SHELL SUBMISSION ON POHOKURA JOINT MARKETING AUTHORISATION REVOCATION

30 MARCH 2004

Introduction

1 This submission is made by Shell Exploration New Zealand Limited and Shell (Petroleum Mining) Company Limited ("Shell") in response to the Commerce Commission's draft determination dated 23 February 2005 (the "draft determination"). The draft determination proposes to revoke the authorisation the Commission granted in Decision 505 to allow Shell, OMV New Zealand Limited ("OMV") and Todd (Petroleum Mining Company) Limited ("Todd"), (Shell, OMV and Todd together the "Pohokura Joint Venturers") to enter into arrangements to jointly market and sell gas produced from Pohokura gas field.

Summary

2 The Commission proposes to revoke the authorisation granted in Decision 505 on the basis that either the authorisation was granted on information that was false or misleading in a material particular, or there has been a material change in circumstances since authorisation. Shell submits that neither ground for revocation is established because in terms of the relevant provisions of section 65 of the Commerce Act:

2.1 the information given to the Commission as to the JV parties' then view of the likely factual and counterfactual was accurate and did not mislead the Commission; and

2.2 the fact that the JV parties' then view did not accord with the way in which events subsequently unfolded does not constitute a material change in circumstances.

3 In addition, Shell contends that, even if the Commission asserts jurisdiction under section 65, the Commission's discretion should not be exercised to revoke the authorisation because:

3.1 the Commission has not yet carried out an appropriately robust cost/benefit analysis of the impact of revocation; and

3.2 such an analysis would reveal significant commercial risks attaching to revocation as compared with minimal competitive downside in the event the authorisation remains.

4 Shell's view is that now is not an appropriate time for the Commission to intervene in the absence of a gas balancing agreement between the Pohokura Joint Venturers. It would be better if the Commission considered the issue at a later date when there is some certainty as to the prospects of separate selling being successfully established.

Draft determination

5 Briefly, in the draft determination (at paragraph 96) the Commission's preliminary conclusions, on the information available to it, are that:

5.1 the authorisation in Decision 505 was granted on information that was false or misleading in a material particular, or that there has been a material change in circumstances since the authorisation was granted;

5.2 as a result, the Commission has jurisdiction to consider whether to revoke, amend or grant a further authorisation in substitution of Decision 505;

5.3 after considering whether to revoke, amend or grant a further authorisation in substitution for, Decision 505, the Commission should exercise its discretion to revoke the authorisation given in Decision 505; and

5.4 the Commission does not consider it should amend, or grant a further authorisation in substitution for, Decision 505.

6 The Commission states, at paragraph 48 of the draft determination:

> *In their statements…, the Pohokura Joint Venture said that separate marketing and sale of gas either had practical difficulties that "would be difficult if not impossible to overcome"; or is not "feasible" in the foreseeable future or for the expected life of Pohokura". Within 9 months of the Commission's authorisation of joint marketing and sale of gas from the Pohokura field the Shell, OMV and Todd acted contrary to these statements. Presumably, in that short length of time, the "difficult or impossible practical problems" have been overcome and it has become "feasible" to separately market and sell Pohokura gas. Moreover, again contradicting the Pohokura Joint Venture's statements to the Commission during its consideration of the authorisation application …, separate marketing has not resulted in a delay to the date of final investment decision or to the development and production timetable for Pohokura gas.*

7 The Commission then finds alternative grounds for revoking authorisation under section 65 of the Commerce Act, which provides:

> *… if at any time after the Commission has granted an authorisation … the Commission is satisfied that –*
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> *(a) the authorisation was granted on information that was false or misleading in a material particular; or*

> *(b) there has been a material change in circumstances since the authorisation was granted -*
>
> *… the Commission may revoke or amend the authorisation or revokes the authorisation and grant a further authorisation in substitution for it.*

8 The draft determination postulates that the criterion under either paragraph (a) or paragraph (b) is fulfilled. That is, either the information provided to the effect that the final investment decision could only be achieved by 2004 with joint marketing and sale, was false and misleading; or a material change in circumstances occurred since authorisation to the effect that joint marketing was not necessary to achieve final investment decision by 2004. Either way, subsequent events had proved that joint marketing and sale was not essential to bring the final investment date forward.

9 Put more simply, either that information was incorrect at the time it was provided or circumstances changed subsequently to render it incorrect. Either of those alternatives, the Commission claims, fulfils a criterion for revocation. Further, the Commission suggests (at paragraph 67), the false or misleading criterion would be satisfied regardless of whether such information was provided "intentionally or otherwise".

