Submission by

WORLD ENERGY COUNCIL | BusinessNZ Energy Council

to the

**Economic Development, Science, and Innovation Committee**

on the

**Fuel Industry Amendment Bill**

23 January 2023

**THE FUEL INDUSTRY AMENDMENT BILL**
**– SUBMISSION BY BUSINESSNZ ENERGY COUNCIL—**

## INTRODUCTION AND GENERAL COMMENTS

1. BusinessNZ Energy Council (BEC)[1] welcomes the opportunity to provide feedback to the Economic Development, Science, and Innovation Committee (referred to as 'The Committee") on the Fuel Industry Amendment Bill (referred to as 'the Bill').

2. Energy affordability is one of three crucial limbs of the trilemma, alongside sustainability and energy security. Affordable energy ensures that households can fully participate in society. For instance, their ability to commute to work or school affordably.

3. Supply constraints following COVID-19 and the invasion of Ukraine in 2022 sent oil prices surging. Prices remained high but have since stabilised. Governments around the world introduced measures to reduce the cost felt by motorists at the pump. BEC recognises that the amendment to the Bill is aimed at improving energy affordability, especially during a time of heightened cost of living.

4. The Bill gives the Commerce Commission the ability to launch an inquiry into the competitiveness of terminal gate prices. In conducting the inquiry, the Commission must consider whether prices are not consistent with what would be expected in a competitive market. Section 29G (1) of the Bill, states that the Commission must make a recommendation to whether price regulations should be imposed. Section 29I gives the Minister the ability to impose price regulation on all, or any, terminal gate prices. The Minister's decision can be the same as, or different to, the Commerce Commission's recommendations.

5. Despite the desirable aim of improving energy affordability, BEC believes the amendment to the Bill could manifest a multitude of unintended and undesirable consequences – potentially harming consumers in the long-term. Price controls have been repeated across the world, under varying circumstances, and on a multitude of different goods and services. Extensive historical examples of price controls date back to Revolutionary France. They were popularised in several Western countries during World War Two and became widespread in the 1970s to tame rampant inflation.[2]

6. History displays a common verdict towards price controls: they often generate costly distortions, worsen competition, hurt consumers, and create environmental damage.[3] BEC believes giving the Minister the ability to regulate fuel prices – and in the event of such regulations becoming imposed – could repeat the same predictable consequences price controls have shown throughout history. This submission outlines BEC's opposition to the amendment, based on the potential negative implications of threatening and imposing price controls.

7. Among many other considerations, BEC believes in advocating for prudent and durable policies that balance efficiency, equity, and effectiveness in solving identified problems – while also considering the possible unintended consequences and costs to society more generally. Price controls (in this case, price ceilings) take a short-cut to lower prices. In doing so, the power of price signals is muted. This creates sub-optimal allocations of scarce resources.

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[1] Background information on the BusinessNZ Energy Council is attached as Appendix One.
[2] *Price Controls: Good Intentions, Bad Outcomes*. World Bank, 2020.
[3] Ibid. p 12 – 19.

**The power of market determined prices**

8. Prices play a crucial role in any economy. Prices convey the underlying conditions of any given product or resource, reflecting its scarcity. Fundamentally, prices guide what resources are used, the quantity of resources that are to be used, at any given time, and the type of products resources are eventually made into. Prices guide consumers and producers to change their behavior: reducing consumption or increasing supply, and vice versa.

9. On the supply side, prices provide a financial incentive for producers to incrementally adjust supply and allocate resources to where they are valued the most from one market over another. For instance, after a natural disaster the power of prices conveys a signal that resources, like bottled water, must flow to a disaster-stricken area.

10. On the demand-side, prices ensure scarce resources are sold to those who are willing to pay at a price they are willing to bear, ensuring resources flow to those who demand it most. A market coordinated through prices is often the most efficient way to ration scarce resources, minimising waste by balancing supply and demand and making sure that over-supply or under-supply is quickly dealt with. The system of profits and losses creates a strong incentive for producers to shift supply swiftly with the aim of maximising profits or minimising losses.

