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Z Energy / Chevron New Zealand NZAA submission on Statement of Preliminary Issues

The New Zealand Automobile Association Incorporated

342-352 Lambton Quay
PO Box 1
Wellington 6140
NEW ZEALAND

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SUBMISSION TO: Commerce Commission

REGARDING: **Z Energy Limited / Chevron New Zealand**

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ATTENTION: The Registrar

ADDRESS: Commerce Commission
PO Box 2351
Wellington 6140

EMAIL: registrar@comcom.govt.nz

SUBMISSION AUTHORISED BY Mike Noon
General Manager, Motoring Affairs
New Zealand Automobile Association Incorporated
PO Box 1
Wellington 6140

SUBMISSION AUTHOR Mark Stockdale

AUTHOR E-MAIL mstockdale@aa.co.nz

AUTHOR PHONE (04) 931 9986

NOTE TO REQUESTOR

This is a public submission and no portion is confidential.

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Background on the New Zealand Automobile Association

The New Zealand Automobile Association (NZAA) is an incorporated society with 1.45 million Members. It represents the interests of road users who collectively pay over \$2 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.

Content of this submission

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Executive summary

New Zealand is a relatively sparsely populated, geographically broad country which is currently well served by five competing fuel importers and suppliers in the North Island and four in the South Island.

The NZAA considers the Commerce Commission is tasked with undertaking a thorough review of the proposed merger of Z Energy Limited and Chevron New Zealand to ensure there is not a reduction in competition in the retail petrol and diesel market that would be disadvantageous to consumers, or a change in market dominance that would favour one fuel supplier over the others.

The NZAA has identified a number of areas of focus where there is a risk that market competition may diminish or where the combined entity may gain unequal market dominance and the ability to raise fuel prices. These include:

- i. midstream components of the fuel supply chain, including access and control of terminal storage and Refining NZ processing capacity
- ii. smaller towns with Caltex and Z as the only current retailers
- iii. 95 octane petrol which is mainly sold only by Caltex and Z in North Island cities

To mitigate some of these potential risks to competition, the NZAA recommends the Commerce Commission investigate conditions that could be imposed to maintain existing levels of competition, such as:

- i. regulatory interventions to increase midstream competition in supply and terminal storage
- ii. requiring the merged entity to divest sites or an ongoing requirement for the Caltex network to be operated independently of the Z network
- iii. requiring Caltex and Z service stations to display the price of 95 octane petrol on its price boards

1. Introduction

The NZAA's submission focuses primarily on the potential *negative* impacts of the merger on the **retail supply of petrol and diesel** (12.5.1 and 12.5.2 of the Statement of Preliminary Issues). We do not comment on the other areas of interest or possible *positive* benefits of a merger as set out in Z Energy Limited's notice seeking clearance, such as economies of scale cost savings resulting from combined fuel procurement, distribution and administrative functions. It is for the Commerce Commission to assess whether these potential benefits outweigh the risks in deciding whether or not to approve the acquisition.

Of the three preliminary issues the Commerce Commission is focussing on, our industry knowledge and associated commentary mainly relate to:

- would the merged entity be able to raise prices or reduce quality by itself?

From the outset, the NZAA does not consider that the proposed acquisition could or would have a detrimental impact on fuel quality. The Engine Fuel Specification Regulations 2011 tightly govern domestic retail fuel specifications and quality, and long-term regular random monitoring by the Ministry for Business, Innovation & Employment has identified no issues of concern. Therefore we do not consider the existing fuel procurement arrangements are likely to materially change, in respect of fuel quality, under any change of ownership of Chevron NZ.

Therefore, the following sections only analyse the potential for the merged entity to raise prices, and in particular we consider what impact the proposed merger may have on:

- retail pricing behaviour generally;
- diminishing price competition and choice in the premium petrol market; and
- diminishing price competition and choice in small towns.

Our submission also makes recommendations to the Commerce Commission to consider further analysis or conditions that could be imposed to mitigate potential risks of the merged entity reducing competition and raising prices.

