Z ENERGY SECOND SUBMISSION ON THE COMMERCE COMMISSION'S MARKET STUDY INTO THE RETAIL FUEL SECTOR: DRAFT REPORT

1 In this submission, Z addresses:[1]

1.1 **Profitability** (paragraph 3). In Z's view the Commission's profitability analysis needs to be placed in the proper context, including taking account of changes since the 2016-2018 period considered in the draft report that show that higher returns are not persisting. Various other adjustments ought to be made to the Commission's calculations; those progressed further at the conference are discussed in this submission.

1.2 Competitive conditions at the **wholesale** level (paragraph 59), including **distributor contracts** (paragraph 98). Z considers:

(a) Wholesale competition is vigorous and effective, and supports a competitive and vibrant retail market.

(b) Terminal gate pricing (**TGP**) similar to the regime in Australia would:

(i) have the potential to improve price transparency (and therefore monitoring by the Commission and others) and the conditions of wholesale competition; and

(ii) constitute a limited, targeted regulatory intervention that would avoid foreclosing any industry structure above or below the terminal gate. Recommending this intervention would therefore also allow the Commission to promote competition but not require it to take a view on the likely trajectory of demand for fuel, or the most appropriate structure for industry, into the future.

(c) A maximum distributor contract length of up to 7 years would maximise the potential effectiveness of a TGP regime, and provide assurance about the competitiveness of distributor contract terms without materially curtailing freedom of contract for midstream participants and distributors. This would allow the Commission to promote competition without unnecessarily stifling the ongoing development of distributor participation in fuel markets.

1.3 **Retail** price and product offer (paragraph 114). Z reiterates its support for recommendations requiring premium prices to be advertised on price boards and regarding ongoing government monitoring at the retail level.

2 This version of the submission is public; confidential and commercially sensitive information has been redacted. Release of this information would be likely to unreasonably prejudice Z's commercial position. Please contact us if you receive a request for the information.

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[1] This submission supplements Z's previous submissions on the Commerce Commission's market study; it covers points raised in submissions on the Commission's draft report, and at the Commission's 24-27 September conference.

PART A: PROFITABILITY

Overview

3 This Part A covers a number of points discussed at the conference and in others' submissions:

3.1 Profitability analysis must be placed in context (from paragraph 7).

3.2 Intangibles ought to be recognised as costs (from paragraph 17).

3.3 Points relating to ROACE specifically (from paragraph 27).

3.4 Business cases are an inappropriate basis from which to draw inferences about future profitability (from paragraph 54); and

3.5 Economic Value Added, an alternative approach proposed by Ireland, Wallace and Associates (from paragraph 56).

4 Z acknowledges that the Commission is using profitability as an indication of whether the retail fuel market tends over time towards outcomes that would be expected in a workably competitive market; no profitability-based intervention is proposed. However profitability is nonetheless an important topic for Z and the industry, as well as for the Commission's findings and recommendations. Z notes:

4.1 While a genuine "cost/benefit analysis" is for the Government to undertake, the Commission's profitability findings influence the level of intervention it is likely to recommend and/or the level of intervention that is likely to be ultimately adopted. Overstating profitability may result in recommendations that are unnecessary and not "fit for purpose". Any "over-corrections" may result in unintended consequences and inefficient outcomes, and may risk undermining New Zealand's fuel supply chain and retail markets.

4.2 The Commission's profitability findings will have an impact in the market. Reputation matters, and it is important that profitability analysis is accurate and placed in the proper context for consumers.

4.3 Similarly, Z's investors and other capital market participants are watching the market study with interest. Z has already had to explain to its investors how the Commission's draft profitability numbers match up with Z's latest earnings updates and declining share price, and how the Commission's assessment of profitability will inform regulatory intervention.

5 Z refers also to the post-conference submission by independent expert Incenta Economic Consulting, provided along with this submission. The Incenta submission covers Tobin's q, intangibles, decommissioning and restoration costs, and revaluation gains.

6 In the following sections Z sets out its comments on the Commission's profitability analysis.

The Commission should use up-to-date data, and profitability analysis should be placed in its proper context – this would show a downward trend

7 Context is important to the Commission's profitability analysis, and changes since the Commission's observed 2016-2018 period indicate that returns are declining rather than persisting. For example:

7.1 The Commission's ROACE analysis covers the period from 2016-2018. Even with no adjustments or corrections made, the Commission's ROACE figure for Z in FY19 is 17.2%, 6.2% lower than Z's FY18. Z's provisional half year FY20 results indicate that Z's latest ROACE would be lower again, at approximately **[**REDACTED**]**.[2]

7.2 Z's investment strategy is to substantially limit new capital investment in its core business (with the new investment bias to digital rather than physical assets). Such an approach is inconsistent with a finding that returns are particularly high and likely to persist in the future.

8 It is important to place profitability analysis in the proper context and use data that is as up to date as possible.

9 First: the Commission's 2016-2018 analysis uses Z's FY16-FY18 data, but Z's financial year runs from 1 April to 31 March, meaning the period of the Commission's analysis finished more than 18 months ago. FY19 data is available so would be a more appropriate choice.

10 Additionally, assuming other firms' data represents calendar years 2016-2018, the period of Z's analysis is out by nine months and is not directly comparable with the analysis of other firms. The closer match to calendar year 2018 is Z's FY19 (with 9 months in common).

11 Setting aside adjustments that should be made to the Commission's calculation (discussed below), the Commission's ROACE figure needs to be both updated and placed in the proper context:

11.1 The Commission's calculation of Z's ROACE in FY18 is 23.4%. By the Commission's own draft calculations, Z's FY19 ROACE is significantly lower, at 17.2%. This FY19 figure is also more relevant and comparable for the reasons given above.

11.2 This downward trend has continued more recently. On 12 September 2019 (part way through Z's FY20), Z published an earnings update revising its earnings guidance down from $450-$490m to $390-$430m.

11.3 Although they are yet to be finalised, Z's half year FY20 accounts provisionally indicate a ROACE of approximately **[**REDACTED**]** (again, using the Commission's own draft calculations with no adjustments or corrections).[3] Z

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[2] This figure reflects the 12-month period ending 30 September, so incorporates half of FY19. It is calculated using the same approach the Commission used in the draft report **[**REDACTED**]**.

Note that this figure uses earnings calculated on the basis of historic cost – as per the Commission's draft report approach – whereas Z recommends that the Commission use replacement cost (among other adjustments and corrections), as discussed from paragraph 39 of Z's September submission.

[3] See footnote 2.

can confirm this calculation with the Commission when its half year FY20 accounts are finalised.[4]

12 It is important to include the content from Z's FY19 data. Inclusion of this more relevant period into the Commission's analysis will reduce the overall assessment of returns. Importantly, it demonstrates that higher returns have not persisted (as does Z's provisional half year FY20 data).

13 This trend of declining returns within the Z business, which commenced in 2016, is also indicated by falling retail fuel margins for Z over the period.

14 Similarly, expectations of the future need to be understood in context:

14.1 In response to uncertainty about the future demand for fuel Z has publicly committed to capping the level of capital employed in its core fuels business to 2018 levels. Z's high internal hurdle rates are not indicative of positive expectations of the future; rather they reflect uncertainty and an unwillingness to invest in long life physical (rather than digital) assets.

14.2 While many disagree on the exact timing of the end of retail fuel, there is no question that fuel volumes will decline during the life of investments in this sector. The Business Energy Council suggests a decline in petrol use between 10-35% from 2020-2030.

15 Viewed in their full context, the business cases and hurdle rates for new, incremental investments provide little reliable guidance on expectations of future profitability. A more reliable guide is the observable downturn in returns and margins. Updating the Commission's ROACE analysis to include at least Z's FY19, and noting the wider context and trends that have continued since then, is a more useful data set to use to assess whether profitability will "persist".

