competition in certain geographic areas?<sup>11</sup>

*Pass-through of changes in input costs to retail prices*

31. Changes in the cost of imports of refined fuel may affect retail prices for petrol and diesel. We refer to the relationship between input costs and retail prices as the "pass-through rate".
32. Pass-through rates may be an indicator of the intensity of competition. They may assist us in examining how the intensity of competition has varied over time, and across regions.
33. We also intend to consider whether there is asymmetric pass-through of input cost changes. For example, are cost increases passed through more quickly, or to a greater extent, than cost decreases.

---

<sup>11</sup> Evidence of higher prices or margins in these areas may indicate that competition downstream is being affected.

## Factors affecting competition

34. We intend to focus our analysis of *factors affecting competition* on five main areas which may affect competition in retail fuel markets.

### 34.1 **Structural conditions for entry and expansion:**

What are the costs of establishing an independent source of supply or supply chain? Does the size and nature of these costs affect new entry and/or the expansion of existing players in the supply of retail fuel (eg, economies of scale, sunk costs, and regulations)?

### 34.2 **Infrastructure sharing (horizontal) arrangements:**

Do joint ventures or arrangements throughout the supply chain (e.g. refinery, borrow and loan, coastal shipping agreements) affect new entry and expansion from the non-major fuel firms and affect rivalry between the major fuel firms? If so, how?

### 34.3 **Wholesale (vertical) supply arrangements:**

Do the terms and conditions in wholesale supply agreements affect new entry and expansion from importers or resellers, or competition between the major fuel firms? If so, how?

### 34.4 **Consumer behaviour and firms' pricing strategies:**

Why do retailers use selective price discounting, loyalty and bundling strategies, and how do consumers respond to these? Why has discounting increased, and why have importer margins risen at the same time? How transparent is information on retail prices for different fuel grades? Do these features of the market result in better or worse outcomes for consumers?

### 34.5 **Coordinated behaviour among firms:**

Is there evidence of coordinated conduct in the retail fuel markets? Are the outcomes (eg prices and margins) that we observe in the fuel sector consistent with coordinated behaviour?

35. These five focus areas are described in more detail below.

### *Structural conditions for entry and expansion*

36. We are seeking to understand:

36.1 the size and nature of any structural barriers to establishing an independent source of supply or supply chain; and

36.2 how these affect new entry and/or the expansion of existing players in the supply of retail fuel.

37. This includes assessing the requirements and costs of establishing an independent supply chain (including terminal storage, distribution, and retail sites), and

requirements and costs of exiting the industry. We intend to consider how these costs could affect competition. For example, significant economies of scale, large sunk costs, and significant regulatory requirements/costs may discourage new entry.

38. If these requirements and costs are significant, and there are no contractual alternatives, they may limit the actual or potential market structure to a relatively small number of firms. The ability for rival firms to enter or expand in regional markets may also be constrained. This may provide existing firms with a degree of market power and result in higher prices to consumers overall.

*Infrastructure sharing (horizontal) arrangements*

39. We are seeking to understand how joint horizontal agreements throughout the supply chain affect:
- 39.1 rivalry between the major fuel firms; and
  - 39.2 new entry and expansion from the non-major fuel firms.
40. There are various joint horizontal agreements throughout the fuel supply chain between the major fuel firms. These include the joint use of the refinery, refinery to Auckland pipeline (RAP), Coastal Oil Logistics Limited (COLL) shipping arrangements, and shared national storage of fuel in a network of terminals throughout New Zealand (the 'borrow and loan' system).
41. We intend to consider how these arrangements, and any terms of any access to these arrangements, may affect competition. Two possible examples are listed below.
- 41.1 These arrangements may constrain new entry and reduce competition for retail fuel. This is particularly relevant where structural barriers to entry are high (ie, if a new firm's ability to effectively compete relies on access to a key piece of infrastructure).
  - 41.2 Sharing of key infrastructure may influence firms' ability and incentive to coordinate their behaviour, rather than competing strongly. This may be through information sharing and transparency, by equalising cost structures, or by other mechanisms (eg, if the terms and conditions of these agreements affect the ability and incentive for parties to compete).

