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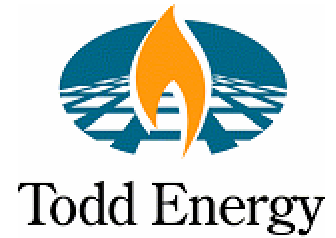

POHOKURA AUTHORISATION APPLICATION

SUBMISSION BY THE APPLICANT IN RESPONSE TO THE COMMERCE COMMISSION DRAFT DETERMINATION (16 MAY 2003)

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9 June 2003

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1. INTRODUCTION

1.1 This submission is made by the Pohokura joint venture parties, OMV New Zealand Limited ("OMV"), Shell Exploration New Zealand Limited, Shell (Petroleum Mining) Company Limited (together "Shell") and Todd Petroleum Mining Company Limited ("Todd") (together the "applicants").

1.2 This submission addresses the relevant matters which the Commerce Commission ("the Commission") must now address in order to affirm the preliminary view that authorisation be granted to this application. This submission does not respond, at this time, to all matters raised in the Draft Determination. The applicant reserves the right to make further submissions at the conference on 1-3 July 2003 in response to submissions made by other interested parties.

1.3 The position of the applicants, in response to the key decision points in the Draft Determination, is as follows:

1.3.1 It is accepted that the most likely counterfactual is one based upon Scenario 1 marketing.

1.3.2 The Commission has erred in its assessment of the difference between the proposal and the counterfactual. In particular, the applicants maintain that the proposal is pro-competitive when compared with the counterfactual. Further, the view of the Commission that Scenario 1 marketing would involve only a one year delay is unsustainable. The applicants affirm their position that Scenario 1 marketing would result in a delay of at least three years.

1.3.3 The Commission has erred in its findings that there are likely to be detriments associated with the joint marketing approach. The applicants maintain that no detriments attach to the proposed joint marketing arrangements.

1.3.4 The Commission has understated the public benefits which will result from the proposed joint marketing arrangements.

1.3.5 As the benefits exceed the detriments, the Commission should grant authorisation unconditionally.

1.3.6 In any event, the conditions proposed in the Draft Determination are impractical, *ultra vires* and otherwise inappropriate.

1.3.7 The imposition of a five year limitation to the authorisation (from the date of first production) will mean that some or all of the applicants would be unable to:

(a) secure funding of the remaining development costs; and

(b) enter into contracts to supply gas for longer than a five year duration.

1.3.8 The imposition of a requirement that the field be developed by a certain date would be unacceptable. The applicants would in that situation face an intolerable investment risk, because a delay caused by (for example) adverse weather or the act or omission to act of a third party would render the authorisation invalid.

1.3.9 The Commission ought to exercise its discretionary powers, under section 58B(2)(a) of the Commerce Act 1986, to extend the benefit of this authorisation to successors. There will be no successor unless and until such a person acquires a participating interest from one of the current joint venture parties. Accordingly, such competition issues, as may arise, can be adequately addressed under section 47 of the Act in relation to that acquisition. If the Commission does not extend the benefit of the authorisation to successors, this will potentially render redundant the benefit of the authorisation for the remaining joint venture parties where there is the transfer of a participating interest. If the authorisation does not extend to successors, then the Pohokura joint venture parties will need to address the prospect of interruptions in the supply of gas which may result while there is uncertainty relating to the status of the authorisation. The likely outcome will be that the Pohokura joint venture parties will be unable to offer long term contracts upon terms and conditions acceptable to third parties. In addition, this condition would mean that bank finance could not be obtained for development of the Pohokura field, because the bankers will insist upon an unfettered right to dispose of a joint venture party's interest in the event of default.

1.3.10 The Commission has not sufficiently articulated its ring-fencing proposal to provide an adequate opportunity for comment on this issue. In any event, the applicants are adamant that any such arrangements would be unworkable. In addition, it is likely that any such arrangements would be in breach of the Companies Act 1993, thus rendering the proposed condition *ultra vires* the Commission's statutory powers.

2. EXECUTIVE SUMMARY

2.1 Scenario 1 is not three independent sellers. Scenario 1 is three highly coordinated and constrained sellers of gas produced from a single field jointly owned.

2.2 Joint marketing would not involve any lessening of competition when compared with Scenario 1.

2.3 Scenario 1 would result in a delay of at least three years when compared with joint marketing.

2.4 There are major public benefits attaching to the early development of the Pohokura field. These benefits are significant and clearly outweigh the detriments, because there are none.

2.5 The proposed conditions are impractical, *ultra vires* or otherwise inappropriate.

2.6 Each of the conditions would defeat timely development of the Pohokura field and accelerated investment in new electricity generation facilities, contrary to the goals set out in the Pohokura Government Policy Statement.

2.7 The reason for this Government Policy Statement is that the national interest requires that there be security of existing supply of electricity. In addition, there are increasing demands for electricity which require new electricity generation facilities to be built. If there are delays in the development of Pohokura this will mean supplies of electricity will not be secure, and this will have a major impact on New Zealand's welfare and economic growth.

2.8 Nothing would be achieved by insisting upon Scenario 1 selling.

3. GENERAL PRINCIPLES

3.1 This section provides some preliminary comments on key interpretation points which will be further developed in the remaining parts of this submission. In summary this section addresses the following main issues:

3.1.1 It is not apparent that the Commission has properly taken into account the Government Policy Statement, issued in April 2003, which relates specifically to the need to develop the Pohokura field.

3.1.2 The three reasons advanced by the Commission to support the conclusion that the proposal lessens competition, when compared with the counterfactual, are not sustainable.

3.1.3 The Commission has not properly analysed the issue of detriment. There are no detriments.

3.1.4 The Commission has applied an incorrect standard of proof in assessing the public benefits and has understated these benefits.

3.1.5 As there are no detriments and, in contrast, positive benefits arising under the proposed joint marketing, authorisation should be granted unconditionally.

3.2 Section 26 statements

3.2.1 The Minister has communicated to the Commission two Government Policy Statements which are relevant to this application.

3.2.2 The first of those statements, issued in March 2003, is a general policy statement which makes no express reference to the Pohokura field. It is more in the nature of an overview of how the Government would like to see the industry develop in the future. It points to the potential for the development of a secondary or wholesale market for the trading of excess and shortfall quantities of gas. In this context the need for balancing and reconciliation is recognised. In relation to the wide-ranging matters set out in this statement, the Government indicates an expectation that efficient industry arrangements be in place by December 2004.

3.2.3 In contrast, the second of the Government Policy Statements, issued in April 2003, deals exclusively with the importance of the development of the Pohokura field for energy security. The statement notes that, with steadily increasing demand for electricity, New Zealand needs an additional 150MW of electricity generation per annum to meet demand growth. The statement also records that development of the Pohokura field will help to remove uncertainty about New Zealand's medium-

term energy security including facilitation of early decisions on new electricity generation investment.

3.2.4 Where, as here, a section 26 statement is communicated, the Commission is required to have regard to such statements in reaching its decision. In *New Zealand Co-operative Dairy v Commerce Commission* [1992] 1 NZLR 601, 612-13, the High Court held that such statements "must be given genuine attention and thought, and such weight as the tribunal considers appropriate."

3.2.5 The Commission noted in passing the general content of each of these Government Policy Statements in paragraphs 84-85.

3.2.6 The Commission proceeds, in various parts of the Draft Determination, to note the first general Government Policy Statement (see, for example, paragraphs 140-50, 163, 394, 436, 506, 510). In this context the Commission relies upon the Minister's statement to support the potential emergence of a wholesale market. In so accepting the Minister's statement, the Commission does not take into account the need or likelihood for future discoveries and increased production to support such potential market developments.

3.2.7 In contrast, there is only one reference in passing (paragraph 451) to the second Pohokura Government Policy Statement in the Draft Determination. This absence of attention to this Government Policy Statement is noteworthy given that this Statement was specific to Pohokura. In these circumstances, it is difficult to accept that the Commission has given genuine attention and thought to this statement. In particular, no consideration has been given to how the proposed conditions may impact upon new electricity generation investment decisions. In section 10 below, we set out how each of the proposed conditions has the potential to frustrate the achievement of these policy goals.

3.3 <u>The Competition Test</u>

3.3.1 The Commission correctly accepts that the competition analysis is based upon a comparison of the proposal (or factual) and the most likely counterfactual (paragraphs 9-10, 239-42).

3.3.2 The section on competition effects (paragraphs 362-403) contains a number of material misdirections. It also provides insufficient detail of the Commission's reasoning to enable a fully articulated response.

3.3.3 At the conclusion of this section of the Draft Determination (paragraph 400), the Commission finds that the proposal is likely to lessen competition for three reasons:

(a) *Impact of the arrangement on competition:* it cannot be assumed, in this setting, that three sellers rather than one will result in more competition. The critical matter is to compare joint marketing with Scenario 1 marketing. Joint marketing here requires that three entities be forced to cooperate and agree on development and marketing strategies. It is wrong to characterise this as single entity selling. Turning to Scenario 1 selling, it is critical to note that, before this can occur, there also needs to be cooperation and agreement on all of the key development and marketing arrangements. Scenario 1 is not three independent sellers. Scenario 1 is three highly coordinated and constrained sellers of gas produced from a single gas field jointly owned. Sections 4 and 5 below describe in detail the parallel issues which concern both forms of selling. The similarities are such that potential purchasers of gas will not be better off under Scenario 1 marketing. Indeed, there is the likelihood that purchasers will be worse off under Scenario 1 because the divided production volumes will constrain flexibility to meet purchasers' needs, increased risk will attach to the performance of each individual contract and there will be the additional burden of the contractual mechanisms necessary to balance the rights and obligations of the joint venture parties.

(b) *Price discrimination:* the discussion on price discrimination (paragraphs 385-89) is flawed. Price discrimination occurs when a firm makes two sales at two different rates of return. For present purposes, it is convenient to think of the practice as one where the same product is sold by the one seller to two buyers at different prices. The Commission asserts that the price discrimination "would not be possible under the counterfactual" (paragraph 388). No reasons are given for this assertion. It is a conclusion that is not sustainable. For the conclusion to be correct, each of OMV, Shell and Todd would have to sell to all customers at prices which achieve equal rates of return. This is no less likely to happen under Scenario 1 selling than it is under joint marketing. Accordingly, there is no difference between the proposal and the counterfactual, and accordingly, no lessening of competition results based upon this ground. On the contrary, any price discrimination is likely to be allocatively and dynamically efficient in this industry.

(c) *Effect on the development of competitive markets:* it is suggested that joint marketing will be likely to delay or inhibit market developments, such as the introduction of a spot market or an overs and unders market. This argument appears to be based on the notion that there will be additional depth in the market because there will

be more sellers under Scenario 1 selling than there would be under joint marketing (paragraph 399). This reasoning does not apply to the current setting, because as noted above, Scenario 1 will not be analogous to competitive marketing between the three different joint venture parties. Rather the forced introduction of Scenario 1 marketing will retard development of a competitive production market in New Zealand for the reasons set out in section 5.1 below.

3.3.4 Accordingly, the proposal involves no lessening of competition when compared with the counterfactual. It is open to the Commission to decline jurisdiction in relation to this application.

3.3.5 Apart from these three grounds for asserting that there is a likely lessening of competition, there are various other comments in this section of the Draft Determination which potentially involve a misdirection. The issue of the market power of the Pohokura joint venture is not the relevant question (see, for example, paragraphs 377, 385 and 387). The relevant inquiry is limited to the counterfactual question.

3.4 Detriment/benefit

3.4.1 As noted in paragraph 407 of the Draft Determination, the Commission is required to identify and quantify the detriments which would, or would be likely to, result from the lessening in competition (if there is any) between the factual and the counterfactual.

3.4.2 In paragraphs 425-48, the Commission makes no attempt to quantify the asserted detriments. Accordingly, the applicants do not have an opportunity to comment upon the quantum of detriment the Commission believes to exist. The absence of any quantification of detriment also impacts upon the ability of the applicants to comment on the balancing of benefits and detriments.

3.4.3 The detriment assessment must be based upon the lessening of competition between the factual compared with the counterfactual. The Commission needs to reassess its approach to detriment, in conjunction with the competition assessment considerations just described.

3.4.4 The applicants maintain that this proposal involves no detriment.

3.5 Conditions

Section 61(2) confers a discretion upon the Commission to attach conditions to any authorisation. There are, however, certain matters which govern the exercise of the discretion.

3.5.1 Where no detriments attach to the proposal, the Commission does not have jurisdiction to impose conditions. Indeed, the appropriate course in that situation would be for the Commission to decline jurisdiction to the application.

3.5.2 Where the Commission is satisfied that the benefits of a proposal outweigh its detriments, it should likewise decline to impose conditions.

3.5.3 The Commission does not provide adequate reasoning to support the conclusion at paragraphs 502-504 that, by themselves, the accepted benefits would not exceed the detriments. This statement is made in the context of the Commission accepting that there is a "good chance" that the benefits are in the upper bound of the range of $22.8 to $57 million. Against this finding, the Commission concludes, at best only intuitively, that non-quantified detriments may not be outweighed by these benefits. Appropriate analysis of this balancing exercise will enable the Commission to reach the view that no conditions are necessary.

