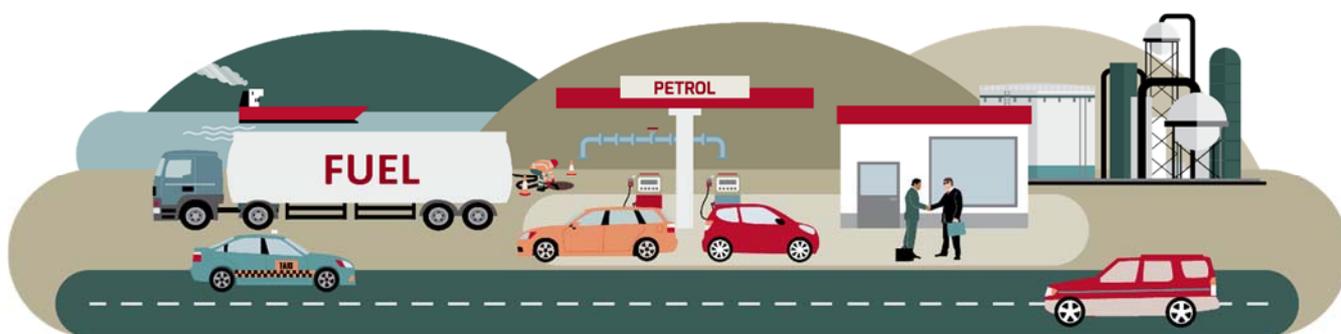


Market study into the retail fuel sector

Draft report – Executive summary

Date of publication: 20 August 2019



Associated documents

Publication date	Reference	Title
12 December 2018	ISBN 978-1-869456-74-0	Draft market studies guidelines
12 December 2018	ISBN 978-1-869456-75-7	Market Study into the Retail Fuel Sector – Statement of Process: Our intended process and how you can contribute
31 January 2019	ISBN 978-1-869456-81-8	Market study into the retail fuel sector: Invitation to comment on preliminary issues
18 April 2019	ISBN 978-1-869456-92-4	Market Study into the Retail Fuel Sector: Working paper – Focus areas
18 April 2019	ISBN 978-1-869456-91-7	Market Study into the Retail Fuel Sector: Working paper on assessing profitability

Commerce Commission
Wellington, New Zealand

Executive summary

Purpose of this paper

- X1 This report sets out the preliminary findings of our study of the New Zealand retail fuel market. The study considers factors that may affect competition for the supply of retail petrol and diesel used for land transport throughout New Zealand, whether competition to supply retail petrol and diesel is functioning well for consumers, and if not, how it could be improved.
- X2 Fuel is an essential purchase for many New Zealanders. Motor transport plays a key role in our day-to-day lives; getting us to work, school and away on holiday. Money spent on petrol and diesel can be a significant proportion of household and company bills.
- X3 Roughly 3.2 billion litres of petrol and 3.6 billion litres of diesel are consumed annually in New Zealand. Fuel purchased at service stations and truck stops accounts for about 98% of the petrol and 73% of the diesel consumed, at an annual cost of more than \$10 billion.
- X4 Petrol and diesel prices have attracted considerable public attention recently. Concerns have been raised about whether New Zealanders are getting a fair deal at the pump. Public interest in fuel prices prompted the Minister of Commerce and Consumer Affairs to ask us to undertake this study.
- X5 The study looks at a range of outcomes that we would expect to see in a market that is working well for consumers over the long term. These include the choices available to consumers, the quality of the fuel and services on offer as well as levels of investment, innovation and profitability.
- X6 New Zealand consumers pay relatively high prices for petrol and diesel. In the March 2019 quarter, New Zealand had the third highest pre-tax premium petrol and diesel prices in the OECD.
- X7 The price consumers pay at the pump is affected by a range of factors, including the global crude oil price, the level of the New Zealand dollar, taxes and changes in fuel company operating and distribution costs.
- X8 Whether consumers consider fuel prices to be high or low does not necessarily mean the market is, or is not, workably competitive. When it comes to price and profitability, an important outcome in a workably competitive fuel market is that both will tend to reflect normal rates of return over time, after covering supply costs.

- X9 In the study we are not concerned with short-term profits, which can be high for many reasons, including strong performance. They are not necessarily indicative of competition concerns. Rather, we are focused on longer term profitability and whether this is persistently high, as that could suggest prices are 'too high' and competition is not working as well as it could.
- X10 We currently consider that many fuel companies appear to be achieving a level of profitability in New Zealand that is persistently higher than what we estimate a reasonable return would be in a workably competitive market.
- X11 We have identified several factors we consider are hindering competition and contributing to these high returns. The core problem, in our view, is that an active wholesale market does not exist in New Zealand. This is weakening price competition in the retail market.
- X12 There are two interrelated factors we consider are affecting wholesale competition:
- X12.1 Z Energy, BP and Mobil's (the majors) joint infrastructure network gives them an advantage over current and potential fuel-importing rivals, who face higher costs to enter the market; and
- X12.2 Wholesale supply relationships, including contractual terms, between the majors and their resellers reduce competition and limit resellers' ability to switch supplier.
- X13 The combination of infrastructure sharing arrangements and supply relationships has helped to prevent rival fuel importers from entering the market or competing more vigorously against Z Energy, BP and Mobil. In addition, these same three firms have limited incentive to compete strongly against each other on price at either the wholesale or retail level.
- X14 New Zealand's only other fuel importer, Gull, has succeeded in entering some North Island retail markets and will shortly open its first South Island retail site. It has had a positive impact in reducing prices for consumers in some areas where it operates. However, it is also incentivised to maximise its own profits and can do so by setting its prices beneath the majors' average retail prices, without the threat of further competition driving prices down.
- X15 We have outlined some potential options that we consider could improve competition and outcomes for New Zealand consumers and discussed how they might be pursued. Ideally, the design and implementation of any changes would involve input from the industry. However, we also outline potential options for more direct government intervention that could improve competition outcomes.
- X16 Our findings and recommendations are preliminary at this stage. We are now seeking comment on these.

- X17 We will consider this feedback when preparing our final report. The final report will be delivered to the Minister by December 2019, who will then decide how to respond to our findings and recommendations.

