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SUBMISSION ON DRAFT DETERMINATION ON POHOKURA JV APPLICATION FOR AUTHORISATION OF A RESTRICTIVE TRADE PRACTICE PURSUANT TO SECTION 58 OF THE COMMERCE ACT 1986

This submission is in response to the draft determination released 16 May 2003 by the Commerce Commission on the application by OMV (previously Preussag Energie GmbH), Shell Exploration New Zealand Limited/ Shell (Petroleum Mining) Company Limited, and Todd (Petroleum Mining Company) Ltd, to joint market the gas from the Pohokura gas field. The submission is made by:

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Ballance owns the Ammonia Urea Plant in South Taranaki, and is the largest single user of gas in New Zealand after Methanex and the major gas fired power stations.

Ballance is structuring this submission around the questions the Commission have requested comment on.

Question 1 – The commission seeks comment on the likely impact on the analysis of the Application in the event that Methanex either continues production, mothballs, or closes its three plants

Ballance has no comment to make on this question.

Question 2 – the commission seeks comment on the possible impact of the two GPSs and in particular what effect they may have on the issues being addressed in this draft determination.

In Ballance's view, in terms of timing, and wording, the GPS on the importance of the Pohokura Gas Field has significantly and singly impacted on the draft determination outcome.

With regard to the Commission's statement in paragraph 86 that it is required to have regard to relevant GPSs under s 26 of the Act, Ballance understands that s 26 requires the Commission to have regard to the *economic* policies of the Government. Although the very recently developed

Pohokura GPS may represent an economic policy, Ballance presume that it should not be regarded as the determining economic policy the Commission should have regard for. In our view the Pohokura GPS has tended to emphasize the short term over the long term and defined a fairly narrow priority within that around electricity generation. One assumes that the Government also sees a competitive market as an important economic policy, and would acknowledge the significant value the Petrochemical sector contributes to both the Taranaki region and national economy and would wish to see that preserved in the interest of the economic health of the nation. This is not explained very well in the Pohokura GPS. In the absence of some supporting statements by the Government that it backs its own legislation with respect to the purpose of the Commerce Act 1986 it would be easy to attempt to interpret this particular GPS in isolation of the wider economic policies of Government.

Although the Commission is only required to give the Pohokura GPS genuine attention and thought, and such weight as it considers appropriate, it is hard to escape the conclusion that the Commission could not avoid giving the Pohokura GPS *significant* weight. This conclusion is based on the reading of the Commission's report. The Commission's findings throughout the report seem to indicate that the Commission can find little evidence to support the Application yet concludes by giving the Application conditional support.

Question 3 – The Commission seeks comment on the developments in Australia and other jurisdictions and asks, in the New Zealand context, how much relevance these developments have for this application.

The Commission appears to have taken a thorough canvass of the Australian and other jurisdiction experiences.

In all cases the conclusion supports the drive to separately market the gas. The only exceptions appear to be when the accepted counterfactual is no development, or where there exists a monopoly buyer. Neither exists in the New Zealand context. Therefore the only conclusion that the Commission should draw from this, is that experience in overseas jurisdictions that promote competitive practices, provide no support from this avenue for the Applicants.

Question 4 – The Commission seeks comment on its current view that the joint venture exception applies to the proposal.

It would seem to Ballance that the provisions under s 30 and s 31 are designed to be consistent with the purpose of the legislation.¹ That is:

“The purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand”.

Ballance would note that this particular wording appeared in 2001, in the Commerce Amendment Act 2001, presumably to give the principal legislation a stronger binding philosophy absent from the original legislation. In this context s 30 and s 31 must exist to promote the purpose of the Act. The previous case law decisions referred to by the Commission refer to cases prior to this amendment being made and as such may no longer be relevant in light of the later amendment.

It has already been noted a number of times in various submissions as well as the Commission's own draft ruling that Joint marketing of Pohokura Gas is not in the long term benefit of consumers within New Zealand and therefore Ballance would submit that the joint venture may not be exempted by s 31(2)(a).

Question 5 – The Commission seeks comment on its definition of the market as the national natural gas market.

Ballance supports the Commission's conclusions on market definition.

¹ Commerce Act 1986 s 1 (a)

Question 6 – The Commission seeks comment on its conclusion that separate marketing is feasible and that the Pohokura field would be developed even if authorisation were not granted.

Ballance supports the Commission's conclusion.

Question 7 – The Commission seeks comment on the characteristics of its counterfactual.

Ballance supports the Commission's view on the characteristics of the counterfactual (as outlined in paragraph 319)

Question 8 – The Commission seeks comment on the likely length of delay under the counterfactual.