16 Finally, as was discussed at the conference, returns have to date naturally risen and fallen over time, encouraging new entry when rising and reflecting increased competition when falling.[5] The returns observed over the 2016-2018 period have been matched with significant new investment, such as from Caltex Australia, expansion of independent brands, and new entry, such as from TOSL. Unsurprisingly, returns are now declining as a result of this new entry and expansion. Periods of lower returns historically saw a reduction in new investment, closure or sale of many retail sites, and the exit of Shell.

Intangibles ought to be recognised as costs

17 Z submits that it is appropriate to include intangible assets – in particular contracts, leases[6] and goodwill – as a capital cost in the denominator for both ROACE and Tobin's q.[7] In short:

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[4] Z's half year FY20 results will be finalised by, and announced on, 31 October 2019.

[5] Z notes that whether, and to what extent, returns will rise again depends in part on the trajectory of aggregate demand over coming years, and the impact of responses to climate change.

[6] In this section Z discusses the appropriateness of including leases as a capital cost in general. From paragraph 30 below Z discusses the value that ought to be attributed to those leases.

[7] Z notes that, along with excluding intangibles Z acquired from Chevron, the Commission's calculations provided to Z also exclude **[**REDACTED**]** of capital related to Z's acquisition of Flick (only

17.1 Intangibles reflect costs incurred to generate earnings (and, for Tobin's q, market value). Those earnings are taken into account, so the costs should be as well.

17.2 Profitability analysis should be indifferent to different business models, e.g. leased vs owned sites, dealer vs company-owned ownership models.

17.3 Intangibles reflect costs that a new entrant would incur.

Intangibles reflect costs incurred to generate earnings

18 In acquiring Chevron, Z paid a substantial amount for contracts and goodwill. This capital outlay should be considered in the Commission's analysis; it is the cost associated with the revenue stream (which the Commission *has* included) Z now earns from the previous Chevron business.

19 Z refers also to the cross-submission by Incenta, provided with this submission. Incenta explains why intangibles in the form of organisational capacity should be included in ROACE and Tobin's q analysis, and estimates Z's organisational capability intangible asset as approximately $235 million at the end of Z's FY19.[8] This organisational capacity is a separate consideration to (and does not include) the value of contracts.

Profitability analysis should be indifferent to different business models

20 Businesses should not be penalised for, and profitability analysis should not differentiate between, different business models. The draft report factors in retail sites owned by companies (as it should); it should therefore also recognise the costs of alternative business models, i.e.:

20.1 leases, where firms choose to lease rather than outright own their physical sites; and

20.2 the cost associated with winning and retaining supply contracts in dealer-owned models.

21 Z recognises that in some cases it may be difficult to estimate the "cost" associated with dealer contracts, as business relationships are built up over time through staff employed to assist dealers and manage relationships, investment in brand, financial

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relevant from FY19 – the year Z acquired Flick). Unlike the Chevron contracts, Z considers that it is appropriate to exclude Flick from Z's capital employed because that capital is unrelated to fuel.

However the Commission has also included certain earnings related to Flick – **[**REDACTED**]**. This **[**REDACTED**]** should also be excluded on the same basis. Given time constraints Z has not made this adjustment (which would apply from FY19 onwards only) throughout this submission when showing the approach it recommends the Commission takes. The change is likely to be reasonably minor, adjusting Z's ROACE by approximately **[**REDACTED**]** for FY19 on the Commission's draft report approach.

[8] This $235m figure includes the whole of Z's business at the end of Z's FY19, not just the value of Z's organisational capacity intangible asset acquired from Chevron.

assistance and other factors. However in Z's case the "cost" of the Chevron contracts is clearly quantified in the market – in the price Z paid to acquire them.[9]

22 In Z's view the Chevron contracts did not only gain value upon "the somewhat random event of an acquisition by another firm".[10] Had the merger not occurred, ROACE analysis for Chevron would also have needed to take account of its dealer-owned business model, or otherwise would have arbitrarily over-stated Chevron's ROACE.

Costs that a new entrant would incur

23 The draft report notes that contracts are "not a cost a firm would incur when expanding (or entering a market)."[11] Z submits that equivalent costs in fact would be incurred. A new entrant would need to ensure it had a reliable channel to market, with:

23.1 a company-owned model: acquiring fixed assets or leases (and therefore leases should be included too); and/or

23.2 a dealer-owned model: convincing dealers to sign on for a reasonable term.

24 A new entrant would consider the present value of the costs (and benefits) of acquiring dealer contracts vs acquiring its own sites. While a dealer owned model is by definition more "capital light", the Commission's approach of excluding the cost of contracts is an implicit assumption that a dealer owned model is more profitable than a company-owned model.

25 A new entrant might convince dealers to sign on through various means (e.g. up-front investment or price), but regardless would incur cost in doing so. The time and effort Chevron has put into winning and retaining those contracts – reflected in the price Z paid for them – is a cost already incurred[12] that should be recognised in the Commission's analysis.

26 Other intangibles such as goodwill and brand should also be recognised in the Commission's analysis. Firms invest significant capital into staff, expertise, know-how and relationships. A new entrant that did not incur these costs would be unable to compete effectively or win supply contracts (and see also Incenta's analysis of organisational capability intangible assets).

ROACE

27 In this section, Z submits that various adjustments should be made to the underlying costs considered when calculating ROACE, including in relation to leases,

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[9] Note: at the conference Z mentioned its understanding that Chevron historically transferred assets, leases and businesses to dealers at discounted rates, in exchange for the terms those dealers then agreed to.

Z has since investigated further and now clarifies that in fact the extent of the value given to dealers was much less than Z previously understood. Regardless, Z believes that Chevron contracts should be included in the Commission's analysis for the other reasons given.

Note also that Z's previous understanding was conveyed to Incenta, and was used by Incenta in preparation of parts of its previous, 3 September report.

[10] Draft report, Attachment D, paragraph D156.2.

[11] Draft report, Attachment D, paragraph D156.1.

[12] Rather than an ongoing cpl discounted price. Z acknowledges that ongoing discounts need not be included as "costs", because that would be circular. They affect the numerator and denominator at the same time and are better considered as components of price rather than a cost.

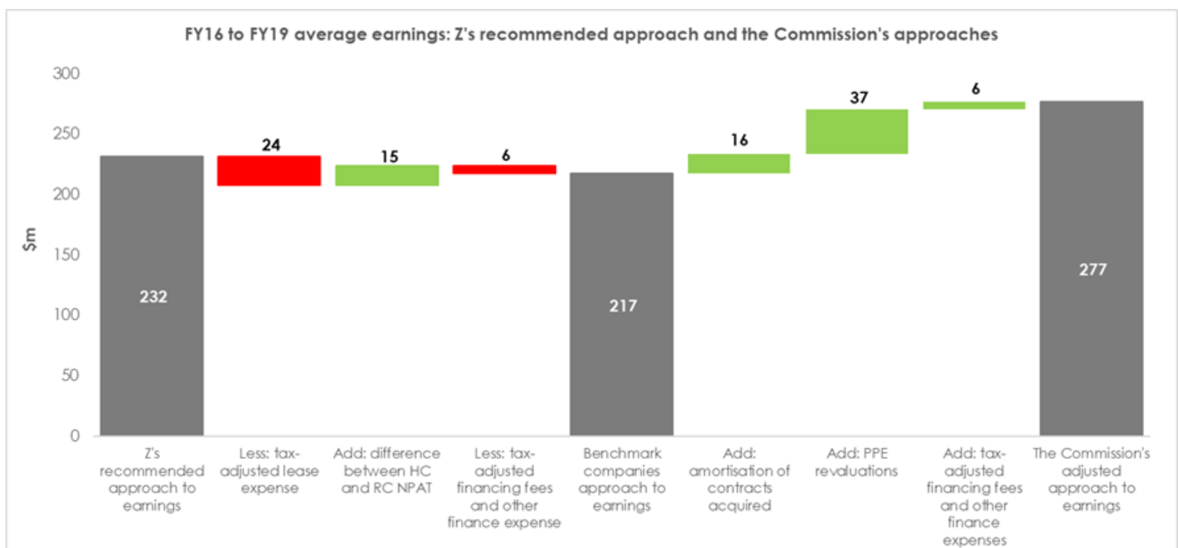
synergies, revaluation gains, decommissioning and restoration costs, and non-fuel revenue. These points are additional to the points above that apply to both ROACE and Tobin's q (i.e. using up-to-date data, placing the analysis into context, and including intangible assets).