Market context

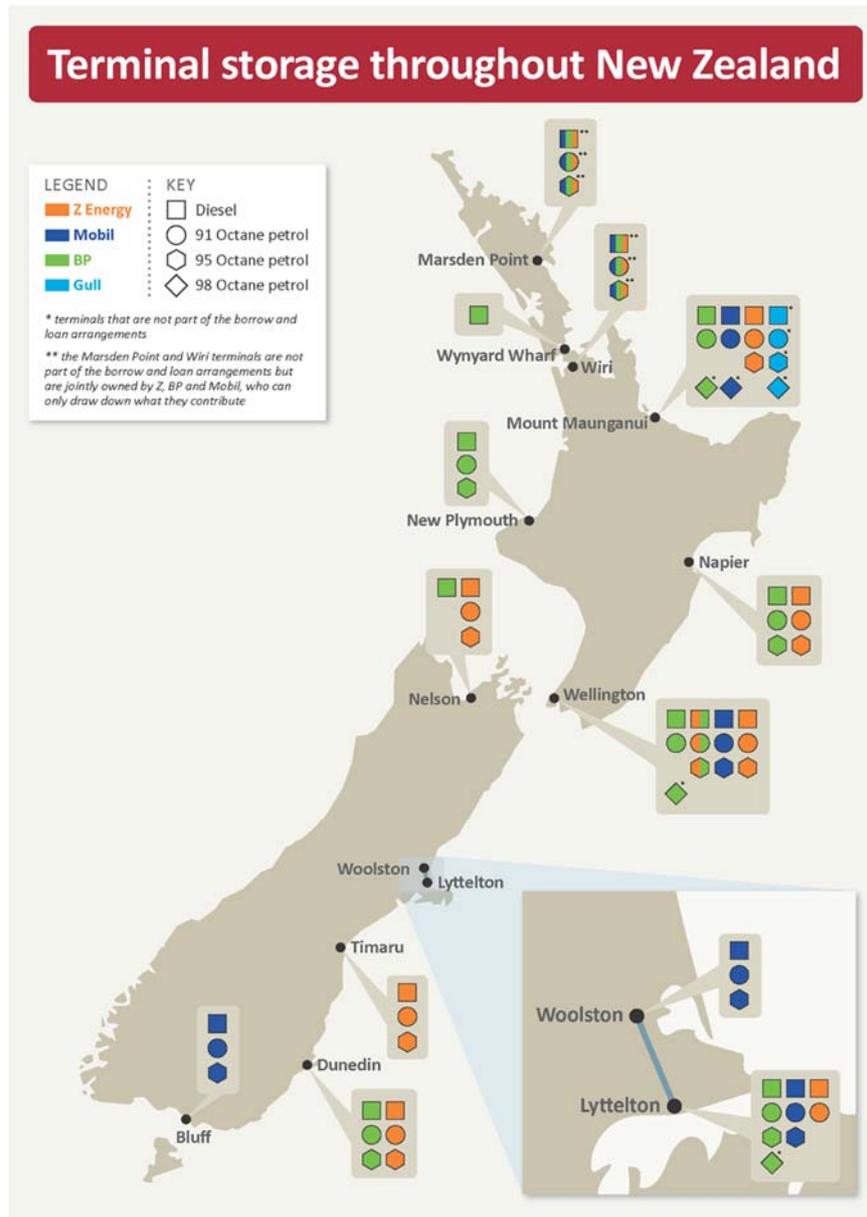
- X18 The competition issues affecting retail fuel prices in New Zealand have their historical origins in a time of government funded infrastructure and regulated wholesale pricing.
- X19 Prior to 1988, the wholesale price of fuel was regulated with the aim of providing a 13% return to importers. These importers – BP, Mobil, Caltex and Shell – were prohibited from being retailers and instead supplied fuel to independent retail sites at regulated prices.
- X20 To reduce costs and maximise production and distribution efficiencies, importers set up a series of joint ventures that enabled them to share key infrastructure assets. This included the construction of the Marsden Point refinery in the 1960s and the creation of a coastal shipping network to transport refined fuel to shared terminals at regional ports.
- X21 When the fuel industry was deregulated in 1988, the majors immediately entered the retail market, buying prominent retail sites of their own and securing long-term supply contracts with independent retailers.
- X22 The result was that the majors each became effectively vertically integrated, ending most wholesale competition. They also continued to benefit from the cost efficiencies of their infrastructure sharing agreements, which have largely continued unaltered since deregulation.

New Zealand fuel industry today

- X23 The fundamental structure of the New Zealand fuel industry has not materially changed in the past 30 years, though the number of companies and their respective influences has.
- X24 There are currently four companies that import fuel into New Zealand.
- X25 Z Energy, BP and Mobil each import crude oil to be refined at Marsden Point, which produces approximately 58% of the petrol and 67% of the diesel used in New Zealand. From here it is transported either by pipeline – to service Auckland and Waikato – or by coastal shipping to the companies' storage terminals at regional ports.
- X26 These three companies also import refined fuel to their terminals in Mt Maunganui, Wellington and Lyttelton. Together, they control over 90% of the fuel supplied to New Zealand consumers.

- X27 Gull is the only other importer of fuel and is not party to any of the infrastructure sharing agreements that exist between Z Energy, BP and Mobil. Gull imports all of its fuel into its Mt Maunganui terminal and from there trucks it to its North Island retail outlets.

Figure X1 Terminal storage throughout New Zealand¹



- X28 Currently, retail consumption is a near even split between petrol and diesel. Premium petrol (95 and 98 octane) makes up about 23 percent of total petrol consumption.

