**Submission by NGC on the Draft Determination of a
Restrictive Trade Practice for the Joint Marketing of Pohokura Gas**

9 June 2003

Introduction

NGC welcomes the opportunity to make a submission on the Commerce Commission's Draft Determination in respect of the Pohokura Joint Venture's application for authorisation of a restrictive trade practice to jointly market and sell the gas produced from the field. The NGC Group of Companies is involved in the transportation and wholesaling of natural gas in New Zealand. This submission is made on behalf of the NGC Group of Companies by NGC Energy Limited. NGC looks to this authorisation process to ensure that it can participate as a purchaser on appropriately competitive terms.

This submission is complementary to our initial submission and the two NZIER reports, rather than a reiteration of the points made in those documents (available on the Commission's website). The two NZIER reports expand on and support the views put forward in our initial submission. Having considered the Draft Determination, NGC maintains the position expressed in its initial submission.

NGC strongly supports the early development of the Pohokura and other gas fields to ensure a diverse and reliable gas supply. In this regard, NGC believes the Commission is generally heading in an appropriate direction by signalling that it will grant an authorisation only if it is subject to robust conditions to constrain the potential for anti-competitive behaviours. While NGC considers that it would have been preferable to require the applicants to submit a detailed joint marketing agreement which incorporated appropriate safeguards, and to authorize that agreement, the conditions contemplated by the Commission could achieve a similar outcome.

In this submission, NGC proposes some refinements to the Commission's draft conditions which seek to:

- Realise the early development of the field;
- Minimise the potential harm of this anti-competitive arrangement;
- Avoid market distortions due to restrictions on contract duration; and
- Minimise market distortions due to information asymmetries relating to field reserves.

It should be noted that NGC's views as expressed in this submission relate to large gas fields in the New Zealand context, particularly one such as Pohokura which is, in effect, replacing the depleting Maui field. The market conditions faced by smaller fields may make commercial solutions that allow separate marketing impractical.

This submission comments briefly on the:

- Technical feasibility of separate marketing;
- Overstated benefits of joint marketing;
- Understated detriments of joint marketing;
- Harm to public interest of joint marketing;
- Refinements of the suggested conditions; and
- NGC's overall conclusion on the Draft Determination.

Technical Feasibility of Separate Marketing

NGC agrees with the Commission's view that separate marketing is technically feasible in New Zealand. However, consideration of whether it is practicable and desirable should be made on a case by case basis. Requiring separate marketing for small fields may make their development uncommercial. Clearly in the case of Pohokura, the field is large and the market is looking for a replacement for Maui, so there is little doubt that the field can be successfully marketed.

The Draft Determination correctly identifies the technical feasibility of separate marketing, as shown by the:

a) Examples of the Geographe/Thylacine and Yolla fields in Australia;
b) Commission's survey of AIPN[1] members regarding Gas Balancing Agreements (GBA);
c) Existence of at least three model form contracts to provide a starting point for the GBA;
d) Consideration of the economic incentives to develop the field under separate marketing; and
e) Evolution of policy thinking in Australia regarding separate marketing.

In addition, NGC reiterates the direct experience of separate marketing of gas from the Kapuni field: under the terms of the High Court's judgment in the *Kapuni* litigation, the output of the field is equally divided between the Kapuni JV and NGC. Each markets gas from the field separately, and in competition with each other.

Benefits of Joint Marketing are Overstated

In NGC's view, the Commission has been overly generous in assuming a 12 month delay in production date due to separate marketing in its counterfactual. If the Commission issues its final determination in August 2003, the JV partners would have 29 months to complete the tasks outlined in Table 8 of the Draft Determination before the expected production start in February 2006. A number of these activities could be progressed concurrently. There appears to be a strong economic incentive to develop the field as soon as possible, so the JV partners could reasonably be expected to resolve any issues quickly rather than delay the project.

NGC also encourages the Commission to consider the prospect that overall development of the field could proceed as planned, driven by the economic incentive to market the condensate and LPG, even if agreement is not reached on separate gas marketing by February 2006.

Consequently, the posited benefits should be adjusted downwards.

In NGC's view there is a strong argument that no additional time should be allowed in the counterfactual for the implementation of separate marketing. These agreements and their negotiation are within the control of the applicants. Applicants for authorisation should not be permitted to argue that an authorisation should be granted to prevent their acting inefficiently and opportunistically, to the detriment of the public.

Detriments of Joint Marketing are Understated

While the Commission discusses many of the detriments of joint marketing, it has not attempted to quantify many of them. NGC considers that they are likely to be understated in the Commission's Draft Determination. NGC agrees that joint marketing will slow the development of competitive and

[1] Association of International Petroleum Negotiators.

efficiency enhancing processes in the gas sector – relative to the counterfactual. To quantify this detriment, the Commission might review the analysis of efficiency gains anticipated in the electricity market design.[2] Here, dynamic considerations dominated and, as in other Commission assessments, considered a range of percentage improvements in long run costs.

Harm to Public Interest in New Zealand

NGC agrees with the Commission's conclusion that the detriments due to the joint marketing of the Pohokura gas field outweigh the benefits by a substantial amount (absent appropriate conditions on authorisation).

This conclusion is consistent with the competition concerns expressed in NGC's initial submission and repeated here, namely the:

a) Lessening of competition between JV partners with respect to Pohokura gas – this is potentially significant in light of the small number of participants in the New Zealand market;
b) Lessening of competition between fields - because of the limited number of participants in the market, one or more of the partners could obtain the power to set a minimum price and other key terms across the production sector, if each partner has a full veto over joint marketing decisions at Pohokura;
c) Potential distortion of the supply chain - at least one JV partner owns an associated company further downstream that could have access to information supplied by other buyers; and
d) Lack of constraints on the market power of the seller – given the current and predicted characteristics of the market, the applicant's posited constraints do not appear to be robust.