2. Constraints on price competition

The NZAA submits that in cities and large provincial towns in New Zealand there is no substantial lack of competition in the retail fuel market. In well-populated areas, there are up to five different suppliers, and motorists may have a choice of more than five retail brands. For all intents and purposes, the retail fuels they sell are homogenous (excluding biofuel blends) so motorists can easily substitute one brand for another.

All five suppliers offer nationwide price competition in the form of redeeming supermarket discount docket, or loyalty programmes like AA Smartfuel discounts or Fly Buys rewards (see Table 2 below). Furthermore, retail price competition additional to these national discount programmes also occurs in some of the main centres, notably wherever Gull operates (see section 3).

Z Energy's application for clearance states there are 16 retailers in New Zealand, but many of those serve small rural communities and have no direct competition. However, regardless of the number of competing fuel retailers in New Zealand, those retailers only have control over a small portion of the overall cost of fuel with which they can then manipulate retail prices. Excluding taxes, the majority of the cost of fuel is incurred prior to retail, i.e. in the 'midstream'.

This is particularly pertinent in the case of the independent Caltex service stations. Their ability to compete or differentiate on retail prices will not increase under the proposed merger, when the wholesale price they pay will be the same as that incurred by the Z Energy network – meaning the wholesale price for 50% of the market will be set by Z Energy (above the Commerce Commission's 40% threshold for competition concerns). Whereas under the status quo, an independent midstream participant like Chevron had the ability to source fuel at different costs to its competitors (we understand Gull and Mobil Oil NZ have been able to do this, which has enabled some of the regional price competition referred to in section 3 below).

It is in the midstream components such as Refining NZ, terminal storage, shipping and domestic freight where the NZAA submits there is not enough competition in New Zealand, and which restricts the ability to effect greater price competition throughout the price chain, from refining through to retailing. (Z Energy's notice seeking clearance notes that it is "difficult to enter the midstream level of the market on a national basis")¹.

While this is the status quo, the NZAA contends that this scenario will not improve under the proposed merger, with Z Energy being entitled to more refinery processing capacity due to its

¹ Z Energy Ltd, Notice seeking clearance to acquire Chevron New Zealand Limited, June 2015, page 18

increased market share, and notably, controlling more terminal storage which brings a greater risk of terminal access being restricted by price, especially at those ports where the only terminal storage will be owned by the merged entity (Timaru, and Nelson for petrol).

Recommendation:

The NZAA suggests that the Commerce Commission investigate ways in which midstream competition could be increased. For example, we understand Australian regulators have investigated opening up their terminal storage market (to all fuel importers) as a means to reduce barriers to entry in the retail fuels market and increase price competition. Similarly, access to Refining NZ processing capacity could be provided to all fuel suppliers (based on the average downstream market share), and not just midstream participants (i.e. those that have a shareholding in the refinery) as at present.

Therefore the NZAA would like the Commerce Commission to consider whether any such interventions could be considered as a condition of the merger.

3. Retail price competition and the “Gull effect”

During the last couple of years, it has been observed that there has been a “price war” in parts of the North Island, with some service stations discounting the price of 91 octane petrol and diesel in particular. Anecdotally, premium petrol is rarely discounted and so there is less visible competition in the premium petrol market (see section 5). The size of the pump price discounts varied both inter- and intra-region, and last year discounts of 20-30 cents per litre (cpl) or more were regularly observed. However in May this year the widescale price discounting came to an end, but there is still some smaller-scale discounting in the Gull-supplied areas. Anecdotally, these are around 10cpl although some discounts of 30cpl have been recorded.

The causes for the regional price discounting are many and varied (including retailers matching competing supermarket discount docketts and loyalty scheme discounts), but the NZAA contends the common denominator is that discounting tends to occur in areas served by (or near to) a Gull service station. Indeed, the NZAA has coined a phrase to describe this: the “Gull effect” which signifies the effect of the presence of a Gull service station on local pricing.