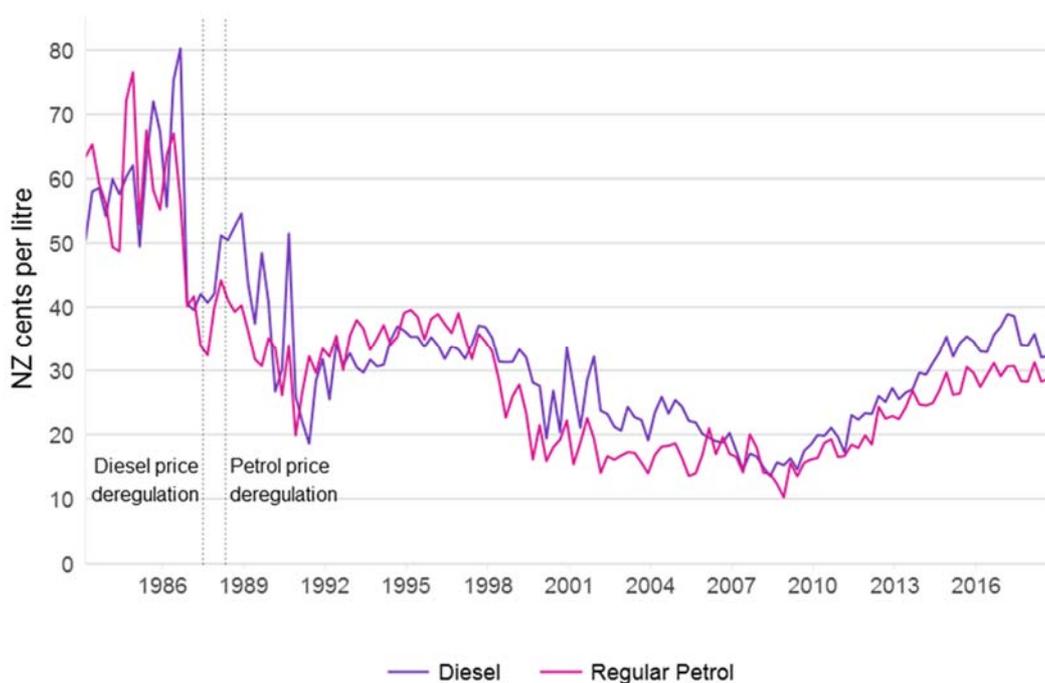
¹ In addition, Z Energy has a small amount of private storage of B100 (bio-diesel) at its plant in Wiri, the Wiri terminal and at its Mt Maunganui terminal. Z Energy currently operates no other private storage.

- X29 Collectively, Z Energy, BP, Mobil and Gull control the supply of fuel to more than 1,300 retail sites under 20 different retail brands, either directly or indirectly through a distributor or reseller.
- X30 While approximately 65% of retail sites are operated under non-major brands, these sites only accounted for 20% of fuel volumes sold as at March 2019.
- X31 Gull will also shortly enter the South Island market, in addition to a new importer – Timaru Oil Services Limited (TOSL) – that is currently building terminal storage at the Port of Timaru with the aim of commencing trading from 2020.

Rising fuel margins

- X32 Following deregulation, importer margins initially fell before rising again until Gull and Challenge entered the market in the late 1990s. As shown below, margins were then on a downward trend until around 2008. Shell exited the market in 2010, selling its assets to the newly created Z Energy. Margins have trended up ever since.

Figure X2 Quarterly regular petrol and diesel importer margin (real Dec 2018 prices)



Source: MBIE (2019)²

- X33 When Z Energy purchased Shell it publicly stated its intention to increase retail fuel margins and deliver a higher quality customer experience.

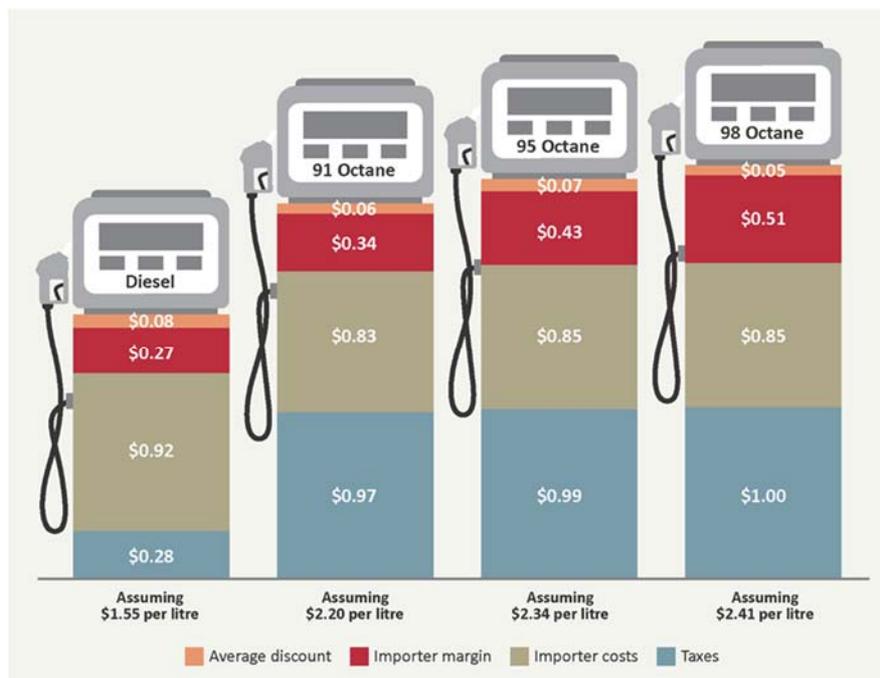
² MBIE <https://www.mbie.govt.nz/building-and-energy/energy-and-natural-resources/energy-statistics-and-modelling/energy-statistics/weekly-fuel-price-monitoring/>.

- X34 The majors consider the margins at that time were not sustainable, or at least not sufficient to attract investment, which is reflected in submissions to us on this study. Shell's desire to compete on price to drive volumes can help explain these low margins prior to it exiting New Zealand.
- X35 Z Energy adopted a strategy where it was comfortable losing some market share in order to increase margins, which it argued would enable it to invest further in its retail network. This strategy was successful and as a result the price of petrol and diesel increased as gross margins grew.
- X36 After a period of comparatively low margins, BP and Mobil effectively followed Z Energy's lead, while Gull sat beneath the price umbrella the major companies created and focused on delivering a slightly lower frills price offering to increase its market share.
- X37 Prices and margins subsequently rose to a point where retail fuel prices, expressed on a pre-tax basis, were among the highest in the OECD and higher than in some Pacific Island nations.

Retail price components

- X38 While most headline fuel prices are openly advertised on service station price boards for consumers to see, the wholesale price of fuel is not easily observed. However, we can break down retail fuel prices to show the components that make it up – government taxes, the cost of the fuel itself and the gross margin importers earn (which includes domestic operating costs as well as profit). We also calculated the average discount consumers claimed at the counter.