3.5.4 In determining whether benefits are likely to be achieved, the Commission need only satisfy itself on this matter in accordance with the ordinary civil standard of proof: *Foodstuffs v Commerce Commission* (1992) 4 TCLR 713, 721. Accordingly, the Commission must attach weight to claimed benefits where it is satisfied that they are likely to occur on the balance of probabilities. In the current case the Commission misdirects itself on this test, as it proposes to impose conditions to ensure with a degree of certainty that the benefits will result (see, for example, paragraphs 26 and 504). This test sets a higher standard than that which applies under the civil standard.

3.5.5 In exercising its discretion, the Commission has, on the basis of the reasoning contained in the Draft Determination, failed to have proper regard to the matters addressed in the Pohokura Government Policy Statement of April 2003. It is foreseeable that each of the proposed conditions has the potential to defeat the aims of Government, for the reasons set out in section 10 below.

4. THE PROPOSAL AND THE COUNTERFACTUAL

4.1 The applicant has applied for authorisation to:

4.1.1 discuss and agree on all relevant terms and conditions, including price, quantity, rate, specification and liability for the joint sale of gas from the Pohokura field; and

4.1.2 negotiate and enter into contracts for the sale of the Pohokura field gas jointly (i.e. as one seller).

This is the proposal.

4.2 In order to further inform upon the proposal, Table 1 sets out the key gas sales parameters and the manner in which they are resolved under joint marketing.

4.3 For the purposes of this application, the applicants are prepared to accept that Scenario 1 selling is the most likely counterfactual, on the assumption that all necessary agreements are reached between these parties to make possible this so-called form of separate selling.

4.4 It is important to understand, in more detail, what is entailed under Scenario 1 selling. Table 1 again sets out the key gas sales parameters and the manner in which they are resolved under Scenario 1 selling.

4.5 Table 1 demonstrates that the coordination required under both the proposal and the counterfactual is essentially the same. That is the inevitable outcome of the arrangements which are necessary to enable the development of a joint venture gas field.

4.6 Two key messages, which are developed as part of the next section, emerge from this requirement for coordination between the joint venture parties:

4.6.1 It is inaccurate to characterise joint marketing as being equivalent to marketing by a single entity. There will be competitive tensions between the joint venture parties which will impact upon the ultimate joint venture decisions relating to the sale of gas.

4.6.2 Scenario 1 marketing is not separate marketing at all.

Table 1 – Development, production and gas sales parameters

Key parameters	Joint marketing: JVPs co-ordinate development, production and marketing. Key parameters principally determined as follows:	Scenario 1 selling: JVPs co-ordinate development, production and arrangements necessary for separate gas sales. Key parameters principally determined as follows:	Is Scenario 1 more competitive, less competitive or is there no difference?
Physical			
Commencement date(s)	Determined by development schedule agreed between JVPs	Determined by development schedule agreed between JVPs and need to reach inter-seller agreements (3 year delay over joint marketing)	Less
Term	Determined by agreement between JVPs and buyers	Determined by agreement between each seller and its buyers. Sellers will avoid guarantees of term because of risk of over-extraction from the common pool.	
Total quantity	Total volume determined by recoverable reserves. Annual and daily contract volumes determined by negotiation between JVPs and buyers	Total volume determined by recoverable reserves. Annual and daily contract volumes determined by (iterative) negotiations between JVPs.	Less
Production rate	Determined by plant capacity agreed among JVPs	Determined by plant capacity agreed as a result of (iterative) negotiations between JVPs prior to any discussions with prospective buyers. Rate will be lower because of inefficiency (for same size plant) – see below "Production flexibility"	Less
Production flexibility (MDQ, MHQ, above MHQ)	Capped by plant capacity and minimum operational production limit for the plant (turndown ratio). Determined by negotiation between JVPs and buyers.	Capped by plant capacity and turndown ratio. Contract flexibility further constrained by: a. terms of gas balancing arrangement agreed between JVPs (i.e. allocation of reserves risk amongst JVPs, including constraints on overlift, underlift and makeup rights) b. system operational constraints mean that each seller may not know during any day whether or not its buyers are lifting at MDQ/MHQ c. co-ordination of sales above agreed allocated capacity may take considerable time to negotiate and so the	Less

Key parameters	Joint marketing: JVPs co-ordinate development, production and marketing. Key parameters principally determined as follows:	Scenario 1 selling: JVPs co-ordinate development, production and arrangements necessary for separate gas sales. Key parameters principally determined as follows:	Is Scenario 1 more competitive, less competitive or is there no difference?
		ability to exploit a market opportunity in sufficient time may be limited d. lack of demand-side input Capability to make short term gas sales up to plant capacity will be hindered	
Gas quality, specification	Determined by facilities design agreed between JVPs	Determined by facilities design agreed between JVPs	No difference
Delivery point	Determined by facilities design agreed between JVPs	Determined by facilities design agreed between JVPs	No difference
Seller maintenance obligation	Determined by facilities design agreed between JVPs	Determined by facilities design agreed between JVPs	No difference
Buyer uplift obligation	Minimum uplift determined by facilities design agreed between JVPs	Minimum uplift determined by facilities design agreed between JVPs	No difference
Other			
Nominations regime	Standardised arrangements determined by operating constraints and market requirements	Standardised arrangements determined by operating constraints and market requirements. Sellers must be co-ordinated	No difference
Allocation of reserves risk	Within the constraints of a coherent field offtake policy, the reserve risk can be determined by negotiation between JVPs and buyers. Options include: a. Seller risk: possible liquidated damages or supply from other fields b. Buyer risk: raises issues of information, reserves review, constraints on field operations and 3rd party gas sales	Individual seller negotiations with buyers constrained by: a. Issue of whether buyers will ever accept reserves risk under separate marketing? Buyers will know that the sellers will be competing to extract the gas, increasing the reserves risk to the buyer. b. Need for intra JV agreement if third parties are to have rights to information, reserves review, constraints on field operations c. Need for gas balancing arrangement (i.e. allocation of reserves risk amongst sellers, including overlift, underlift	Less

Key parameters	Joint marketing: JVPs co-ordinate development, production and marketing. Key parameters principally determined as follows:	Scenario 1 selling: JVPs co-ordinate development, production and arrangements necessary for separate gas sales. Key parameters principally determined as follows:	Is Scenario 1 more competitive, less competitive or is there no difference?
		and makeup rights) would conflict with any seller obligation not to make 3rd party gas sales if reserves redetermined downwards d. Ring fencing of marketing activities between fields owned by each seller would restrict ability to use reserves portfolio to manage supply risk	
Liability for failure to supply	Determined by negotiation between JVPs and buyers e.g. obligation to act as a reasonable and prudent operator and limited basis for interruptions (threat to life, property or the environment)	Determined by negotiation between each seller and its buyers but: a. what each seller can offer will be limited by the security of supply available under inter- seller agreements b. each seller will need an indemnity from other sellers for any liability for failure to supply caused by another seller overlifting and sellers will pass this to buyers	Less
Liability for delivery of non-specification gas	Determined by negotiation between JVPs and buyers	Determined by negotiation between each seller and its buyers. Note that different buyer spec requirements will mean that sellers will have different plant requirements, thus impacting on cost contributions, Note that JVPs must agree plant design including redundancy and back up. This agreement will likely give JVPs the same basis for sale of gas from Pohokura.	Less
Price	Determined by competitive process between JVPs and buyers	Determined by competitive process bilateral negotiations between each seller and buyers. Constrained by gas balancing arrangements – balancing in kind unlikely to be an adequate mechanism; therefore cash balancing must be included. Cash balancing will: ➢ set a price floor ➢ be likely to amount to price fixing ➢ probably require disclosure of all contract terms (e.g. Yolla) so that assessments of value can be made	No difference

Key parameters	Joint marketing: JVPs co-ordinate development, production and marketing. Key parameters principally determined as follows:	Scenario 1 selling: JVPs co-ordinate development, production and arrangements necessary for separate gas sales. Key parameters principally determined as follows:	Is Scenario 1 more competitive, less competitive or is there no difference?
Invoicing and payment	Determined by negotiation between JVPs and buyers	Determined by negotiation between each seller and buyers	No difference
Seller's reservations, including: a. Control of Field, Operations b. Additional Gas Sales c. Liquids Recovery	Determined by negotiation between JVPs and buyers, related to allocation of reserves risk	a. Control of Field, Operations: sellers must co-ordinate development and operations decisions. This will constrain individual seller negotiations with buyers. Related to issue of reserves risk – as noted above, significant constraints on seller allocation of reserve risk b. Additional Gas Sales: seller position constrained by terms of gas balancing arrangement (i.e. allocation of reserves risk amongst sellers, including underlift, overlift and makeup rights) c. Liquids Recovery: sellers must co-ordinate development and production decisions. This will constrain individual seller contracts	Less
Buyer maintenance requirements	Determined by buyer facilities design. Some accommodation of buyers' requirements by JVPs	No incentives for one seller to recognise issues of another seller's customer. Therefore individual sellers will have little ability to accommodate buyer requirements. Contract flexibility constrained by terms of gas balancing arrangement agreed between sellers (including underlift, overlift and makeup rights)	Less
Termination	Determined by negotiation between JVPs and buyers	Determined by negotiation between each seller with its buyers. Fact that other sellers will continue producing will constrain ability for one seller to terminate	Less
Seller force majeure	Determined by negotiation between JVPs and buyers	Individual seller position will be constrained by need to co-ordinate with other sellers and match contract force majeure provisions with terms of gas balancing arrangements agreed amongst sellers. Separate sales arrangements will increase barriers to co-operation between sellers and buyers to accommodate unscheduled shutdowns – i.e. there will be no room to accommodate individual buyer requirements	Less

Key parameters	Joint marketing: JVPs co-ordinate development, production and marketing. Key parameters principally determined as follows:	Scenario 1 selling: JVPs co-ordinate development, production and arrangements necessary for separate gas sales. Key parameters principally determined as follows:	Is Scenario 1 more competitive, less competitive or is there no difference?
Buyer force majeure	Determined by negotiation between JVPs and buyers	Individual seller position will be constrained by need to co-ordinate with other sellers and match contract force majeure provisions with terms of gas balancing arrangements agreed between JVPs (including overlift, underlift and makeup rights). Separate sales arrangements will increase barriers to co-operation between sellers and buyers to accommodate unscheduled shutdowns – i.e. there will be no room to accommodate individual buyer requirements.	Less
Confidentiality	Confidentiality of JV information usually required, settled by negotiation	Contract position constrained by requirement to comply with JVOA confidentiality obligations. Any change requires agreement of all sellers (this affects ability to provide reserves information, including in the case of a contract containing reserves review mechanisms)	Less
Dispute resolution	Determined by negotiation between JVPs and buyers	Determined by negotiation between sellers and buyers. However dispute mechanism chosen by one seller may be different to that agreed by another. There may be a conflict of provisions in respect of a common issue	Less

5. THE DIFFERENCES BETWEEN THE PROPOSAL AND THE COUNTERFACTUAL

5.1 The following key arguments are advanced in this section:

5.1.1 The degree of coordination required to make Scenario 1 marketing possible is such that it would not, in essence, result in separate marketing and would not result in any greater competition when compared with joint marketing. Indeed, it would result in less competitive pressure.

5.1.2 There will be no significant differences in the prices or contract terms for the sale of gas between the proposal and the counterfactual.

5.1.3 Price discrimination can occur under both Scenario 1 marketing and joint marketing. Accordingly, the potential for price discrimination does not provide a ground for a finding of any lessening of competition.

5.1.4 Pro-competitive developments in the production market will not be retarded under joint marketing.

5.1.5 The view that Scenario 1 marketing would involve only a one year delay is unsustainable. Rather, Scenario 1 marketing would result in a delay of at least three years.

5.2 Competition Effects

Impact of the arrangement on competition

5.2.1 At paragraph 372 the Commission records that "The most obvious impact of the Arrangement is that gas from the Pohokura field would be marketed by one entity rather than three." This is a key point and it is not correct. The implications that flow from the misunderstanding about this point are critical in the analysis of this application.

5.2.2 First, joint marketing involves three entities being forced to cooperate and agree. This is not equivalent to marketing by a single entity. The different interests, incentives and views of the three parties can be expected to cause competitive tension within the joint marketing forum and make coordination more difficult than it would be for a single entity.

5.2.3 Secondly, there is an assumption that there will be substantive differences in the marketing and sale of gas under joint marketing and Scenario 1 marketing. This is a critical assumption. Inevitably, there is an attraction to the simplistic argument that three sellers in a market will be more competitive than if those sellers combine to form one point of sale. But the comparison here between joint marketing and Scenario 1 marketing is not that simple.

5.2.4 The critical matter is that, given the degree of coordination that will need to be achieved to make Scenario 1 marketing possible, Scenario 1 marketing would not result in any greater competition. In fact, as argued elsewhere, it would result in less competitive pressure.

5.2.5 In section 4 of this submission we have set out a comparison of how the key gas sales parameters will be determined under joint marketing and Scenario 1 marketing. The comparison highlights that under both joint marketing and Scenario 1 marketing the joint venture parties must cooperate and agree on all key development, production and gas marketing arrangements. The initial instincts that separate selling would be better soon disappear once Scenario 1 selling is properly understood. Scenario 1 is not three independent sellers. Scenario 1 is three highly coordinated and constrained sellers of gas produced from a single field jointly owned.

5.2.6 Under Scenario 1 marketing the joint venture parties would have to agree on all key development and production matters in order to develop and operate the field that continues to be jointly owned.