The conclusion around likely delay is the critical determining factor around the Commission's determination. If there was no delay there clearly is not going to be a case for joint marketing and the rest of the discussion would be academic.

Ballance would resubmit that the delays are caused from within the JV only, as the Applicants outline clearly in their own breakdown of sources of delay. The Commission has accepted delays to negotiating GBA's and GSA's to reach its own estimate of likely delay. As noted in table 7 (paragraph 334), one of the comments around negotiating GBAs, is that it shouldn't take "*reasonable parties*" more than a few weeks to agree. Presumably the same comment could apply to GSAs. By allowing 12 months delay the Commission acknowledges that the parties may not be acting reasonably in the JV. The JV parties themselves, by claiming more time to sort out their internal disputes, would appear to be signalling that the Commission is being too optimistic about their level of reasonableness.

Ballance wouldn't want to underestimate the tensions that may exist in the Pohokura JV and the realities therefore of the delays. Ballance fails to see however why the Applicants shouldn't be held accountable for their own delays.

Question 9 – The Commission seeks comment on whether the current level of competition would preclude or limit the Pohokura JV parties from using any market power to engage in anti-competitive behaviour.

The Commission has already concluded that the JV parties control around 88% of current production and about 81% of current estimated remaining reserves. In Ballance's view there is also limited competition in the exploration side. Other than the applicants, most of the other explorers are under-capitalised in terms of investing in wells to carry out their permit obligations. Consequently drilling activity is low, despite Crown Mineral assurances to the contrary. For example Ballance would note that of the 13 wells drilled in 2002 only 6 of these were exploration wells. The remainder were low risk appraisal wells. More importantly there is a significant presence of the Applicants in other exploration and mining permits in NZ.

The Commission also shouldn't ignore the market power created by information asymmetries. To illustrate this point the Commission might consider the information on reserve estimates for Pohokura. From what Ballance understands to be the same data set, one of the JV parties publicly announced a figure of close to 600 PJ, and the Commission, has assumed 750 PJ. The original estimate started at 1000 PJ. Ballance appreciate that reservoir estimation is not an exact science, but neither does it appear to be independently verified. Monopoly rents are normally acquired by monopolists restricting output and raising price. The Commission does not appear to have tested the assumptions around reservoir size and whether 70 PJ pa represents a flatter depletion path than might be assumed optimal in a competitive situation.

In Ballance's view there is no real competition in the current market to limit the JV parties using their market power to engage in anti-competitive behaviour.

Question 10 – The Commission seeks comment on the extent to which joint marketing would enhance the potential for the Pohokura JV to engage in price discrimination and the impact this may have on competition in the gas market or any other market.

The Commission has already, correctly concluded, that joint marketing enhances the potential to price discriminate.

The Commission notes that purchasers would have the right to arbitrage as well to offset the “unfettered market power”. Ballance would submit that this belief should not be taken for granted by the Commission. It would not be uncommon to find that gas contracts stipulate expressly that the customer cannot on-sell gas.

Question 11 – The Commission seeks comment on the extent to which the range of terms and condition of sale would be limited by the Arrangement.

This is difficult to comment on without understanding the degree to which the JV individual partners commercial drivers, including risk profiles are different from each other. It’s also not clear from the joint marketing approach whether individual buyers might be offered a smorgasbord of terms in exchange for price. One would assume however that whether a single contract is offered, or a smorgasbord, the contracts will have to be one agreed to between all the partners first. It will therefore at best be a compromise, or at worst structured to the highest common risk profile of the partners in terms of their individual business drivers.

There appear to be effectively no controls, other than relative bargaining strength, on price and/or risk transfer tradeoffs that would form part of any sale agreement. For example, the buyer may have to accept that they have no rights to supply security, face restrictive force Majeure conditions that favour the seller, may have exclusivity for gas sale imposed, may have limited options in relation to delivery of non-specification gas, have no rights to notification of delivery, face penalties when they can’t take gas, can’t on-sell gas, have no ability to introduce liabilities, and so forth. Normally these risk transfers could be traded off against price if there was a competitive market.

Question 12 – The Commission seeks comment on whether the authorisation of the Arrangement may inhibit the development of a more competitive gas market in the future.

Ballance supports the Commission’s conclusions.

Question 13 – The Commission seeks comment on its conclusion that the Arrangement would lessen competition in the market, particularly beyond the short-term.

Ballance supports the Commission’s conclusions.

Question 14 – The Commission seeks comment on the extent to which the Arrangement would impact on allocative efficiency.

Ballance supports the Commission’s general conclusions on allocative efficiency.