Figure X3 Estimated components of the board price of fuel (1 July 2018 – 31 December 2018)



Source: Commerce Commission analysis of data provided by industry participants.

- X39 The graphic above shows that in the second half of 2018 the average board price for a litre of regular petrol (91 octane) was \$2.20 and the average discount was 6 cents. Taxes accounted for roughly 97 cents a litre and the estimated cost of fuel was 83 cents, leaving 34 cents as the gross margin for importers. It also shows that the average gross margin was higher for diesel and premium fuels in percentage terms.
- X40 The breakdown outlined is the national average. The gross margins importers earn on any given litre of fuel will vary by region.
- X41 By comparison, in December 2018 the average price of a litre of regular petrol in Australia was NZD\$1.56 (estimated at 98 cents pre-tax), including a gross margin of 24 cents.

Fuel market outcomes

- X42 Fuel companies have made several innovations in the retail market that they compete over, such as fast lanes, coffee ordering apps, improved service and better equipped convenience stores. Improvements in pay-at-the-pump technology are also lowering the cost of entry for retailers wanting to offer a basic service to price-sensitive consumers. These developments can offer benefits to consumers.
- X43 However, we currently consider price competition in the retail fuel market is not working as well as it could be for consumers. Our reasons for this are:
- X43.1 fuel companies appear to have been making persistently high profits over the last decade;
 - X43.2 regional differences in retail fuel prices are not all explained by cost differences;
 - X43.3 discounting does not compensate for higher pump prices; and
 - X43.4 there is an increasing price difference between regular and premium petrol.
- X44 Each of these concerns is explained in more detail below.

High prices and persistently high profitability

- X45 There are a range of indicators that in our view suggest the profitability of New Zealand fuel companies is high. These include:
- X45.1 Import margins more than doubling since 2008;
 - X45.2 Fuel company returns on new investment are averaging 20% per annum over the past 5 years, well above our estimate of a reasonable return (6.9 - 8.6%) and international comparator companies (less than 10%);

- X45.3 New retail sites often exceed the company's own profitability expectations, with some achieving unusually fast pay back on investment for what are long-lived assets; and
- X45.4 Ratios of fuel firms' market value (sale price or sharemarket value) to replacement cost (value of its assets) are approximately 1.5 - 1.8, meaning they are valued significantly higher than their physical operation costs to build. We would expect values closer to 1 in a workably competitive market.
- X46 A number of the profitability measures we refer to have a broader focus than the retail fuel market alone and have some limitations. These are discussed in more detail in our profitability analysis, which is attached to this draft report.
- X47 High profitability is also reflected in the fact that the number of retail sites is growing faster than the volume of fuel sold. For example, in a May 2019 presentation Z Energy stated that 35 new sites had been built, growing capacity by 2% in a market where petrol sales declined by 1.5%.³
- X48 By implication, the average volume of fuel sold at each site is declining slightly, yet firms on average expect to generate strong profits on new investment. The interpretation would seem to be that the high returns expected are attributable to high margins, and not new investment growing volumes.
- X49 Commentary in internal fuel firm documents we reviewed indicates firms have been aware that margins were high enough to interest new entrants since around 2012 or 2013. These same documents also noted that entry would be difficult due to the cost involved in building a network in New Zealand.
- X50 Nevertheless, it is likely that high industry profitability has attracted some entry and expansion in the retail market. Gull and other relatively low-priced retailers such as Allied, NPD and Waitomo have grown their retail presence, primarily through unmanned sites offering lower prices than the majors. As noted earlier, TOSL intends to shortly enter the South Island market.
- X51 However, this entry and expansion does not appear to have materially reduced the profits observed across the fuel industry. There is no clear trend towards more competitive levels.
- X52 The majors and financial market analysts expect profitability to remain high, with internal documents we saw indicating firms expect to maintain or grow returns in the next few years.

³ Z Energy "2019 Results Presentation For the year ended 31 March 2019" (2 May 2019) at p.6. Z's submission to us on the preliminary issues paper made a similar point using data from 2016. See, Z Energy "Market Study into the Retail Fuel Sector: Z Energy's Response to Invitation to Comment on Preliminary Issues", para 12.

- X53 The expected persistence of high margins and profit growth is a strong indication that competition is not working well to bring profitability to a more competitive or 'normal' level.
- X54 It is worth noting that while most fuel companies in New Zealand are profitable, some retail sites owned by individual dealers are not. Certain dealer-owned sites operate on relatively slim margins compared to the majors that supply them.

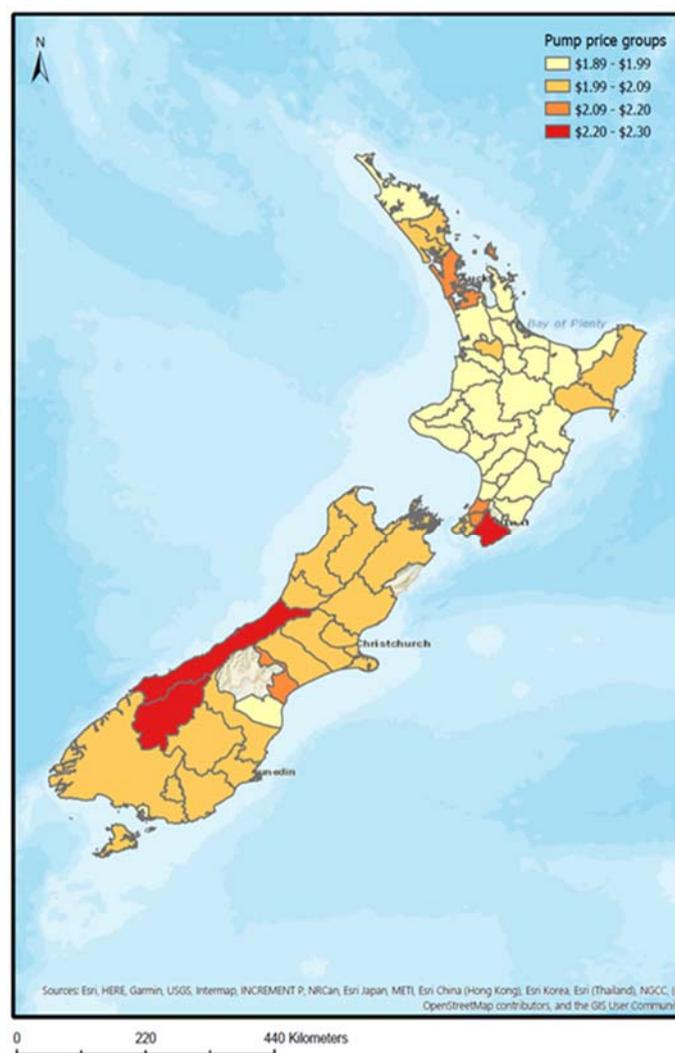
Regional differences in retail fuel prices