We note in Z Energy’s notice for application that it suggests a travelling distance of not more than 5km radius should be considered to analyse the proposed transaction’s effect on retail competition. Z Energy quotes the Commerce Commission’s ruling on *The Warehouse*² decision

² Commerce Commission, Decisions 606 and 607, 8 June 2007

to support the 5km radius. The NZAA suggests that, for price-conscious motorists, the travelling distance they are prepared to travel will depend on the range of price discounts available within a region, including large supermarket discount docket specials (occasionally up to 40cpl) or accumulated AA Smartfuel discounts³ which can exceed \$1 per litre. The bigger the discount, the further motorists will be prepared to travel.

Table 1 below illustrates the costs of travelling certain distances different car sizes (petrol only). The calculations assume a petrol price of \$2.00/litre ex-discount.

Table 1: Fuel cost savings based on distance and car size

	Compact car 1.5-2.0 litre	Medium car 2.0-3.5 litres
Return distance	Travel cost (15c/km at \$2.00/litre)*	Travel cost (17.3c/km at \$2.00/litre)*
20km	\$3.00	\$3.46
30km	\$4.50	\$5.19
40km	\$6.00	\$6.92
50km	\$7.50	\$8.65

* based on NZAA 2015 annual running costs

If a motorist were to purchase 50 litres of petrol at a 10cpl discount, this would save \$5. A 20cpl discount would thus save \$10. Thus for a compact car, it is potentially worth driving at least 20km return to access a 10cpl discount, and for a medium-sized car there is a modest saving to be had by travelling up to 50km return for a 20cpl discount. While in all likelihood motorists would combine such trips with other activity in the vicinity to justify travelling such distances, we contend Z Energy's suggested 5km radius is too small.

Recommendation:

The NZAA suggests further analysis is required to establish what radius is applicable to measure retail competition as it applies specifically to the retail petrol and diesel market, and the relative contribution of price sensitivity in influencing motorists' fuel purchase decisions.

Note, this analysis should also factor in the price premium higher grades of petrol incur (95 and 98 octane) and the influence this may have on motorists travel decisions in order to access a lower premium fuel price (see section 5 below).

³ www.aa.co.nz/aasmartfuel/

4. Limited competition in small towns

While there is some robust price competition in parts of the North Island where Gull operates, this does not extend to any of the South Island, or parts of the North Island where Gull are absent (including Taranaki and the Wellington region). The NZAA is concerned in particular about the lack of competition in rural towns in New Zealand, as evidenced by prices above the main port price (even accounting for freight costs).

By way of example, petrol prices in Westport (where the two service stations are independent) are reported to be 12cpl higher than Greymouth where some of the three sites are company-owned. Fuel to both centres is trucked from Lyttleton, which we estimate adds approximately 3cpl to the cost given that Greymouth's prices are just 3cpl higher than Christchurch.

In Kaikoura, which is served by just two (independent) service stations, prices are anecdotally 10cpl higher than Christchurch where the fuel is sourced from (some 200km away). Yet fuel prices in Blenheim (which is supplied from Nelson 120km away) are the same as the main port price in Nelson and other port cities.

Similar scenarios where retail prices appear much higher than could be reasonably attributed to freight costs apply in Queenstown, Wanaka, Dargaville and Thames to name a few. The NZAA is concerned that disparate fuel pricing could manifest itself in more rural towns under the proposed merger if competition is diminished in some locations predominantly served by Caltex and Z service stations which currently compete under the status quo.

Z Energy has indicated that they are not planning to change the Caltex operating model post-merger, although the term of this commitment is unclear.

Recommendation:

The NZAA recommends the Commerce Commission review locations where Caltex and Z are the only two retailers within a practical travelling distance, and consider whether the merger approval could be conditional upon requiring the merged entity to divest one of the outlets to a competitor, or an ongoing requirement for the Caltex service stations to continue to be run independently of the Z network.

