REVIEW

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 unsuitable.

This report concluded that the current processing fee is the best for delivering optimal returns to all shareholders, taking into account the risks and costs 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.

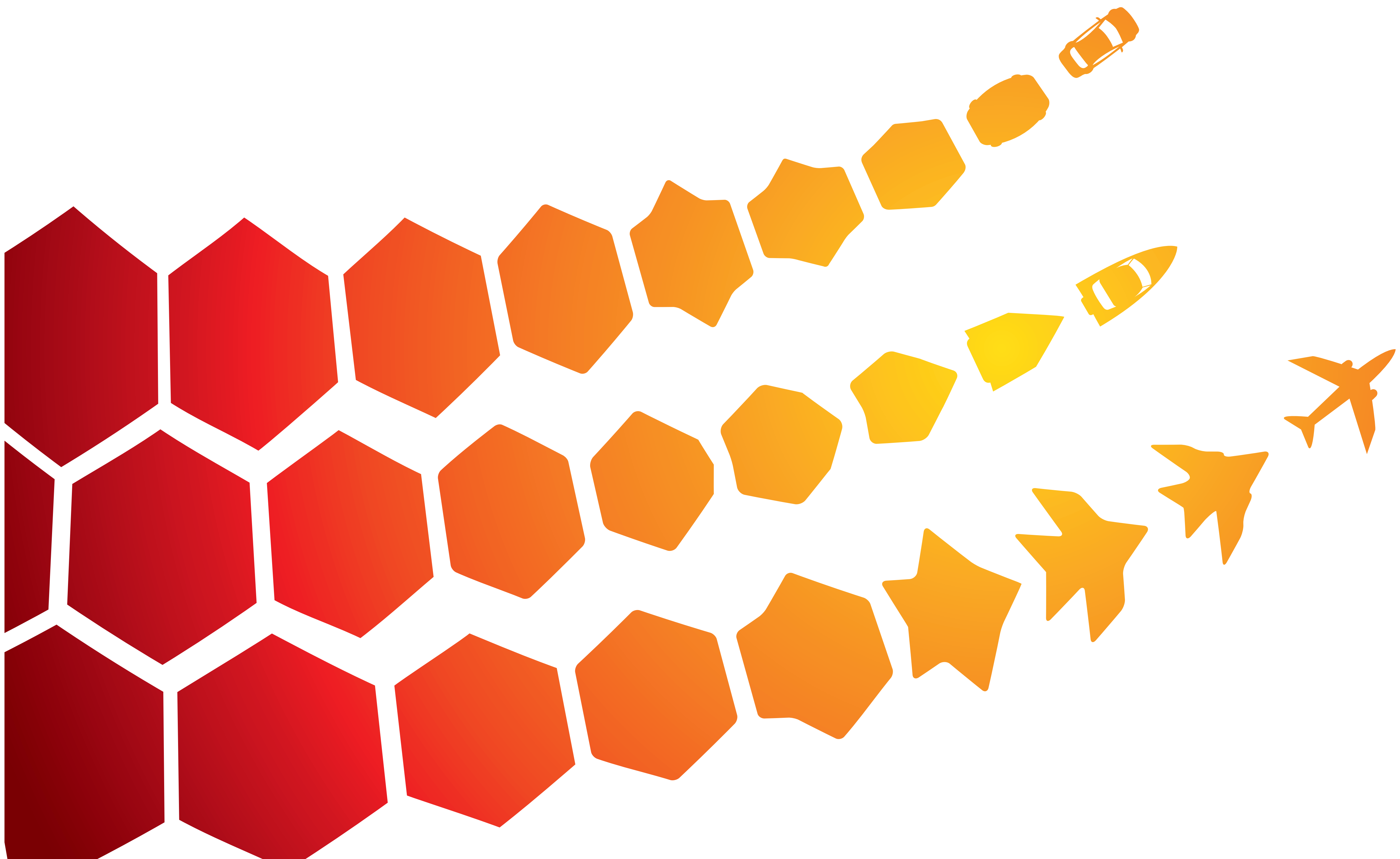
These reports (in summary or full) are published on Refining NZ's website. Further commentary is available from Refining NZ on request.

> "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
Your Energy Hive

EXPLANATION OF THE REFINING NZ PROCESSING FEE



HISTORY

Refining NZ was established in 1961, and the Marsden Point refinery – New Zealand's only petroleum refinery – commissioned in 1964. In the early days a participants' agreement was formed between the refinery's customers, which saw each party pay the refinery a fee to contract its processing services. This agreement reflected that the refinery would operate as a 'toll refinery'.