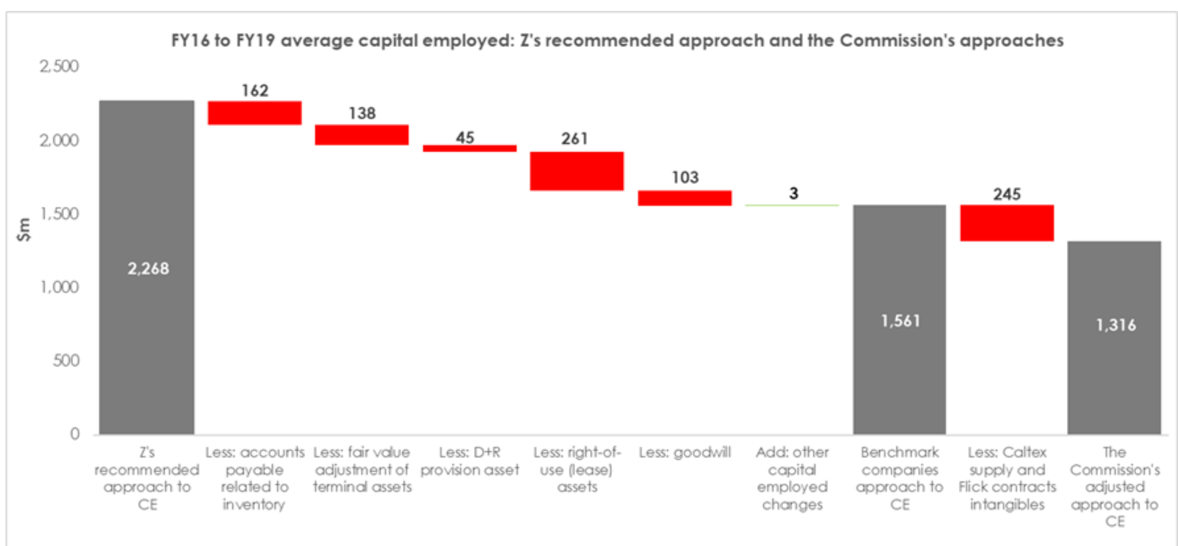
28 The two charts below show, for average earnings and average capital employed for Z's FY16 to FY19, a comparison between three approaches, being:

28.1 on the left, the approach Z submits that the Commission should use;

28.2 in the middle, the approach the Commission uses for the benchmark companies it has compared Z to (see the discussion from paragraph 47 of Z's September submission for more detail); and

28.3 on the right, the approach the Commission used in the draft report (but, to be clear, updated to include Z's FY19 as is appropriate and discussed above).





29 The workings for these charts, and other earnings and capital employed analysis, are set out at Appendix 1.

Value of leases that ought to be included

30 Z submits that leases should be included as a cost in ROACE analysis on the basis of full replacement cost. If that is not possible, a second best option is to include the present value of the lease payments. This point was discussed briefly at the conference.

31 The Commission should assess returns in a manner that is independent of business models and financing decisions. Firms may choose to buy or lease assets, and returns analysis should be indifferent to those financing decisions.

32 Valuing leases consistently with the method for valuing owned assets is the most appropriate way to ensure the Commission's ROACE analysis is made on a pre-finance basis and does not produce different results based solely on different (legitimate) financing decisions.

33 The Commission has rightly used full replacement cost for owned assets; in principle the Commission should therefore also use the replacement cost of leased assets (an issue discussed in more detail in Incenta's 13 September report). However, if the Commission is unable to identify full replacement costs, a reasonable alternative approach is the present value of the lease payments (i.e. the capitalised lease payments).

34 Without this adjustment made to the Commission's draft report numbers, the ROACE analysis does not give an accurate picture of profitability per se, and its results are not comparable across firms that have made different financing decisions.

Commission should recognise the ROACE-inflation caused by synergies

35 Z notes that since acquiring Chevron it has achieved synergies of approximately $40-42m.[13] These synergies result in Z's ROACE being inflated from FY18 onwards, in that Z has reduced its costs (the ROACE denominator) as a result of cost savings.

36 Put another way, had Z not acquired Chevron or not generated these synergies, the ROACE across the Z and Chevron businesses would be lower, reflecting higher (pre-synergy) costs being incurred.

37 The Z/Chevron synergies deliver ongoing benefits in terms of efficiency and competitiveness. Accordingly, these synergies should be recognised in any ROACE analysis (at least for a period of time), rather than be erased instantly. Note:

37.1 In competitive markets (like those Z operates in) firms are incentivised to reduce costs in order to obtain a cost-advantage over their competitors. Competitors will respond, but will not be able to do so immediately. Firms benefit from efficiencies for a period of time before the market responds; this benefit is the incentive that drives firms to seek efficiency enhancements in the first place.

37.2 In regulated, non-competitive markets (i.e. those regulated under Part 4 of the Commerce Act) the Commission explicitly recognises these incentives and firms' right to earn the benefit of cost cutting for a period. The Commission

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[13] The vast majority of which are due to cost reductions. Z refers to its 28 September 2017 investor presentation: https://investors.z.co.nz/static-files/65226c9c-dfaa-4746-9ea2-51f862fa49a9 (page 10).

allows firms to retain 100% of any reductions in their operating expenses for a period of 5-6 years, via IRIS calculations.

38 In Z's view the best way to recognise the benefit of cost efficiencies is to calculate Z's ROACE as if these synergies had not been achieved, i.e. to add back in the pre-synergy operating expenses. These synergies were booked recently enough – first in FY18 – that the Commission need not consider when Z should cease to earn the benefit. The Commission can confidently make this adjustment for FY18 to now (half year FY20), well short of the 5-6 year period it allows via IRIS calculations.

39 Failing to make this adjustment would result in ROACE analysis that instantly erases any cost advantages and in fact punishes firms for lowering their costs, as the result is a higher ROACE (which in the context of the market study is used as a justification for intervention).

40 Further, the Commission's ROACE analysis is intended to indicate the extent of competition in retail fuel markets. To the extent that Z's ROACE is inflated due to cost efficiencies, it does not usefully indicate the extent of competition. In fact, rigorous efforts to cut costs are indicative of highly competitive markets.

41 This issue is separate to the relevance of intangibles, which is discussed above from paragraph 17.

Other points raised in submissions/at conference

42 Z refers to the other points made on profitability in its submission and expands below on topics raised by other submitters and at the conference.

Revaluation gains should be excluded

43 As discussed in Z's September submission and again at the conference, it is appropriate to exclude revaluation gains from Z's earnings. Z refers to the points on revaluation gains made in the cross-submission by Incenta, provided with this submission.

44 In particular, Incenta notes that the most material of the revaluation gains that Z reported in its accounts resulted from its change from accounting for assets on an historical cost basis to a fair value basis. These revaluation gains should not be treated as a source of income when calculating returns; they reflect the effect of changing Z's accounting method to one that has greater meaning for the Commission's task.

Decommissioning and restoration costs should be included

45 Z submits that decommissioning and restoration costs (**D&R**) should be included in the Commission's analysis. The cost of D&R is included with the relevant business case before investment and Z books these costs over the expected life of an asset. D&R costs apply whether a site is leased or owned. They are an essential part of the cost of providing retail fuel and a cost that all firms must account for in all market conditions.

