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Submission on Market Study into retail fuel sector – preliminary issues

Introduction

The New Zealand Automobile Association (NZAA) welcomes the opportunity to provide comment on the preliminary issues discussion paper.

The NZAA is an incorporated society with over 1.7 million Members. It represents the interests of road users who collectively pay over \$3 billion in taxes each year through fuel excise, road user charges, registration fees, ACC levies, and GST. The NZAA's advocacy and policy work mainly focuses on protecting the freedom of choice and rights of motorists, keeping the cost of motoring fair and reasonable, and enhancing the safety of all road users.

Comments on the relevant questions for which we have feedback are provided below.

No part of this submission is confidential.

Questions on our approach to the study

Q1. Whilst the scope is limited to competition in the retail market, we suggest that the retail margins (paragraph 25.2) also need to be compared against other fuel product margins, namely aviation, marine, bitumen and bulk diesel. It has been speculated by MBIE that margins on retail fuel have risen far more than margins on other fuel products (if at all), although this was unable to be established by the *New Zealand fuel market financial performance study* (2017). Whilst some of this margin increase may be explained factors unique to the retail market, we are concerned about the possibility of retail fuel margins cross-subsidising other fuel products and consequently we think these margins should be compared, including their proportionate increase over time. In particular, we think the various fuel product margins should be assessed as to whether:

- they are each sufficient to make a viable return; and
- operating costs are proportionately distributed across fuel products according to volume of product produced

(For example, is the contribution from margin to the refinery upgrade proportionate to the volume of each fuel produced at the refinery? We note that in 2014 retail margins rose following refinery losses. This had never previously occurred, with fuel companies separating refinery costs from other parts of the business. Did margins for other fuel products also rise at the same time, or were all the refinery losses recovered from retail fuel margins?).

Submission on Market Study into the retail fuel sector – invitation to comment on preliminary issues

Further, the investigation of margins needs to separately assess regular (91 octane), premium (95 and 98 octane) petrol grades, and diesel, as margins are consistently higher for premium petrol and diesel compared to regular petrol. Our view is that the margins on premium grades (and diesel) are higher than justified for their share of capital costs.

Specifically, the undiscounted retail price for 95 octane is typically 9 cents per litre (cpl) higher than 91 octane (with 98 octane priced 8cpl higher again). Yet 10 years ago the differential between 91 and 95 was just 5cpl. Further, data from Hale & Twomey on landed fuel costs shows 95 octane generally costs about 4cpl more. The AA questions why the margin is higher than the additional product cost, when the wholesale, distribution and retail infrastructure for any petrol grade is the same and often shared. We suggest it needs to be established whether the margin for premium petrol is proportionate to its share of costs.

Furthermore, when service stations discount the pump price of fuel, more often this discount only applies to 91 octane and diesel, and not petrol (this is enabled by the absence of premium price information on the roadside price boards which we will cover in Q37 & 39 below). Therefore the price differential between petrol grades may be even larger and this leads us to speculate that premium petrol prices are subsidising regular petrol prices. Data collated for the Regional Fuel Tax monitoring clearly shows the average price for 95 octane is more than 9cpl higher than the average price for 91 octane petrol. We believe this to be demonstrably unfair to consumers who purchase premium petrol (approximately 20% of all petrol sales). In many cases, consumers have no choice but to purchase 95 octane or above as this is the minimum octane recommended by the car manufacturer (generally European cars, performance models, and classic cars).

We have similar concerns about retail diesel margins. Anecdotally, a lot of retail diesel is sold on fuelcard, often attracting substantial permanent discounts or fixed pricing that is disconnected from the pump price. We speculate therefore that retail diesel margins are artificially high to cross-subsidise the volume of diesel that is sold at discount via fuelcard. We would be interested to establish whether the costs of supplying diesel are sufficiently higher than regular petrol to justify the higher margin.