As outlined above, NGC considers that the Commission's conclusion on this matter is clear because, if anything, the Draft Determination overstates the benefits and understates the detriments. Consequently, the draft conditions imposed on any authorisation may need to be more robust. NGC proposes refinements to the conditions below that seek to recognise "real life" issues for the field developers while ensuring proper controls.

Refinements to Conditions

If the Commission is to authorise the joint marketing arrangement, NGC agrees that robust conditions will be necessary to ensure the posited benefits are delivered and the detriments from anti-competitive arrangements are minimised.

Ring-fencing

The ring-fencing will have to ensure that marketing of Pohokura gas is fully independent of decisions on other gas fields, in order to be effective in limiting the potential for inappropriate information flows and coordination of pricing both horizontally across fields and vertically between associated companies. There appear to be two basic options to achieve this:

a) A member of the JV with no interest in any other gas fields would assume sole responsibility for marketing of Pohokura gas on behalf of the JV. The other JV members would have no decision rights in respect of gas offers and gas sales, and would only receive the contracts finally entered into, not information about bidding strategies etc; or

[2] eg The Wholesale Electricity Market Study October 1992 "A Managed Transition Toward A Facilitated Market" Final Report WEMS/4

b) An agent, such as a major consultancy firm, would be given guidelines of what is acceptable to the JV. Such guidelines would include standard terms and conditions for contracts. The agent will need to be given a base price and production range that ensures it is economic for development to proceed. However this minimum revenue requirement should be based on project economics rather than forecast market prices. The agent would then negotiate the best possible portfolio of contracts on behalf of the JV which would only see the final contracts. All other information relating to offers and negotiations would remain confidential to the agent.

NGC notes that all JV partners have interests in other fields, so the second option appears to be the only robust approach to avoid inappropriate information flows.

In NGC's view, any failure to include a condition keeping marketing information and decision-making separate would not only contribute to the co-ordination of prices across fields and the associated detriments (effective monopolisation), but also potentially lead to competitive detriments in downstream markets due to vertical information flows.

Fixed Date for Gas Supply

NGC believes a single fixed date for gas supply to commence may lead to unnecessary contractual and authorisation problems when the delay may be caused by a technical supply issue. NGC believes the conditions should balance incentives for early supply with practical approaches to market dynamics and technical uncertainty.

Period of Authorisation

With respect to limiting the authorisation period, NGC believes the objective is to minimise the anti-competitive conduct to that necessary to allow early development of the field. Therefore it is important to separate the concepts of:

- How long the JV partners can act jointly; and
- The extent of the anti-competitive arrangement.

The first of these points could be considered to be the "marketing period" and should commence as soon as the authorisation is granted. It is likely that both sellers and buyers will be seeking to contract gas supply before production starts. NGC believes that a backstop date is necessary to limit this marketing period, though the limit imposed by the authorised extent of the behaviour is likely to occur before the backstop date. The end of 2007 may be an appropriate backstop termination date for the marketing period.

The second point, extent of anti-competitive behaviour, could be defined in terms of time or gas quantum. Many of the contracts may be of medium to long term duration, so a time-based limit on the extent would need to allow for contract duration that extends beyond the marketing period. Time limits on contract duration may well distort efficient decision-making on contract terms and length. Our earlier submission outlined the nature of gas supply different buyers may be seeking, for example generators seeking to develop a new power station or aggregators prepared to stand in the market.

NGC believes a limit on the extent of the behaviour would be better achieved by restricting the quantity of gas that can be jointly marketed. This can be achieved either by specifying a fixed amount or basing the amount on a percentage of the P90 reserves. NGC favours the latter approach as the percentage can be initially set to underwrite the field development, while an incentive is established to take actions that increase the P90 reserves over the development period. NGC has not had access to the confidential information in the authorisation application, so can only speculate on precise terms. It may be necessary to jointly market around two-thirds of the P90 reserves to make the development economic. However, the revenues from the condensate and LPG may reduce the level required.

NGC believes this approach satisfies the objectives of:

- Ensuring the JV partners can contract sufficient gas to make the field development economic;
- Providing time for the JV partners to finalise separate marketing arrangements, to apply after the jointly marketed gas has been delivered;
- Limiting the amount of gas that is sold subject to this anti-competitive arrangement; and
- Improving market information with respect to field reserves.

Authorisation Cannot Be Assigned

NGC agrees that the authorisation should only apply to the existing parties. Any future assignees or successors should be subject to the scrutiny of the Commission, so any potential issues relating to associated horizontal or vertical businesses can be considered appropriately.

Conclusions

NGC supports robust conditions on any authorisation to adequately address the issues raised in the submissions, to ensure the posited benefits are realised, and to minimise the harm to competition. In particular, expediting field development should be incentivised.

In NGC's view the conditions should:

a) Require fully independent ring-fencing of the sales process;
b) Allow joint selling of gas from the date of the authorisation being granted to the end of 2007;
c) Limit the amount of gas that can be jointly sold to the percentage of P90 reserves necessary to ensure the economic development of the field; and
d) Restrict the authorisation to existing parties.

Signed on behalf of NGC Energy Limited

Dr Paul Hodgson
Regulatory Affairs Manager