46 In other words, firms cannot avoid incurring D&R costs eventually. Fuel retailers must earn sufficient margins to account for D&R (and hence Z books them). If D&R costs were included only when sites are closed, it would skew any profitability or returns analysis generally. If D&R costs were all incurred in the years where Z closes sites, its profitability figures for those years would be artificially low given the large, lumpy D&R costs incurred. Regular booking of D&R costs is the only way for the Commission to obtain a consistent view of profitability over multiple years.

47 Z's approach is to capitalise D&R costs when a new site is established (via lease or purchase). Each subsequent year the D&R provision is recalculated and various adjustments made. Every three years the value of the D&R obligation is reassessed by an independent engineering firm to reflect an updated view on the future costs.

48 At the conference the Commission asked how Z treats D&R when it *replaces* assets, rather than decommissioning them and restoring the site. Z's process is as follows:

48.1 D&R bookings are made per-asset by reference to the expected life of that asset. This will be the earlier of the asset's useful life, the expected end of the lease (including exercising rights of renewal) or, for owned sites where Z is planning on selling the site, the expected sale date.

48.2 When an asset (e.g. a tank) is removed and replaced (i.e. because the site continues to operate as a service station), the D&R provision associated with the outgoing tank is utilised and is replaced with a new D&R provision for the new asset.

49 Z refers also to the points on D&R costs made in the cross-submission by Incenta, provided with this submission. Incenta's worked hypothetical example shows that including the allowance in prices for restoration would result in a finding of material excess returns even with prices delivering precisely NPV=0.

Commission should note the influence of non-fuel revenue

50 Z's business is integrated and Z's accounting does not split out costs associated with earning non-fuel revenues (e.g. income on convenience store sales). As a result, Z's data used in the Commission's profitability analysis includes fuel and non-fuel revenues.

51 Z raised in its submission and at the conference that the inclusion of non-fuel revenues was likely to be inflating the Commission's profitability measures for Z, because:

51.1 non-fuel activities are likely to earn a higher return, given the associated difference in risk – fuel demand is more price inelastic than non-fuel demand; and

51.2 capital employed from shared infrastructure required for convenience retail is relatively low.

52 The second point was discussed in more detail at the conference. To elaborate: the vast majority of costs at a retail site are associated with the sale of fuel. The only assets that are used for the sale of convenience goods are the building and associated land. With or without a convenience offering, manned fuel sites typically require (at least) a staff area, counter, queueing space and bathrooms. The marginal additional floor plan required to sell convenience goods is reasonably small, and as a result the return on capital employed for those non-fuel revenues is likely to be higher than for fuel sales.

53 Ideally the Commission would exclude non-fuel revenue (and the associated costs) from calculation of Z's ROACE. Assuming this is too difficult with the data and time available, Z submits that the Commission should at least recognise in its ROACE analysis the general influence of non-fuel revenue (e.g. by explicit recognition of the influence or a downward adjustment based on an estimate of the influence).

Business cases are an inappropriate basis from which to draw inferences about future profitability

54 As discussed in Z's September submission and again at the conference, it is critical to understand Z's business cases in context. That context makes them inappropriate as a basis from which to draw inferences about future profitability. As per Z's September submission:[14]

54.1 Z has stated publicly that as part of its revised investment approach Z will only invest in assets with a five year discounted payback threshold. This represents capital rationing in the face of uncertainty about the future of fuel, and a public commitment to limit capital employed in the core business. It does not represent a confident expectation about returns (in which case Z would presumably be investing new capital too).

54.2 Z's strategy is to invest in capability such as customer experience, digital products, productivity, innovation and brand. These investments naturally have much shorter service lives than fixed assets such as retail sites and this is reflected in the depreciation rates that accounting standards require Z to use.

55 Viewed in their full context, the business cases and hurdle rates for new, incremental investments provide little reliable guidance on expectations of future profitability. A more reliable guide is the observable downturn in returns and margins. Updating the Commission's ROACE analysis to include at least Z's FY19, and noting the wider context and trends that have continued since then, is a more useful data set to use to assess whether profitability will "persist".

Alternative approach: Economic Value Added

56 Ireland, Wallace and Associates submitted suggesting that the Commission consider the use of Economic Value Added (**EVA**) as a measure of profitability.

57 In Z's view, there is little difference between EVA and a proper assessment of ROACE, and little value in replicating ROACE analysis in a different arrangement for EVA. Both attempt to measure economic profits from historic accounting data. Both are only as useful as the inputs used, including the choices of input, quality of data and comparability of data.

58 If the Commission intends to continue with an accounting-based approach to measuring returns then, given time constraints and the similarities between ROACE and EVA, Z believes the better approach is to continue with ROACE analysis rather than replace or complement it with EVA. While Z has concerns about ROACE and the inputs used, similar issues would exist for EVA. While the time available for parties to consider profitability in general has been limited, ROACE has at least been the subject of explanation by the Commission, submissions by parties and discussion at the conference.

[14] At paragraphs 65.1 and 65.2.

PART B: COMPETITIVE CONDITIONS AT THE WHOLESALE LEVEL

The wholesale market is competitive

59 The Commission made a draft finding that many distributors and dealers have comparatively poor access to information about market prices for wholesale fuel and this reduces their ability to make informed decisions about their wholesale purchases. As a result, the Commission made a draft finding that transparency of pricing at the wholesale level could be improved by instituting a disclosure regime akin to the terminal gate pricing regime in Australia.[15]

60 Z has provided evidence previously that wholesale competition is vigorous and dynamic already. This was supported by other submissions,[16] and in comments at the Commission's conference.[17]

61 Far from being "locked up", the wholesale market has significantly changed over time, and there is no reason to believe that will not continue. For example:

61.1 Distributors were almost non-existent in retail markets as recently as 2009, and now have an approximately 16% share of retail supply, along with a high proportion of planned NTIs.[18] This does not reconcile with an analysis that distributors are subject to restrictions that materially constrain their ability to compete in retail markets.[19] Waitomo has indicated:[20]

> Our view is that, over time, the continued expansion of low-cost distributors like Waitomo, and others such as NPD, will deliver the much-needed price competition and choice consumers want, especially in areas like Wellington and the South Island where motorists are generally paying much more for fuel than the rest of New Zealand. As competition intensifies in these areas, pricing will react accordingly, and consumers will have greater choice about where, and at what price, they buy their fuel. As a result, regional pricing variation will also be eliminated, or at least reduce.

And:[21]

> Access to supply in Wellington and the South Island is not a barrier to entry for us.

61.2 Distributors and other retail market participants have demonstrated their ability to extract competitive terms from midstream participants, and reflect that in their impact on retail competition. This is clear both from their

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15 Draft report, paragraphs 8.26-8.28.

16 BP's submission on the draft report at pages 3, 30-36 and Mobil's submission at page 4.

17 Pages 33 and 35 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019; page 26 of the transcript from Z's confidential session, 27 September 2019.

18 See Z's submission on the preliminary issues paper at paragraphs 9-11 for data on this point.

19 As the Commission noted in chapter 6 of the draft report, specifically at pages 172, 198, 199 and 200.

20 In its submission on the draft report at 2.7.

21 In its submission on the draft report at 2.10.

materially increased and increasing[22] participation in retail markets and Z's observations about their contracting terms over time.[23]

62 Regardless, Z acknowledges the concerns of the public and other stakeholders. The conditions of competition are not obvious to stakeholders, and consequently it is not necessarily clear to those stakeholders that retail prices are set competitively.

63 Z also agrees with the Commission that the conditions of wholesale competition impact retail competition and so are an appropriate area of focus for addressing stakeholder concerns. Z considers TGP, as outlined in the following sections, has the potential to enhance the conditions of wholesale competition and improve stakeholder confidence in the competitiveness of retail fuel prices.