Questions on trends in market structure

Q2. In the AA's view, the growth in *independent* brands (e.g. Allied, NPD, Gull, Waitomo etc.) and the contrasting reduction in retail sites of the major brands can be attributed to the difference in operating model between the independents and major brands, and the associated difference in retail prices that these models provide. Fundamentally, these independent brands typically retail fuel from unmanned service stations (but not exclusively) often located on the outskirts of populated areas or in semi-rural communities. By contrast, the major brands have a well-established model of 'full-service' stations which include covered forecourts, a shop, toilets, and additional services like a carwash. These sites occupy more land space and are often centrally-located in more expensive real estate areas, not to mention employ staff. Not unreasonably, we expect that these 'full-service' stations would cost more to operate than smaller, unmanned sites, and that some of these additional costs are recovered from the retail margin. By contrast, as unmanned sites have lower operating costs, their retail margin should be lower, thus enabling unmanned sites to retail fuel at a lower price.

With the growth in fuel prices over the past decade, price-sensitive motorists seek out lower fuel prices and thus may find unmanned service stations attractive, and so this business model is proving popular with a segment of consumers. Moreover, the growth in retail margins at full-service stations is such that unmanned service stations are able to retail fuel at a significantly

discounted price to be attractive to consumers, which is likely giving the independent brands confidence to expand their operations.

Furthermore, we understand that the expansion of established independent brands like Allied, NPD and Waitomo, which traditionally operated truckstops only servicing fuelcard customers, has also been enabled by improvements in mobile payment technology which allows anyone to pay at the pump provided they have a credit or debit card or bankcard.

Q3. We observe that since the establishment of Z Energy, industry margins have risen significantly, in line with Z Energy's stated strategy noted in paragraph 32.1.3. With their purchase of the assets of Chevron NZ, Z Energy is now the single largest supplier of fuel in NZ, and this has further consolidated their ability to set industry margins. Nevertheless, it is also the case that the growth in margins has encouraged the lower-cost independent brands to expand (as noted in Q2 above), and that this has actually increased competition in the retail fuel market by giving motorists more choice of retailers and also more competition in fuel price (wherever those independent brands operate). The converse of this is that elsewhere retail prices are higher wherever the independent brands don't operate.

The AA contends that this obviously competitive behaviour results in fuel prices in parts of the country being higher than they would be if the major brands did not compete on price; to the extent that the AA believes the higher fuel prices are cross-subsidising lower prices charged by the same brands elsewhere. This is best illustrated by the fuel prices charged in the Wellington region often being approximately 20cpl higher than in nearby Levin, where an unmanned Gull operates. To date, there are no independent unmanned service stations in the Wellington region, although Waitomo will be opening two shortly (in Wellington city and Upper Hutt).

This same observation also generally applies to the South Island (as noted in paragraphs 44 & 46), although independent brands are expanding in the South Island (notably NPD) and so some price competition due to the different operating models does occur in parts of the South Island.

Questions on trends in gross margins and regional pricing

Q4. We submit that one likely factor in the rise of retail gross margins will be due to the increase in marketing costs, which includes both pump price discounting (price competition) and loyalty scheme discounts off the advertised pump price. As part of the investigation into margins, it would be useful to establish how much of the gross margin is attributable to these marketing costs. This could also explain why margins on retail fuel may be higher than other fuel products, which do not involve the same level of marketing.

Q5. Similarly, the AA believes that the difference in margins between regions is likely explained by marketing costs, specifically pump price discounting, as referred to in our answer to Q3. That is, if aggressive price competition with unmanned service stations in some areas leads to manned service stations selling fuel at prices that do not fully recover costs, the AA contends this results in a cross-subsidy from other service stations in the retail chain which sell fuel at higher price – with a higher margin to cover the overheads across the network. It would be interesting to establish if this is indeed the case – i.e. are some service stations selling fuel at an unsustainably low price? Or to put it another way, is every litre of fuel sold at every service station sold at a profit?

Q6. In recent months there has been a change in pricing strategy, with an observed reduction in the price differential, and also with increasing levels of price competition in the South Island

with the expansion of independent brands like NPD. Even in Wellington there is some price variation, despite the absence of low-cost brands like Gull or Waitomo.

Questions on trends in profits

Q9. If Return on Average Capital Employed (ROACE) is to be used, we think it would also be useful to compare with the ROACE of comparable industries with similar levels of capital investment (e.g. other energy utilities) or perhaps the ROACE of vertically-integrated fuel suppliers in comparable countries.

The 2017 *New Zealand fuel market financial performance study* sought to identify ROACE for different market segments and companies, including possibly by region, which would have helped identify which segments or regions are under-performing or where ROACE is above average.