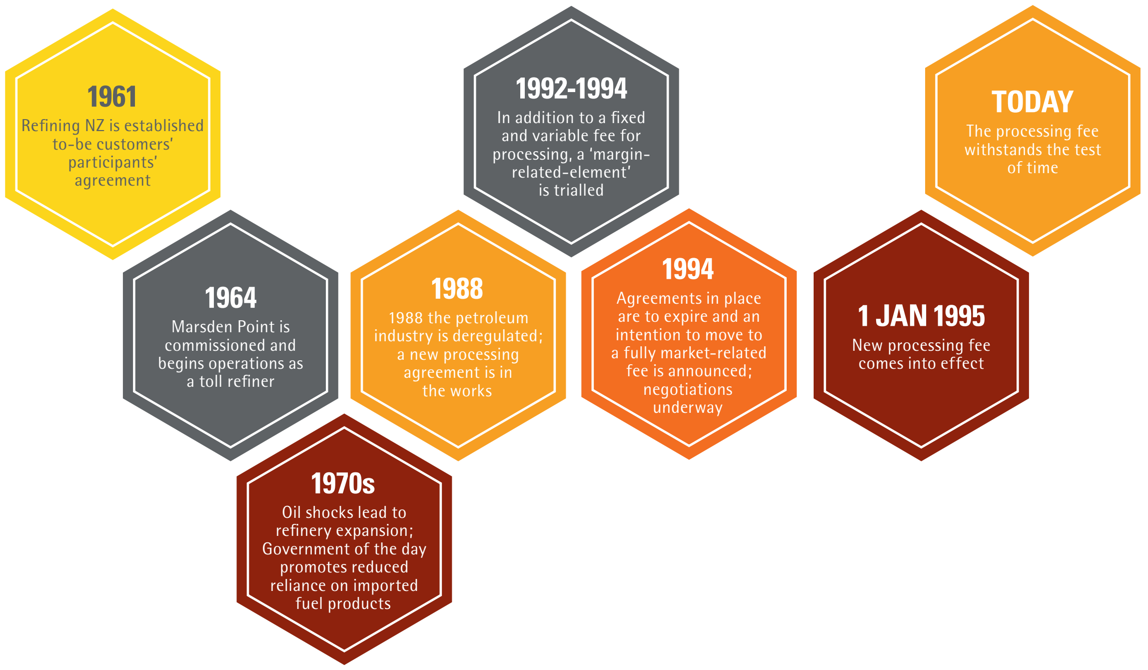
Today Refining NZ continues to operate as a toll refiner, and continues to charge its customers a processing fee, albeit a different fee post deregulation of the industry in 1988.

As a toll refiner Refining NZ makes products, such as petrol and diesel, from crude oil and other feedstocks provided by its customers. This is a unique billing 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 is provides the refinery most of its income.

Following deregulation, a new processing fee needed to be agreed in light of the changed operating environment.

Chairman of the independent board of directors at the time, Ian Farrant, said the intention was to "move the basis of the processing fee towards a fully market related fee with an acceptance that this would entail greater risk and volatility in the company's income, but should increase long term profitability."

Having been deemed to be fair and reasonable to all shareholders, the new fee – fixed at 70% of the refining margin, subject to a fee floor and margin cap – came into effect on 1 January 1995. It has endured ever since.



DEREGULATION/COMPETITION

The key catalyst for the creation of the 1995 rocessing fee was the deregulation of the petroleum industry.

The 1988 Petroleum Sector Reform Act removed all controls over the wholesaling and retailing of petroleum that had been in place for 50 years: Refining NZ was set on its own for the first time and in the new operating environment would need to meet its own capital requirements. Controls on its profits were also removed.

Most significantly, it would have to offer truly competitive margins to incentivise its customers to continue contracting its services as they could freely import products from overseas.

From that day on, when faced with the choice of either importing products or making them at Marsden Point, customers could (and do) choose the more competitive, more economic option.

Today, some 25% of the country's fuel products are imported, which means customers are already engaged with import markets. The remaining 75% 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 both parties share. This is where the refinery's unique 70/30 split of its gross refining margin comes into play.

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 crude 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 crude freight cost and so on.

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

Refining NZ works out the market value of both refined products and crude by using publicly sourced Singapore prices (quoted by agencies such as Platts). Refining NZ also needs to take into account any product quality premia, because some product produced in New Zealand has a higher specification than that quoted in Singapore.

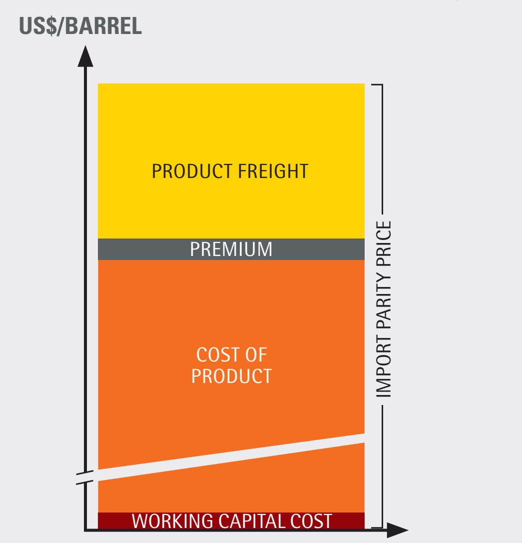
70/30 SPLIT

The 70/30 split sees Refining NZ keep 70 per cent of the GRM from each barrel it processes. Its customers receive the remaining 30 per cent of the margin. The split was chosen as it best reflects the COSTS and RISKS shared by the company and its customers.