64 In the following sections Z defines TGP, and sets out its views on:

64.1 The benefits that have been identified from the similar regime in Australia.

64.2 The potential benefits that could be captured in New Zealand in a range of industry structures.

64.3 How prices would be constrained under a TGP model.

64.4 Why TGP should be adopted without additional supply chain regulation.

64.5 Why TGP is a better choice than the Commission's alternative proposal.

TGP would enhance competitive conditions and increase confidence in those conditions

What Z means by TGP

65 By TGP Z means, essentially, a similar regime to that in Australia; that is:

65.1 Each supplier of petrol, including premium (95 and 98) and diesel from a terminal would need to publicly post a daily terminal gate price.[24]

65.2 If buyers met operational conditions they would be eligible to buy at the terminal gate at the posted price.

65.3 Suppliers and their customers would be free to negotiate term contracts on a different basis (but in practice this may be referenced to TGP).

65.4 Suppliers could not unreasonably refuse to supply, but a refusal would be reasonable where to supply would affect the ability to service existing contractual commitments.

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[22] As noted in Z's submission on the preliminary issues paper at paragraphs 9-11.

[23] Provided at paragraphs 121-134 of Z's submission on the draft report. See also paragraph 98.1 below.

[24] As to the meaning of "supplier" in this context, see from paragraph 76 below.

66 The Australian regime also contains some price and terms disclosure, and dispute resolution, which could be adapted and/or adopted.[25]

TGP has potential benefits for transparency and the conditions of wholesale competition

67 There have been two significant reviews of the TGP regime in Australia. The first review was carried out in 2008/2009 by The Australian Government Department of Resources, Energy and Tourism (**RET**). Notably:[26]

67.1 The introduction of the TGP regime has been generally well received, with a number of submissions expressing support for the regulations.

67.2 RET found that the transparency created by the TGP regime facilitates greater access to fuel for all industry participants.

67.3 RET found that the TGP arrangements operate effectively in the market and the Oilcode is achieving its objective of improving transparency.

68 RET reported that very few wholesale fuel sales actually occur at the posted TGP.[27] The Australian Institute of Petroleum consider that this is a reflection of the market being relatively short of product, and the consequential desire for industry participants to enter into long-term contracts in order to guarantee reliable supply.[28]

69 The fact that few sales actually occur at TGP does not undermine the value of a TGP regime. In Australia, terminal gate prices are nevertheless accepted and supported by suppliers as the basis for long-term contract pricing.[29] In 2008 the ACCC noted that published TGPs broadly followed actual average wholesale prices, which suggests that published TGPs may be, on average, a reasonable approximation of the actual price of unleaded petrol sold at the wholesale level.[30]

70 Overall, RET considered that the TGP arrangements under the Oilcode provided a greater level of transparency of wholesale fuel pricing than had occurred previously, and publishes a price at which spot sales can occur.[31]

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[25] However, in Z's view the separate aspects of the Australian Oilcode that circumscribe dealer contracting are not appropriate for adoption in New Zealand (see further below from paragraph 111).

[26] Australian Government Department of Resources, Energy and Tourism, *Oilcode Review – Statutory review of the Trade Practices (Industry Codes – Oilcode) Regulations 2006* (May 2009).

[27] Australian Government Department of Resources, Energy and Tourism, *Oilcode Review – Statutory review of the Trade Practices (Industry Codes – Oilcode) Regulations 2006* (May 2009) at page 8.

[28] Australian Government Department of Resources, Energy and Tourism, *Oilcode Review – Statutory review of the Trade Practices (Industry Codes – Oilcode) Regulations 2006* (May 2009) at page 28.

[29] Australian Government Department of Resources, Energy and Tourism, *Oilcode Review – Statutory review of the Trade Practices (Industry Codes – Oilcode) Regulations 2006* (May 2009) at page 28.

[30] ACCC, *Monitoring of the Australian Petroleum Industry – Report of the ACCC into the prices, costs and profits of unleaded petrol in Australia* (December 2008) at page 58.

[31] Australian Government Department of Resources, Energy and Tourism, *Oilcode Review – Statutory review of the Trade Practices (Industry Codes – Oilcode) Regulations 2006* (May 2009) at page 28.

71 RET released a further report on the Oilcode in 2016. The following points emerged from this report:[32]

71.1 Petrol retailers indicated that TGP provides a useful reference price for market participants and should continue to be maintained.

71.2 Industry participants considered the TGP requirements to be a relatively low-cost regulation. The industry is constantly reviewing wholesale prices to reflect changes in global oil prices and movements in the US$/AU$ exchange rate. The cost of implementing TGP is also minimised by posting prices on the Internet. In addition the TGP provides a low cost mechanism for contracts to reflect constantly changing wholesale prices. Stakeholders were of the opinion that, were the Oilcode to be repealed, the industry would likely be faced with another means of wholesale price disclosure which may be more costly.

71.3 The ACCC uses TGP as a benchmark for wholesale prices when monitoring fuel prices to ensure compliance with the Competition and Consumer Act and identify anti-competitive behaviour.

71.4 Overall, the review found that the benefits of the Oilcode outweighed any associated costs, and that it continued to be fit for purpose through facilitating an equitable market environment for petroleum wholesalers and retailers.

72 Z considers there is no reason the same benefits would not be potentially available in New Zealand, including both for transparency and the conditions of wholesale competition.

Potential benefits of TGP can be captured within a range of industry structures

73 Z considers the Commission should recommend TGP for the reasons given above.

74 Z considers the Commission should not recommend further changes in the supply chain as part of implementing TGP, because that would be:

74.1 Unnecessary, given the potential benefits of TGP could be achieved within different industry structures that may exist. In other words, a particular industry structure does not need to be mandated in order for the potential benefits of TGP to be captured.

74.2 Undesirable, given further changes may well lock in an industry structure that is unsuitable now or in the future. In other words, mandating a particular industry structure could prevent efficient, pro-competitive change or evolution.

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[32] Australian Government Department of Resources, Energy and Tourism, *Oilcode Review – Final Report* (May 2016).

75 As the Commission is aware, it is Z's preference that current arrangements do not continue, at least in their current form, as described in the following paragraphs.[33]

76 **[**REDACTED[34]**]**

77 The operation of COLL would not need to change, and COLL would not need to be materially impacted. More detail on the midstream arrangements is provided below (paragraph 85).

78 Z's preferred scenario would capture the benefits of transparency and potential improvements to the conditions of wholesale competition (further detail on price setting is provided in the following section (paragraph 84)). It would also redress the currently weak investment incentives that are part of the current arrangements,[35] and which have an impact regardless of the trajectory of demand:

78.1 Even when demand is stable, borrow and loan participants' incentives to invest in maintenance of their existing network is weakened by the borrow and loan arrangements. That is, when significant capital expenditure is required all capital costs are attributed to the terminal owner, but the operational costs arising where the owner does not invest are incurred by all borrow and loan participants in the form of increased shipping and trucking costs.

78.2 As demand falls (as is predicted over the longer term) these weakened incentives are exacerbated which could result in a disorderly wind-down of terminal investment. In an efficient market the costs created by a terminal closing would be priced into the alternative arrangements that the former terminal owner would have to make.

78.3 In periods of rising demand (which Z does not anticipate occurring to any material extent in the future) borrow and loan participants have an incentive to increase their market share but not invest in terminal capacity to the same extent.[36]

79 That said, as Z has discussed with the Commission, and has considered further since the Commission's conference, its view is that TGP and borrow and loan are not mutually exclusive.[37]

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[33] As canvassed with the Commission previously, the arrangements create only weak investment incentives and, importantly from Z's perspective, are vulnerable to "free-riding" by participants that are under-invested in tankage relative to their market share. See specifically Z's submission on the preliminary issues paper at pages 31-32 and the transcript from Z's meeting with the Commission on 24 July 2019 at pages 4-5.