5.2.7 In addition, Scenario 1 marketing requires the joint venture parties to put in place the contract mechanisms necessary to balance the rights and obligations of each joint venture party as they separately sell and uplift gas (and other products) from the field. These contract mechanisms must address, as among the joint venture parties, the key contract parameters (including the allocation of risk and reward, and operating procedures) in much the same detail as contracts for the sale of gas to third parties. Each joint venture party would have to ensure that the arrangements among the joint venture parties supported its proposed gas sales to third parties. Each joint venture party would have to also ensure that the arrangements between the joint venture parties balance each party's rights and obligations so that it was not at a disadvantage to the others.

5.2.8 As gas markets evolve to include such features as a liquid spot market, a large number of sellers, a large number of buyers, gas storage, and so forth, the market based mechanisms will develop to address the key contract parameters among the joint venture parties (including the allocation of risk and reward and operating procedures). The form and content of the formal arrangements among the joint venture parties becomes relatively straight forward when one can rely upon the market based mechanisms. This is evidenced by the simplified and standard form of gas balancing arrangements that are today used in North America.

5.2.9 In the absence of such market based mechanisms that can address the allocation of risk and reward, and operating procedures, the joint venture parties would have to implement

for themselves solutions to these issues. In the New Zealand context these arrangements would have to be substantially more complex than the simplified forms of arrangement that have emerged in developed markets.

5.2.10 The need to put in place the detailed arrangements for balancing the rights and obligations of the joint venture parties to each other as they separately sell and uplift gas from the field would give the joint venture parties less flexibility and variance in contract terms with potential gas purchasers.

5.2.11 In summary, it is difficult to envisage how potential gas purchasers would be any better off under Scenario 1 marketing that under joint marketing. Joint marketing would involve the three entities being forced to cooperate and agree on all key development, operating and sales parameters before going to market. Scenario 1 would involve the three entities being forced to cooperate and agree on all of the same key matters. Scenario 1 marketing is not analogous to competitive marketing. The quantity of gas being sold under Scenario 1 would be no greater than that sold under joint marketing which in both instances would be agreed between the joint venture parties. In fact, under Scenario 1 there would be extra layers of constraint:

- the division of the production volumes between the three joint venture parties;
- increased risk attached to the performance of each individual contract; and
- the details of the contract mechanisms necessary to balance the rights and obligations of the joint venture parties to each other as they separately sell and uplift gas.

Effect on prices and contract terms from joint marketing

5.2.12 At paragraph 383 the Commission finds that "In a market where individual suppliers are not in a position to vary output, there is a very substantial constraint on each supplier's ability or incentive to compete on price…No supplier can increase its revenue or market share by undercutting (which in practice would mean selling below the market clearing price) its competitors." Further, at paragraph 392 the Commission notes that "in general the factors that affect price (principally supply and demand patterns) are also the predominant influences on terms and conditions." These are key conclusions that we support. As noted above, the co-operation and agreement on development and production parameters required for the development of the field under joint marketing and Scenario 1 marketing will constrain each party's ability to compete on quantity, terms and price.

5.2.13 The detailed arrangements for balancing the rights and obligations of the joint venture parties to each other will further constrain competition on all key contract terms.

5.2.14 Each joint venture party will be subject to the same detailed constraints on its ability to sell gas from the Pohokura field which it will carefully protect and in doing so enhance the value of its investment relative to the other joint venture parties. Each joint venture party will know that if it tries to sell on terms substantially more beneficial to it than the terms set with its joint venture parties that it risks losing a possible deal. Each joint venture party will also know that if it tries to sell on terms more beneficial to the buyer than the terms set with its joint venture parties then it will lose value. Therefore, the contract terms for the sale of gas to third parties will tend to settle around the terms agreed among the joint venture parties.

5.2.15 The Commission records at paragraph 393 that "the choice of terms and conditions offered potential acquirers of gas is likely to be greater under separate marketing, and that a reduction in this choice amounts to a lessening of competition." Detailed analysis of the key contract terms (see section 4) that must be set by reference to the joint decisions on development and production matters and the contract mechanisms required between the joint venture parties to facilitate Scenario 1 marketing does not support that conclusion. In fact the key contract terms will in general be either no different under joint and Scenario 1 marketing or, where there are differences they will often reflect that marketing under Scenario 1 will be more constrained than under joint marketing.

Price discrimination

5.2.16 In paragraph 388 the Commission concludes that some price discrimination "may be possible" under joint marketing but that it would not be possible under Scenario 1 marketing. The Commission notes that "It has not ruled out the possibility that such price discrimination would cause a loss of competition in the gas market or in downstream markets."

5.2.17 It is not accepted that price discrimination "can usually occur only where the seller has a substantial degree of market power" (paragraph 385). Price discrimination occurs in competitive market situations. It is possible that it could occur with separate marketing as well as with joint marketing depending upon such factors as:

- Whether or not there are any provisions in gas supply contracts which unreasonably prevent the buyer from on-selling gas.

- Seller market power. We reiterate that there is no material competition difference between joint marketing and Scenario 1 marketing.

- Countervailing buyer market power. We agree with the Commission's observation that the buyer may have some countervailing market power (paragraph 387). It is important to have regard to the sale of gas from Pohokura over the life of the field and not just in the near term when gas demand may exceed gas supply. Over the life of the field supply and demand circumstances are likely to vary widely influenced by many factors outside the control of the joint venture parties.

- In paragraph 391 the Commission notes that "some individual buyers may have a strong preference to avoid dealing with a particular Pohokura joint venture party even if this meant paying a premium in the price of the gas." We note that this raises the possibility of price discrimination under Scenario 1 marketing.

Effect on the development of competitive markets in the future

5.2.18 The Commission argues that joint marketing of Pohokura gas will mean fewer sellers than would otherwise be the case and that consequently the depth to the market would be less. It is concluded that this would inhibit pro-competitive developments in the production market (paragraph 399). This relies upon an assumption that under Scenario 1 marketing the three joint venture parties will compete.

5.2.19 For the reasons outlined above we consider that Scenario 1 marketing is not analogous to competitive marketing and that it would not introduce pro-competitive pressure into the New Zealand market. The quantity of gas being sold under Scenario 1 would be no greater than that sold under joint marketing which in both instances would be agreed between the joint venture parties. In fact, under Scenario 1 there would be extra layers of constraint, in particular, the contract mechanisms necessary to balance the rights and obligations of the joint venture parties to each other as they separately sell and uplift gas.

5.2.20 The forced introduction of Scenario 1 marketing before the market structures necessary to support separate marketing are sufficiently developed will retard development of a competitive production market in New Zealand for the following reasons:

- It increases risk and cost to gas explorers and producers and decreases field value. Of particular importance is that it will increase the time between finding a gas field and first production which will reduce the value of the field. This will deter investment in exploration and development of gas fields and limit likely competition from new fields.

- The increased risk, decreased field value and additional costs and constraints associated with gas field development will be particularly significant for the relatively small companies on whom the vibrancy of the New Zealand exploration industry depends.

- The contract mechanisms agreed among the applicants to facilitate Scenario 1 marketing would constrain the individual and collective incentives and ability to develop the upstream gas market. For instance, under joint marketing the joint venture parties would have a strong incentive to operate the plant at capacity and look for opportunities to sell gas when the capacity is not fully utilised and the contractual and operational capability to do this. Under Scenario 1 marketing the practical effect of the arrangements among the joint venture parties is that they are likely to (at least) severely restrict the capability of each joint venture party to enter into contracts to take advantage of spare short term plant capacity.

5.2.21 Authorisation of joint marketing of gas from Pohokura will assist the development of competition in the gas production market because:

- It will avoid the unnecessary costs, delay and risk that will be incurred if Scenario 1 marketing is imposed in the current gas market.

- The Commission has previously noted that there are no significant barriers to entry to the New Zealand exploration market. This is important because low barriers to entry are important for the continued development of a competitive market. The imposition of regulatory hurdles as significant as the requirement for Scenario 1 marketing and the conditions suggested by the Commission (in particular the inability to assign the benefit of the authorisation of joint marketing in this instance) would be a significant barrier and deterrent to new exploration.

- It will permit the applicants to maximise their return from the Pohokura field by contracting to operate the plant at capacity.

Summary

5.2.22 In summary:

- Joint marketing involves three entities being forced to cooperate and agree. This is not equivalent to marketing by a single entity.

- Scenario 1 requires the three joint venture parties to cooperate and agree on all key development, production and gas marketing arrangements.

- Scenario 1 marketing is not analogous to competitive marketing. Scenario 1 is three highly coordinated and constrained sellers of gas produced from a single gas field jointly owned.

- Under Scenario 1 marketing the need to put in place the detailed arrangements for balancing the rights and obligations of the joint venture parties to each other as they separately sell and uplift gas (and other products) from the field will give the joint venture parties less flexibility and variance in contract terms with potential gas purchasers.

- The quantity of gas being sold under Scenario 1 would be no greater than that sold under joint marketing which in both instances would be agreed among the joint venture parties. In fact, under Scenario 1 there would be extra layers of constraint.

- It follows that there will be no economically significant difference in prices or contract terms.

- It also follows that Scenario 1 marketing will retard the development of a competitive production market rather than enhance it.

- Price discrimination is possible under both joint and Scenario 1 marketing. The possibility of price discrimination under joint marketing is not associated with any increase in market power by producers. The likelihood of price discrimination is reduced by the possibility of reselling of gas and countervailing market power by buyers over the life of the field.

5.3 Delay

The Commission's Approach

5.3.1 The Commission (at paragraph 329) states that the applicants have failed to specify the likely delay between joint marketing and Scenario 1 marketing. This is incorrect. In the application a three year delay was identified for the purposes of analysis. This point was repeated in the applicants' letter to the Commission dated 21 March 2003 and at the presentation made by the applicants to Commission staff on 11 April 2003. The point was also made that a three year delay was conservative.

5.3.2 In paragraphs 320-60, the Commission considers the likely delays in the development and production of the Pohokura field under Scenario 1 marketing when compared with joint

marketing. The conclusion is reached (paragraph 360) that there will be only a one year delay between the proposal and the counterfactual. The Commission's reasons for reaching that conclusion are as follows:

(a) some relevance is attached to the AIPN survey (paragraph 333);

(b) no allowance needs to be made for an appeal of the Commission's decision because the appeal would be likely to run in parallel with other field development preparation (paragraph 337);

(c) there would be little need to duplicate the work already undertaken by STOS as field operator (paragraph 341);

(d) the joint venture parties will want to maximise their revenues by recovering the most liquids from the field as quickly as possible (paragraph 344);

(e) the joint venture parties will conclude all necessary gas balancing arrangements, product allocation agreements and uplift allocation agreements within this time frame (paragraphs 345-49);

(f) agreements on the appropriate levels of CAPEX and OPEX are unlikely to cause substantial delay (paragraphs 353); and

(g) it is inferred that no substantial delay will attach to the conclusion of the gas sales agreements entered into by each of the joint venture parties (paragraph 355).

5.3.3 We address each of these reasons in turn, and we also address other potential delays:

AIPN Survey

5.3.4 The Commission's adviser carried out an informal survey of international AIPN members, which the Commission finds of some relevance in assessing possible delays in the context of this application. The Commission does acknowledge that the survey was not carried out in a scientific manner. The evidence it produces can be described, at best, as anecdotal.

5.3.5 In paragraph 334 of the Draft Determination it is stated that over 50 responses were received, but only 17 email responses have been made available on the public register. We understand the remainder of responses have been destroyed or cannot be found. This makes it difficult for the Pohokura joint venture parties to properly assess the Commission's reliance on this survey, compounding the fact that the Commission gave no prior

opportunity to comment on the proposed survey before carrying it out.

5.3.6 The law on the proper use of survey evidence is well-established and clear (see *Patience & Nicholson (NZ) Ltd v Cyclone Hardware Pty Ltd* [2001] 3 NZLR 490, *ARA v Mutual Rental Cars Ltd* [1987] 2 NZLR 647, *Customglass Boats Ltd v Salthouse Bros Ltd* [1976] 1 NZLR 36). Those principles, summarised below, do not appear to have been followed in this case.

5.3.7 The value of survey evidence and weight, if any, that can be given to it depends upon its adherence to certain principles:

- the survey should be conducted scientifically and in accordance with generally accepted objective standards. The questions asked should not imply a particular response. The methodology used and the results obtained must be exactly recorded.

- the cross section of the population sampled must be representative and relevant to the question asked. The sample size must be sufficient to be a fair representation to constitute probative evidence.

- the methodology of the survey, instructions to the interviewer (i.e. the Commission's adviser), the surveys actually carried out, the questions asked and the answers received should all be disclosed to interested parties in advance so they have adequate opportunity to check the honesty and accuracy of the survey. The totality of the answers given must be disclosed and made available.

5.3.8 Even from the limited information available, the following flaws in the survey analysis are readily apparent:

- A mere 17 responses do not make a reasonable sample. Of those 17 emails, almost half do not make substantive responses to the questions asked.

- The recipients of the email were given absolutely no information about the background circumstances or conditions applying in the New Zealand marketplace, and were not even told what the relevant jurisdiction was. Several respondents recognised this, saying that it all depends on the parties, their experience and differing circumstances. As one noted: "It only makes sense to consider 'average time' if we know something about the parties involved."