In order to monitor the impact on competition of the merger, if approved, it would be useful for the Commerce Commission (or the Ministry of Business, Innovation & Employment) to develop an indicator to estimate what is a reasonable margin for given locations based on transport costs and turnover, i.e. estimate what is a reasonable mark-up above the main port price for

places like Kaikoura or Westport. This could be determined by estimating the extra costs for towns based on population sizes like 2,500 or 5,000, and given distances from port e.g. 200km.

5. Premium petrol competition

The fuel companies indicate that approximately 75-80% of all petrol sold in NZ is 91 octane ('regular'), with the remainder made up of 95 and 98 octane (collectively 'premium').

Table 2: Discount scheme and petrol grades offered by the five main national retailers

Retailer	91 octane	95 octane	98 octane	Discount scheme
BP	✓	✓	✓	AA Smartfuel
Caltex	✓	✓	X	AA Smartfuel
Gull (North Island)	✓	X	✓ (E10)	Progressive
Mobil	✓	✓	✓ (North Island only)	Foodstuffs
Z	✓	✓	X	Progressive, Flybuys

The smaller independent brands like g.a.s. retail 91 and 95 octane (although anecdotally some small rural sites do not offer a premium grade). Very few retail outlets sell all three grades of petrol (less than 2%). In the case of Mobil, and most BP service stations, the outlet will offer either 95 or 98 octane but rarely both. BP predominantly retails 98 at its company-owned 'Connect' sites in metropolitan cities, whereas 95 is predominantly sold at its independent 'BP 2go' sites which are more common in provincial areas. Mobil does not offer 98 octane in the South Island, and as Gull has no outlets there, BP is the monopoly supplier of this grade in the south.

95 octane tends to retail for 8-9cpl more than 91 octane (depending on brand), while 98 octane costs another 8cpl – or 16-17cpl more than 91 octane. This excludes Gull Force 10, which is 10% bioethanol ('E10') blended with 90% mineral 95 octane petrol to create a 98 octane blend, which is priced lower than the 98 mineral octane fuels retailed by BP and Mobil (Mobil also retails an E10 98 octane blend and E3 91 octane blend in the Wellington region).

Z Energy's notice seeking clearance suggests that premium and regular grade petrol are partly substitutable, but this is only true insofar as engines which are configured to run on 91 octane petrol can also use premium grades. Some owners of cars configured to run on 91 octane may

choose to buy a premium grade out of ignorance, or for perceived engine performance or fuel economy gains. However, testing⁴ by the NZAA suggests there are negligible fuel economy benefits in using a higher octane than required, although performance characteristics were not measured. The NZAA contends that the price differential (which has gradually risen from 5cpl six years ago) would discourage many motorists from voluntarily consuming a higher grade than required. Purchasing 50 litres of the next highest grade of petrol will cost an extra \$4.00, or add \$72 to the annual fuel bill of a typical compact 1.5-2.0 litre car travelling 12,000km a year.⁵

However, engines which are configured to run on 95 octane or above cannot substitute this fuel for regular 91 octane without risking long-term engine damage unless it is modified.

The majority of light vehicles operating in New Zealand are configured to run on 91 octane fuel. However, many European cars and premium or performance models are configured to run on 95 octane or above, and most older, carburettor-fed (or 'classic') cars are also configured to run on a higher grade fuel (in some models 100 octane which is not retailed in NZ).

95 and 98 octane fuel is generally substitutable, with only a few high-performance or modified cars requiring 98 octane. However, not all vehicles are ethanol-compatible⁶, in particular those with carburettor-fed engines.

Some late-model cars with knock-sensing engine technology that retards spark timing can substitute premium petrol with regular. However, with 3.1 million light vehicles in the fleet with an average age of 14 years⁷, there are proportionately few cars in NZ with this technology, or with modified fuel systems, that permit owners to substitute premium petrol with regular.