*Wholesale (vertical) supply arrangements*

42. We are seeking to understand whether (and how) the terms and conditions that are agreed between major fuel firms and their wholesale or retail customers affect:
- 42.1 new entry and expansion by importers or resellers; and
  - 42.2 competition between the major fuel firms at the wholesale level.
43. In contrast to independent entry by independent fuel supply, retail-only entry may be more easily obtained via a wholesale supply agreement with a major fuel firm.

However, the terms and conditions of such agreements may (in some respects) limit the ability of resellers to enter and expand, or to compete effectively with majors.

44. If there are high switching costs for resellers to change supplier, this may reduce the ability and incentive for major fuel firms to aggressively compete against each other. We intend to look at exclusive supply arrangements, the duration of these arrangements, and other supply conditions that might make it harder for resellers to switch.
45. Other potential examples of high switching costs could include if the firm is required to replace key equipment (such as tanks), or undertake significant rebranding, if it seeks to change supplier.
46. High switching costs may also affect the prospects of a new importer of refined fuel contracting for distribution services.

#### *Consumer behaviour and firms' pricing strategies*

47. We are seeking to understand:
  - 47.1 why firms adopt price discounting, loyalty programmes and bundling strategies, and how consumers respond to these;
  - 47.2 why discounting has increased, and why importer margins have risen at the same time;
  - 47.3 transparency of information on prices for different fuel grades; and
  - 47.4 whether these features of the market result in better or worse outcomes for consumers.
48. The rise in retailers' use of pricing strategies such as selective discounting, loyalty and rewards programmes may benefit some consumers, but could also make it harder for consumers to make well-informed decisions and increase their search and switching costs. If some consumers have difficulty comparing prices, or switching to better alternatives, then retailers may not have to compete as strongly to attract and retain them.
49. For example, selective discounting, loyalty and rewards programmes may hinder effective competition if they:

- 49.1 reduce transparency, making it more difficult for consumers to compare offerings;<sup>12</sup>
  - 49.2 reduce the incentive for consumers to shop around because they already consider they are getting a good deal;
  - 49.3 increase consumers' search and switching costs, by bundling or tying different products together; or
  - 49.4 discriminate against consumers who do not belong to these programmes.
50. Further, in contrast to 91 octane petrol, the prices for premium fuels such as 95 and 98 octane petrol are typically not displayed on public price boards. This may also hinder effective competition by increasing consumers' search costs. For example, consumers may not know the price of premium fuels until they have driven to the pump, and would need to drive into multiple outlets to compare prices.

*Coordinated behaviour among firms*

51. We are seeking to understand whether features of retail fuel markets, including those that we previously identified in the Z/Chevron investigation as being conducive to coordinated behaviour, are affecting outcomes for the supply of retail petrol and diesel.<sup>13</sup> These features are listed below.<sup>14</sup>
- 51.1 There are a number of independent suppliers of retail fuel. However, most rely on the majors for their fuel supply. Gull is the only fully independent player in the market.
  - 51.2 The retail fuel that firms sell is largely the same. There is differentiation in the service offering but in some local areas the degree of differentiation is low.
  - 51.3 Board prices are transparent and readily observable to rival firms.
  - 51.4 Firms are regularly interacting as a result of the shared ownership of infrastructure and operations by the major fuel firms.
  - 51.5 Consumers make small regular purchases of a product.
52. We recognise that identifying features that are conducive to coordination does not necessarily mean that coordination is likely or sustainable. However, we will seek to

---

<sup>12</sup> The prevalence and complexity of discounting and loyalty programmes may make it harder for consumers to compare offers. As a result of limited information, consumers might resort to 'rules of thumb' or other shortcuts to make choices.

<sup>13</sup> Coordination is not necessarily unlawful. It may be limited to firms adapting their behaviour and accommodating each other through repeated interaction in the market.

<sup>14</sup> *Z Energy Limited and Chevron New Zealand* [2016] NZCC 10 at [168]-[203].

understand whether these features are leading to outcomes in retail markets that are consistent with coordinated behaviour rather than firms seeking to compete strongly – in particular, on price.

53. Each of the other focus areas may also be relevant to the consideration of coordinated conduct. Each may affect the ability and incentive of suppliers at various levels and locations to compete or to accommodate each other in the market.