- The responses on potential negotiation time varied wildly – reflecting the fact that it is such a situation-specific question, as well as the diverse backgrounds of the respondents'

national location and experience. For instance, one response said of gas balancing: " I have looked into this several times but have always been able to find a better solution (usually joint marketing)".

- Several responses expressly mentioned the complexity of both the documents involved and the commercial issues to be negotiated. For instance: "…the negotiating of and crafting of these agreements may be an arduous task. In short there is no simple standard form agreement which serves to resolve the underlying commercial issues between the parties…"

- Most responses appear to be from the United States or countries with much larger gas markets exhibiting the usual indicia of fully mature markets (depth, liquidity, storage facilities, financial markets, etc.). Additionally, the United States has a long history of developing gas balancing agreements, with litigation producing many court precedents for guidance. Emails suggesting that gas balancing can be negotiated and documented in a few short weeks or months are all derived from having that detailed background to draw on, which New Zealand parties do not. It is a fact that there is no New Zealand experience of the contracts which are necessary to support balancing arrangements, and the extent of the learning curve that will be involved should not be underestimated.

5.3.9 The survey information does not meet the criteria to be lawfully usable as any evidence of delay timeframes.

5.3.10 Moreover, given the haphazard nature of the survey, the wide mixture of responses and the uniqueness of the market and other conditions the applicants would face if forced to pioneer separate marketing in New Zealand, the Commission cannot credibly attach any weight at all to these emails.

Appeals

5.3.11 The Commission has expressed the view that any appeal would be likely to run in parallel to other field development preparation (paragraph 337).

5.3.12 If authorisation is denied, or granted on unacceptable terms, the joint venture parties most expedient option to develop the field would be to appeal the decision. At the moment the scheduled date for the final investment decision (involving a commitment to proceed to spend a further [   ] to develop the field) is March 2004. The parties will be unable to proceed past this decision point until the gas marketing risk is resolved. This risk will also impact on finances. The Commission's conditions mean that funding for the project will not be obtainable, continued development preparation will come to a halt.

5.3.13 Accordingly, if authorisation is not unconditionally granted to this application, the most likely outcome will be an appeal during which time the applicants would not continue to incur expenditure, and certainly not beyond the FID point. The project team would be disbanded and would only be remobilised when security in relation to marketing is achieved. The applicants will not incur further major development expenditure without a secure marketing platform.

Duplication of operators

5.3.14 The Commission has expressed the view that the parties are "unlikely" to duplicate sub-surface work in separate marketing and that, to the extent that some additional interpretation of the existing data may occur, it is unlikely to amount to "much" of a delay (paragraph 341).

5.3.15 We have already addressed this matter in our letter to the Commission dated 21 March 2003 and at our presentation to Commission staff on 11 April 2003. The position is as follows:

- Key to earliest development of the Pohokura field is that the joint venture parties are willing and able to co-operate in all aspects of the work required to appraise and develop the field. Anything that (a) blocks the ability of the joint venture parties to fully co-operate on work critical to the appraisal and development or (b) introduces additional work is likely to delay the development of the field and the commencement of production of gas.

- The joint venture has engaged Shell Todd Oil Services (STOS) to conduct technical and operational work for the appraisal and development of Pohokura. The joint venture parties in general rely on the work STOS conducts on behalf of the joint venture in deciding how to appraise and develop the field. That appraisal and development work is integrated with the commercial/marketing work undertaken by the joint venture parties.

- The joint venture parties have conflicting interests in aspects of the appraisal and development of the field (for instance, use of downstream infrastructure). Those conflicts are manageable in the context of an overall joint effort to develop the field. In that situation, the joint venture parties are sufficiently aligned as to work jointly in the key aspects of appraisal, development, commercial and marketing work. That co-operation saves time and cost.

- The current appraisal and development schedule relies upon appraisal, development, commercial, and marketing work being undertaken concurrently and with strong integration and reliance on the work of STOS to achieve first gas in February 2006.

- The applicants consider that if the joint venture is required to separately market gas this will introduce (further) misalignment. The alignment that currently exists that allows the joint venture parties to co-operate and rely on the resources of STOS will be severely impaired. Accordingly, if the applicants were forced to separately market, aspects of operatorship would have to be considered. That would be a substantial and time consuming exercise.

- As CRA noted in their report dated 20 December 2002, the high level of uncertainty, very large sunk costs and common property characteristics of this project combine to imply scope for post-contractual opportunism in gas marketing and production arrangements. This scope produces inordinate co-ordination difficulties in specifying a credible arrangement for separate marketing. This co-ordination problem is exacerbated by the fact that New Zealand does not have a spot market for gas and is almost certainly not going to have one of the requisite depth in the foreseeable future.

- Enforced separate marketing will compel the applicants to invest in extra risk mitigation strategies. This will include spending more money and time prior to development decisions in understanding the subsurface structures. Management of "shocks" post development will be more difficult under a separate marketing arrangement (with competing contracts), and so ex ante investment to reduce the probability of such surprises will be valuable.

- The misalignment of joint venture party interests in managing the subsurface risk will very likely result in each joint venture party undertaking at least in part its own subsurface analysis rather than relying solely on the work of a common operator. This will introduce more cost and delay. It is very likely that the separate subsurface analysis will generate different conclusions and this will cause further misalignment.

5.3.16 The Commission has expressed the view that both Shell and Todd should be "reasonably comfortable" with STOS' analysis under either joint or separate marketing. Separate selling is a totally new dynamic in the New Zealand context and status quo positions cannot be assumed to prevail. New protocols between the joint venture parties and STOS will be required and these will take time to agree and implement. For example, there will need to be clear understandings relating to the circumstances in which instructions can be given to STOS. For this reason, Shell and Todd do not accept the Commission's position that they can be "reasonably comfortable" with STOS' analysis.

5.3.17 The issues which give rise to potential concern include:

- advice on reserves, subsurface;

- decision on the optimal design of the plant, pipelines, redundancy etc;
- capacity restrictions notifications and allocation of deliverability;
- deciding who gets capacity when it is short and parties have minimum quantity requirements;
- timing of capacity; and
- use and share of under-utilised capacity.

5.3.18 Some means of addressing those issues would have to be found. Possibilities include each party engaging its own operator or, at least undertaking a substantial level of independent review of the operator's work.

Maximisation of revenues

5.3.19 Given the current fuel concerns for electricity generation in New Zealand, extraction of the Pohokura gas may well be valuable to the joint venture parties and to the economy. However, the applicants will not invest in the necessary infrastructure to extract that gas (and the liquids) until they have in place contractual arrangements for the sale of gas and management of the massive risks they face. Enforced separate marketing would significantly increase commercial risks, and therefore the scope and complexity of the appropriate contracts.

5.3.20 The Commission's framework for drawing its conclusion is inappropriate, because it fails to incorporate the state of the market and appropriate commercial decision making that reflects risk management and the availability of delay options. The gas market in the immediate future has downside risk as well as upside potential and, beyond the short term, uncertainty is such that it is difficult to plausibly specify scenarios. The uncertainty and the magnitude of the sunk investment required to develop Pohokura requires, for acceptable economic and commercial risk management, long term contracts in place before investment that develops the field. Without such contracts, individual joint venturers are vulnerable to very substantial risks that depend upon the future state of the market. Once such contracts are in place, there would be urgency for development and gas off take. Before they are in place, there will be commercial decisions to be taken about the timing of these contracts. The contract timing will be affected by institutional arrangements, e.g., the permissibility of joint marketing (and any regulatory conditions on it), and by commercial assessments of the options to delay.

Gas balancing and related agreements

5.3.21 The Commission has accepted that product balancing arrangements are likely to be the most contentious issue facing the applicants if required to separately market gas from Pohokura.[1] It devoted five short paragraphs to this issue in its Draft Determination, leading to the view that "the incentive of realising early revenue from the sales of Pohokura products is a strong incentive to successfully conclude the negotiations". The Commission has not provided any assessment of how the negotiations might be concluded and has not addressed any of the substantive points raised by the applicants, including in its letter dated 21 March 2003 and at the presentation to Commission staff on 11 April 2003.

5.3.22 Scenario 1 would require the applicants to agree on a balancing arrangement. While not having to deal with the same scale or scope of complexity as a Scenario 2 balancing arrangement (because of the mitigated over-extraction incentives), the transaction costs of negotiation will be significant and the time required to complete the agreement will inevitably delay the project.

5.3.23 The are two primary balancing arrangements that theoretically could be considered. The first is balancing externally with a market and other fields and the second is internal balancing. External balancing is not practicable in the New Zealand context at present and will not be considered further.

5.3.24 Internal balancing requires taking gas from one party and providing it to another. This is impossible during term gas contracts unless the sanctity of buyer contracts is impinged or if gas is withheld from the market and that would prevent buyers, bankers and shareholders supporting the development. The alternative is to attempt to force bankers and shareholders to take on disproportionate reserves risk towards the end of the life of the field. Reserves risk under normal joint marketing conditions is already a major uncertainty for bankers and they consequently rigorously review that risk before providing finance. Scenario 1 marketing further increases the reserves risk (because of the common pool problem). The level of risk is likely to be unacceptable to bankers.

5.3.25 The remaining option is to balance quantity between the joint venture parties at an agreed price. That price would have to change with market conditions and hence be regularly updated to the market price. There are real difficulties in determining the

[1] . There will be a need to try and anticipate and deal in advance with the competing contractual issues between owners. The current disputes and litigation among downstream purchasers of Maui gas and between those purchasers and the Crown are illustrative of the consequences of competing views on rights to gas. If those sorts of differences were elevated into the producer context, a high level of disfunctionality would result. As already discussed, anticipating and dealing with all such issues in advance would not be feasible. Even if they could all be dealt with, very substantial delay in development would result.

"market price" in New Zealand because sales at the producer level are small in number, large in volume, sporadic and on deal specific terms and conditions.

5.3.26 Unless the balancing price is adjusted regularly, perverse and inefficient incentives will be established within the joint venture. For example, if the balancing price is higher than the price sold by the separate parties then the separate parties will have an incentive to sell their entire share at the balance price. Alternatively if the balancing price is lower than the price sold by the separate parties then the separate parties will have an incentive to take gas from the other parties at the balance price. This net result is that parties sell under each others' contracts and prices have to be agreed between the parties. The two key features of joint selling have thus been recreated. It can thus be seen that in the New Zealand context at this time separate selling arrangements will inevitably have to be so close to joint selling that from a competition point of view they are equivalent.[2]

Cost to maintain production - CAPEX/OPEX

5.3.27 The primary issue here is how to structure the obligation to pay operating costs to maintain production. The options are to pay either on the basis of use or on the basis of equity interests in the field. Under Scenario 1 marketing, allocating those costs would become particularly problematic in the tail of production and if one party has overlifted against its equity entitlement earlier in field life. As the party's lift decreases later in field life, it is unlikely to want to contribute to OPEX on an equity basis.

5.3.28 In all joint ventures around the world the joint venture parties pay their equity share of costs and capital. Because in New Zealand there is not the ability to maintain equity balances by balancing excess/under take by the parties, the parties will seldom if ever receive their equity percentage of production. They may therefore want to discuss a new untried system of varying the contribution to costs and capital depending on the likely future benefits that may accrue to one or other of them.

5.3.29 This however opens up even bigger problems because it means that both the equity returns and equity obligation to costs and capital could vary. This effectively will be varying the equity interests in the joint venture.

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[2] The negotiation of the development plans and the mechanisms to balance the rights of the applicants will introduce a series of negotiations that are avoided if the gas is marketed jointly. It is difficult to predict the length of these negotiations. The CRA report refers to the work of Libecap and Wiggins (1985). They study the impact of information asymmetries on negotiation time for joint agreements in the US oil and gas industry. Each party to the proposed agreement on a given gas or oilfield may have multiple wells drilled into the field. From these wells information about the field is gathered, which is private to that party. Since under a joint arrangement the share of net revenues from the whole field attributable to each party is determined by the value of the wells each party owns, each party has an incentive to overstate the value of its wells. This reduces the ability of each party to credibly share information on the value of its wells. In these circumstances, negotiation of joint venture operating agreements takes on average seven years, versus six months when there are no such information asymmetries. The Libecap and Wiggins work is instructive as to how much extra time information asymmetries can add to the length of a negotiation.

5.3.30 The parties may have to face the risk that at some stage incremental operating cost and capital costs to maintain production may not be approved because a party no longer receives a sufficient return to justify the expenditure. This would result either in production declining pre-maturely or the other parties having to fund costs disproportionately. In either event there are likely to be significant disputes among the joint venture parties.

5.3.31 Other issues that are likely to arise include:

- obligation to pay capital cost necessary to maintain production profile;
- liability to pay increased costs for gas treatment at end of field life;
- contribution to capital costs to increase production or overcome unexpected problems; and
- allocation of abandonment costs.

Gas Supply Agreements

5.3.32 In paragraph 355 the Commission accepts that it is likely that the gas supply agreements will need to follow the agreement on gas balancing agreements. The applicants would be unlikely, under Scenario 1 marketing, to test the market until there was sufficient comfort in gas balancing arrangements. The individual joint venture parties will be required to meet individual buyer's requirements, which will not necessarily match each joint venture party's entitlement to gas from the field. For example, a new CCGT requires around 20 PJ per annum for a period of 12 to 15 years. Todd individually would be unable to meet this demand. While a buyer could buy two parcels of gas, a prudent buyer would want the one Pohokura seller's contract to be conditional upon also receiving another contract from a Pohokura seller. In these and other circumstances, it would be futile to incur the costs of negotiating contracts with potential purchasers without the prior knowledge that there are balancing arrangements to support the performance of the contracts.