Question 15 – The Commission seeks comment on the extent to which the Arrangement would impact on the productive efficiency of the industry.

Ballance supports the Commission’s conclusions for the supplier side.

Question 16 – The Commission seeks comment on the extent to which Arrangement would impact on the dynamic efficiency of the industry in the short-term and also beyond the short-term

Ballance has no comment to make on this question.

Question 17 – The Commission seeks comment on means by which the loss of dynamic efficiency may be quantified, and the outcome of any such quantification.

Ballance has no comment to make on this question.

Question 18 – The Commission seeks comment on the extent of overseas ownership of the Pohokura JV and of acquirers of gas.

80% of Ballance is NZ owned.

Question 19 – The Commission seeks comment on the extent to which any price discrimination by the Pohokura JV may lead to income transfers from gas consumers to the Pohokura JV, and to the extent to which this would cause economic detriment.

The assumption around wealth transfer overseas through ownership structure would underestimate the transfer from overseas companies on the acquirers' side. For example if the NZ based, overseas owned company just passes on increased gas costs to NZ consumers and maintains its own profit going overseas, then the wealth transfer is from NZ consumers to overseas companies. This might be the case for electricity generators, such as Contact, or NGC selling wholesale gas to electricity generators. The overall impact therefore is a greater transfer from NZ to overseas than the ownership structure would suggest.

Question 20 – The Commission seeks comment on the conclusion that the detriments attributable to the on-going joint marketing of gas from the Pohokura field would be significant, particularly beyond the short-term.

Ballance supports the Commission's conclusion.

Question 21 – The Commission seeks comment on the value that should be placed on the benefits to the public arising from early production of condensate from the Pohokura field.

Ballance has no comment to make on this question.

Question 22 – The Commission seeks comment on the value that should be placed on the benefits to the public arising from early production of LPG from the Pohokura field.

A paper presented at the *2002 New Zealand Petroleum Conference 24-27 February 2002* by CJ Mulvena, LPG Manager for Shell (Petroleum Mining) Company Ltd titled *New Zealand LPG supply and demand - Now and in the future* noted that:

“The LPG production volumes available from Pohokura are expected ... to be loaded onto midsize gas carriers (around 10,000-20,000 t) for export distribution. ... The improved freight economics for exports will enable LPG to add significant value to the overall project. ... The improved export opportunities available to the Pohokura producers will however inevitably lead to upward pressure on domestic prices especially for propane as the marginal export opportunity value improves.”

This contains two relevant points to the Application:

1. LPG from Pohokura is destined for export, and so that there may be no benefit to the NZ public arising from early production of LPG from the Pohokura field.
2. It would however benefit the Applicants to produce early as noted by the comment on the impact on the Pohokura project economics. This statement Ballance believe also reflects our belief that even under separate marketing there is a strong incentive by the Applicants to develop the field early.

Question 23 – The Commission seeks comment on all aspects of the demand assumptions adopted by the Commission.

Ballance would refer back to comments by Professor Tim Hazledine in his report to Ballance on the original application when he was commenting on CRA's welfare loss calculation using the perfect competition model.

- 4.4.1 “First, they are based on what economists call perfect competition, meaning that price is simply determined by the intersection of demand and supply (=marginal cost) curves, with no manipulation of the market. Apart from the factual inaccuracy of this assumption, on which more below,”

And,

- 4.4.3 “Third, the market for Pohokura gas in no way is perfectly competitive, which requires many buyers and sellers. The relevant scenarios here are just one versus just three independent sellers of this gas – ie, monopoly (cartel) or triopoly.² Economists’ standard models of oligopolistic industries predict that the price goes up as the number of competing sellers goes down -- for example by about 20% when going from three sellers to one.³ What this means is that CRA’s prediction of increased supply with joint marketing (monopoly cartel) would not necessarily eventuate, so that the independent marketing counterfactual would not necessarily have the higher prices needed to generate the predicted welfare losses.”

Ballance would submit that if the model for calculating the welfare loss is flawed then it is of questionable value to debate on the parameters of the model, and an alternative more appropriate model should be used.

It does appear that NZIER produced a report on behalf of NGC that offers an alternative model and analysis on welfare losses that might better reflect the Pohokura case⁴.

Question 24 – The Commission seeks comment on the limitations of using a linear demand curve given the “lumpy” nature of gas consumption.

See comments Question 23.

Question 25 – The Commission seeks comment on all aspects of the supply assumptions adopted by the Commission, including the appropriateness of \$8 as a ceiling price.

See comments Question 23.

