MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

BRIEFING

Proposed response to Refining NZ's strategic review questions

Date:	11 June 2020	**Priority:**	Medium
Security classification:		**Tracking number:**	3702 19-20

Action sought		
	Action sought	**Deadline**
Hon Dr Megan Woods **Minister of Energy and Resources**	Discuss the advice in this briefing with relevant colleagues.	22 June 2020

Contact for telephone discussion (if required)				
Name	**Position**	**Telephone**		**1st contact**
Andrew Hume	Policy Director, Energy and Resource Markets	04 901 1474	s 9(2)(a)	✓
Gareth Wilson	Principal Advisor	04 460 1375	s 9(2)(a)	

The following departments/agencies have been consulted

Minister's office to complete:

- ☐ Approved
- ☐ Declined
- ☐ Noted
- ☐ Needs change
- ☐ Seen
- ☐ Overtaken by Events
- ☐ See Minister's Notes
- ☐ Withdrawn

Comments

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BRIEFING

Proposed response to Refining NZ's strategic review questions

Date:	11 June 2020	**Priority:**	High
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Purpose

This briefing provides advice on your response to questions posed by Refining New Zealand (RNZ) on its strategic review, following your meeting on 4 June with Naomi James.

Recommended action

The Ministry of Business, Innovation and Employment (MBIE) recommends that you:

a **Note** that RNZ has written to you seeking your input into its strategic review before its board makes decisions at the end of June.

Noted

b **Note** that we have prepared responses to RNZ's questions, and advice on the proposed responses.

Noted

c **Agree** to forward and discuss this briefing with relevant colleagues, including the Minister of Finance, Minister of Transport, Minister of Economic Development, Minister for Climate Change Issues, Minister for Infrastructure, and Prime Minister.

Agreed

d **Agree** that we will finalise the response letter following your feedback by 22 June.

Agreed

Andrew Hume
Policy Director, Energy and Resource Markets
Building, Resources and Markets, MBIE

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Hon Dr Megan Woods
Minister of Energy and Resources

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Overview

1. You met with Refining New Zealand (RNZ) on 4 June for an update on its strategic review from Chief Executive Naomi James. You invited RNZ to set out its questions for you in a letter, and you undertook to discuss with colleagues before responding. A copy of RNZ's letter is attached in Annex 1.

2. RNZ would appreciate your response in time for its board to consider as soon as possible, before the end of June 2020, when it expects to make final decisions on the first phase of the review, and inform the market.

3. We have previously advised you on the implications of the key options under consideration by RNZ, which are to reduce or to close its refinery capacity. In the closure option the Marsden Point site would transition to a fuels import terminal, largely supplying the Auckland and Northland regions; other regions would be supplied by imported fuels.

4. RNZ has made it very clear that the status quo is not an option. Petroleum refining faces very challenging global market conditions resulting from significant excess capacity, including in the Asia Pacific region. RNZ competes directly with newer and much larger refineries in the region which appear to enjoy better economies of scale and other sources of competitive advantage. These structural challenges have been exacerbated this year by the impact of Covid-19 on the global economy, and particularly the dramatic reduction in demand for petroleum fuels.

5. s 9(2)(g)(i) [redacted] If closed, the refinery infrastructure would likely be mothballed, but we understand that recommissioning a mothballed refinery would require significant capital investment and is not a likely prospect.

6. As previously advised, we consider that closure of the refinery would not pose unmanageable risks to fuel supply security under most plausible disruption scenarios, but the ability to refine domestically produced crude oil would reduce the impact of a severe disruption of global fuel supply chains (e.g. major regional or global conflict). Closure of the refinery would, however, have a number of adverse consequences, including:

   a. the loss of more than 320 jobs in Northland[1], many of which are highly paid engineering and technical jobs, at a time when New Zealand is recovering from a significant economic recession and likely facing very high unemployment rates

   b. a material reduction (about 30 percent) in domestic oil stockholding that would need to be replaced (costing fuel users circa $10 million per annum[2]) to meet obligations under the International Energy Agreement. If domestic stocks were preferred over off-shore stocks for domestic fuel security reasons, closure of the refinery could warrant new policies to build and maintain domestic fuel stocks (at considerably higher cost), and

   c. lost opportunities to support a transition to future low emission fuels (biofuels and hydrogen) by leveraging existing specialist skills and refinery infrastructure.