Other Matters

5.3.33 In addition to the above matters discussed in the Draft Determination, the applicants say that the following factors will also contribute to delay.

Parties involved in negotiating separate marketing

5.3.34 It is important to record that there are a number of parties whose interests must be addressed, including:

- Consortiums of banks to finance development
- Shareholders
- Buyers of the gas
- Authorities: e.g. Commerce Commission

5.3.35 Each of those stakeholders is likely to have conflicting interests. Unless those conflicting requirements can be satisfied, no development is possible. The process of meeting those interests will be an iterative, recursive and time consuming one.

Rights of use of joint venture assets and liabilities for disproportionate use

5.3.36 Under the existing joint venture agreement all assets are used on an equity basis. Under separate selling that would have to be changed to accommodate imbalance and spread marketing requirements. A major point of resolution would be whether and on what basis, a joint venture party may have access to more than its equity share of capacity.

5.3.37 There will be associated liability issues in the event of:

- Damage to the assets while a party is accessing more than its strict equity entitlement.
- Liabilities for assets used disproportionately by a party. Under the existing joint venture agreement each party picks up its own equity share for third party liability, environmental liabilities etc. If at the time of an incident one party is using the assets disproportionately should this party assume such proportion of liability associated with the use of the assets or pay its equity share even if it is hardly using the assets?

5.3.38 There will have to be penalties on the use of unauthorised capacity and some means of deciding whether the unauthorised use of capacity was deliberate or accidental.

Plant design and sparing capacity

5.3.39 It is possible that under Scenario 1 marketing, the joint venture parties' requirements of design parameters may change significantly at the end of the separate selling process. The expectation that this would happen would drive parties to defer detailed design until after separate marketing had been completed. There would need to be an iterative process to get agreement on design. Once this agreement is reached it would constrain the ability of the joint venture parties to offer different terms and conditions except in the unlikely event that the joint venture parties agree to fund the facility to achieve different capabilities.

5.3.40 This means that under Scenario 1 marketing detailed design takes place in series after marketing, whereas under joint marketing detailed design can occur in parallel with marketing.

5.3.41 Other issues that would have to be addressed would include:

- who pays for additional capacity and redundancy
- allocation of planned capacity
- rights to excess capacity
- protection of rights to capacity
- penalties for use of another's capacity
- who pays to overcome constraints

Additional Commerce Commission approval

5.3.42 As noted above, if the Pohokura joint venture parties are required to engage in Scenario 1 marketing, they will need to enter into contract mechanisms to balance the rights and obligations of each joint venture party. In the absence of a suitable commodity market, the cash balancing arrangements will be of particular importance. This matter will not be settled, because of the potential for cheating, unless the parties know the price at which they will each sell gas to purchasers. This inevitable sharing of information has the potential to be viewed by the Commission as being likely to have the effect of (or to provide a mechanism for) fixing, controlling or maintaining the price of gas to be supplied by each joint venture party. Accordingly, there is the risk that the gas balancing agreement would contain a provision amounting to price fixing.

5.3.43 Unlike the case of joint marketing, Scenario 1 would be unlikely to have the benefit of the section 31 exemption. Clearly there would not be joint supply to purchasers under Scenario 1, and there is the potential that there will be supply which will be disproportionate to the interests in the field which are attributable to each joint venture party.

5.3.44 Accordingly, Scenario 1 will involve a different competition assessment to that which applies to the current application, and a new application for authorisation for Scenario 1 marketing will be required.

Sequencing problems

5.3.45 Finally, it is important to consider the process by which the issues identified above may be resolved. It may be possible to address some of the matters in parallel and not necessary that

they be addressed sequentially. Accordingly, the timeframes indicated for each matter might not all be cumulative.

5.3.46 However, it is likely that each matter will require to be addressed more than once. The process would be an iterative and repetitious one. For example it is highly likely that:

- evaluation and design of plant parameters will need to be revisited once Scenario 1 arrangements have been effected, to ensure that the plant design initially selected is capable of meeting the cumulative obligations of the sellers under the various gas sales agreements, for example product mix.

- any design changes required as a result of that review will need to be tested not against those customer requirements but also against practical operational requirements and cost. If there are issues of either sort then there will be a need to address those with buyers.

- the design team is likely to be demobilised/remobilised during this process to avoid unnecessary costs. In fact, whereas the joint venture has been undertaking marketing in parallel with preliminary and detailed design, design and development is likely to cease if any of the proposed conditions are imposed upon the authorisation.

5.3.47 Finally, if authorisation is not unconditionally granted there will be a delay pending an appeal as stated earlier. The design team will be demobilised pending the resolution of any such appeal.

5.4 Timeline of delay

At our presentation to Commission staff on 11 April we provided and made available a schedule of the sequence of tasks required to be achieved to bring the Pohokura field into production. We are currently reviewing this schedule and will, in the next few days, provide a revised schedule which will set out the relevant timeline which will further support our claim that Scenario 1 will clearly involve a delay of more than three years.

6. DETRIMENTS

6.1 As already discussed, there can be no claim that separate marketing has competition benefits over joint marketing. In fact, joint marketing has competition benefits over separate marketing. Accordingly, there are no detriments attaching to joint marketing.

6.2 We deal with the Commission's specific detriment claims below.

<u>Allocative Efficiency</u>

6.3 The Commission claims that joint marketing would result in allocative efficiency losses due to:

- Price discrimination; and
- Longer-term retardation of a competitive gas market.

6.4 The CRA report discusses the ability of the joint venture parties to price discriminate, and the efficiency consequences of any price discrimination. The key conclusions are that:

- there is no difference between the factual and the counterfactual regarding the ability of the Pohokura joint venture parties to price discriminate;
- "substantial market power" is not a prerequisite for price discrimination. In fact, firms facing competitive pressure may be forced to price discriminate to recover their fixed costs and be viable, whether they market jointly or separately; and
- if price discrimination is possible (which depends on resale opportunities), it is likely to be allocatively and dynamically efficient in this industry.

6.5 The Commission argues that separate marketing would facilitate a more competitive gas production market, because the separate sellers would result in a greater depth to the market.

6.6 We emphasise again that Scenario 1 marketing is not the same as competitive marketing. Scenario 1 is three highly coordinated and constrained sellers of gas produced from a single field jointly owned. Comparing Scenario 1 marketing to joint marketing is not the same as comparing three sellers to one. This is a theme of the CRA report and this submission.

6.7 We also wish to re-emphasise that because separate marketing increases risk and decreases field value, it *must* also reduce entry incentives. The contract mechanisms agreed among the applicants to facilitate Scenario 1 marketing would constrain the individual and collective incentives and ability to develop the upstream gas market. Accordingly, it is actually separate marketing that would retard the

development of a more competitive gas production market. As CRA noted in its original report, joint marketing is pro-competitive and dynamically efficient.

6.8 The increased risk and decreased field value consequent upon separate marketing is particularly significant for the relatively small firms on whom the vibrancy of the New Zealand market will depend. As CRA notes in its report, the small New Zealand market and non-tradability of gas must affect the interest of large multinational firms to explore here.

Dynamic Efficiency

6.9 The Commission claims that there will be dynamic efficiency losses moving forwards from a retardation of a competitive gas market. For the reasons noted above, this is incorrect.

6.10 The Commission also claims that joint marketing would deter entry and enhance the potential for Shell and Todd to "leverage their market power into down-stream markets" (paragraph 435). The CRA report demonstrates that these risks are actually greater under separate marketing than under joint marketing. Joint marketing would:

- provide greater incentives for entry as it implies lower risk and higher field value; and

- constrain any attempt by one joint venture party to provide favourable supply terms to a subsidiary.

7. PUBLIC BENEFITS

7.1 The Commission has considerably underestimated the benefits of joint marketing in its Draft Determination:

- The Commission has assumed that separate marketing would only lead to a one-year delay in production. As discussed elsewhere in this submission, this is not plausible.

- Assuming the one-year delay, the Commission has attempted to predict the extra surplus from Pohokura at the end of field life in order to offset this against the earlier loss. At least under one production scenario, the Commission estimates a net benefit from delayed production of gas. Such a scenario is extremely unlikely. It may be that there is a mismatch between model results and a qualitative assessment resulting from attempting to predict demand and supply conditions, and accordingly welfare, so far out into the future utilising trends. CRA believes that it is more appropriate to treat welfare past some near date, in our case six years in advance, as stationary, as described in its report.

- The Commission has limited its analysis of liquids to condensate and has not attempted to estimate the losses arising from delayed LPG production. CRA carries out this extra analysis.

7.2 The CRA report quantifies the appropriate public benefits.

8. THE AUSTRALIAN BACKGROUND

8.1 The applicants consider it useful to examine the Australian situation and to make comparisons, where comparisons are validly drawn, between what has happened in Australia and what is proposed in New Zealand. Many of the issues examined in the Australian gas industry as it has evolved are being examined in New Zealand as well. It appears the Commission agrees with that examination. However, it is crucial to apply the proper comparison framework to the gas market conditions currently existing in New Zealand. The Commission has not done this. This section below explains the reasons why:

- the ACCC authorities deserve to be given more weight and attention;
- the consistency of approach of the ACCC is striking;
- the examples raised by the Commission as evidence of separate marketing bear little resemblance to the conditions facing the Pohokura gas field;
- the results of the COAG report are completely consistent with a finding that separate marketing from the greenfields Pohokura site is unlikely to be feasible, a view confirmed by one of the authors of this report Mr David Agostini (see Appendix B).

8.2 <u>The Australian decisions</u>

8.2.1 The Commission at paragraphs 163–67 of its Draft Determination briefly acknowledges the directly applicable Australian precedent, although it examines only two of the more recent ACCC decisions concerning the North West Shelf Project and the Mereenie Producers. To the extent this selective reference to the ACCC decisions gives the impression that they are somehow outdated or isolated precedent, it is wrong. In fact, the ACCC decisions form an unbroken line of authority from 1977 onwards determining that:

- separate marketing of natural gas is not feasible given the market conditions in different regions of Australia; and
- to force the separate marketing of gas would be likely to slow or prevent field development, and retard exploration and industry growth generally, hence leading to an outcome no more competitive than one where joint marketing is acceptable.

8.2.2 The Commission appears to have given little weight to the consistent line of ACCC authority. It has not carried out a proper comparison of the market conditions in question in those decisions. Rather, the Commission simply notes that it has chosen a different counterfactual to that consistently employed by the ACCC. Whereas the ACCC accepts that a scenario of ‘no development’ is likely if joint marketing is prohibited, the

Commission has selected a scenario of ‘delayed development with a form of coordinated marketing’ (Scenario 1).

8.2.3 The Commission then uses its choice of a different counterfactual to simply dismiss the Australian decisions as irrelevant, without any real discussion of the powerful logic and analysis contained in those decisions. But the core question in the ACCC cases was whether the relevant market conditions were sufficiently developed to be able to support separate marketing. That crucial enquiry transcends the issue of which counterfactual tool is applied, and the reasoning and observations in those cases remain highly pertinent and persuasive in relation to this current application.

8.2.4 The Commission has simply skipped ahead to give primacy to atypical instances of what may or may not arguably be ‘separate marketing’. But the force of the ACCC cases cannot be so lightly dismissed. In fact, they offer a much closer comparison point for this present application on a number of quite crucial issues.

8.2.5 The North West Shelf Project determination:

- surveyed the United Kingdom and United States gas ‘commodity markets’ and found a number of features of the gas markets in existence there which have enabled separate marketing to have become the norm;

- compared that with the West Australian gas market and recognised that “few (if any) of these features currently exist” and that it was instead a ‘contract’ or ‘project market’;

- developed an important checklist of market features against which to measure progress towards a mature market where separate marketing would become viable, and resolved to revisit that progress where necessary; and

- declared that market circumstances in West Australia were not sufficiently mature to support separate marketing.

8.2.6 The key focus was always on whether suitable and sufficient market features were in place to enable separate marketing to be feasible. That is the proper enquiry for the Commission to address in relation to Pohokura.

8.2.7 The Commission has not discussed this analysis at all in the New Zealand context. In particular, it has not addressed where on the time-line of market evolution it believes the Pohokura field sits in relation to the Australian history. The reality is that because of the Maui-dominated development of the New Zealand gas market, this is the first time this issue has arisen in New Zealand. The Pohokura application is the equivalent of Woodside’s pioneering application to the ACCC in 1977.

8.2.8 To draw the correct comparisons with the Pohokura situation requires careful analysis of the factual circumstances present in the ACCC cases. The Commission has not sufficiently analysed those circumstances. Neither the North West Shelf Project (1998) nor the Mereenie Producers (1999) determinations concerned new greenfields developments. The gas field in question in the North West Shelf case had already been in production for around 13 years and the determination was required because a new joint venture party was not subject to an existing earlier authorisation. A counterfactual of 'no development' seemed an odd element to the decision, as there was no question about the gas not coming into production - field development had long since been achieved already. That same gas field was actually the subject of the Woodside ACCC authorisation of 1977, when it was a greenfields new development. That is the appropriate factual comparison. When dealing with it as a greenfields site, the ACCC had given authorisation with no conditions attached and for an indefinite time period.