COSTS

As a result of deregulation, customers can choose between buying fuel products overseas (import) and bringing them to New Zealand OR buying crude and bringing it to New Zealand to make into products at Marsden Point.

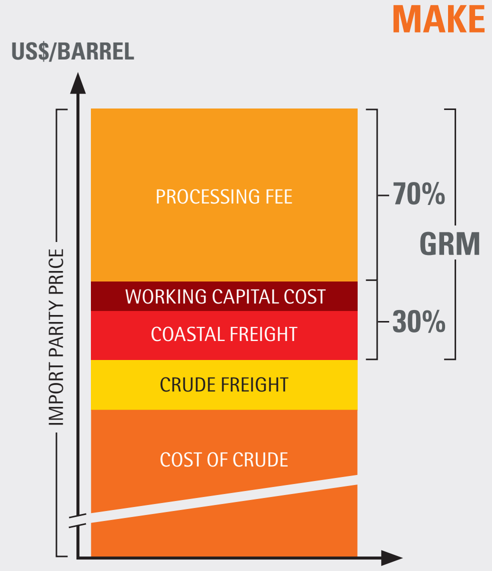
IMPORT



If they take the import option and buy their fuel products, then they are paying for (bottom to top):

- Working capital cost for holding inventory
- The products themselves
- A product quality premium which relates to New Zealand's stringent fuel standards
- Freight costs to get products to New Zealand ports.

MAKE



If they choose to make their products at Marsden Point, then they are paying for (bottom to top):

- The crude needed to make the products
- Freight costs to get the crude to Marsden Point
- Coastal shipping to get their products from Marsden Point to ports around New Zealand
- Higher working capital costs for holding inventory
- A processing fee to Refining NZ.

Whatever the cost of the import option (also known as the import parity price) it fixes the maximum Refining NZ can charge for its toll processing, otherwise it won't be competitive with the import option. Theoretically it is easy to work out the maximum processing fee: - just subtract the cost elements of making the products at Marsden Point from the import parity price.

This is not as simple as it first seems: working capital costs and freight costs around New Zealand are not transparent and can be difficult to quantify, and this uncertainty needs to be factored into the equation.

Modelling by the creators of the current processing fee arrangement showed that 30% of the calculable difference between buying and making was a reasonable substitution for the net working capital costs and local coastal shipping costs: and so the 70/30 split was born.

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 customers)
- The risks associated with buying crude and chartering shipping (borne by the customers)
- The risks of vessel availability (including scheduling) and demurrage in a variable shipping market (borne by customers)
- The risk of maintaining operation and plant integrity to provide reliable supply to the New Zealand market (borne by the refinery).

MARGIN 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 customers make a pro-rata Fee Floor payment to the refinery. This is paid back should the Floor be exceeded in the coming months of that calendar year. Similarly, should the margin fall below the $US9 per barrel cap in the coming months of that calendar year, any cap reductions are paid back to the refinery by customers.

MODERN AGREEMENT

Despite being 20 years old, the processing fee is a well-constructed, robust, modern agreement. 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."

It is a modern agreement because:

ALIGNMENT

With the 70/30 split, both parties have 'skin in the game': – they both share risks and rewards. There is a common interest in achieving the best possible commercial returns, which is a contractual strength. Refining NZ is incentivised to maximise the value from the crude oil its customers provide, and customers are incentivised to maximise their use of the processing facilities, for example by buying the best value crude oil. Together they maximise the gross margin.

COMMERCIAL RELEVANCE

To keep in touch with changing markets, each year benchmarks for crude and products are reviewed to check for any necessary adjustments, product premia are reviewed to reflect any differences in Refining NZ's products compared with benchmark products, and freight costs are reviewed to make sure they are in line with market conditions.

The fee floor and margin cap provide protection from unexpected market shocks for Refining NZ and the customers (respectively): the fee floor ensures Refining NZ receives a guaranteed minimum income during periods of low margins, while the margin cap gives the customers certainty that their processing fees will fall within a predictable, competitive range.

MAXIMUM RETURNS

With guaranteed income from the fee floor, Refining NZ is provided with enough funding for business as usual in the short to medium term. Lending institutions derive comfort from the fee floor, leading to cheaper access to funding for Refining NZ. The fee floor is a strong commitment from customers, and ensures the ongoing viability of the refinery's business throughout the various cycles of the refining game.