- X55 It is well known that there are material variations in fuel prices between regions and locations. In some cases, regional price differences can be at least partly explained by differences in cost or taxes. For example:

X55.1 The West Coast of the South Island has some of the highest prices in the country. There is no storage terminal on the West Coast, so fuel needs to be trucked long distances from other terminals (at relatively high cost); and

X55.2 Auckland prices are subject to the regional fuel tax introduced in 2018.

Figure X4 Average retail pump prices across New Zealand (2019)



- X56 In many cases regional price differences reflect differences in competitive conditions. For example, prices are generally higher in Wellington than Masterton, although it is more expensive to truck fuel to Masterton from Wellington harbour. This may be explained by Gull having a service station in Masterton, but not currently operating in Wellington.
- X57 The fact that all fuel sold in the South Island originates from the majors also appears to be linked to weaker price competition (without Gull) and therefore higher prices.
- X58 Prices in Wellington and the South Island may reduce in the future if comparatively low-priced retailers expand into these areas and TOSL's entry in Timaru is successful.

Discounting is not a substitute for more generalised price competition

- X59 Discount and loyalty programmes like AA Smartfuel, Z Energy's Pumped and Mobil Smiles, as well as supermarket dockets, are a prominent feature of New Zealand's retail market.
- X60 In 2018 over 41% of petrol and diesel sales were made at a discount to the advertised pump price. This has risen from 22% since 2011. The average size of the discounts offered has also increased from 2 cents to 11 cents per litre for petrol and from 2 cents to 16 cents per litre for diesel over this period.
- X61 The majors have submitted that this is a sign of strong retail competition and we accept that they do actively compete on discount offerings.
- X62 However, in our view, discounting is a poor substitute for more generalised price competition. We note that as importer margins have increased over the last decade, discounting has also increased. We currently consider the reverse trend would also occur. If board price competition was stronger, margins could be lower, there would be less discounting and all consumers could benefit from lower prices.
- X63 In addition to these broad trends, analysis of specific changes in discounts suggests that over the period 2016-2019, changes in discount size (measured in cents per litre) are associated with slight changes in the advertised board price in the same direction. Over this period a 10 cent per litre increase in discounts is associated with an estimated pump price increase of:
- X63.1 1 cent to 2.7 cents for 91-octane petrol; and
- X63.2 2.4 cents to 4.9 cents for diesel.
- X64 Discounting can in effect 'sort' or discriminate between customers who claim discounts and those who do not. Some consumers may be excluded from discount offers due to the criteria in place, such as the minimum spend required to trigger the discount at certain fuel retailers.

- X65 Discount programmes can also shift consumer focus away from the actual net price they pay to the size of the discount or reward, particularly if the price is not displayed. Further, they can make it more difficult for consumers to compare post-discount prices between retailers and understand which one is offering the lowest actual price. As a result, consumers in a discount programme may be less likely to switch retailers in response to an increase in the price at the pump.
- X66 What this means in practice is that a large proportion of total consumer demand may not regularly be imposing a price discipline on retailers. Retailers' volumes may be less affected by a rise in pump price than they would be without these discount programmes.

Commercial fuel cards

- X67 Although the study is focused on the retail market, sales to commercial fuel card holders – typically small and medium-sized businesses – account for about a quarter of volumes at retail sites.
- X68 Fuel cards can deliver significant benefits to buyers by enabling them to receive a single bill at the end of the month, place limits on purchases made (for example, fuel can only be purchased during certain hours), and receive discounts off pump prices.
- X69 However, these benefits may come at the cost of softening price competition in a similar way to consumer discount schemes.
- X70 Fuel cards are valuable to retailers as they provide a steady base of buyers who are relatively indifferent to the pump price at the site they obtain their fuel.
- X71 Fuel card holders are known as 'sticky' customers and are unlikely to shop around in response to a short-term price rise, as they may be more focused on the benefits they consider their card offers them. This again means there is likely to be a valuable section of fuel buyers that retailers know they do not need to attract by competing on board price.
- X72 We also consider fuel cards may soften competition by reinforcing the majors' control of their supply chains, which is discussed further below.

Premium petrol margins

- X73 Premium petrol, which is retailed at higher prices and margins than regular petrol, may also be contributing to high industry profitability.
- X74 Premium (95 and 98 octane) petrol prices currently tend to be about 13-15 cents above the price of regular (91 octane) petrol, after accounting for discounts. The difference was about 7-8 cents in 2011. This has meant the premium petrol margin has increased faster than regular petrol.
- X75 Based on the evidence we have seen, the extra margin fuel companies are earning on this product does not reflect actual cost differences between premium and regular petrol.

- X76 It is more likely due to premium petrol prices seldom being displayed on service station price boards, making it difficult for consumers to compare prices. Premium petrol consumers may also be less price sensitive. In addition, fewer retailers sell 95 and 98 octane petrol, reducing competition for those that do.
- X77 We also consider that some consumers may be purchasing premium petrol unnecessarily, potentially due to a lack of understanding about whether it is needed for their car.