7. Taken together, these adverse consequences plus loss of ability to refine domestic crude oil suggest the maintenance of domestic refining capacity is of some strategic value to New Zealand, at least for a transitional period.

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[1] RNZ currently employs about 400 people directly or indirectly, and more than 80 per cent of those jobs would be lost if it converted to a fuels import terminal.

[2] This cost estimate is based on recent purchases of options on offshore stock, which is the least cost method of maintaining IEA stockholding compliance. The cost to the Government is recovered from fuel users through a levy on petrol and diesel.

8. It is not straightforward to quantify that strategic value, and therefore difficult to assess the merits of any interventions that might help or encourage RNZ to retain its refinery business, even for a limited period of time. We have however identified some potential policy measures, which could be considered in the months ahead, and which might support the case to retain refining capacity in New Zealand.

9. RNZ has requested responses to six topics or questions. We have set out our views and proposed responses to each topic/question below, with comments on potential interventions that might influence the duration and nature of any transition away from refining.

10. We suggest the letter begins by noting you have consulted some of your Cabinet colleagues and your response is informed by their views. Your response, however, does not represent Government policy as such, but signals some policy options that might be considered depending on the decisions taken by RNZ during or following its strategic review.

Proposed responses to RNZ's questions

The strategic importance to New Zealand of maintaining refining capacity in New Zealand

11. As noted above and in previous advice, we think that domestic refining capacity does have some strategic value, and we propose a response along these lines:

    a. *I acknowledge the important role RNZ plays in the supply of petroleum fuels in New Zealand, including refining and distributing the refined products. I consider the maintenance of domestic refining capacity has some strategic importance to New Zealand, including its contribution to fuel supply security and to the potential development of new domestic industries producing low emission fuels.*

How the refinery today contributes to New Zealand's IEA obligation to hold oil stocks and what impact transition to an import model with product storage could have

12. Closure of the refinery would likely result in New Zealand holding more final product stocks but lower levels of stocks overall (up to 30 per cent lower), because there would be no crude oil inventory ready for refining. Under the International Energy Agreement (IEA) New Zealand would need to replace that reduced stock in order to remain compliant with the IEA obligation to hold stocks equivalent to 90 days of import demand net of exports. RNZ is aware of this impact.

13. Current policy is to meet the IEA stock-holding obligation at least cost by purchasing options on stocks held offshore to make up the difference between total commercial stocks and the 90 days stockholding level. The Government's costs are passed on to fuel users via a levy on petrol and diesel. The cost of purchasing options on the additional stock needed if the refinery were to close is estimated to be in the range of $6.5 to 12 million a year.

14. A 30 per cent reduction in domestic stocks is a reasonably significant change. While the supply chain for imported refined fuels is not more or less risky than the supply chain for imported crude oil, we think a change of that magnitude could warrant a review of stockholding policies. A review could assess the costs and benefits of measures to incentivise or require a minimum level of domestic stockholding, as a buffer against global or domestic supply disruptions. We note that many other countries maintain domestic reserve stocks for this purpose.

15. A stockholding policy that incentivised fuel companies to hold minimum levels of stock in New Zealand could create a revenue stream that would help support RNZ's refining

operations. It could also support other forms of stockholding, including via the conversion and repurposing of existing crude tankage at the refinery to hold refined fuels.

16. If you agree that the crude oil inventory associated with RNZ's refining operation makes a valuable contribution to domestic fuel security, you could indicate you are prepared to consider new policies that could potentially help RNZ monetise that value. It would come at a cost of at least $6.5 million per annum (and probably significantly more), which would likely be passed on to fuel users.