[REDACTED**]**

[34] **[**REDACTED**]**

[35] As noted in the draft report at paragraphs 5.55 to 5.86; see also pages 2 and 11-15 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019.

[36] This has been explained previously, see the transcript from Z's 24 June 2019 meeting with the Commission at pages 5-10 and 13-14.

[37] See pages 22-27 of the transcript from the Retail Fuel Study Consultation Conference on 25 September 2019 for further detail.

80 Should the current borrow and loan arrangements remain in place below the terminal gate,[38] in the case of tanks within the borrow and loan arrangements terminal gate prices could be posted by all participants, since all participants have a right to draw product from all tanks. In the case of private storage (such as Gull's tanks at Mt Maunganui) prices would be posted by the terminal owner, and any other party to whom the owner offered capacity.

81 In terms of the minimum changes that would be required to the borrow and loan arrangements:

81.1 Z considers the borrow and loan arrangements could in theory continue in materially the same form alongside a TGP regime.

81.2 The main accommodation the borrow and loan arrangements would need to make for TGP would be in relation to demand forecasting for the purposes of driving the shared shipping and informing terminal owners for their planning purposes. A TGP regime would not have any impact on aggregate national demand. However, demand forecasting could become more complex to the extent spot sales become common and terminal gate customers change the ports from which they purchase for delivery to particular areas (as opposed to volumes being sold on contract). As such, the criteria for forecasting may need to change.

81.3 The operation of COLL would not need to change, and COLL would not need to be materially impacted.

82 Neither of these changes would need to be material, particularly since they would involve adjusting the arrangements in order to preserve them. However, if TGP were introduced and borrow and loan remained in place, the transparency and potential wholesale competition benefits of TGP could be captured, but the weak investment incentives in relation to terminals would not be addressed.

83 As a result, the Commission need not be concerned with recommending regulation beyond TGP, as whether or not current arrangements remain in place does not affect the ability for TGP to operate.

Prices would be constrained under a TGP regime

84 Practical constraints on any supplier's pricing power are real, and there would be competitive tension at ports even where all port infrastructure is owned by one market participant. Importantly, competitive tension would operate whether or not borrow and loan arrangements remain in place below the terminal gate. That is:

84.1 **Each midstream participant owns desirable terminal assets:** The Commission has previously found that the midstream participants have a degree of practical dependence on one another's terminal network.[39] This is not sensitive to the particular arrangements that are used to facilitate access to each other's terminals i.e. whether by way of borrow and loan arrangements below the terminal gate, with suppliers uplifting from each others' terminals subject to paying a throughput fee, or by some other system

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[38] Borrow and loan arrangements "above the terminal gate" refer to a terminal owner "borrowing" product when the product is discharged into its tanks. Borrow and loan arrangements "below the terminal gate" refer to participants' right to draw product from any terminal.

[39] See Commerce Commission, *Z/Chevron clearance determination* [2016] NZCC 10 from paragraph 70.

such as purchasing product from the terminal owner (or from one of a number of suppliers) at the terminal gate. That is because the asset owner will in all cases seek a return for the utilisation of its asset, and in seeking that return will be constrained by its own need to use other players' assets elsewhere in the terminal network.

84.2 **Bargaining power of majors protects pricing for distributors:** The bargaining power of the midstream participants protects the bargaining power of the distributors. In other words, a midstream participant would not provide unattractive terminal gate pricing to a distributor because the distributor could seek terms from another midstream participant, and midstream participants all have sufficient bargaining power to secure competitive terms at all ports. Furthermore, as Z has previously submitted, supply of large blocks of volume assists to manage the commercial risks associated with always being committed to substantial minimum output from the refinery and a national distribution network; as such, midstream participants are incentivised to place blocks of volume.

84.3 **Next best alternatives:** Regardless of the above, there would be constraints on the level of terminal gate prices even where a supplier owned all of the terminal infrastructure at a port, provided by customers' next best alternative supply methods. Most relevant is the trucking alternative, which is a more proximate constraint than the Commission has previously acknowledged. Trucking costs should also not be considered in isolation, but rather the entire alternative supply chain to the relevant delivery point should be taken into account (since the costs to ship to terminals differ). For example, at the Commission's conference Mr Bodger of Gull suggested he would be unlikely to lift fuel from Napier and New Plymouth because of his "good terminal" at Mt Maunganui "that's supporting our markets in those areas".[40]

Additionally, as BP has indicated:[41]

> Building bigger terminals and trucking longer distances clearly is a feasible business model. … Equally, the following examples show the cost competitiveness of trucking:
>
> (a) Mobil still chooses to truck to Taranaki despite BPNZ opening a terminal at New Plymouth;
>
> (b) BPNZ chooses to deliver some Invercargill fuel from Dunedin rather than load from Bluff; and
>
> (c) BPNZ sells 98 octane fuel from Mosgiel to Warkworth, despite only having terminal facilities for 98 octane at Mt Maunganui, Wellington and Lyttelton.
>
> Indeed, if BPNZ were to 'start from scratch' in building its network, it would operate from a much smaller number of terminals and make more use of trucking.

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[40] See page 10, lines 6-10 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019.

[41] In its submission on the draft report at 4.16.

Further:[42]

> BPNZ's workings indicate that terminal expansion in a port such as Nelson would cost in the order of four times as much per annum as current trucking activity across all suppliers.

84.4 **Asset utilisation:** There is a strong incentive for infrastructure owners to have their significant investments utilised.[43] Asset owners do not want their assets sitting dormant, as this is not revenue generating.

It would be potentially detrimental to the industry's ability to adapt to future conditions if any particular industry structure were locked in alongside TGP

85 As above, in Z's view, altering or doing away with at least some aspects of borrow and loan would be preferable in terms of the investment incentives at terminals. However, Z considers this should not be mandated; the supply chain would be best left to evolve over time, and importantly, for the reasons given above, doing so would not prevent the adoption of an effective TGP regime.

86 It would be undesirable to recommend regulating for the current borrow and loan arrangements. As above, pricing constraints would operate on terminal gate prices regardless. And in doing so, the Commission would be recommending locking in the weak investment incentives that arise under the current arrangements, which have adverse impacts regardless of the trajectory of demand.

87 It would equally be undesirable to regulate for any particular supply chain structure. It is obvious from the range of views expressed during the market study that predictions about the length and nature of the industry's future vary widely. As such, it would be risky to lock in any particular industry structure by regulating for its existence, and it is not clear it would be possible for industry participants, let alone the Commission or government, to appropriately assess at this stage the optimal industry structure into the future. Instead, the industry should be left as much as possible to adapt to changing conditions over time.[44]

88 TGP would not give rise to any additional hurdles to adapting the supply chain over time to face new challenges. TGP is compatible with adapting:

88.1 To compete with imports. A merchant refinery (including responsibility for coastal shipping – as the Commission is aware while local refining remains viable it makes economic sense to continue a single coastal shipping operation) would in Z's view help the refinery compete against the import

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[42] In its submission on the draft report at 5.6.

[43] See also Z's submission on the Commission's preliminary issues paper at paragraph 42; Z's submission on the Commission's working papers at paragraph 21; pages 9 and 15 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019.

[44] Z also considers it worth noting that if borrow and loan were to be mandated, midstream participants' choices about how to participate in the supply chain would be constrained by regulation, but that would not be the case for other market participants.

alternative, potentially improving the longevity of New Zealand having access to both imported and locally-refined product.[45] **[**REDACTED[46] [47] [48]**]**

Implementing a TGP regime would not make it more difficult to move to a merchant refinery.