Information provided was not false or misleading

The Commission's framework

10 The Commission states in the draft determination (at paragraph 94):

> *…the Commission considers that having established that OMV, Shell and Todd are now marketing and selling gas separately to a timetable largely consistent with the timetable the Commission found would only be achievable if the Parties marketed and sold gas jointly, it is appropriate to revoke the authorisation.*

11 The fact that a counterfactual as described by an applicant for authorisation (or clearance) subsequently does not in fact transpire, does not of itself mean that information given suggesting that counterfactual was false or misleading. Nor does it mean that there has been any change to material circumstances of fact (as opposed to opinion). It simply means that events have unfolded differently than was reasonably and honestly predicted at the time such information was provided.

12 The Commission itself recognises in its *Mergers and Acquisitions Guidelines* that defining the counterfactual (or factual) is not an exact science. Rather,

it is described as "… a pragmatic and commercial assessment of what is likely to occur… "[1] More specifically the *Guidelines* state:

> *Although the initial formulation of the counterfactual is introduced at an earlier stage in the analysis, a final view on all its features may not be arrived at until the competition analysis has been completed.*[2]

13 That is, the counterfactual is considered *after* the Commission itself has had the opportunity to complete its own expert analysis of the circumstances opined to by the applicants.

14 Even then, the level of residual uncertainty will sometimes be so great that the Commission will accept, or prescribe, a range of counterfactuals on the basis of information at that time known to the Commission. Indeed, it must rarely be the case that, more than 2 years after an application for authorisation (or clearance) is received by the Commission, either the counterfactual or factual as described by the applicant ex ante, will have come to pass.

15 It is unrealistic to suggest however that, on every such occasion, the Commission has made its decision on false or misleading information. If that were so, the Commission would probably have grounds for revoking every authorisation of a restrictive trade practice that it has granted. For example, the timeline postulated by the applicants in relation to the Number Administration Deed in Decision 356 has been well and truly departed from.[3]

16 Further, while there is no equivalent power (to section 65) to revoke clearance or authorisation of a business acquisition, section 69 does require that for such clearance or authorisation to be effective, the relevant assets or shares must be "acquired in accordance with the clearance or authorisation" and while it is in force. There must at least be an argument that, if the Commission's analysis with respect to the application of section 65 were to hold, where a clearance or authorisation for a business acquisition has been given on the basis of a factual or counterfactual which proves post facto to be inaccurate, that protection no longer applies. This would be a surprising result.

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[1] Commerce Commission, *Mergers and Acquisitions Guidelines*, p.21.

[2] Ibid.

[3] Decision 356: Newcall Communications Limited, Teamtalk Limited, Telecom New Zealand Limited, Telstra New Zealand Limited and Vodafone New Zealand Limited, 17 May 1999.

The information provided by the Pohokura Joint Venturers

17 Shell submits that there was no false or misleading information provided, intentionally or otherwise, by the Pohokura Joint Venturers. The mere fact that separate marketing is now being proposed – despite the views expressed by the applicants for authorisation that this would not happen - does not make their views as expressed at the time the application was made "false or misleading".

18 The views, as expressed in the application itself and throughout the authorisation process, constituted the accurate and honest appraisal of the applicants' collective expectation of the likely counterfactual, at the time those views were expressed. Separate marketing was – at that time - considered to be a commercially daunting prospect involving certain delays, when compared to the anticipated timeline for the alternative scenario of joint marketing of gas.

19 Shell did not anticipate - and could not have reasonably anticipated - the degree of difficulty that it subsequently struck in attempting to negotiate commercial arrangements around joint selling. The practical reality is that the respective commercial interests of the Pohokura Joint Venturers were much less aligned than Shell (or those other parties) appreciated at the time when the views relating to likely timing were expressed to the Commission. As we note below, these circumstances always existed, it is just that the respective parties had not appreciated either the extent of the misalignment or, accordingly, the ultimate commercial ramifications.

20 Subsequently, Shell found that it had no alternative but to proceed with marketing separate parcels of gas, in the hope that the commercial risks which it had identified in the authorisation process could be managed down the line. In fact, Shell's decision to commit to a final investment decision was made:

20.1 in the knowledge that some commercial arrangements of the kind that had been described to the Commission at the conference, remained subject to negotiation, such as gas balancing arrangements;

20.2 with the express intention of satisfying the timing condition attached to the authorisation as specified in Decision 505; and

20.3 in the context of the commercial comfort provided by the residual existence of the authorisation if the commercial issues associated prove insurmountable – for example, a "joint selling" mechanism (to each Joint Venturer) may be the most achievable balancing mechanism available.

21 But none of this renders the "information" provided (i.e. the Pohokura Joint Venturers' view of the likely factual and counterfactual) "false or misleading". That information was a true reflection of their collective view at the time and, in that sense, did not mislead the Commission. Indeed, the Commission was not "misled" – it simply made a calculation on the basis of a considered view of the likely counterfactual – having regard to the submissions of interested parties. Ultimately, events unfolded in an unexpected manner. Of itself, this cannot impugn the information originally provided.