8.2.9 The Mereenie Producers decision did not involve a greenfields development either. The field had been producing since the mid-1980s and several earlier contracts had been agreed and performed. The applicants sought to enter another new contract linked to expansion of the facility. This led one party to argue, perhaps plausibly, that as development had long since taken place and initial costs recovered, there was no reason why separate marketing could not commence for further contract negotiation rounds. Yet even in that situation the ACCC still doubted that market conditions existed to support separate marketing, and saw appropriate and sufficient benefits to grant authorisation. *A fortiori*, it is even more apparent that separate marketing from a greenfields undeveloped site in New Zealand's immature market conditions is not feasible.

8.2.10 For the Commission here to prevent joint marketing from the Pohokura field when it is a long way from being in production yet is a much tougher line than the ACCC decisions and greatly compounds all the usual difficulties that field owners face in bringing a new field to production. The result will be significant delay in gas entering the market.

8.3 <u>The ACCC's view is consistent</u>

8.3.1 It has been overlooked, not only by the Commission but also by the tendentious NZIER paper prepared for NGC that the ACCC itself recently re-considered separate marketing and made a submission to the COAG review in May 2002. The ACCC revisited its earlier views from the North West Shelf Project decision. It repeated the checklist of elements of a mature market that need to develop before separate marketing is feasible, and expressly noted (at page 88) that where those elements are absent:

"… the prohibiting of joint marketing of gas might dissuade new investment in gas production. In that instance, authorisation of joint gas marketing is likely to be in the public interest and is likely to remain a feature of the gas industry until such criteria are satisfied. It is not clear that the market has evolved (according to the indicators set out in the Commission's North West Shelf Authorisation determination of July 1998) to enable separate marketing. The construction of gas transmission and distribution pipelines has fostered new entry into gas production and sales by joint venture producers, who maintain the industry norm of co-ordinated marketing. In those circumstances it would be difficult to demonstrate that co-ordinated marketing activities are necessarily a breach of the Trade Practices Act. Arguably it has facilitated new investment although it may be one of a number of factors contributing to a reduced level of competitive activity in the market"

8.3.2 The consistency of the ACCC, even beyond the North West Shelf Project case, is impressive. When specifically addressing this point in 2002, the ACCC stood by its earlier views that the relevant markets had still not evolved to a situation where it thought separate marketing was feasible.

8.3.3 We note that the Commission has had discussions recently with ACCC staff members and drawn conclusions on their views, seemingly in line with the above statements. However, filenotes and transcripts of the ACCC discussions have not been made publicly available by the Commission, so the applicants have no opportunity to examine the whole context of the discussions or test the Commission's interpretations.

8.3.4 Notwithstanding this the Commission claims, in relation to the Australian gas market that "*Joint Marketing may have been the standard approach in the past, but examples of separate marketing are now beginning to occur*." (paragraph 300). This is directly contrary to the ACCC's view, expressed to COAG just last year, that there had been new entry by "… joint venture producers who maintain the industry norm of co-ordinated marketing."

8.3.5 The ACCC is not noted for being any sort of "soft" regulator. It has a specialist Gas Group of staff members devoted to in-depth study of and regulation of the industry. It has produced several reasoned, fully-argued decisions authorising joint marketing in circumstances similar to the Pohokura field, and is consistent in its views. In all the circumstances, it is those decisions of the ACCC that deserve more authoritative respect, rather than speculative discussions about isolated instances of what purports to be separate marketing.

8.4 Maturing markets and the COAG review

8.4.1 There remains a major question whether Australian markets in 2003 are the appropriate comparison point for the New Zealand market. The Australians have evolved a lot further down the path towards a mature gas market than we have. Critically, the Australian market is many times larger than is the case in New Zealand. Even so, Australia is only now on the verge of reaching a market which might soon be capable of supporting forms of separate marketing, and only in some regions. The key ACCC cases were decided at a time when Australian market conditions more closely resembled those still pertaining in the less-developed and relatively immature New Zealand market. Australian experience from the 1990s provides a close parallel for the New Zealand market in 2003, which is much further back on that evolutionary path.

8.4.2 The ACCC list of relevant elements from the North West Shelf determination stated (at page 48):

> "While it is impossible to be prescriptive about exactly what market features need to develop before separate marketing will be viable in WA, the greater the number of the following list of market developments that are introduced, the greater the likelihood that separate marketing will be viable:
>
> - a significant increase in the number of customers;
> - the entry of new competitive suppliers;
> - additional transportation options;
> - storage;
> - the entry of brokers/aggregators;
> - the creation of gas-related financial markets; and
> - the development of substantial short term and spot markets."

8.4.3 The appropriate question is not whether separate marketing might be feasible even if one or two of the elements of a mature market are not present – because, in New Zealand, we do not have any of those key elements yet. It is a somewhat academic or moot point whether separate marketing would be feasible with any one element missing, but at the very least a number of them, or the majority of them are required. Before New Zealand considers enforced separate marketing, with its potential cost to the growth of the industry and chilling effect on badly-needed

exploration, at least some of the elements should be present – which they are not.

8.4.4 For example, both the New Zealand and Western Australian markets can be characterized by:

- few customers;
- limited transport infrastructure;
- few sellers
- lack of gas storage;
- few brokers/aggregators;
- lack of gas-related financial markets;
- the lack of substantial short term and spot markets.

8.4.5 In the context of these similarities, the applicants consider that the issues identified concerning the feasibility and lack of separate marketing in the Western Australian market have relevance to considerations of the feasibility of separate marketing applied here in New Zealand. The conclusions of the most recent review in Australia, the Energy Market Review for the Council of Australian Governments (COAG), appear to support that. The applicants have commissioned an Australian expert in the matter to provide his opinion. Mr David Agostini comes from a central role in that recent COAG review in Australia.

8.4.6 The main conclusion of the COAG report is that there must be careful focus on the facts of each particular application for authorisation of joint marketing. It mandates the ACCC to continue its case-by-case approach. The applicants agree that approach is appropriate, and maintain that the Commission here has not paid enough attention to the particularities of the Pohokura situation.

8.4.7 The Commission appears to rely more heavily on the KPMG report made to the COAG review than the findings of the review itself. Mr Agostini in his report explains that the KPMG arguments were far from universally held and that several of its suggestions were rejected. Much depends on a proper analysis of the field under examination. But even under the thinking espoused by KPMG a new greenfields development like Pohokura would clearly fall within the criteria for cases where KPMG would not expect separate marketing to be feasible. The Commission fails to acknowledge the force of this finding of KPMG and COAG.

8.5 Comparisons and examples relied upon by the Commission

8.5.1 The Commission has also looked to the Australian experience. In particular the Commission cites the Thylacine/Geographe and Yolla joint ventures as examples of separate marketing occurring.

8.5.2 While, in this evolving eastern Australian market, the opportunity has arisen for joint venturers to develop novel arrangements, that does not mean they amount to 'separate marketing'. . Further, there are important distinctions to be made between that market and New Zealand market. They are very different in terms of size and relative maturity. As Mr Agostini notes, even the eastern States' market alone is more than triple the size of the New Zealand market.

8.5.3 Notwithstanding the significantly more advanced maturity of the eastern Australian market compared to the New Zealand market, relative to the factors identified above, producers in their submissions to COAG have made it clear that the eastern Australian market has not yet developed the degree of maturity necessary for true separate marketing to be adopted as the norm[3, 4, 5, 6]. Mr Agostini underlines this point where he points out the COAG Energy Review Panel concluded that comparison with markets such as the United States and United Kingdom are invalid, as such comparisons ignore the relatively immature nature of the Australian market.

8.5.4 The examples cited by the Commission, namely Geographe/Thylacine and Yolla, are not in our view supportive of any general proposition that separate marketing is feasible in other than the most particular circumstances. It should be noted that Origin Energy, a participant in both joint ventures, has stated

[3] BHP Billiton: 14 October 2002

- Joint marketing exists primarily because of a 'lack of depth' in the Australian market to support separate gas marketing.
- Until the gas market in Australia gets deeper and all available gas can be placed immediately at a market price a la US or UK it is hard to see why anybody would agree to jointly develop a resource without a market.

[4] ExxonMobil: 27 November 2002

- It is highly unlikely that a large greenfield gas project like the PNG Gas Project will occur if the proponents do not have the ability to jointly market. The shallowness and illiquidity of the market means that it would be near impossible for each proponent to independently secure the necessary and sufficient contracts to underwrite the substantial investment required for such a project.
- The shallowness and illiquidity of the south eastern Australian gas market would also place the Gippsland Basis gas separately marketed by ExxonMobil and BHP Billiton at commercial disadvantage because comparable sales opportunities needed to allow joint development of the resource will rarely coincide. Such disadvantage would result in inefficient depletion of the Bass Strait fields, reducing profitability and associated government revenues from the project, and would reduce the economic life of the fields.

[5] Woodside: 11 October 2002

- In most cases in Australia, market opportunities are limited in number, scope, and timing.

[6] BHP Billiton: 14 October 2002

- Comparisons with the US and major European gas markets are erroneous. While the market has evolved from this situation to a point where, particularly over the past few years, inter-State gas trade (in south-eastern Australia) and inter-basin (i.e., upstream) gas competition are becoming more prevalent, it still lacks the depth and liquidity associated with overseas markets (USA and Europe) which have been cited as comparative cases where separate marketing occurs.

to COAG: "*The lack of a liquid wholesale contracts market means the technical and physical limitations of gas reservoirs and their development (even in mature fields/basins) as likely to be highly inefficient under separate marketing arrangements."*

Woodside, a participant in the Geographe/Thylacine joint venture, has stated:

> "Several factors have worked to potentially make separate marketing feasible for the Thylacine and Geographe joint ventures. These include:
>
> - The confidence the largest participants in the joint ventures feel in finding a market to service, in a timely manner, their investment in jointly owned facilities. Woodsides's case, this confidence was based on finding an acceptable market with TXU. In Origin's case, this confidence may be based on their role as both a significant buyer and seller in Eastern Australia markets.
>
> - The relatively small size of volumes which the smaller participants must place compared to overall demand. This relative size, compared with the existence of aggregator type buyers, decreases the market risk the smaller participants face in placing their gas."

8.5.5 Mr Agostini points out that novel arrangements have been developed which have been termed separate marketing. However he also points out that, with regard to the eastern markets:

- such separate marketing is practicable only in unusual and specific circumstances which may prevail only for a limited time; and

- such examples only exist where the magnitude of the uncommitted volumes held by non-vertically integrated parties to the joint venture are tiny relative to total market throughput.

8.5.6 Mr Agostini is of the opinion that none of the arrangements cited by the Commission "*has any relevance to the practicality of separate marketing, where those unique circumstances do not exis*t." Further, in Mr Agostini's opinion, none of these arrangements would seem to offer an appropriate model for Pohokura.

8.6 Key points to note in relation to the so-called examples of separate selling in Australia are as follows:

- the Geographe/Thylacine fields have not yet been developed. As the Commission's own filenote of 24 March 2003 records, crucial arrangements such as balancing agreements have yet to be

concluded. According to the Woodside Concise Annual Report 2002 (page 20) the final investment decision date for these fields is not due until March 2004. It cannot be assumed that separate marketing will be implemented until such time as all necessary arrangements are concluded and the field comes into production. Meanwhile we note that Woodside is pursuing joint marketing arrangements in relation to other fields it is bringing into production. Blacktip, an offshore field discovered in September 2001, is of a similar size to Pohokura. The joint venture has announced a contract to sell 40 PJ per annum over 20 years from 2007 to Alcan. The development and joint marketing of gas is subject to a development decision and regulatory approvals.

- In any event unique circumstances attach to the Geographe/Thylacine example,

- The Yolla developments centre upon the initiatives of one of the key shareholders and the operator, namely Origin. Yolla is a marginal field, and development depended on Origin's expectations being met. Origin's desire to purchase the gas from the field was made known to the other shareholders and the dynamics of the arrangements which unfolded are understandable from a commercial point of view. For example, given Origin's desire to purchase the gas, it is reasonable to assume that the other shareholders would have realised that development was less likely to proceed if gas was sold to purchasers other than Origin. And so, the issue facing the other shareholders was to ensure that they obtained a competitive price. This they established initially through AWE seeking competitive bids, which then presumably provided a benchmark price for the contracts with the remaining shareholders in Yolla.

- Accordingly, the Yolla example is really just a case study of the dynamics of how a field may be developed where a major shareholder, being the operator, also has a commercial agenda to become the dominant purchaser of gas from the field.

- The VENCorp example is not a precedent of any real significance. The Victorian gas market is still based mainly on long term contracts. There is no significant spot market in Victoria, and a spot market is unforeseeable for the moment in New Zealand.

- Of relevance is the fact that there are some 157 Pohokura's (in terms of gas reserves) capable of being brought into production in Australia. A delay in one (Geographe/Thylacine) will not jeopardise overall gas supply. Other fields are available to fill any significant production gap. That is not the case in New Zealand.

8.7 Conclusion: comparing Australian 'apples' with New Zealand 'apples'

8.7.1 It is critical that the Commission does not draw invalid inferences as to what is practicable with Pohokura simply on the basis of nascent examples of novel marketing arrangements in the

eastern Australian states. That provides no general proof as to the general feasibility of the concept of separate marketing vis a vis Pohokura. It is essential that the Commission focus on the feasibility in the context of the circumstances prevailing here in New Zealand, and take into account the maturity of the market in terms of the features critical to separate marketing

8.7.2 As the ACCC identified in its 1998 determination:

> "The key issue in the context of this authorisation, however, is not necessarily whether separate marketing is superior to joint marketing, but rather whether separate marketing is feasible in WA".