Question 26 – The Commission seeks comment on likely and possible gas production through until 2020. The Commission seeks comment on what might be a reasonable range of production to use when undertaking its analysis, in particular, the plausibility of MED’s assessment and of the assumption of 175 PJ per annum gas production from 2010 onwards

See comments Question 23.

Question 27 – The Commission seeks comment on all aspects of the assessment of the benefit to the public arising from the avoidance of a delay in production of gas, condensate and LPG from the Pohokura field.

See comments Questions 22 and 23.

Question 28 – The Commission seeks comment on the value that should be placed on benefits to the public arising from lower production and transaction costs, enhanced exploration incentives and from reduction in adverse effects on the environment.

Ballance would note that there are no apparent benefits to the public to lower production and transaction costs, as it appears to be the Applicants intent to price to the market regardless of their cost structure. Higher production and transaction costs, in this circumstance, will only impact on the Applicants profit.

² And not many buyers, so even oligopoly/monopoly modeling may not be quite right, as there is a bilateral bargaining situation here under which given demand curves may not exist.

³ This is from the Cournot-Nash model, assuming linearity and symmetric costs and that the elasticity of demand at the competitive price is -1.

⁴ NZIER (May 2003) *Monopoly Gas Marketing – The welfare effects of joint marketing* Report to NGC

Ballance supports the Commission's conclusions on exploration incentives and adverse effects on the environment.

Question 29 – The Commission seeks comment on its assessment of the weight that should be given to public benefits and detriments that would arise from the Arrangement.

Even allowing for an imperfect model, the public benefit looks small, and one could argue given the various inaccuracies likely to be contained therein, may be zero or negative.

The arguments for not allowing joint marketing on the other hand on detriments of lessening competition appear to be a lot stronger and more strongly established in research than the arguments for allowing it.

Ballance's understanding of the Commerce Act 1986 is that a potentially anti-competitive arrangement may be allowed where public benefits outweigh the detriments. Ballance were unable to locate within the report what value had been attributed to the detriments to compare against the benefit in order to determine where the balance of the evaluation lies. Given the earlier qualitative assessments on the negative impacts on allocative and dynamic efficiency by allowing joint marketing, it would be our view that the hurdle to negate any benefits aren't very high, even allowing for very conservative assumptions.

The previously highlighted NZIER report to NGC in fact suggests that overall welfare losses amount to \$350 million to \$1,500 million under a joint marketing scenario. Ballance believes that this is a significant detriment when compared to the best case of \$57 million benefit produced under the alternative model.

Question 30 – The Commission seeks comment as to the appropriateness of these possible conditions, or any other conditions.

Ballance would submit that the Commission's draft determination in allowing joint marketing, albeit with conditions, is generally inconsistent with its overall findings. The qualitative assessments generally don't support joint marketing, and the public benefit is relatively modest. It is our view that if the detriments associated with losses in dynamic and allocative efficiencies are quantified and compared with public benefits it is highly probable that the detriments would easily outweigh the benefits. In fact an alternative economic model more consistent with the case being studied is that there are significant (\$350 million - \$1,500 million) welfare losses associated with joint marketing. Therefore:

1. The JV may not be exempted under s 30/ s31 of the Commerce Act (in light of the 2001 amendment), and,
2. Economic detriments substantially outweigh benefits.

Thus logically the conclusion under the current legislation suggests that the joint marketing should not be allowed.

The overriding influence in the decision therefore appears to be the Minister of Energy's GPS on Pohokura.

In addition Ballance would also comment to the Commission, that it is unacceptable that "*unreasonable behaviour*" by any JV party can be a reason to allow joint marketing to occur. Ballance believe that there should be a major disincentive introduced for JV parties, through provisions in the Crown Minerals Act 1991 and Crown Minerals (Petroleum) Regulations 1999, who hold up or threaten to hold up gas field development, particularly a strategic field (as the Minister of Energy has determined Pohokura to be).

Nevertheless although Ballance can see no case for allowing joint marketing to occur and it cannot support the Commission's draft determination in this respect, it accepts that the final determination might still conclude that it be allowed. Ballance would therefore suggest a number of additional measures be imposed on the Applicants in order to redress some of the adverse effects of joint marketing.

1. That the Pohokura geology data set including well data be independently assessed to determine reservoir in terms of total size and maximum feasible production rate. In other words there should be an attempt to reduce asymmetries in the information to ensure that supply is not being withheld. This should be funded by the Applicants.
2. Contracts for gas may not include provisions that unreasonably prevent the buyer from on-selling gas in order to limit the JV's scope to price discriminate.
3. There should be an avenue for acquirers to appeal unreasonable contract terms.