EXPLANATION OF THE REFINING NZ PROCESSING FEE

Over the past 20 years, the agreement has been subject to regular reviews to make sure it has remained fair and reasonable to all shareholders.

In addition to annual internal reviews of benchmarks, crude and product premia and freight costs, Refining NZ has commissioned a number of independent reports since 1995 to assess whether the 70/30 split remains the best processing arrangement.

Hale & Twomey (2014) assessed alternative options and found them unviable.

This report concluded that the current processing fee is the best for delivering optimal returns to all shareholders and is shared by the refinery and its customers, in a variety of different local and international cost environments. Other reports including by Purvin & Gertz and other third parties arrived at the same conclusion.

These reports (in summary or full) are published on Refining NZ’s website. Further commentary is available from Refining NZ on request.

“Alternative processing arrangements will either result in a steadier income for Refining NZ but supply that is severely uncompetitive for its customers in a low-margin environment or competitive supply of products at all times for customers but severe income variation for Refining NZ. In either of these extremes, the model is unlikely to be sustainable over a normal refining cycle.”

Hale & Twomey (2014)
Refining NZ was established in 1961, and the Marsden Point refinery — New Zealand’s only petroleum refinery — commenced in 1964. In the early days a participants’ agreement was formed whereby the refinery would operate as a ‘toll refiner’. This agreement ended in 1988, but the refinery would operate as a ‘toll refiner’. Today Refining NZ continues to operate as a toll refiner, and continues to charge its customers a processing fee, albeit a different fee post deregulation of the industry in 1988.

As a toll refiner, Refining NZ makes products, such as petrol and diesel, from crude oil and other feedstocks provided to its customers. This is a unique tolling arrangement, which means Refining NZ does not own any of the feedstock it uses to make products, or the products themselves. Rather, it charges its customers a market-related processing fee for its services. The processing fee is very important as it provides the refinery most of its revenue.

Following deregulation, a new processing fee needed to be agreed in light of the changed operating environment. This agreement ended in 1988, but the refinery would operate as a ‘toll refiner’. Today Refining NZ continues to operate as a toll refiner, and continues to charge its customers a processing fee, albeit a different fee post deregulation of the industry in 1988.

Today, some 20% of the country’s fuel products are imported, which means customers are already competing with import margins. The remaining 80% of products are manufactured by Refining NZ at Marsden Point. Refining NZ needs to make sure it offers a competitive processing arrangement that is fair to the company and its customers, reflective of the costs and risks of vessel availability (including scheduling), freight rates, risks of stock and currency gains and losses, the risk of maintaining operation and plant integrity to provide reliable supply to the company and its customers.

WHAT IS A GROSS REFINING MARGIN?

A gross refining margin (GRM) is the difference between prices for refined products (including product freight), and the costs of materials to manufacture those products (such as crude and freight).

No two refineries are the same and are often different on a number of levels: they have different product mixes, product volumes, equipment, manufacturing processes, energy use and costs, and so on.

For this reason, no two refineries will make the same margins. In a New Zealand context, GRM is essentially the difference between landing all refined products at New Zealand ports where they will be sold (e.g., Wellington, Wanganui, Invercargill), and the landed barrel prices at the refinery in Whangarei.

Refining NZ works out the market value of both refined products at New Zealand ports where they are sold (e.g., Wellington, Wanganui, Invercargill), and then subtracts the cost of crude oil from that value to arrive at a product selling price. The net product selling price then represents the maximum margin that can be made from the crude oil its customers provide, and customers are incentivised to maximise the GRM by taking advantage of the refinery’s processing facilities, for example by buying the lowest cost crude oil, together they maximise the gross margin.

RISKS

The 70/30 split is also a fair reflection of the risks borne by either party, including:

- Risks of stock and currency gains and losses associated with maintaining crude, product and intermediate product inventories (borne by the refiner).
- The risks associated with buying crude and chartering shipping (borne by the customers).
- The risks of unusual availability (including scheduling) and demurrage in a variable shipping market (borne by customers).
- The risk of maintenance, operation and plant integrity to provide reliable supply to the refinery (borne by the refinery).

Refining NZ takes 70% of the GRM for its services, and its customers make a pro-rata Fee Floor payment to the refinery. This is paid back should the floor exceed the in the coming months of that calendar year. Similarly, should the margin fall below the $15.00 per barrel cap in the coming months of that calendar year, any reductions are paid back to the refinery by customers.

MODERN AGREEMENT

Despite being 20 years old, this is a well-constructed, robust, modern agreement. This has been confirmed by a report by Hale & Twomey in 2014, which concluded: "The current processing fee structure and split of gross refining margin provides an appropriate balance between Refining NZ’s return and customer competitiveness."

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MARGINE CAP AND FEE FLOOR

The processing arrangements with customers contain both a Margin Cap and a Fee Floor clause. If the year-to-date Processing Fee is below the pro-rata Fee Floor then the company make a pro-rata Fee Floor payment to the refinery. This is paid back should the floor exceed the in the coming months of that calendar year. Similarly, should the margin fall below the $15.00 per barrel cap in the coming months of that calendar year, any reductions are paid back to the refinery by customers.

ALIGNMENT

To keep in touch with changing markets, each company’s benchmarks for crude and products are reviewed to benchmark their returns. This has been confirmed by an independent report by Hale & Twomey in 2014, which concluded: “The current processing fee structure and split of gross refining margin provides an appropriate balance between Refining NZ’s return and customer competitiveness.”

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