88.2 To any reduction in supply chain infrastructure in response to falling demand. Specifically, as noted above, as demand falls over the longer term the incentives to de-commission storage assets should be sheeted home to individual terminal owners. Under current arrangements, higher supply chain costs are "socialised" among the borrow and loan participants - this issue is symmetrical with the incentives issues Z has previously identified and the Commission has acknowledged.[49]

89 In the event the industry structure is left to evolve over time, all midstream participants have an incentive to avoid a higher-cost supply chain. Midstream participants including Z have acknowledged the advantages of a single coastal shipping operation at least while local refining remains acceptably competitive with the import alternative.[50]

90 If a TGP regime was mandated by regulation, suppliers would have an obligation to comply and as such suppliers would be required to make the changes necessary for the regime to operate effectively. Any further desired changes in the supply chain could be agreed at any time, whether before or after implementation (i.e. with the regime already operating).

Entry to COLL would not have additional upsides for competition, and would constrain options for the future competitive conditions of the industry

91 Z understands the other option the Commission has considered involves greater participation in the shared infrastructure arrangements "by enabling an import entrant to add… one or more terminals to the borrow and loan arrangements" and in doing so gain access to COLL's services.[51]

92 As set out above, in principle this is undesirable as it would lock in certain structures and thus limit industry participants' ability to adapt the industry structure over time to take account of changing conditions.

93 But specifically in relation to this proposal, any entrant to the shared infrastructure system would take a share of the cost of COLL. The economics of COLL are linked to the refinery rather than terminals. That is, the underlying purpose of COLL is to service the refinery's output. To that end, the refinery cost structure funds COLL, by theoretically providing for import parity pricing to the terminal (that is, the 30%

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[45] As noted in Z's submission on the draft report at paragraphs 155-162.

[46] **[**REDACTED**]**

[47] **[**REDACTED**]**

[48] **[**REDACTED**]**

[49] As noted in the draft report at paragraphs 5.55 to 5.86; see also pages 2 and 11-15 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019.

[50] See BP's submission on the draft report at paragraphs 5.15 and 5.15, and Mobil's submission on the draft report at page 3.

[51] See pages 15 and 16 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019.

gross refining margin that is available to refinery participants must in part fund the operation of COLL).[52] As such it may well not be cost-effective for a non-refinery participant to join COLL.

94 In Z's view, this proposal would not have any additional benefits for competition compared with TGP as outlined above. At the conference there was no apparent appetite for such an option either, including from existing terminal owners. Gull in particular referred to the benefits of its model that would be undermined by access to the shared infrastructure and COLL arrangements:[53]

> We believe currently we have a very efficient model for distribution, so we bring in what's known as an MR tanker into Mt Maunganui now, we discharge that whole tanker and we send it back to Asia. So that is a one port call, that is a cheaper hire for the ship, more efficient discharge taking all of that fuel off the ship in one go rather than in teaspoons, and you'll find that some of the ports around the country will be draft restricted, so you actually have to download the ship before she comes into that port to discharge fuel. So you get some incremental costs to each of those ports.

95 Gull also noted in its submission on the draft report, "Gull does not see that construction of further infrastructure, nor entering the national B&L system, as effective mechanisms for entry into the South Island market due to the cost and constraints that would pose."[54] Furthermore, no player has so far sought access to the arrangements.[55]

96 There would be some further complexities in this proposal. It would only make sense to allow an entrant to join if the entrant's storage was complementary to the existing network, or contributed capacity to the network that added value overall, rather than simply adding capacity per se.

97 Finally, the scale of investment required for access to shared infrastructure would only be within the reach of few companies i.e. the cost of a new 40ML terminal would be **[**REDACTED**]**. As a result, this proposal is not likely to result in improved competition. By comparison, product at a terminal gate would be available to a wide range of existing and potential market participants, given it requires much less investment (i.e. ownership or contracts to supply a potentially small number of retail sites, and access to secondary distribution).

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[52] See **[**REDACTED**]**. See also BP's submission on the draft report at paragraph 4.18.

[53] See pages 6 and 7 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019.

[54] Page 1.

[55] This point was also supported by BP at the conference – see page 16, lines 18-21 of the conference transcript for day two (25 September 2019).

PART C: DISTRIBUTOR CONTRACTS

Distributor contracts reflect a competitive wholesale market

98 Distributors have bargaining power. As above, supply of large blocks of volume assists to manage the commercial risks associated with always being committed to substantial minimum output from the refinery and a national distribution network. The consequent incentive to bid for distributor business, and the lack of other structural barriers, give distributors options and therefore bargaining power. For example:

98.1 **[**REDACTED**]**

98.2 **[**REDACTED**]** In Z's view, suppliers compete aggressively for large blocks of volume, and do so particularly in response to losses of volume.

TGP augmented by a maximum contract length has the potential to enhance the conditions of wholesale competition

99 Along with a TGP regime, Z has suggested a maximum term of 7 years for contracts with distributors. This term is proposed because it strikes an appropriate balance between providing for commercial certainty and ensuring there are regular opportunities to test the competitiveness of the underlying commercial offer.

100 The benefits of a longer term, including up to at least 7 years, include:

100.1 Ensuring distributors are able to credibly offer security of supply in bidding for longer-term customer arrangements (commercial customer arrangements are often between three and 5 years in length).

100.2 Justifying the significant investment required by a supplier in benefits a distributor may value including business support such as inland fuel terminals, support for point of sale systems, retail specific equipment and operational support such as retail-focused HSSE information.

101 As long as sufficient time is allowed for the purposes above, imposing a maximum contract length would allow distributors to test the market at regular intervals and, ultimately, secure competitive terms of supply.

A "grey list" of terms is unnecessary and potentially detrimental

A grey list is not justified for distributors

102 The considerations that justify a grey list of contract terms in consumer contracts (and potentially small business contracts with a value under $250,000) do not apply in relation to distributors. The relative bargaining power is not comparable given distributors are large and sophisticated businesses that understand their own needs and are able to pay for expert advice to assist them.[56]

103 As above, the evidence of their competitiveness in retail markets (including in competition with their suppliers' brands), and their growth, development and change over time, suggests the market is working for distributors. It is not clear to Z that the Commission has identified a genuine problem in need of a remedy.

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[56] See Z's submission on the draft report at paragraphs 121-126.

The particular terms posited for a grey list are not suitable for such a characterisation

104 The terms posited for a grey list, or for circumscribing terms in some way, are in practice typically justified. In that context specifying terms to be included on such a list could merely increase the administrative burden of negotiating contracts and even limit negotiating tactics or chill pro-competitive deals.

105 As to the specific types of provision in the draft findings:[57]

105.1 **Supplier control over wholesale pricing, and non-transparent pricing:** The competitive outcomes in retail markets suggest wholesale pricing to distributors is competitive. Nevertheless, Z acknowledges stakeholder concerns, and a lack of observability in relation to wholesale pricing from a monitoring perspective. TGP (as outlined above) represents a method of addressing these concerns and facilitating competitive pricing without interfering with freedom of contract[58] in circumstances where the parties are well placed to look after their own interests.

105.2 **Exclusivity:** In Z's view, split supply is available to distributors now. Z considers it would have an incentive (and other midstream participant suppliers would be likely to have a similar incentive) to bid for any large block of volume. As such, there is nothing to stop distributors offering their volumes to the market in any proportions they choose, and obtaining supply on competitive terms.

Furthermore, to the extent better pricing terms are available for larger blocks of volume, mandating split supply (as opposed to distributors being able to use it as a bargaining chip in contract negotiations) could result in worse outcomes for distributors.

It is possible that limiting the maximum length of distributor contracts may make distributors more willing to experiment with split supply, as they would be regularly triggered to review the competitiveness of their terms where they might otherwise not do so on the basis that existing terms are satisfactory. A limited contract length might also incentivise distributors to focus more on, or develop greater expertise in, procurement practices in order to maximise their effectiveness in this regard. In any event, as the Commission acknowledged in its draft report, "without long duration any exclusivity provision is of limited effect".[59]

105.3 **Rights of first refusal:** As above, with a limited term, the effect of any exclusivity provision is limited.

106 Z does not consider its contracts to be unjustifiably restrictive, and maintains the view that distributors are well placed to negotiate contracts that meet their needs.