In respect of premium fuels, Caltex and Z Energy offer the same grade. Therefore, in cities in the North Island in particular, motorists whose vehicles require 95 octane, but who do not wish to pay extra for 98 octane, must effectively buy their petrol from either Caltex or Z (while in South Island cities they also have the choice of Mobil).

Therefore, under the proposed merger, price competition for 95 octane fuel may be diminished as there will effectively be only one supplier of 95 octane in North Island cities, which will be sourced at the same midstream cost. Similarly, the combined entities dominance in the supply of 95 octane could result in higher prices and gross margins for that grade in monopoly areas.

⁴ www.aa.co.nz/membership/aa-directions/driver/fuel-duel-2/

⁵ Assuming a fuel consumption of 7.49 litres per 100km (NZAA 2015 annual running costs)

⁶ www.aa.co.nz/cars/maintenance/fuel-prices-and-types/biofuel-and-environmentally-friendly-cars/

⁷ Ministry of Transport, [NZ Vehicle Fleet Statistics](#) 2013

Price boards

As noted in the section 3 above, there has been some significant price competition in recent years in well-populated parts of the North Island that are served by all five national retailers, almost exclusively for 91 octane and diesel. But there is a distinct lack of price competition for premium fuels, something that AA Members commonly complain about. The NZAA contends that the reason discounting is so intense on 91 octane petrol, and diesel, is because these are the only fuels that consistently have prices boldly displayed on roadside price boards.

Price boards are an optional, but effective, marketing tool. Fuel companies are legally required to display the price of all fuels they sell, and universally comply with this by listing the current price at the bowser⁸. Historically, service stations displayed the price of all grades on their price boards. With the increased availability of a third, 98 octane grade (since 2000), and the increasing price differential between the three petrol grades, the vast majority of service stations now only display the price of 91 octane, plus diesel. The NZAA believes the failure to display the price of premium grades contributes to explaining the failure for price competition to exist on premium grades, in those locations where there is price completion on 91 octane and diesel.

We ask the Commerce Commission to consider what impact the proposed merger will have on price competition in those North Island cities where only Caltex and Z offer 95 octane.

Price is a significant determinant in motorists' decisions regarding where they purchase fuel, and price boards are the main means by which they compare prices. The high cost of buying a premium fuel is of concern to motorists, and in addition the NZAA receives many complaints from Members who have inadvertently purchased 98 octane at an even higher price, when they only intended to buy 95 octane. We attribute this to the lack of price information on price boards, and the lack of clarity about which premium grades of petrol are sold (with the price boards displaying premium fuel brand names rather than octane rating).

Recommendation:

To mitigate possible reduced competition for 95 octane in North Island cities in particular, the NZAA recommends the Commerce Commission investigate, as a condition of the proposed merger, that price boards at all Caltex and Z service stations be required to display the price and octane rating of all petrol grades sold on-site, along with diesel (and preferably automotive LPG if applicable). Such a requirement for Caltex and Z service stations may also help spur price competition amongst other brands in the premium petrol market.

⁸ [Energy \(Fuels, Levies, and References\) Act 1989](#), s35(1)(d) (although this Act does not specifically mandate displaying prices at the bowser)