17. We suggest a response along the following lines:

    a. *I understand closure of the refinery would likely result in less commercial stock, in aggregate, being held in New Zealand. Under current policy settings, the Government would need to procure additional stock, or options on offshore stock, to maintain compliance with the IEA stockholding obligation. This cost would be passed on to motorists.*

    b. *I believe a material reduction in domestic stocks could also warrant a review of the Government's stockholding policy, including the costs and benefits of holding minimum levels of stock from a fuel supply resilience perspective. Domestic stocks can help mitigate the impacts of significant supply disruptions, both global and domestic.*

    c. *If, following a review of stockholding policies, domestic stocks were considered strategically important, some mechanism would be needed to incentivise fuel companies to hold the required level of stock in New Zealand. In that case, domestic stockholding could provide a potential revenue stream for Refining New Zealand or other companies that can provide it, whether through refining or otherwise.*

    d. *I cannot, however, predetermine or predict the outcome of any such policy review at this stage.*

18. Depending on RNZ's response to the above and the materiality of it to RNZ's decisions, an alternative position could be to monetise the value of those oil stocks immediately, until such time that a stockholding review could be completed. This could be considered in light of the wider impacts of Covid-19 and Government's immediate Covid-19 recovery strategy.

Any potential changes in Government policy for fuel supply chain resilience requirements, as identified in the Pipeline Inquiry – or related to independent control of NZ's fuel infrastructure

19. RNZ is considering an option in which it separates its infrastructure business, comprising the Refinery-to-Auckland Pipeline (RAP) and associated tankage, from its refining business. [redacted] s 9(2)(b)(ii) and s 9(2)(ba)(i) [redacted]

20. The Inquiry expressed some reservations about the ability of the existing joint venture arrangements to make timely capital investment decisions in infrastructure supplying jet fuel to Auckland Airport. It considered that investment could be more responsive to market needs if decisions were made by an infrastructure owner or operator that was independent of the fuel companies.

21. The Inquiry recommended the Government monitor the industry's progress towards making investment in storage and other resilience improvements, but it stopped short of recommending changes to the ownership or operation of the relevant infrastructure.

22. We understand RNZ is looking for signs that the Government will take action, in response to the Inquiry's report, to encourage the joint venture parties to exit and/or to facilitate RNZ's expansion into the downstream fuel supply infrastructure as an independent owner or operator.

23. Cabinet has not yet considered the Government's response to the Inquiry, s 9(2)(f)(iv) [redacted]

24. In principle, having a larger infrastructure business with stable revenues could help support RNZ's more volatile refinery business earnings. However, we consider RNZ's infrastructure business options are largely separable from its refinery business options; strategic decisions about one can be made independently of decisions about the other. We therefore do not recommend considering policy options that would facilitate RNZ's expansion into adjacent infrastructure for the purpose of encouraging it to maintain its refining capacity (if that is what RNZ has in mind).

25. We propose a response along the following lines:

    a. *The Government has not yet decided on its response to the Inquiry's recommendations. In any case, at this stage I do not expect the response to include proposals that would necessarily encourage or facilitate independent control of New Zealand's fuel infrastructure.*

Options for RNZ to access lower cost electricity and gas, including lower distribution charges

26. RNZ has advised it is engaging with its electricity and gas suppliers to explore options to reduce energy costs to the refinery. Suppliers, especially electricity and gas network businesses with dedicated infrastructure and largely fixed costs, have a strong incentive to retain a large customer. They may be prepared to offer some relief from network or energy prices in order to lower the risk RNZ will reduce its capacity or close its refinery altogether.

27. The Electricity Authority's new transmission pricing guidelines, published on 10 June, will likely result in higher electricity costs for RNZ from 2022. The new guidelines also provide a potential discount mechanism for customers in some circumstances, but we do not know whether RNZ would be able to benefit from it.

28. The Government has little control over the costs of electricity or gas faced by individual consumers. We think energy supply costs are best left to commercial negotiation between RNZ and its energy suppliers and we suggest responding along those lines.

What should RNZ assume about longer term EITE allocations under the ETS

29. RNZ currently operates under a Negotiated Greenhouse Agreement (NGA) which expires in 2023. At that time RNZ will enter the ETS and will have the same ETS treatment as other firms undertaking emission intensive trade exposed (EITE) activities. This includes the same gradual reduction in its rate of industrial allocation assistance, and the same policy treatment under any revised industrial allocation settings from the review. RNZ has noted it faces some uncertainty about the future emission costs it will face as a result of the review.