Ultimately one way to do this is to identify what a benchmark retail price is (say, main port price), allowing for an acceptable ROACE and net profit for different business models (e.g. manned vs. unmanned, paragraph 87), so that consumers can compare what they pay against that (such a figure could also be incorporated into the MBIE weekly fuel price monitoring). At a regional level, what would be useful is to compare the average regional price with the benchmark retail price, as this will help indicate the effectiveness of competition.

Note for example the comment in paragraph 79 relating to the 2017 *New Zealand fuel market financial performance study*, where Gull implied the South Island is not as financially attractive. How do the costs of supplying and retailing fuel in the South Island compare to the North Island? In paragraph 81, the same report noted that transport costs are higher in the South Island. What would a fair South Island benchmark price be to determine whether the level of competition is reasonable?

Questions on trends in discounts

Q10. The MBIE methodology doesn't take into account the volume of fuel that is sold at a discount, presumably because this data is unavailable from fuel companies, although perhaps this could be established as part of the Commerce Commission inquiry. As alluded to in Q9 above, we suggest consideration be given to MBIE developing enhanced margin monitoring, such as requiring fuel suppliers to provide a range of data attributes that can be compared, to better monitor margin trends over time.

Q11. The AA believes the increase in gross margins is partly due to the increase in discounting, i.e. marketing programmes as per Q4 above. This has likely occurred as the main fuel brands aggressively compete with each other to grow or secure market share.

Q12. We note that loyalty schemes are a form of competition, specifically price competition, and there is strong competition amongst these schemes by fuel companies to attract customers, with frequent matching of discounts amongst competing schemes. Additionally, not all loyalty scheme discounts are funded by fuel companies, with unrelated businesses also offering fuel discounts, which enables consumers to use their spending on other goods or services to reduce their fuel costs.

Q13. One key driver of regional differences in price competition will be the presence (or absence) of independent unmanned service stations. It is worth noting that the only differences in regional discounting will be off the pump price – whereas loyalty scheme discounts apply

universally across the country irrespective of the pump price (at least, wherever the company offering the loyalty discount operates).

Questions on the supply chain: wholesale supply

Q31. We think it would be useful to establish how easy it is for resellers to switch suppliers, i.e. change contracts. What are the length of contracts and what are the penalties to break them?

Q36. As the price is set by the wholesaler, they have the ability to change and control the price to resellers and dealers to limit price competition from those independent brands. This could be limited by some controls over how wholesalers set or adjust prices, such as via establishing Terminal Gate Pricing as in Australia.

Questions on the supply chain: the nature of retail competition

Q37. As noted in Q1 above, the AA contends that consumers of premium grade petrol are unable to access the same level of pump price discounting that is available for 91 octane. This is entirely attributable to the absence of the premium price on the roadside price boards, which is the industry norm (they generally only advertise the price of 91 octane price, and diesel). This reduces price competition on premium petrol as consumers are effectively unable to shop around on price by monitoring the price boards (instead they must drive up to the pump to determine the price, or monitor the Gaspay app).

In a 2016 AA member survey, 76.6% of members said they monitor roadside price boards, and 81.3% said that service stations should display the premium price on the roadside boards. The AA believes the solution is that all service stations should be required to display the price of all fuels they sell on the roadside boards (as has been mandated in NSW and QLD for example). Observationally, many price boards have space to display a third product price. The AA believes this would improve price competition and choice for motorists, and ultimately result in a reduction in fuel costs for motorists whose vehicles use premium petrol.

Q38. The increase in service differentiation has increased competition and choice for consumers. In particular it has provided greater choice in the retail offer by enabling motorists who only wish to purchase fuel to go to service stations that only supply fuel, in turn providing greater price competition by offering a lower price than full-service stations who have a higher margin to cover the cost of other services which the motorist does not want to access (e.g. they do not want to purchase food or beverages or use other services).

Q39. As noted in Q37 above, the absence of the premium petrol price on the roadside boards makes it difficult for consumers to compare prices. Whilst the AA believes mandating the display of premium prices on roadside price boards would address this issue, other ways to enable motorists to compare prices could be greater consumer utilisation of the Gaspay app, or the publication of real-time prices on a website (or app), such as the mandatory fuel price transparency schemes operating in NSW, QLD and Western Australia.

Yours sincerely



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