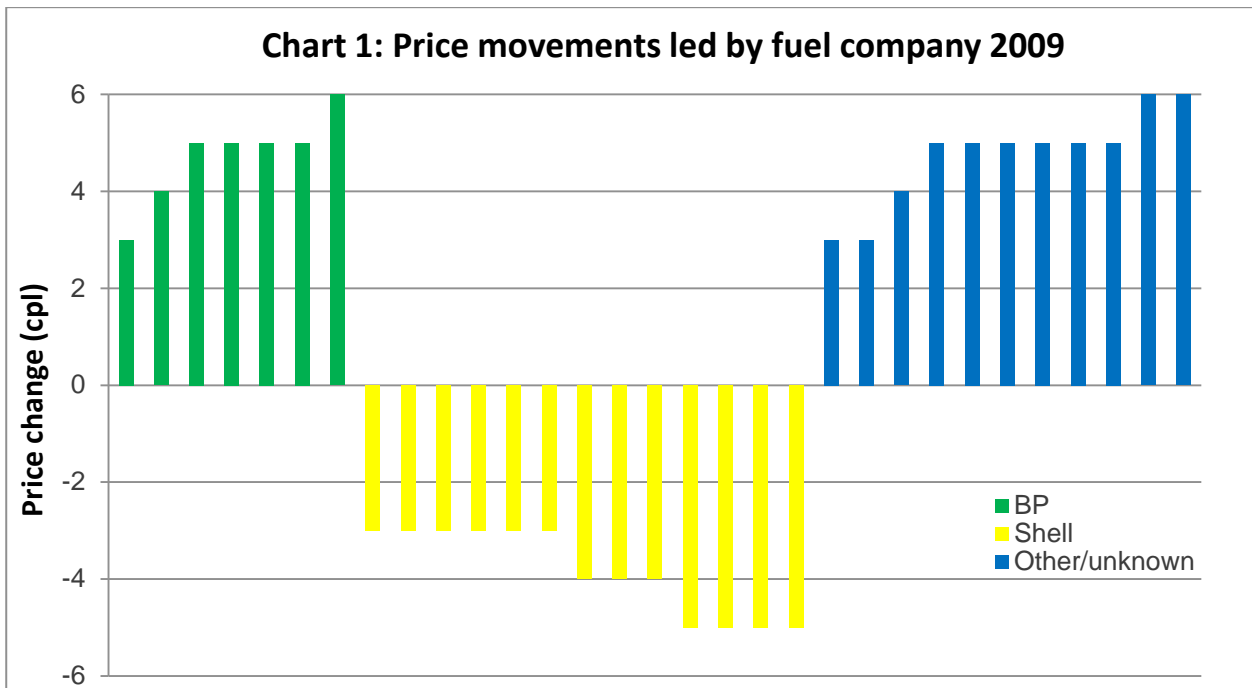
6. Change in gross margins and pricing behaviour

Since Z Energy’s entry into the market in early 2010, the NZAA has observed a change in pricing behaviour by Z Energy compared to its predecessor Shell, and this has coincided with a gradual increase in gross margins that have risen from admittedly historic lows of an average 14cpl in 2009 to an average of 33cpl in the current calendar year⁹.

(Some caution around interpreting current gross margins is required as it does not take into account retail fuel volumes sold at discounted prices as referred to in section 3 above.)