No material change of circumstances

22 The Australian authority cited by the Commission (*Re Media Council of Australia* (1996) ATPR 41-497, 42-226) contains a more rigorous test for a "material change of circumstances" than has been applied in the draft determination.

23 *Re Media Council* found that public benefit and detriment considerations were germane to finding a "material" change of circumstances and whether such change warrants revocation of authorisation.[4] In determining the public benefit and detriment the Australian regulator had to compare the position with and without the authorisation that would be likely to exist in the future. It was held that a significant public detriment was required to warrant a revocation of an authorisation.

24 In the draft determination (at paragraph 32) the Commission has identified the benefit critical to Decision 505 - that being the early development and production of the Pohokura field. It also states (at paragraph 60) that the material relevant change is that the nexus between joint marketing and sale and early production no longer exists, stating authorisation would not have been given without that nexus (paragraph 93). But Shell submits that the benefit of early production is no longer fundamental to the Commission's analysis, as regardless of whether the parties are marketing and selling gas from Pohokura jointly or separately, early production will occur.

25 On the other hand, the draft determination does not articulate *any* public detriment to warrant revocation. As events have turned out, the public of New Zealand is getting the "best of both worlds". That is, the Pohokura Joint Venturers are endeavouring to separately market their gas – in which event competition will not be lessened as the Commission had originally feared. At the same time, the parties remain on target to develop the field within the timeframe contemplated by the Commission. The outcome

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[4] *Re Media Council of Australia* (1996) ATPR 41-497, at 42-241

achieved post-authorisation in this case is one where the potential anti-competitive harm identified by the Commission in fact may well be *avoided* by the applicants' subsequent conduct. That would seem to be a situation that least demands the Commission to utilise its power to revoke.

26 Shell submits that the question whether there has been a material change of circumstances should be approached cautiously by the Commission. In particular, the mere fact that the subsequent conduct of the parties to a restrictive trade practice (which the Commission has authorised) may differ from that which the Commission – assisted by the submissions of those applicants and other interested parties – expected at the time the authorisation was granted, does not constitute a "change of circumstances".

27 The dictionary definition of the term "circumstances" is "external conditions that affect or that might affect action". Applying that definition to the present context, that means the external conditions that are affecting or might be affecting the Pohokura JV parties in their attempts to market and sell gas from that field. In this regard, the relevant conditions have not materially altered. On the contrary, the commercial difficulties potentially arising in the context of separate marketing that were alluded to by the applicants still persist – and have still yet to be resolved.

28 It is fair to say that volatility within the internal commercial dynamics of the Pohokura Joint Venture formed a material aspect of the context in which the views expressed to the Commission with respect to the difficulties associated with establishing separate marketing arrangements were formed. So while separate marketing was known to very difficult in general – these difficulties were expected to be accentuated by the nature of the commercial dynamics of the Pohokura Joint Venture. This environment continues today. Furthermore, it is the root cause of the failure of the parties to commence a joint selling process in a manner that would comply with the timetable laid down by the Commission in Decision 505.

29 For its part, Shell did not anticipate the difficulties which have been encountered in looking to establish joint selling arrangements. But – unfortunately – those difficulties are not inconsistent with the prevailing commercial environment. And now it is that same environment that means that the ultimate success or failure of the separate marketing path currently being attempted is a matter giving rise to significant commercial uncertainty.

30 So while the underlying facts have not changed, events have subsequently unfolded differently from the applicants' previous opinion as to what would happen.

Discretion to revoke

31 Even assuming one of the grounds under s65(1) were to apply, Shell considers that this is certainly not a case where the Commission should exercise its discretion under section 65. The Commission notes (at paragraph 89) that the Commission *must exercise its discretion based on the facts of the particular situation before it*.

32 The facts here are simply that the counterfactual did not come to pass exactly in the way that the applicants had honestly and reasonably anticipated. But, that would be a likely outcome with the majority of matters determined by the Commission. Certainly, we can point to other instances where the outcome as described to the Commission in fact has not been achieved. Shell believes that the Commission would be in a better position to address these issues once the commercial dynamics have had a chance to play out. That would mean re-examining the matter in, say, a year's time just prior to first gas from the Pohokura field and hopefully resolution of the outstanding gas balancing agreement. There would seem to be no downside in exercising caution in this way.

33 Shell is not asking that the Commission amend the existing authorisation or substitute it with another so it bears no onus in this regard. In that context, all Shell asks is that the Commission give due and proper consideration as to whether or not it is appropriate to revoke the existing authorisation. That requires a *robust* and *forward-looking* consideration of the ramifications of the Commission's initiative. Shell submits that it would be imprudent to apply the somewhat simplistic "straight conduct test", especially in an environment where there is such uncertainty as to what that conduct is likely to be.