30. While it may not be possible to provide RNZ with greater certainty about its emissions costs under the ETS, we think RNZ could be encouraged by some reinforcement of key messages about the policy intent of the ETS and the EITE mechanism.

31. If you were minded to encourage the maintenance of domestic refining capacity, the Government could perhaps signal an openness to consider a temporary extension of the existing NGA, if that would result in lower emissions costs or provide RNZ more certainty

about future costs. s 9(2)(g)(i) [redacted] We do not recommend it.

32. We suggest a response along the following lines:

    a. *I acknowledge that RNZ faces some uncertainty about its future emissions costs under the ETS, due to the review of the industrial allocation settings. I cannot anticipate any outcomes from the review, but I would emphasise that the purpose of the EITE mechanism is to mitigate the risk of emissions leakage and that the review will not change this.*

How RNZ's assets, skills and personnel capabilities may play a role in the New Zealand Government's planned transition to a lower carbon fuels future

33. As noted above and as previously advised, we consider there is some option value in the potential for refinery operations at Marsden Point to assist in a transition to low emission fuels, particularly hydrogen and drop-in biofuels that could be produced in New Zealand.

34. RNZ has made it clear that alternative fuels cannot address the short term issues facing its refining business. There is no realistic prospect of a commercially viable hydrogen or biofuels business in the near term.

35. There is some policy development underway in the green fuels space, but we think it will be some time before substantive policies are established that would support or be supported by RNZ's assets and personnel capabilities. We suggest responding along the following lines:

    a. *I am aware that RNZ's refining assets and personnel capabilities could play a future role in New Zealand's transition to lower carbon fuels. However, it is challenging at this stage to identify precisely when or how that role might emerge.*

    b. *The Government is committed to reducing emissions and I consider it very likely there will be interventions to accelerate the development of low emissions fuels, including hydrogen and liquid biofuels. The Government is actively looking into the possibility of developing domestic capability and capacity in production of low emission fuels, through various initiatives focusing on bio-economy, forest industry transformation and low emission transport. However, as any policy proposals developed through these initiatives require extensive consultation and in-depth analysis, the Government is not in a position to propose or introduce any new policy to accelerate development of low emission fuels before the conclusion of Refining NZ's strategic review.*

    c. *If RNZ decides to retain its refinery operations, I strongly encourage it to engage with MBIE's Provincial Development Unit to explore green fuels opportunities that could make best use of RNZ's strategic assets and skills.*

Any other considerations the Government wishes to provide as input to the strategic review

36. RNZ currently employs around 400 people directly, a similar number indirectly, and has previously been assessed as contributing about 7 per cent of the Northland GDP. A terminal operation would likely employ less than 20 per cent of that number of people, with a different mix of skill sets. RNZ employs about 50 engineers, with specialist expertise in energy consumption, chemical, mechanical, civil, processing units, process control, electrical and metallurgical engineering, maintenance and process safety and another 70 employees and contractors who are skilled operators and tradespeople operating and maintaining the refinery.

37. We suggest responding along the following lines:

a. *I acknowledge the significant role RNZ plays in the local economy and that maintaining refining capacity would mean the retention of many highly skilled and highly paid jobs. This would be particularly welcome at a time when the Northland region and many other regions expect to face high rates of business failure and unemployment.*

Timing and next steps

38. RNZ has indicated its board will make initial decisions on its strategic review before the end of June, and will then announce those decisions and next steps to the market.

39. We recommend you forward this briefing to relevant colleagues and discuss your response with them as soon as possible, in the week ending 19 June. We will finalise the response letter for you to send in the week beginning 22 June based on your feedback informed by your discussions.

Annex 1

Letter from RNZ on June 5th, 2020

5th June 2020

Hon. Megan Woods
Minister of Energy and Resources

Via email: m.woods@ministers.govt.nz

Dear Minister,

We appreciate the time you have taken to focus on the challenges facing Refining NZ and thank you for the time you took to speak to me yesterday.