As the COAG review put it:

> "The Panel, however, recognises that joint ventures face some challenges in dealing with production balancing issues and that these need to be addressed in the unique circumstances of each case in determining the applicability of individual competitive marketing. **It is acknowledged that there are circumstances where separate marketing is not practical."**

9. PRIOR STATEMENTS

9.1 Shell proposes, in a separate letter, to respond to various statements made in the Draft Determination regarding its commercial relationship with Todd, and other statements made in relation to perceived inconsistencies.

9.2 Todd's position is that it has already answered the Commission's questions on the matter of previous statements, as the Commission has noted in paragraph 285 of the Draft Determination.

9.3 Todd also considers that the Commission's statement of its relationship with Shell, at paragraphs 60 and 401, is wrong. Todd records that:

- The statements are unsubstantiated by any analysis or explanation.
- [ ]
- [ ]
- The Commission made no attempt to raise this with Todd as a relevant issue prior to issuing the Draft Determination.
- In summary, the Commission persists in making the assertion that Shell and Todd are weak competitors without substantiating that in any way, even when invited to do so by Todd.
- Todd did not accept the Commission's conclusions in Decision 408/411 and rejects its assertions even more strongly now.

9.4 The Commission also notes the minutes of the Pohokura Offtake Committee of 4 September 2000 in support of the proposition that the applicants have in the past considered that separate marketing of gas from the Pohokura field "was possible and practical, and it was what was likely to happen".

9.5 The applicants do not accept that the minutes of the meeting evidence that the applicants held this view. The minutes of the meeting simply state "Todd expected to take, at least in part, its equity entitlement to Pohokura product (LPG and gas). It was agreed that the Committee would undertake work to develop and implement a gas offtake agreement to permit this". The Commerce Commission has misinterpreted the minutes and taken them out of context.

9.6 Todd's position was that it wanted to have an ability to access Pohokura gas for its own purposes if it so desired. That is why the minutes record that "Todd expected to <u>take</u>, <u>at least in part</u>, its equity entitlement …" (emphasis added). Todd did not state that it wanted to separately sell Pohokura gas. If this had been Todd's position the minutes would have recorded it as such. The Pohokura Offtake Committee agreed that it would "undertake work to develop and implement a gas offtake agreement to permit this". The Pohokura Offtake Committee did not agree that it would develop and implement a separate gas marketing

arrangement. The applicants did not hold a collective view that separate marketing was possible in the New Zealand context and that is why the minutes record that it would “develop and implement a gas offtake agreement” which is a general form of arrangement for Todd to access gas on its own behalf. At the time of this meeting the Pohokura Offtake Committee had not undertaken detailed investigation of the feasibility of separate marketing in the New Zealand context.

9.7 In support of this we note that the minutes of the Pohokura Offtake Committee meeting of 4 September 2000 record that “The Chairman is to prepare a Scope of Work … for a report to address: Gas Offtake Arrangements, Gas Balancing, Joint Sales…Commerce Act implications of joint and separate marketing”. The purpose of this work included to review and consider the feasibility of separate marketing in the New Zealand context. The Commission has previously been provided with the Scope of Work for this report and a copy of the report produced in December 2000 as the result of this study. The minutes correctly record that the discussion was about finding a way in general to achieve Todd’s desired outcome. More recently, Todd has proposed that it might purchase gas from the applicants. It is considered that this suggested uplift arrangement is consistent with the minutes of the Committee.

10. THE PROPOSED CONDITIONS

10.1 Limited Period of the Authorisation

10.1.1 In paragraph 511 the Commission states that its "current view is that the time period of the authorisation should be 5 years." This proposed condition is uncertain because it gives no indication of the commencement date for the five years. From discussions with Commission staff, we understand that this five year period is intended to commence from the date of first production of gas from the Pohokura field. Our analysis proceeds upon this assumption.

10.1.2 Should authorisation only be granted for five years, the field will not be developed to achieve joint or Scenario 1 marketing. The basic reason for this is that the project would not receive the necessary funding. Todd has asked its bankers, Westpac, to indicate what implication this condition would have on its ability to raise limited recourse funding. Westpac's response is attached as Appendix C.

10.1.3 [ ] Westpac's opinion is that a five year term would make debt-financing of the project untenable. Todd will also require Board approval. The project will have to meet strict rate of return criteria on a risk adjusted basis.

10.1.4 The OMV investment criteria is as follows: the current schedule for the development of the Pohokura field requires that the joint venture parties approve the development of the field in April 2004 for first gas in early 2006. In order to give this approval in April 2004 the Board of OMV New Zealand Limited and its parent companies will need to be satisfied that the proposed investment meets OMV's investment criteria. This will require that there is a contract for the sale of gas of sufficient volume and value that the economic analysis of the proposed investment meets OMV's investment hurdles on a risk adjusted basis. This will almost certainly require a gas contract with a term of more than five years. If the proposed investment does not meet these internal hurdles then it will not receive Board approval and cannot proceed.

10.1.5 Whilst Shell usually funds all development projects from internal cashflow it has a strict capital allocation process that must be followed if funding is to be made available. This process includes mandated review points in the project schedule that must achieve sign-off. In particular, the last of these reviews is undertaken as the final check before the decision is taken to proceed to development. Amongst other requirements, there is in general a need to have a contract in place that will underwrite the expenditure. In this regard, whilst Shell acts as its own bank, the hurdles that must be jumped to achieve a positive

investment decision are not dissimilar to those required for external funding.

10.1.6 There is another dimension to this issue. Both Genesis and Contact have publicly stated their need for long term gas supply contracts from Pohokura to support investment in new electricity generation facilities.

10.1.7 The Commission does not provide any reasoning relating to how it arrived at this five year figure. This is surprising given that the Australian authorisation cases have routinely approved much longer terms, especially for new greenfields sites not already in production. For example, greenfields sites have been authorised for indefinite periods (Woodside's North West Shelf and WA Petroleum) or for the life of any contracts, including long term contracts such as 30 years for the Cooper Basin.

10.1.8 Should the Commission impose this condition, funding will not be available to enable development of the field, and decisions on new electricity generation investment will be frustrated, contrary to the express wishes set out in the Pohokura Government Policy Statement.

10.2 Requirement for Pohokura to be Developed by a Certain Time

10.2.1 The Commission proposes to impose a condition that the authorisation be made conditional upon the production of first gas by the beginning of February 2006, and full production capability occurring by 30 June 2006. By way of preliminary comments, this condition would impose a business strategy upon us which we would not be prepared to follow. Schedules which are calendar driven, rather than data driven, are recognised to increase risks of failure. The views of an independent expert on this issue, IPA's president Ed Merrow, are set out in "Taking on a Cult of Mediocrity", *Upstream*, 23 May 2003, 28-29.

10.2.2 If authorisation is granted upon this condition, the Pohokura joint venture parties would not be prepared to invest in further development of the field unless they were confident that these dates could be met. There are a wide range of risks, outside of the control of the joint venture parties, which could impact upon this.

10.2.3 Project time estimates are at best 50:50. It is equally probable that they will be missed as it is they will be bettered. To attach conditions such that a large part of the probability curve is not accounted for is unacceptable.

10.2.4 Set out below are a list of issues that could possibly impact the date of February 2006 for first gas from the Pohokura field. This list is the basis and starting input of the project risk register. These risks have not been ranked nor has any mitigation planning been established. Mitigation planning can have it's own

set of inherent risks often found to have a cost impact. In addition there are other project risks that do not pertain to schedule which are not shown on this list. The risks have been grouped by major project execution element and some that are common to each element have been repeated for completeness. Most of these risks involve events outside of the control of the applicants.

Reserves

Sub-Surface static and dynamic modelling provides information not in line with our current assumptions
Significant compartmentalising of reserves exists
Loss of key people
Well stream characteristics change
Number of wells significantly changes after dynamic modelling
Location of wells significantly changes after dynamic modelling
South well test data adversely impacts work to date

Hearings & Consents & Approvals

Environment Court hearings go to Appeal
HSE case for NUI's is rejected by OSH
Onshore Pipeline access not attained
Certifying authority delay issue of certificate of fitness
Unable to secure third party assets currently considered in base construction schedule

Engineering & Procurement

Significant changes to field development plan at final issue in November
Procurement delays of major equipment (e.g. Dehydration Package)
Late delivery of Linepipe for sub sea pipeline
Engineering resources are unavailable to conduct design
IT crash & loss of project data
Time pressure causes errors in design & construction
Loss of key people during execution
Geotech information for Jackets is late affecting design start
Geotech information indicates concept selection is inappropriate
Incorrect/inappropriate material selection
No solution for disposal of produced water
Functional specifications for major contract scopes are inadequate for realistic bid from bidders

Installation

Unable to mobilise vessels in 2004/5 summer season
Mobilised vessels are late due to prior commitments overrunning
Pipeline buckle during pipe-lay
Weather downtime for jacket installation/pipelay/hook-up etc
Shipping damage to installations
Fishing boat and pipeline snag
Rig collapse/buckle
Piling refuses & jackets have to be re-sited
Terrorist activity

Drilling

Extended well delivery times due to technical difficulties

Unable to mobilise vessels in 2004/5 summer season
Mobilised vessels are late due to prior commitments
Wells do not perform as expected & start up is delayed
Greater levels of CO_2 & H_2S found during drilling of development wells
Late delivery of well materials
Quality problems with well services equipment and services
Enhanced productivity techniques are required for well
Terrorist activity

Construction

Inadequate resources available locally to perform fabrication work
Industrial action affects progress
Weather affects site preparation work/need to execute work in high risk periods
Access agreements for pipe stringing not agreed
Anti project activists effect protests at sites
Skill shortage affect construction schedule
Time pressure causes errors in design & construction
Contractors go bust during execution
Catastrophic failure of equipment during testing
Contractor has a force majuere
Failure of equipment at Site Acceptance Testing
Terrorist activity

Commissioning

Construction/commissioning interface breakdown area to system handover
Operating under Permit to work will slow down final construction
Poor mechanical completion definition
Ay required simultaneous operations e.g. drilling & producing will slow both activities
Drying of pipeline to required specification becomes problematic
Pipeline dewatering is unsuccessful at first attempt
Lack of available resources for commissioning activity peaks
Hydrocarbon leak
Malfunction of equipment
Malfunction of controls systems
Inadequately detailed operations procedures
Unexpected hydrate formation or other process upsets not planned/mitigated for
Unexpected wax formation
Slugging in the pipeline after start up
Incomplete operation documentations and start up spares from equipment suppliers

HSE

Safety incident at sites during execution
Environmental incident during execution
Health problems affect progress (Food poisoning @ camp/ on rig)
Misalignment of regulations interpretations leading to rework of facilities/equipment

Funding

Cost estimates do not meet JV partner funding criteria

Reviews

VAR 3 review does not agree concept is optimum
VAR advises project is not ready to proceed to execution
DtL reviews challenge well design and impact progress
Pre-Hydrocarbon introduction review identifies incomplete work immediately prior to start up

Project Management

Loss of key people during execution
Project management Systems failure
Failure of change management system leads to rework

10.2.5 These events, which can cause material delays, are not mere possibilities. They are events which do occur. Some local examples illustrate the point. There were delays in the installation of the Maui B platform of four months caused by adverse weather and delays due to weld repairs which were required to be made to the topsides which were sourced from Singapore. Once the platform was installed, there were significant shutdown delays caused by a flowline choke rupture. There was also a delay of about a year in the installation of the Maui A platform, caused by a combination of very unfavourable weather, the fact that the laybarge initially brought out by the contractor proved inadequate in those conditions so that a larger vessel had to be mobilised, and unfavourable and unexpected subsurface soil conditions which meant that the leg piles could not be driven with the hammers initially brought out by the contract (replacement hammers had to be brought out from Europe). Installation work had commenced in December 1975 but had to be abandoned during the winter of 1976, which meant that the platform was left partially installed and exposed until installation could be completed in early 1977. Another example is the Goodwyn platform which is operated by Woodside in Western Australia. There was a delay of well over a year in the production of first gas because of the major piling problems which were encountered.

10.2.6 This condition would also impose financial constraints which would inhibit development of the field. As stated in the attached letter from Westpac (Appendix C), project financing would only become available after the field is developed, if this proposed condition is imposed.

10.2.7 For these reasons, this condition would also frustrate the possibility that the Pohokura field be developed to enable early decisions on new electricity generation investment, contrary to the Pohokura Government Policy Statement.

10.3 Assignment of Authorisation to Successors

10.3.1 In paragraph 516 of the Draft Determination, the Commission has indicated that it proposes to restrict the authorisation to the existing parties to the application. The only reason given for this is that there is the potential for increased coordination between various gas fields.

10.3.2 This concern is, in fact, overcome by the business acquisition provisions contained in section 47 of the Commerce Act. For any party to be a successor it will need to acquire a participating interest in the Pohokura field from one of the parties to this application. Any such acquisition will be subject to section 47. Accordingly, whether or not there is an application for clearance, the Commission will have the ability at the outset to test the legality of the acquisition under the same substantial lessening of competition threshold which applies to the proposed joint marketing arrangements of the applicants. In particular, the question of coordinated market power, the essence of the Commission's current concerns, is now a matter which can be properly addressed under the merger threshold.