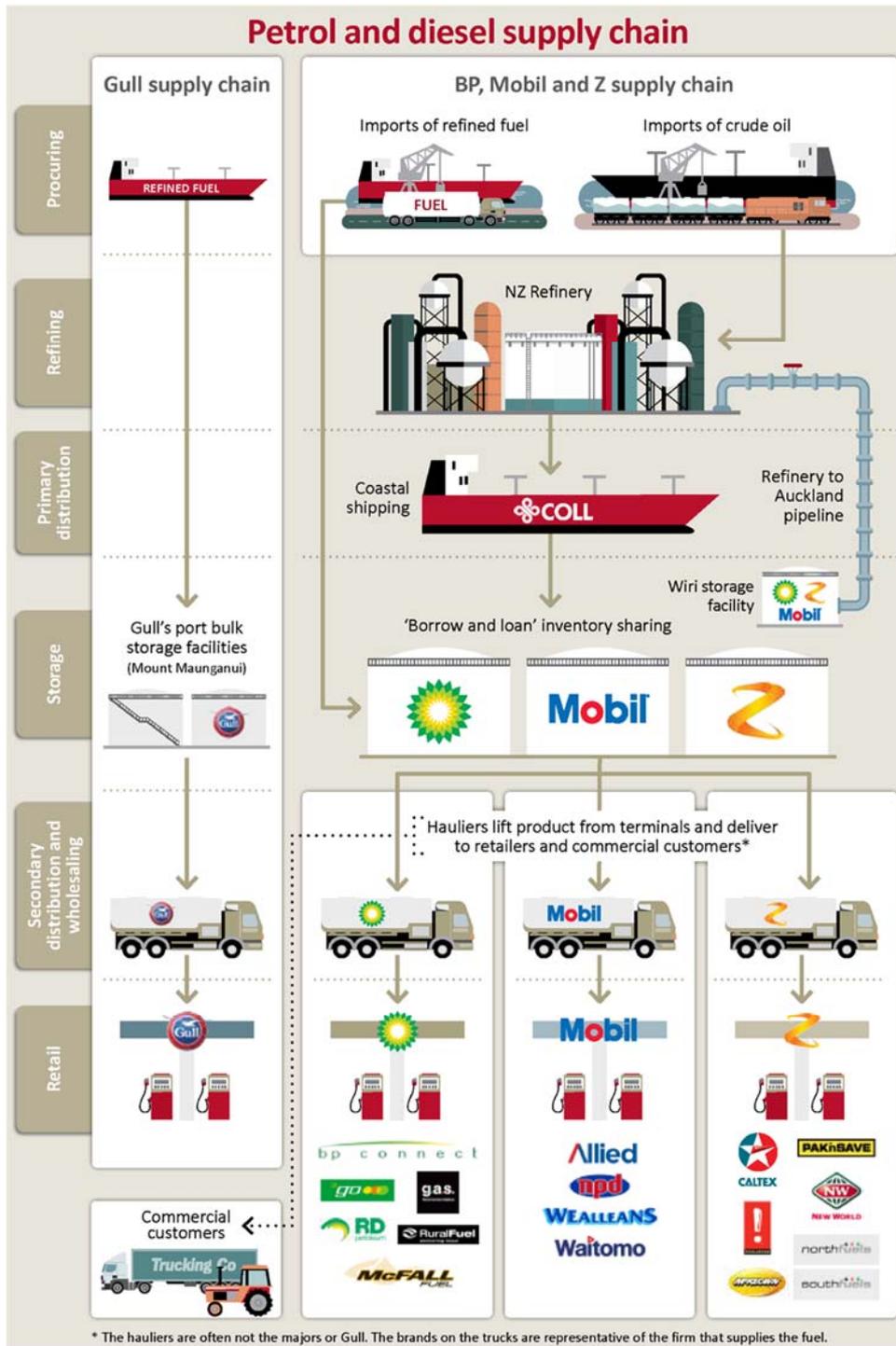
Causes of these outcomes

- X78 We believe the market observations outlined above are largely symptoms of issues further up the supply chain.
- X79 New Zealand is a lightly populated country located some distance from the major global sources of imported crude oil and refined fuel. This impacts directly on the price we pay for petrol and diesel, however it does not account for the persistently high profitability of our fuel companies.
- X80 The core problem, in our view, is that an active wholesale market does not exist in New Zealand. The majors' cost advantages and vertically integrated networks, combined with their wholesale supply relationships, have removed the scope for aggressive price competition at the wholesale level. This is where we would normally expect to see strong competition given the large volumes resellers are prepared to purchase.
- X81 Without an effective wholesale market, price competition is largely limited to retail markets, where it is inconsistent across regions. The absence of wholesale competition also appears to have had the effect of setting a minimum price level above which retail price competition can occur.
- X82 While resellers can and do offer petrol and diesel prices below the majors and Gull, primarily by offering low cost service offerings like unmanned, pay-at-the-pump stations, there is a limit to the price competition they can offer. This is dictated by the wholesale price they pay their suppliers.
- X83 The profit level the majors have built into their wholesale pricing is therefore currently protected and retail profits can also be extracted where they face limited competition.
- X84 There are two interrelated factors we consider are affecting wholesale competition:
- X84.1 The majors' joint infrastructure network gives them an advantage over current and potential fuel-importing rivals, who face higher costs to enter the market; and
- X84.2 Wholesale supply relationships, including contractual terms, between the majors and their resellers reduce competition and limit resellers' ability to switch supplier.

Infrastructure sharing and effects on competition

X85 The majors have overcome some of the challenges associated with delivering fuel to New Zealand consumers by sharing key infrastructure. This includes a complex mix of interrelated arrangements covering everything from the processing of crude oil, coordinated scheduling of distribution of refined fuel by pipeline and coastal shipping vessels, and access to nation-wide fuel inventory through shared terminal storage facilities under the 'borrow and loan' system.

Figure X5 The petrol and diesel supply chain



- X86 By combining their resources in this way, the majors have reduced their costs of supply compared to any rival importers that need to establish separate stand-alone supply chains.
- X87 While there are terms and criteria under which a rival importer may join any of the infrastructure sharing agreements, this has never happened. In reality, these terms are untested, the majors appear to have considerable discretion on allowing access and the process and criteria for applying for access are not made readily available.
- X88 Without access to aspects of these shared arrangements, and with existing resellers committed to restrictive wholesale supply agreements (discussed further below), fuel importers seeking to enter the New Zealand market face significant barriers.
- X89 The investment required includes securing land and tankage for terminal storage at a suitable port, many of which are not equipped to handle fully-laden fuel tankers. From there, a new importer must truck its fuel to a network of retail sites on suitable land, with required consents and appropriate facilities. While it is possible that existing resellers could be persuaded to switch to a new importer for their wholesale supply, this has not occurred in New Zealand post-deregulation.
- X90 The majors, by comparison, are able to transport fuel refined at Marsden Point, which is cheaper than imported refined fuel, via pipeline to our largest market, Auckland, at a cost no rival importer can currently achieve. They are also able to limit their use of comparatively expensive trucking costs through their coastal shipping network.
- X91 Their control of these key assets through the supply chain enables them to supply fuel at a cost that is likely to always be lower than the cost facing a new competitor.
- X92 While the majors' joint supply chain has some pro-competitive effects, such as enabling them to compete where they do not have their own terminals, the inherent cost savings do not appear to be flowing through to lower prices for consumers. This is seen, for example, in the South Island where retail prices and gross margins are generally higher even at sites located close to coastal terminals.