**Muted prices: the failure of controls**

11. In price-regulated markets with ceilings, prices are artificially lower than the market determined price. If consumers and producers did not change their behavior in response to artificial prices, this would not be a problem – but evidently they do. Considering consumers are budget-constrained, they face choices and trade-offs. Higher prices mean consumers are given a signal to reduce consumption or expect a diminished ability to purchase other goods or services they equally demand. With each marginal increase, those who are unwilling to pay at that new price level stop buying the item, or in the case of fuel, may find ways to decrease the amount they consume. For instance, by driving less, eliminating short trips, and adopting modes of transport that consume little or no fossil fuels.

12. On the flipside, regulated prices that stop prices going beyond a certain level – a price ceiling – mutes the signal to cut back on consumption. Motorists will not be encouraged to reduce demand. Artificially lower prices may in fact increase demand. BEC believes New Zealand should transition away from fossil fuel powered light-weight vehicles, and reduce emissions associated with transportation. BEC is concerned that potential price controls could slow this transition.

13. The ETS component of fuel prices is likely to increase depending on the trajectory of carbon prices. BEC supports the ETS, as in this case it ensures motorists internalise the public externality of emitting carbon dioxide when driving internal combustion engine vehicles (ICEs). According to data provided to BEC by the Automobile Association (AA), the ETS component of petrol, is about 18.3c per litre and 20.7c for diesel. This is an important signal – which will strengthen overtime – that encourages motorists to switch to lower emitting or battery electric vehicles. Possible price regulations would create artificially lower fuel prices, and subsequently could weaken the price signals conveyed to motorist via the ETS and fuel excise.

14. As mentioned earlier, prices ensure that those who value the resource the most, and are prepared to pay for it, receive the resource. Price regulations that artificially lower prices on a particular good, increases its demand. Some people use the price-controlled goods or services more generously than they would otherwise due to the artificially lower price. On the supply-side, producers lack the signal to adjust their behaviour. It becomes uneconomical to sell additional supplies. More demand, and less supply, lead to artificial shortages.

15. The OPEC oil embargo in October 1973 created a global oil supply shock. Oil prices increased from $2 to $11 a barrel.[4] In 1978, Iran cut oil exports to the west altogether. The price more than doubled again from $15 to $39 a barrel.[5] In the United States, over this period, price regulations were introduced, controlling the price of fuel at the pump.

16. The two supply shocks increased the scarcity of fuel, but price controls exacerbated the scarcity and created an artificial shortage. These price regulations reduced domestic oil production, diminished the effectiveness of conservation programs as motorists did not largely change their behaviour, and inspired black market transactions and hoarding.[6] Since prices were not free to rise beyond the regulated level, motorists still demanded a similar quantity of fuel from before the shock.

17. As a result, rationing this scarce resource was now determined by first-come-first-served. Those who arrived at the filling stations first, may fill their car and exhaust local supply. While those who came late, received little supply to no supply. During this period, motorists with half a tank would fill up the other half as a precaution.[7] This meant motorists were driving with more fuel in their tanks than they would usually. Motorists hoarded vast amounts of supply into their personal inventories – supply that would have been available otherwise.[8] The era became synonymous with disgruntled motorists waiting in long queues.

18. Conversely, markets with fluctuating and skyrocketing prices in response to supply shocks witness motorists consuming less fuel, or enough to get them to their planned destination. This ensures local supplies are not exhausted and resources flow through to those who value them the most.

19. Notwithstanding circumstances of large price shocks, in markets with price controls, price signals are still largely muted. Policymakers and decisionmakers in charge of setting price caps are often too slow or unable to identify changing circumstances that could impact demand and supply. Subsequently, without observing the dynamic changes in time, this slows their ability to amend price caps. Usually, central decision-makers cannot act fast enough to account for the changing world, as the relevant information is usually dispersed and decentralised across many businesses and individuals. Circumstances can change day to day or hour to hour. There is a natural time delay before decision-makers receive this information. In a market with free prices, the changing circumstances, both small and large, are reflected through fluctuating prices that are not controlled and capped. This ensures the balancing of supply and demand in a market with a new set of circumstances.

20. If price regulations are imposed, an assessment of what the price level should be will take place. BEC believes the assessment of a desirable price level seems to be relatively arbitrary. The desirable price, in this case, a price that is classified as *fair* runs into significant problems with its exact definition: what price is fair? BEC acknowledges that this definition of a fair price would be observed by an assessment of what the price would be if it were consistent with what the Commerce Commission would consider a competitive market. However, BEC is doubtful about the effectiveness and accuracy of setting this new 'competitive' price.