34 The Commission seems to be advancing a proposition that, in the event that the authorised conduct is not being undertaken at a particular time during the currency of the authorisation, the authorisation can be revoked without any need to consider the welfare implications. The Commission states in the draft determination (at paragraphs 93-94):

> *The Commission considers that had it known at the time of the determining the original application that separate marketing and sale would still make the final investment decision achievable by June 2004, the Commission would not have authorised the proposed arrangement.*

Taking these factors into account, the Commission considers that having established that OMV, Shell and Todd are now marketing and selling gas separately to a timetable largely consistent with the timetable the Commission found would only be achievable if the Parties marketed and sold gas jointly, it is appropriate to revoke the authorisation.

35 But Shell submits that the question should be formulated differently. It is not whether, with the benefit of hindsight (which of course it now has), the Commission would have made the same decision. Rather, it is whether now, given that the regulatory instrument has been issued, it is appropriate to revoke it. That requires a thorough consideration of the costs and benefits of such an initiative.

36 So, in Shell's view, the Commission must (in its usual prudent way) identify and compare the factual (where the authorisation is revoked) with the counterfactual (where the authorisation remains on foot). In Shell's view, that analysis would proceed along the lines set out below.

Cost benefit analysis

37 In both the factual and the counterfactual, one of two scenarios is likely to eventuate:

37.1 separate selling will be effectively implemented, including all relevant balancing arrangements; or

37.2 separate selling will prove too difficult and the parties will be forced to revert to a joint selling mechanism.

38 The likelihood of either occurring is difficult to establish with any certainty. In that context, Shell is reluctant to provide a particular view in case it is deemed post-facto to have "misled" the Commission in the event that its view does not ultimately accord with actual events. Shell would prefer simply to examine both scenarios under both the factual and counterfactual.

39 The first scenario will be neutral in welfare terms. In the factual, the parties will not have an authorisation for joint selling but, in any case, will not need one. While in the counterfactual, the parties will have an authorisation but will not have cause to avail themselves of it.

40 The second scenario, using the rationale of Decision 505, is the "less competitive" of the two in the sense that there will be one seller of Pohokura gas instead of three. But the question then becomes, why will that situation have arisen? Shell submits, most likely because the

commercial difficulties inherent in the separate selling structure have won out - rendering separate selling arrangements impractical.

41 So in the factual, in the second scenario, the Commission will effectively expose the Pohokura Joint Venture to the latest risk inherent in the commercial path adopted. In particular, as the parties have already informed the Commission, a variety of major commercial obstacles – such as concluding balancing arrangements – have yet to be negotiated. For all the reasons given in the process that lead to the Commission's Decision 505, this is considered to be a fraught process. It may well fail. The prospect of litigation is real, especially given the state of the prevailing commercial dynamics within the Pohokura Joint Venture, as already described above. In such circumstances, the parties would not be able to revert to a joint selling mechanism as the Commission will have removed the "safety net" which would have been provided by the authorisation remaining in the counterfactual. Given the strategic importance of Pohokura to the New Zealand economy, the result of such a scenario is potentially calamitous. So by revoking the authorisation, the Commission is removing an option accruing to the Pohokura Joint Venturers – and the value attaching to that option.

42 In summary, Shell contends that the proposed revocation would have the effect of removing a degree of comfort in respect of further unforeseen circumstances from the only parties able to develop the only proven substantial gas field in New Zealand at a time when existing sources are depleting rapidly. The Commission should not take this risk simply because they believe – mistakenly – that they have been misled.

43 It is equally clear, in Shell's view, that it is vital to the public interest that the authorisation remains in full force and effect, at least until the commercial arrangements underpinning Pohokura can be resolved. In that regard, re-examination of the matter in a year's time may be a sensible compromise position.

44 The fact that the parties have so far have been able to develop the field is in part due to the "underwriting" or "insurance" effect of the joint marketing authorisation for the Pohokura joint venture parties. That is, the parties have been able to embark upon a course of separate marketing with confidence – knowing they have the residual ability to jointly sell their gas should the negotiation of gas balancing (or other) arrangements prove to be an insurmountable commercial obstacle.

45 Shell submits that the public interest would not be served by the Commission now withdrawing that backstop, should gas balancing (or other) arrangements either prove too difficult to agree or themselves be

seen to require authorisation. In that event, recourse would have to be had to joint marketing, which would require a fresh authorisation to be sought. The delays attendant in that process (some of which the Commission would have no control over) would constitute an unnecessary risk, and potential cost, to this country.

46 Shell submits that this is not a risk that the Commission should take. Indeed, for the Commission to do so would be inconsistent with its own action in imposing, as part of the authorisation, a condition that the field be brought into operation before 30 June 2006.