As you are aware, we commenced a strategic review in April against a backdrop of structural change in the global refining industry. This has been driven by growth in new capacity in Asia, well in excess of regional demand, resulting in very low refining margins. This overcapacity is forecast to increase over the next 5 years. In New Zealand, this has meant Refining NZ reaching the point where continued operation of Marsden Point Oil Refinery in its current form is unsustainable.

The first phase of our review has been to identify and assess all the options for continuing crude oil refining in New Zealand and options to convert to finished product import operations. We are now close to finalising the first phase of our strategic review and our work is indicating that changes within our control will not be sufficient to allow the refinery to remain economically viable in New Zealand over the medium and longer term.

As the review progresses through to finalisation over the next two weeks, we are seeking Government input on a number of matters (provided to MBIE on 30 April 2020) as follows:

1. **The strategic importance to New Zealand of maintaining refining capacity in New Zealand**
    - *We note that the New Zealand Government has not to date publicly communicated a position in relation to refining in New Zealand. A number of Government policy announcements relevant to the hydrocarbon fuel supply chain have been made over the last 18 months, such as the legislation of the 2050 net zero emission target and the setting of new shorter-term emissions reduction targets, the prohibition on new oil and gas exploration and the decision to restrict Kiwisaver investments in this area.*

2. **How the refinery today contributes to New Zealand's IEA obligation to hold oil stocks and what impact transition to an import model with product storage could have**
    - *We note that the closure of the refinery would reduce the level of oil stocks held in New Zealand by approximately 30% and that any shift to imports will require decisions to be made around the level of NZ storage in the fuel supply chain.*

3. Any potential changes in Government policy for fuel supply chain resilience requirements, as identified in the Pipeline Inquiry – or related to independent control of NZ's fuel infrastructure

- s 9(2)(f)(iv) [redacted]
- *We would like to understand how Refining NZ might be impacted by any upcoming decisions, and whether there is a broader role for Refining NZ to play as an independent owner of New Zealand's shared fuel supply infrastructure, which might encourage adequate investment to New Zealand fuel storage.*

4. Options for RNZ to access lower cost electricity and gas, including lower distribution charges

- *Refining NZ is a significant source of demand for utilities in the Northland region, making up 25% of Northland demand.* s 9(2)(b)(ii) [redacted] *We note that the proposed changes to transmission pricing currently under consideration would further increase these costs.*
- *We are meeting with Transpower's CEO and the Electricity Authority next week. We are also seeking responses from our electricity and gas suppliers, regarding their ability to lower Refining NZ's electricity and gas costs in the near term.*

5. What should RNZ assume about longer term EITE allocations under the ETS

- *Refining NZ has approximately 1.1mt of CO2 emissions at present, representing just over 1% of New Zealand emissions. It was awarded EITE status in April, with the Government's Regulatory Impact Statement noting that while the closure of the refinery would reduce New Zealand emissions, it would likely result in an increase in global emissions (Regulatory Impact Analysis: Regulatory Impact Statement - Future climate change policy treatment for Refining NZ).*
- *We note announcement of new emission caps for 2021 to 2025 this week and the planned review of EITE allocations later this year.*
- s 9(2)(b)(ii) and s 9(2)(ba)(i) [redacted]

6. How RNZ's assets, skills and personnel capabilities may play a role in the New Zealand Government's planned transition to a lower carbon fuels future

- *We have engaged with MBIE and the Government's consultants to provide information on the various capabilities available at Marsden Point.*
- *These discussions have focused on what option value these capabilities may have as New Zealand determines the lowest cost pathway to transition to greener fuels in the future, as under consideration in the Ministry of Transport's Green Freight project.*

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7. **Any other considerations the Government wishes to provide as input to the strategic review**

As you can see, the objective of engaging with Government is to understand the position of Government around the refinery, and the timing of transition, as Refining NZ contemplates the need to make significant changes in its operations.

We have undertaken to update the market on the outcome of Phase 1 of the strategic review by the end of June and had previously requested Government input by the end of May. I would be grateful to receive your response as soon as possible, so that this can be considered by our Board later in June as we finalise the first stage of the strategic review.

As noted, we will also update you on the review's outcome as soon as we are able to, and will make arrangements to do so closer to the time.

Nga mihi,

Naomi James
Chief Executive Officer

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