Refinery allocation

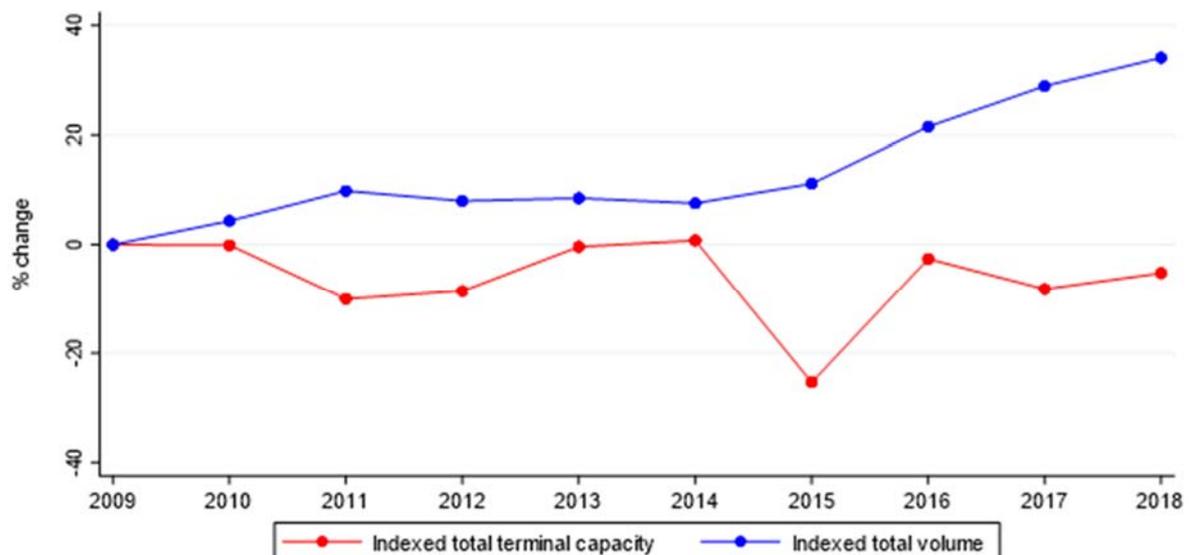
- X93 We also consider that current refinery arrangements may be limiting competition between the majors. Capacity at the refinery is currently allocated based on a three-year average of market shares. This means there is a significant lag before an increase in market share flows through to greater refinery allocation, and the need for such a time delay is currently unexplained in the study.
- X94 If a major wants to grow its market share it would initially need to import more refined fuel to meet increased demand. This is likely to lead to a cost disadvantage in the short term, particularly in the Auckland market which receives fuel directly from the refinery via pipeline.

X95 Further, the refinery allocation and borrow and loan arrangements currently require that information on past and future demand be shared between the majors. This may improve their understanding of each other's likely strategies and help them to accommodate one another's market behaviour.

Capacity constraints are increasing

X96 We currently consider that the infrastructure sharing agreements may have also reduced incentives to invest in terminals, leading to tight supply conditions at many ports. This is reflected in minimal investment being made in storage terminals over the last decade, despite increased demand for fuel.

Figure X5 Total fuel volumes and storage capacity indexed to 2009



X97 The limited investment in storage seems to be related to capacity constraints. This is evidenced by port coordination events, which are used to ration out available supply between the majors and their downstream partners, when terminal supplies are low. While coordination events have fallen recently, some ports are currently under coordination up to 40% of the time for certain fuel types.

X98 There is evidence suggesting this tight supply position serves to limit competition between the majors. The formulas used to ration fuel during coordination events reduce the ability and incentive of the majors to compete for additional contracts; and large resellers appear to be deterred from seeking to switch suppliers out of fear their needs may not be met during a coordination event. Unlike in the United States and parts of Australia, there is no wholesale spot market for fuel in New Zealand.

The wholesale market is inactive

X99 Z Energy, BP and Mobil supply over 90% of the fuel consumed by New Zealand motorists through their own retail sites and wholesale supply agreements with other retailers (also known as resellers). All retailers other than Gull are dependent on the majors for their fuel supply.

X100 Switching at the wholesale level is rare. Resellers, comprising of independent dealers and distributors, often roll-over their supply agreements without seeking offers from other potential fuel suppliers. This reflects a combination of:

X100.1 long-standing relationships resulting in resellers being dependent on their existing suppliers; and

X100.2 contractual terms that make switching difficult.

X101 The lack of switching we see in the wholesale market also reflects some distributors' relatively comfortable position, given they are often sharing in the high profitability we are seeing across the industry.

Relationship dependence reinforces barriers to switching

X102 Many of the wholesale supply relationships majors have with resellers have been in place for decades. In some cases, a major helped establish the reseller through transfer of assets, financial investment, technical assistance or access to customer lists.

X103 Since their establishment, many resellers have grown materially by building their own customer base, and in some cases acquiring other distributors. Increasingly they are building their own retail sites, particularly self-service pay-at-pump sites.

X104 Despite this growth, resellers are not diversified businesses. Maintaining a reliable supply of fuel is critical to their success and they purchase all of their core product, petrol and diesel, from a single supplier. In most cases this is the same supplier they have always had.

X105 The established relationships between the majors and their resellers appears to be reinforcing barriers to switching suppliers. This is reflected in resellers:

X105.1 needing access to their majors' fuel card;

X105.2 being unwilling to open new retail sites in locations where they would directly compete with their own supplier; and

X105.3 factoring security of supply risks into their decisions.

X106 As mentioned earlier, commercial fuel card users are valuable to retailers. As a result, independent resellers can be dependent on their suppliers' fuel card offering, especially as acceptance at a nationwide network of sites can be required to compete effectively. The potential loss of fuel card volumes at their retail sites acts as a disincentive to seek a lower wholesale price from another supplier, or switch to a new importer that does not have a fuel card offering.