21. Notwithstanding the problem of determining a *fair* price, the proposed regulations do not specify the timeframe length that will be used to observe perceived anti-competitive pricing, and or behavior. The timeframe used to observe the extent of competition is important. BEC is concerned that a potential inquiry could use a short timeframe, or a 'snapshot in time,' that does not accurately depict the market in normal conditions, i.e., during price shocks. If the amendment is implemented, BEC believes that any

[4] Schneider, Gregory, *the 1973 Oil Crisis, and its economic consequences, Bill of Rights Institute*
[5] Ibid, p1
[6] Graetz, Michael J. *The End of Energy: The Unmaking of America's Environment, Security, and Independence*. Cambridge: MIT Press, 2011. p15
[7] Sowell, Thomas. *Basic Economics: a Common Sense Guide to the Economy*. Fifth edition. New York, New York: Basic Books, 2015
[8] Ibid, Chapter 3: Price controls

recommendation to investigate and or trigger price regulations should be based on perceived behavior over a sustained period. For instance, four quarters, or longer. This provides some reassurance that price regulations are not imposed after normal market fluctuations.

22. Once price regulations are imposed, the next confronting question is how long they remain imposed. Across the world, price regulations are often justified as temporary measures to lower prices and protect consumers. Price controls on crude oil introduced in the United States during the 1970s were initially supposed to last only 90 days. It took nearly seven years before controls were lifted.[9] Decision-makers have an incentive to extend price controls, as their expiration results in prices reverting to market determined levels, which often increase prices, at least initially. Thus, BEC believes price regulations create the risk of running longer than their initially justified period.

23. As it stands, the proposed backstop enables potential price regulations to be in place for up to ten years. BEC believes this is unreasonable for an industry that experiences daily price volatility. If the amendment is implemented, BEC believes there should be a time limit on potential price regulation(s), and a review period to determine whether price regulations continue. It is also important that the Commerce Commission's potential inquiries are time bound, whereby investigations must be concluded. This ensures the Commission's inquiries are not open-ended events, creating considerable uncertainty.

**Weakened competition and uncertainty**

24. BEC believes there is insufficient evidence to claim New Zealand's incumbent fuel companies are engaging in anti-competitive behavior to keep prices high. Nevertheless, BEC acknowledges that more competition will always be beneficial, both to consumers in the long term and to New Zealand's economy.

25. BEC supports a competitive fuel industry, and a more competitive New Zealand more generally. Competition is a key component in ensuring an efficient fuel industry. It ensures there is a limit to how much a vendor can charge and still make a sale. Rivalry between competitors explains innovation, high quality services and why vendors do not arbitrarily set prices. Competition makes sure firms are nimble, adapting to market conditions and changing to consumer preferences.

26. BEC believes that the justification for regulating terminal gate prices seems to be based on the Commerce Commission's market study commenced in 2018, which investigated competition between New Zealand's incumbent fuel retailers. The Commission's main finding was that fuel companies have 'generated persistently higher profits over the past decade than would be expected in a competitive market.'

27. The Commission outlined several recommendations within the study. Its main recommendation was to introduce a terminal gate pricing regime (TGP). This was later implemented under the Fuel Industry Act 2020. The TGP requires wholesale fuel suppliers to publish a spot price for their fuel and requires the sale of such fuel to any wholesale customer, who wants the fuel, at the spot price. Other recommendations included regulating wholesale supply contracts and measures to inform customers.

28. BEC notes that 'high profits' are not a reliable indication of anti-competitive behaviour per se. Profits and losses, among other factors, reflect what has value and what is efficiently produced. In other words, profits convey what is working. It sends a signal and incentive to enter the market. BEC acknowledges that no market is perfect, and barriers exist that make it difficult for new entrants to enter. The

[9] Graetz, Michael J. *The End of Energy: The Unmaking of America's Environment, Security, and Independence*. Cambridge: MIT Press, 2011. p15

Commerce Commission recommended several changes aimed at reducing these barriers, one of which was the TGP.

29. BEC reiterates that price controls have been shown to weaken competition, not improve it, as they reduce the probability of new entrants. As mentioned earlier, price regulations mute the signal sent by free and fluctuating prices. Regulated prices – and regulated profits – remove the incentives profits create. Entrants are less likely to enter, as the incentive to do so is weak. Investors are more likely to invest in alternative investments with higher rates of return. This reduces the ability of incumbents and possibly new market entrants to access capital, reducing the incentive to improve their services and to innovate.