107 As above, in Z's view a maximum length for distributor contracts (alongside TGP) would be a more appropriate support for the conditions of wholesale competition than a grey list or other means of limiting the terms available to parties, which

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[57] Draft report, paragraph 8.20.

[58] This was a priority outlined by Anna Rawlings at the conference – see page 38, line 14 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019.

[59] Draft report, paragraph 6.55, footnote 471.

would add an administrative burden and may even deter pro-competitive arrangements. It would ensure regular market testing, to provide greater confidence in the competitiveness of contractual terms, without compromising commercial flexibility and freedom of contract more widely.

108 Z endorses the Commission's acknowledgement at the conference of the need in attempting to address contracting issues to be fair to all participants and ensure a level playing field.[60]

Pricing varies between commercial customers and distributors

109 Z and others discussed at the conference a perception distributors are paying more than commercial customers for similar volume deals. Z provided a more complete response to this point in its confidential response to the Commission's questions of 9 July 2019.[61]

110 As above, Z considers distributors have been able to obtain competitive terms for their supply. To the extent the Commission wishes to test that view, Z considers more transparent pricing, along with ensuring distributor contracts are regularly brought to market, would help improve confidence in the competitiveness of terms, and potentially enhance the conditions of wholesale supply.

Dealer terms

111 As the Commission has acknowledged, dealers should not be treated the same as distributors. Dealer-owned sites can be an important feature of a particular operating model and, although it is of course important contracts with dealers are fair and pro-competitive, individual dealer-owned sites switching suppliers has generally not be a strong driver of wholesale competition.

112 In Z's view there is no competition or other problem to be solved in relation to dealer contracts. As Z has indicated previously,[62] dealers have bargaining power, negotiate collectively and take legal advice.

113 As such, a grey list, or dealer contracting restrictions along the lines set out in the Australian Oilcode, are not necessary or appropriate for adoption in New Zealand. Such requirements are at odds with Z's observations of the sophistication of dealer business owners, and their ability to obtain satisfactory terms.

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60 See page 38, lines 26-32 of the transcript from the Retail Fuel Study Consultation Conference, 25 September 2019.

61 **[**REDACTED**]**

62 At paragraphs 121-134 of Z's submission on the draft report.

PART D: RETAIL PRICE AND PRODUCT OFFER

Price boards

114 Z reiterates its support in the September submission of a recommendation (and, if necessary, a requirement in the oil code that implements terminal gate pricing) to require firms to display premium petrol prices on price boards.

115 In its September submission Z also supported a recommendation requiring firms to display post-discount prices on price boards. After the substantial discussion at the conference, Z now considers mandating post-discount prices on boards is not appropriate. While Z considers its post-discount prices on price boards are simple and easy to understand, this is not necessarily the case for other offers in the market, and moreover in Z's view displaying post-discount prices is not necessary for customers to understand a supplier's offer.

116 Concerns about complexity and possible confusion do not apply to the display of premium prices on price boards. As per Z's September submission, Z agrees with the Commission that requiring the display of premium prices alongside regular petrol prices on price boards would aid price comparability and transparency. Consumers are able to quickly isolate the fuel grade they require and ignore irrelevant information. Consumers already distinguish between diesel, regular and in some cases premium prices on price boards.

117 Z reiterates the need for recommendations requiring all firms to display premium prices on price boards. Industry-wide uptake is critical to maximise their potential effectiveness and ensure transparency.

Monitoring

118 Z reiterates its support for a transparent monitoring regime aimed at enabling MBIE to effectively monitor the retail fuel market. A full and effective solution would enable MBIE to monitor prices and accurately assess retail margins each month (taking into account prices, discounts and importer costs for the same period). A more detailed description of Z's proposal was set out from paragraph 87 of Z's September submission on the draft report.

APPENDIX 1: Z WORKINGS ON ROACE, EARNINGS AND CAPITAL EMPLOYED

ROACE: Z's recommended approach and the Commission's adjusted approach

$m	FY16	FY17	FY18	FY19	1H FY20[1,2]
Z's recommended approach to ROACE					
Earnings	181	245	267	235	
Average capital employed	1,517	2,096	2,687	2,772	
Z's recommended approach to ROACE	11.9%	11.7%	9.9%	8.5%	
The Commission's adjusted approach to ROACE					
Earnings	202	308	339	259	
Average capital employed	1,053	1,264	1,445	1,503	
The Commission's adjusted approach to ROACE	19.2%	24.3%	23.4%	17.2%	

[1] earnings are for the 12 months to 30 September 2019; average capital employed calculated using the balances as at 1H FY19 and 1H FY20

Z's recommended approach to ROACE

$m	FY15	FY16	FY17	FY18	FY19
Earnings					
RC NPBT		189	252	284	239
Add: lease expense		30	31	34	36
Add: net interest expense		32	56	52	51
Total RC NPBT plus lease and interest expense		**251**	**340**	**370**	**326**
Less: tax		(70)	(95)	(104)	(91)
Total net operating profit after tax		**181**	**245**	**267**	**235**
Capital employed					
Total assets (incl. right-of-use lease assets)	1,598	1,620	2,755	3,087	3,129
Less: derivative financial instrument assets	(9)	(19)	(9)	(9)	(27)
Add: fair value adjustment for terminal assets	118	119	149	149	149
Add: D and R provision	26	37	50	47	68
Adjusted total assets	**1,734**	**1,757**	**2,946**	**3,274**	**3,320**
Current liabilities	(368)	(440)	(534)	(950)	(866)
Add: short-term borrowings	-	147	51	150	135
Add: current liability derivative financial instruments	6	9	10	17	13
Add: accounts payable related to inventory	113	75	172	238	214
Less: adjusted current liabilities	**(248)**	**(209)**	**(301)**	**(545)**	**(505)**
Capital employed	**1,485**	**1,548**	**2,645**	**2,729**	**2,815**
ROACE		11.9%	11.7%	9.9%	8.5%

Earnings reconciliation

$m	FY16	FY17	FY18	FY19
RC NPBT	189	252	284	239
Add: lease expense	30	31	34	36
Add: net interest expense	32	56	52	51
Total RC NPBT plus lease and interest expense	**251**	**340**	**370**	**326**
Less: tax	(70)	(95)	(104)	(91)
Z's recommended approach to earnings	**181**	**245**	**267**	**235**
Less: tax-adjusted lease expense	(22)	(22)	(24)	(26)
Add: difference between HC and RC NPAT	(72)	61	58	14
Less: tax-adjusted financing fees and other finance expense	(6)	(8)	(6)	(5)
Benchmark companies approach to earnings	**81**	**276**	**295**	**218**
Add: amortisation of contracts acquired	-	19	23	23
Add: PPE revaluations	115	5	15	13
Add: tax-adjusted financing fees and other finance expenses	6	8	6	5
The Commission's adjusted approach to earnings	**202**	**308**	**339**	**259**

Capital employed reconciliation

$m	FY15	FY16	FY17	FY18	FY19
Z's recommended approach to CE	**1,485**	**1,548**	**2,645**	**2,729**	**2,815**
Less: accounts payable related to inventory	(113)	(75)	(172)	(238)	(214)
Less: fair value adjustment of terminal assets	(118)	(119)	(149)	(149)	(149)
Less: D+R provision asset	(26)	(37)	(50)	(47)	(68)
Less: right-of-use (lease) assets	(226)	(226)	(282)	(282)	(282)
Less: goodwill	-	-	(158)	(158)	(193)
Add: other capital employed changes	3	10	(0)	(8)	14
Benchmark companies approach to CE	**1,005**	**1,101**	**1,833**	**1,847**	**1,923**
Less: Caltex supply and Flick contracts intangibles	-	-	(407)	(384)	(380)
The Commission's adjusted approach to CE	**1,005**	**1,101**	**1,426**	**1,463**	**1,543**