10.3.3 The authorisation provisions anticipate that there will be circumstances where it is appropriate for the Commission to grant an extension to an authorisation to persons other than existing parties to the application. Given that there is a mechanism to deal with the Commission's concern here, the Commission should exercise its discretionary power under section 58B(2) and extend the authorisation to successors of applicants who may acquire a participating interest in the field.

10.3.4 There are additional reasons why the Commission should exercise this discretionary power.

10.3.5 First, if successors do not have the benefit of the authorisation, this will inject uncertainty into contracts with those customers who require continuous supply under long term contracts. What if, for example, there is a long term contract of (say) 12 years and one of the existing joint venture parties sold its participating interest to a third party in (say) year 3 of this contract? If the Commission has imposed a condition that the authorisation does not extend to successors, this will mean that neither the remaining joint venturers, nor the successors, will have the benefit of the existing authorisation, and therefore a new authorisation round may be required during the life of the contract. The applicants will therefore face uncertainty that they can in fact enter into a long term contract under which they will be able unconditionally to commit supplies on an uninterrupted basis. Accordingly, this condition may foreclose the opportunity for the applicants to enter into long term contracts.

10.3.6 Second, from a commercial point of view this is a very onerous condition which may lead to an inability to achieve funding for the project, whether by equity financing or project financing. This condition may actually cause delay to project commitment.

10.3.7 In the case of project financing, the financiers are likely to be concerned that they can take over the interest if the owner falters. If authorisation lapses because of such transfer, this exposes not only the financier but the other co-venturers to having the project underwriting contracts terminated. Therefore the condition puts all joint venture parties at risk, not just the assignee.

10.3.8 In any event, any business must enter arrangements with the possibility of exiting without loss of value if circumstances change or the shareholder requires portfolio reconfiguration. This condition undermines this fundamental business requirement. Shareholders may therefore be unwilling to approve the project for this reason. Further, as evidenced by the Westpac letter appearing as Appendix C, it is essential to lenders that they have an unfettered right to dispose of a joint venture party's interest in the event of default.

10.3.9 Accordingly, this condition would also frustrate achievement of the goals set out in the Pohokura Government Policy Statement.

10.4 Ring-Fenced Marketing

10.4.1 The Commission's draft determination states:

> *"517. The Commission would consider making any authorisation conditional on the Pohokura JV parties implementing a ring fencing arrangement for the sales of gas from the Pohokura field. The marketing activities for the Pohokura field would be required to be kept separate from the gas trading activities of the separate Pohokura JV parties.*
>
> *518. The purpose of such a condition is to ensure that gas from the Pohokura field is marketed in competition from gas from other fields."*

10.4.2 The intent and scope of this proposed condition is unclear, and the applicants have doubts as to how the condition can operate in practice and what steps they would have to take to comply with it. However, from what can be inferred from paragraphs 517-518, there are significant difficulties with the proposed condition, both of a practical and a legal nature. The proposed condition should not be included in any form.

Practical issues

10.4.3 It is unclear what the Commission means by ring fencing. Presumably, the reference in paragraph 517 to the marketing and sales of gas from the Pohokura field anticipates that each of the joint venture parties would have marketing and sales teams who would be dedicated solely to the marketing and sale of gas from this field to the exclusion of all other fields in which each joint venture party may have an interest.

10.4.4 For this ring fencing mechanism to be meaningful it would require not just the ring fencing of intermediate level executives. No final investment decision will be made by any of the Pohokura joint venture parties until such time as there is certainty over the proposed process relating to the sale of gas from the field. A cornerstone contract or contracts will be required. The suitability of these proposed sales arrangements will need to be sanctioned by the Board of each of the joint venture parties upon recommendation from the chief executive and other high level management. Accordingly, any superficial ring fencing arrangements will be meaningless.

10.4.5 Each of the joint venture parties will face particular problems with potential ring fencing arrangements. Their particular circumstances are as follows:

(a) *OMV*

- Following the acquisition by OMV of the New Zealand business of Preussag Energie, the business activities of the OMV group in New Zealand have been restructured to be owned and undertaken by OMV New Zealand Limited. OMV New Zealand Limited currently owns the following:

    i. 10% interest in the producing Maui field;

    ii. 35.8618% interest in the undeveloped Pohokura gas-condensate field;

    iii. 39% interest in the undeveloped Maari oil field; and

    iv. interests in a number of exploration blocks.

- The 30% interest in Maari held by OMV Petroleum Pty Ltd is currently being assigned to OMV New Zealand Limited.

- OMV New Zealand Limited has recently established its New Zealand office to manage the interests owned by the company. The New Zealand office will be run by the Commercial and Legal Director. The

Commercial and Legal Director will have wide responsibilities that include: membership of the Board of Directors of OMV New Zealand Limited; membership of the Executive Committee of OMV New Zealand Limited responsible for the day-to-day operation and management of OMV New Zealand Limited; local management of OMV New Zealand Limited, all commercial and legal matters (including marketing) arising in respect of the interests owned by the company; and growth opportunities. OMV New Zealand Limited is recruiting a Commercial Executive to assist the Commercial and Legal Director.

- The E & P industry is capital intensive and has few employees managing large assets. OMV New Zealand Limited will have a small number of employees who will be responsible for a wide range of assets. Given that OMV's commercial and legal work will be performed by a team of 2 people, one of whom is the manager for the New Zealand business and a director of the company, the ring fencing of marketing activities that involves actual separation of actions and decision making will require corporate restructuring and employment of (unnecessary) further staff and increase the cost of doing business in New Zealand. Corporate restructuring will involve substantial costs and may give rise to tax liability issues. From an operational and governance perspective, the Commercial and Legal Director must be involved in, and manage, **all** marketing decisions for the New Zealand business.

- The commercial and legal work undertaken by the Commercial and Legal Director and the Commercial Executive will include all issues associated with asset ownership and operation, and gas and liquids marketing. These matters are interdependent, both within assets and across the whole business. Any substantive separation will give rise to business costs and inefficiencies.

- A ring fencing condition would restrict OMV's ability to effectively compete in the New Zealand gas market. As the Commission notes at paragraph at 363, OMV currently accounts for only a 6% share of gas production (in comparison to Shell and Todd's 62% and 20% shares respectively). Furthermore, contrary to the Commission's views expressed at paragraph 401, OMV is not already a major participant in the market. It is not one of the producers that the Commission (at paragraph 401) identifies as at least appearing to have market power at present. In addition, there is no constraint in competition between

OMV with either Todd and/or Shell (its other Pohokura Joint Venturers) or any other gas producer; [ ] Consequently, there is no justification for the application of the ring fencing condition to OMV.

- OMV is concerned that it should have the ability to optimize its current and potential future gas assets for supply in competition with other producers and fields. As the Commission notes (at paragraph 268), post-Maui additional gas supply is most likely to come from smaller fields; and, therefore the fields that OMV may seek to acquire or find and develop independently. Given that the volumes of gas involved will be relatively small, companies contemplating developing and producing from small fields will need to consider innovative ways of marketing the gas produced. For example, OMV will have an incentive to aggregate gas available for supply and enter into "supply" contracts rather than "field specific" contracts, i.e. entering into contracts for the supply of gas that OMV as seller is able to secure from a number of sources or an aggregate source of gas. In this context, under a ring fence condition, OMV would not be able to offer secure supply from the aggregation of gas from smaller fields it might develop or acquire, with the sale of Pohokura gas either by the Pohokura JV Parties or by itself as a reseller of Pohokura gas.

- It is important that the range of marketing options open to OMV is not limited in such a way as to provide disincentives for the development of such fields, and further investment by OMV in the New Zealand petroleum exploration and production markets. OMV's developing position in the New Zealand gas market will introduce further competition. OMV submits that the Commission should have no concern in relation to OMV being able to market Pohokura gas with gas from other fields in which OMV may have an interest.

- In essence, the effect of a ring fencing condition would be to reduce the flexibility OMV needs to market gas and thereby increase its presence in New Zealand, and to that extent will impact adversely on the development of effective competition in the New Zealand gas production and wholesale markets.

(b) *Shell*

- The value of any likely gas contract from the Pohokura field makes it impossible with Shell's governance guidelines for the negotiating mandate

and/or contractual commitment to be delegated to a level that can be practicably ring fenced. Further, Shell is of the view that such delegation would be in contravention of the legal responsibilities of that director or board. The legal issues are amplified later.

(c) *Todd*

- The E and P business is typified by large value assets managed by small numbers of people. This is certainly true in the case of Todd. We have ten people:

  (i) Managing Director*
  (ii) Commercial Manager
  (iii) Acquisition and Development Manager*
  (iv) Exploration Manager
  (v) Gas Trading Manager
  (vi) Operations and Technical Manager
  (vii) Asset Manager Offshore
  (viii) Asset Manager Onshore
  (ix) Drilling Manager
  (x) Legal Counsel*

- The responsibilities of those marked with an asterix also include Todd's downstream businesses.

- As can be seen from the position, Todd has one person in each "department". We have production interests in Maui, Kapuni, McKee, Mangahewa, and from 2006 Pohokura. If we have to ring fence each of those interests, we would have to hire, for example four or five more Gas Trading Managers. That would be absurd. Even more significant, however, is that key decisions, such as entry into gas sales contracts, are subject to Managing Director approval. A Managing Director could not be ring fenced because of Companies Act issues and the practical impossibility of managing a business under that sort of constraint.

- Todd applies an inter-disciplinary team approach to most matters, including gas marketing and sales. Obviously, gas marketing involves sales, legal and technical matters. Accordingly, it is not the case that Todd's existing ten people could be divided up between fields.

- Imposition of this condition would constrain Todd from managing its assets as a portfolio in a way that no other party in the market is, to Todd's very real detriment. This matter is of real concern to Todd

given that it is in the process of acquiring a further 9.86195% of participating interest in the field from OMV.

Legal difficulties

10.4.6 Even if it is assumed that the practical problems outlined above could be somehow surmounted, the proposed condition would lead to directors of the applicants being forced into a breach of their directors' duties under the Companies Act 1993. The problem can be best illustrated as follows:

- Even if it were practically possible for each of the applicants to appoint separate management or operational teams for each gas field, at some point major decisions affecting those fields need to be escalated to the Board of Directors.
- For instance, the Board of Directors of each of the applicants must give approval to any final investment decision in relation to development of the Pohokura field. This would obviously be a very significant transaction and a high stake investment for the company as a whole.
- The proposed condition would require the Board of Directors to make this decision based solely upon information from the dedicated Pohokura operational team without taking into account any relevant factors concerning other gas fields in which the company has an interest. Directors would be forced to make a decision without full information or understanding of the impact across all the sectors of the company's operations.

10.4.7 The Companies Act 1993 sets out directors' duties in sections 131 to 149. The primary, overriding duty is to be found in section 131. It requires a director when exercising powers or performing duties to "act in good faith and in what the director believes to be the best interests of the company." This applies to each individual director.

10.4.8 The duty to act in the best interests of the company is not only statutory, but derives from an underlying fiduciary obligation. That requires each individual director, as a fiduciary, to alone determine how the interests of the company are best served. Fiduciaries must also ensure that they do not fetter their powers or decision-making with obligations owed to other persons. The proposed ring fencing condition would amount to a fetter on the director's decision-making ability.

10.4.9 Directors cannot act in the best interests of the company if they do not have full information about the decision they must make. The proposed condition would effectively force directors to 'close their minds' to relevant information from the operational teams dealing with other gas fields, knowing that such

information might well influence their assessment of what is in the overall best interests of the company.

10.4.10 Accordingly, the proposed condition would lead to directors acting in breach of the section 131 duty.

10.4.11 As well as the breach of legal duties, this obviously would leave directors in the invidious position of artificially ignoring information they know will be relevant to the company's overall interests. That itself is important in the current climate of heightened scrutiny of corporate governance structures.

10.4.12 Compliance with the condition proposed by the Commission would therefore require directors to breach the Companies Act and expose themselves to liability under that Act. The fact that the condition leads to such an absurd outcome raises the likelihood that it is *ultra vires* the Commission's powers to impose it.

10.4.13 Although the Commission has a discretionary power under section 61(2) of the Commerce Act to impose conditions when granting authorisation, such a discretion held by a public body is never completely unfettered. Principles of statutory interpretation and administrative law make it clear that the courts:

- will seek an interpretation that reconciles apparently contradictory statutory provisions - such as section 61(2) of the Commerce Act and section 131 of the Companies Act.

- will favour an interpretation leading to the most practical and sensible result - perhaps that the Commission's discretion is limited to the imposition of conditions that are realistic and do not breach another statute.

- will not tolerate an administrative decision that leads to an absurdity or is unreasonable or oppressive – meaning that a decision which effectively requires a person to break the law will be deemed *ultra vires*.

10.4.14 The proposed ring fencing condition would be open to challenge by way of judicial review on the grounds that it is *ultra vires* or exceeds the bounds of the Commission's statutory power. It would also be open to court action by shareholders or other parties seeking an injunction under section 164 of the Companies Act to prevent the directors breaching their duties under that Act.

10.4.15 For those reasons, the applicants submit that the proposed condition is not practically workable, is potentially illegal to impose and should not be applied in any form.

10.5 For the above reasons, the prospect of any form of ring fencing would also serve to defeat accelerated investment in new electricity generation facilities, contrary to the Pohokura Government Policy Statement.