30. BEC is also concerned that the amendment to the Bill could create a significant risk and regulatory uncertainty – creating a chilling effect on investment in the sector. It is unlikely that an international fuel supplier would be willing to enter New Zealand if the Minister can impose price regulations on any firm specifically – as outlined in Section 29I of the Bill. Entering a new market requires large amounts of capital expenditure, providing significant risk. The possible threat of price regulation could exacerbate the risk of operating in New Zealand.

31. Notwithstanding these impacts on New Zealand's current (and potential) fuel suppliers, the amendment to the Bill could damage investor sentiment towards New Zealand. With low levels of domestic savings, overseas investment is crucial for growing New Zealand's businesses and economy. BEC notes that New Zealand's economy has largely been built on the back of overseas investment. Price regulations in the fuel industry, create a considerable risk that similar regulations could be imposed on other industries: supermarkets, banks, electricity generators and more. This could damage the perception of operating businesses freely in New Zealand, without overly erroneous regulations and restrictions. Consequently, this could reduce the incentive of all types of firms to enter New Zealand, diminishing the potential enhancement of competition across the country's economy.

32. BEC notes that despite these negative consequences and costs associated with the amendment, no apparent cost and benefit analysis has occurred. If an analysis has occurred, BEC believes this should be published. Analysing the potential costs and benefits of the amendment is crucial. This ensures the intervention is worth the apparent consequences.

**The risks of politics guiding prices, not market forces**

33. The proposed amendment has been justified by a straightforward policy logic: a regulatory backstop will encourage fuel suppliers to be more competitive and thus drive down prices at the pump, as fuel suppliers would rather act more 'competitively,' than have their prices regulated. In other words, the new powers given to the Minister, are a warning to suppliers to be competitive; therefore, the amendment does not guarantee the introduction of price regulations per se. BEC is concerned this could unleash unintended consequences.

34. BEC acknowledges that introducing this policy does not necessarily mean price regulations will be introduced. However, BEC believes the likelihood of the Minister potentially using this lever increases given their new powers to do so. BEC is concerned that the price of fuel could be set based on political pressures, rather than by more efficient market forces.

35. As mentioned earlier, in a market with freely fluctuating prices, prices are dynamic. Sudden price shocks can occur. Supply can suddenly drop, or demand can suddenly increase. Under this scenario, prices reflect the new circumstances – in the case of higher prices, more scarcity of fuel. During these shocks, the public turns to decision-makers to act to reduce high prices.

36. In the case of a price shock – increasing the cost of fuels – BEC believes the probability of imposing price regulations significantly increases. The stabalisation of prices can take time, and New Zealand is

dependent on changing global forces, which again can change slowly or rapidly. Persistent high prices due to global supply constraints also increase the pressure of decision-makers 'to do something,' rather than wait for the market to correct itself overtime. The amendment to the Bill provides an option to 'do something' by regulating terminal gate prices. BEC believes this potential scenario should not be downplayed. As outlined throughout this submission, BEC believes this option could be politically expedient, however, in the medium to long-term, its negative consequences outweigh the potential benefits given to motorists in artificially lower prices.

**Consulting with effected parties**

37. BEC believes a terms of reference should be published, for any inquiry, initiated from the Commerce Commission and the Minister. Publishing the terms of reference will provide transparency about why an investigation should occur, outlining the problem definition and any evidence which justifies the decision to investigate.

38. BEC also believes the Minister should be required, in the Bill, to consult with effected parties before any recommendations precede. This ensures any relevant information can be supplied by effected parties and is duly considered.

## APPENDIX ONE – BACKGROUND INFORMATION ON THE BUSINESSNZ ENERGY COUNCIL

The BusinessNZ Energy Council (BEC) is a group of leading energy-sector business, government and research organisations taking a leading role in creating a sustainable, equitable and secure energy future.

BEC is a brand of BusinessNZ and represents the World Energy Council in New Zealand. Together with its members, BEC is shaping the energy agenda for New Zealand and globally.

BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups: EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Business South
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made representing producers, retailers, consumers of NZ-made goods

BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.
In addition to advocacy and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development (OECD).