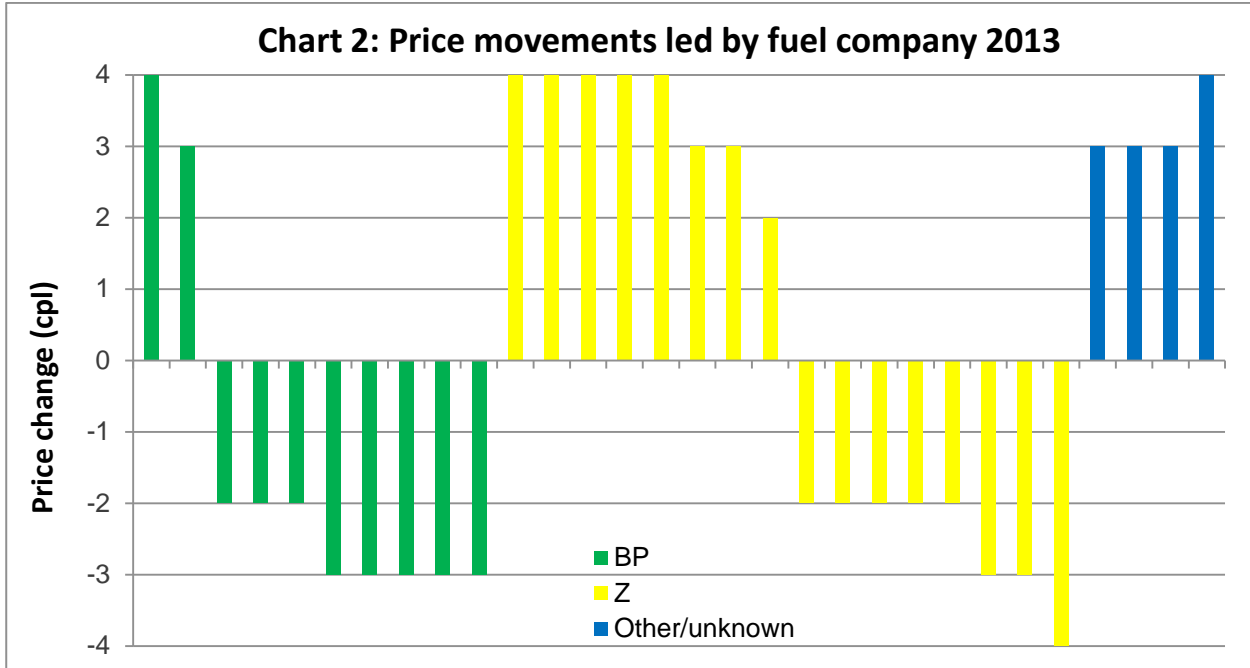
The NZAA’s monitoring of retail price movements shows that almost all adjustments are led by BP or Z Energy (and prior to them, Shell). This appears to reflect their relative market share and dominance, and the fact that most Caltex service stations have been independently-owned for several years. (Note the NZAA’s monitoring excludes Gull price movements as they do not have widespread national coverage.) Historically, Shell tended to lead price reductions, while BP tended to be the first to raise prices at all its company-owned sites. But since the entry of Z Energy to the market, the NZAA has observed that this dynamic has changed.

Charts 1 and 2 below illustrate the number of petrol and/or diesel price movements led up or down by BP, Shell or Z (as applicable) in the 2009 and 2013 calendar years respectively, as recorded by the NZAA (note this data is anecdotal or from notifications by fuel companies).



SOURCE: AA PetrolWatch

⁹ Ministry of Business, Innovation & Employment, [weekly oil price monitoring](#)