- X107 It also potentially allows the major firms to influence where resellers they supply choose to open new sites and what services they offer at those sites. If a major considers a reseller's planned new location is too close to its own branded retail outlet, it has the option to remove or deny that reseller's ability to accept its fuel card.
- X108 Generally, resellers open new sites at locations that complement their supplier's network, rather than competing directly with them. Even if they wished to switch supply to a different major fuel company, the location of their established retail sites may mean they are unlikely to get a better wholesale price from the same suppliers they would then be competing against.
- X109 Another factor influencing distributors' decisions appears to be the supply risk associated with port coordination events or shortages. For example, a major may choose to prioritise supply to distributors with whom they have long-term relationships, especially if they have retail sites that are complementary to its own. This acts as a further disincentive to distributors to switch suppliers.

Restrictive contract terms

- X110 In our view the wholesale supply agreements between the majors and resellers have features that are not consistent with workable competition. For example, these agreements:
- X110.1 are typically exclusive, preventing resellers from obtaining any of their fuel from an alternative supplier, for example to trial a new supplier or diversify their supply;
 - X110.2 commonly have long durations (for example, 10 to 15 years), further limiting resellers' ability to regularly test the market and 'shop around';
 - X110.3 are sometimes tied to the suppliers' retail price or unclear on the methodology for calculating wholesale prices, giving majors the ability to change prices at any time and making it difficult to compare offers between suppliers; and
 - X110.4 include other contract terms, such as 'first right of refusal' clauses, which reduce a reseller's ability and incentives to switch supplier.
- X111 We acknowledge terms like these are not unusual in commercial contracts in workably competitive markets. They can have a range of benefits and may be required to achieve efficiencies, such as securing long-term demand in order to justify investment.
- X112 Nevertheless, we currently consider that in many cases the benefits claimed could be achieved through means that are less restrictive of competition in the wholesale fuel market.

- X113 In addition to these contract terms, if a reseller does consider switching it can be hard to find the best offer because some of the key information they need, such as the future supply price, may not be provided by a major. There is no wholesale spot market in New Zealand, which would potentially provide a useful reference point when considering entering a new supply agreement.
- X114 Resellers' lack of switching contrasts with large commercial buyers who typically enter much shorter contracts and actively test the market by inviting tenders from multiple suppliers.

Land use restrictions

- X115 Separately, we have also observed that when fuel companies close retail sites they sometimes place 'restrictive covenants' on the land that prevent its future use by another fuel retailer.
- X116 Given retail site locations are often selected based on traffic flows and accessibility, as well as local zoning restrictions, the reduced ability to access suitable land potentially raises a new competitor's cost of entering the market or limits their ability to expand into new areas.
- X117 We currently consider that restrictive contract terms, the dependence of resellers on their suppliers and land use restrictions all act as a barrier to wholesale market competition, which means that effective price competition is only possible at the retail level.

The impacts of infrastructure sharing and a locked-up wholesale market

- X118 The combination of infrastructure sharing arrangements and restrictive wholesale supply relationships has restricted rival fuel importers' entry into the market and has limited competition.
- X119 Rival importers do not have the ability to match the majors' comparatively low cost of production and distribution, and on entering New Zealand would find it difficult to attract wholesale customers who are committed to restrictive wholesale supply agreements.
- X120 This has the effect of currently restricting competition primarily to the retail level.

Options to stimulate competition and improve outcomes for New Zealanders

- X121 We currently consider that competition in the wholesale fuel market is not delivering the benefits for consumers that it could. Under current practices, New Zealand consumers appear likely to continue paying more for fuel than we would expect if a workably competitive wholesale market existed.
- X122 There are signs that the market is responding to the high margins being earned over the past decade. Developments that could improve outcomes for consumers in the long term include:

- X122.1 successful establishment of TOSL's new import terminal in Timaru has the potential to bring lower fuel prices to some South Island drivers, if it can secure supply agreements with existing resellers;
 - X122.2 further expansion by Gull and resellers like Waitomo and NPD may provide consumers the option of lower priced fuel in more locations; and
 - X122.3 the development of alternate sources of energy like electricity or hydrogen to power our cars and trucks may help reduce the price of petrol and diesel.
- X123 However, these developments will not address the core problem we have identified with the wholesale market.

Options to improve competition

- X124 We consider there are two broad sets of changes that have the potential to help create a competitive wholesale market, with long-term benefits for retail competition and end consumers. These are:
- X124.1 greater contractual freedom between majors and resellers to better enable switching between suppliers and reduce the barriers preventing new entrants from obtaining wholesale customers; and
 - X124.2 promoting wider participation for independent importers in the majors' shared infrastructure, notably port terminals and the associated logistics in the borrow and loan system.
- X125 There is no guarantee that a competitive wholesale market will develop rapidly if these barriers are removed. Some resellers have a happy co-existence with their supplier and no desire to change. However, there appears to be significant economic incentives for some resellers to switch, including those who may want to use an alternative supplier for at least some of their volumes. This could be expected to lead to more competition over time.
- X126 We have also outlined a series of further options that could help improve competition in the fuel market. These include:
- X126.1 changing the current refinery fuel allocation mechanism to allow the majors to increase their allocation over a shorter time period than three years;
 - X126.2 reducing potentially unnecessary information sharing between the majors' through the refinery Technical Committee and COLL joint venture agreement;
 - X126.3 improving the transparency of premium petrol prices by displaying them on price boards, and helping consumers understand whether they need to purchase 95 or 98 octane for their vehicle; and
 - X126.4 requiring better information be collected from the industry and retained in New Zealand to assist in future market analysis.

- X127 Further details on the options we are considering are outlined in Chapter 8. They reflect our preliminary views on the factors affecting competition for the supply of retail petrol and diesel used for land transport in New Zealand. We have included these options with the intention of initiating a discussion about what changes, if any, may be feasible to implement to help improve competition.
- X128 We invite comment on the options we have set out, and also welcome suggestions of other options that could improve competition. Like the preliminary views expressed throughout the draft report, the options are subject to our further consultation process.
- X129 Comments on our draft report are due by 13 September 2019, with a conference and further comments to follow. Our final report will be published on 5 December 2019.