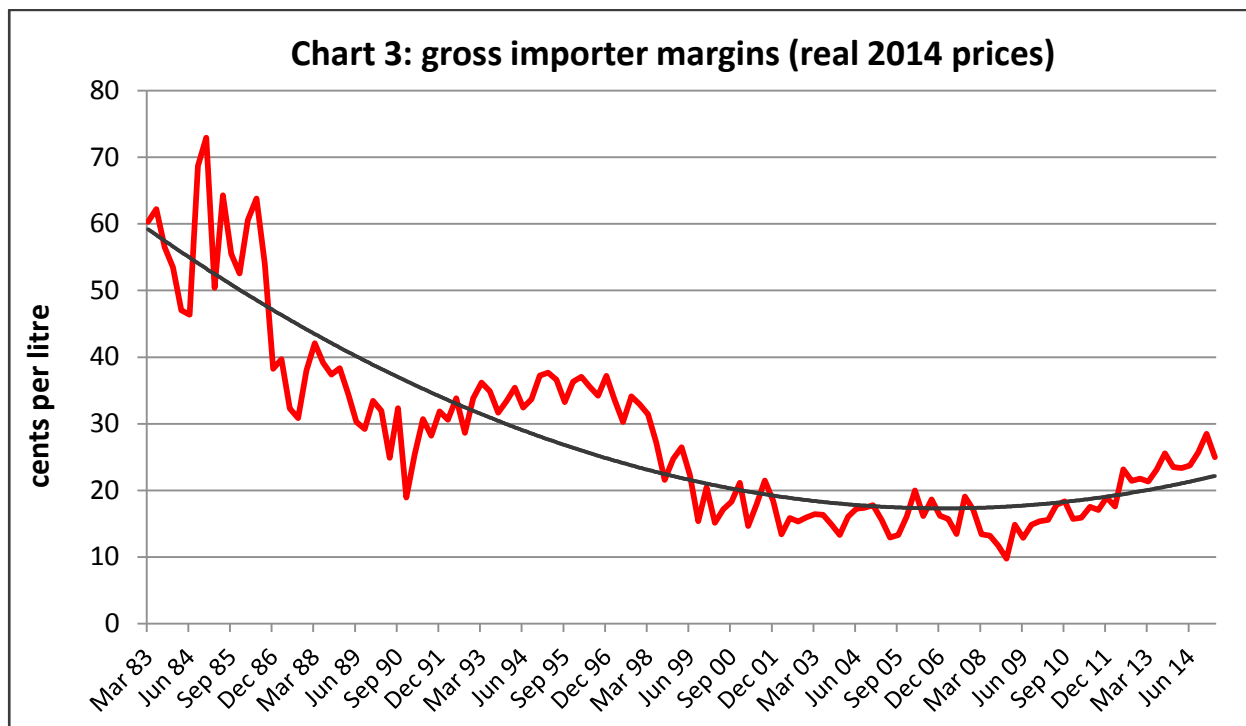
SOURCE: AA PetrolWatch

This data, and our overall annual price monitoring, illustrates that since Z Energy entered the market, they have led the majority of price increases over a period in which gross margins have also risen.

Nevertheless, analysis of gross margins needs to be kept in context of the longer-term trend. Chart 3 below illustrates average quarterly gross margins since 1983, converted to real 2014 prices. This clearly illustrates the upward trend in gross margins since the historic lows in 2008-09.

In addition, it is important to understand the various changing market dynamics that have contributed to the changes in gross margins over time. For example, the fuel market was not de-regulated until the late 1980s, fuel volumes have continued to rise, while fuel companies closed numerous under-performing service stations in the 1990s and 2000s (Hale & Twomey estimated the number of service stations fell from approximately 3,000 in 1985 to 1,265 in 2008¹⁰). This practice has reversed this decade as fuel companies have been increasing capital investment, which some claim is contributing to the increase in gross margins. It is evident that some fuel companies are investing in additional infrastructure, in addition to the \$365m upgrade of the Marsden Point refinery which shareholders BP, Mobil, Z Energy (and formally Chevron) are all investing in.

¹⁰ 2007 ACCC report into Australian petrol prices - Review of applicability to the New Zealand petrol market, July 2008



SOURCE: Ministry of Business, Innovation & Employment: [energy statistics; prices data tables](#)

Recommendation:

To establish what is a reasonable margin and benchmark rate of return on capital employed (ROCE) for New Zealand fuel companies, the NZAA would like the Commerce Commission to compare fuel company gross margins and ROCE with other 'essential utility' providers like electricity and telecommunications, and with fuel companies in similar markets like Australia.

7. Commercial fuel sales and fleet discounts

The NZAA has observed that margins for diesel have long been several cpl higher than petrol, an anomaly that we do not consider is justified given similar sales volumes and infrastructure. For example, MBIE weekly price monitoring calculates the average diesel gross margin for the current calendar year at 38.7cpl vs. 33.2cpl for petrol. In 2009, diesel gross margins were 16.3cpl vs. 14.2cpl for petrol¹¹.

It's our view that the higher margins are due to the fact that the majority of retail diesel sales are sold at discount, via fuel card arrangements used by vehicle fleet operators. Anecdotally, these discounts can be 10cpl or more. In simple terms, the NZAA believes that private motorists buying diesel at the advertised retail price are cross-subsidising commercial vehicle operators.

¹¹ Ministry of Business, Innovation & Employment, [weekly oil price monitoring](#)

Recommendation:

The Commerce Commission to investigate the proportion of retail diesel fuel that is being discounted, and report on the net contribution these discounts makes to the gross diesel margin.