BALLANCE AGRI-NUTRIENTS (KAPUNI) LIMITED

28 February, 2003

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Investigator
Business Competition Branch
Commerce Commission
PO Box 2351
Wellington

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

1. This submission is in response to the application by Preussag Energie GmbH, Shell Exploration New Zealand Limited/ Shell (Pertroleum Mining) Company Limited, and Todd (Petroleum Mining Company) Ltd, to joint market the gas from the Pohukura gas field. The submission is made by:

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Basis for Objection

2. Ballance Agri-Nutrients (Kapuni) Ltd is a potential bidder for the gas in the Pohukura Field for its Kapuni based Ammonia Urea Plant. It is our opinion that the joint marketing of the gas is anticompetitive and in breach of the Commerce Act 1986 and amendments

3. The application by the Pohukura partners if allowed, essentially promotes monopolistic behaviour to be exercised with the purposes of extracting economic rents from New Zealand consumers on behalf of the partner interests. To the extent that the joint venture proposal has the effect of substantially lessening competition in the market it is our contention that section 27 or 30 of the Act do apply to the application.

4. It is also our contention that the detriments of joint marketing outweigh the detriments of separate marketing, even allowing for the premises on which the applicants base their public benefit

5. This submission also notes the lack of balance in the supporting economic arguments. It is our contention that the risks regarding Pohukura have been overstated, the detriments of joint marketing omitted, and certain premises left unchallenged all of which contribute to the imbalance of the conclusions of the report.

6. The Commerce Commission also cannot ignore that the consequence of approval may establish a precedent to allow for all future marketing of gas to be made jointly. To the extent

that there are welfare losses associated with the joint selling of the Pohukura Gas Field, these losses will continue to accumulate with each future gas field development in New Zealand.

7. It should be stated that Ballance has no objection to the partners earning a fair return on their investment in an acknowledged risky industry. Ballance supports the early development of the Pohukura field but does not accept that separate marketing is a key impediment to this occurring.

8. Ballance would hope that the ensuing investigation by the Commerce Commission measures the arguments in an independent objective fashion before the outcome of the application is decided. This is especially when on the technical aspects of gas production, the nature of the gas market in NZ, and gas geology and economics, the Commerce Commission cannot be expected to rely solely on information provided by the applicants.

Objections to arguments why the Pohukura JV parties are applying for authorisation

9. Ballance submits that sections 27 or 30 of the Act do apply to the proposed joint marketing on the basis that the effect is not neutral.

10. There is no other supply possibility than Pohukura for companies like Methanex, Ballance and Contact that offer sufficient volumes of gas to enable them to continue as going concerns beyond the depletion of Maui. Pohukura is the *only* gas source that meets Methanex's immediate and long term needs. The Ballance contract expires in mid 2005 with no secure gas contract beyond this, and Contact have already publicly shelved the building of a gas fired station until they can secure a long term gas agreement. This places the Pohukura prospect in a unique and exclusive position in the future gas market and a joint marketing and selling proposition will result in the absence of any competition in the supply of gas. A joint marketing and selling proposition for one gas field, if there were others from which supply could be obtained, may not substantially lessen competition but when this is the only gas which will be available for supply then in our view the joint marketing of that gas will foreclose competition

11. The argument that joint marketing sends a strong "pro-competitive" signal to the exploration market is in our view grossly overstated. There are many factors that drive an explorer's interest in drilling in New Zealand. The Crown Minerals website news extract from 27 November 2002 for example reports on New Zealand's progressive climb in international ranking over the last 3 years for attractiveness to explore. http://www.med.govt.nz/crown_minerals/news/news.asp?newsID=-1429003318. It is our understanding that this ranking has improved on the back of a more favourable permit regime, high probability of drilling success (historical average 20% and more recently 1 in 3 for on-shore wells), and a depletion of the dominant Maui field (removal of Maui "overhang").

12. Although the opportunity to joint market the gas is seen as a positive for increasing competition, by the applicants, it could be equally argued that the reverse signal applies. Gas field ownership is rarely equally shared as demonstrated in Pohukura (Shell 48%, Preussag 36%, Todd 16%). Joint marketing effectively gives the minority partner leverage over and above their ownership in the field. If joint marketing is an available option, the smaller party who may feel disadvantaged under a separate marketing arrangement can effectively veto any actions by the other party and force them into a joint marketing arrangement as a price for co-operation. To the extent that this is a frustration on the major partners it discourages the risk spreading that is so important in the exploration business.

13. This is also the reason why, if allowed, joint marketing may become the norm, not the exception, for future gas field development. Joint marketing obviously derives benefit to one or more of the applicants over separate marketing, otherwise this application would not be made. That the application is being made suggests that the partners acknowledge that there is a risk that joint marketing would be in breach of the Commerce Act. If there is a potential breach of the Commerce Act this suggests the application is inherently negative for the consumer. Approval of the application therefore will perpetuate the consumer loss for all future developments of all gas fields.

14. It should be noted that one or other of the partners currently hold an interest in at least 18 out of the 70 existing petroleum permits in this country. The current parties in this application represent the 3 dominant explorers in New Zealand. A successful application could entrench their position.

15. It should also be noted by the Commission that the Pohukura tender effectively will set a benchmark for gas pricing post Maui. This will therefore not only affect the price for Pohukura but possibly all gas fields in New Zealand with non-contracted gas reserves including Mangahewa (100% Todd), McKee (100% Todd), and Kapuni (50% Todd, 50% Shell).

16. These 3 points taken together add to a substantial detriment of the joint marketing approach not covered in the applicants' submission

17. The application from the JV concedes that their application might fail on the grounds of the Commerce Act 1986 provisions. It is then the applicants' contention that the benefits of joint marketing outweigh the detriments to the public. This is also open to challenge with some of the points raised above. It is our contention that the CRA report:

    a. Overstates the risks of the Pohukura project being delayed. This is a consequence of incorrect assumptions made in the report and/or counter arguments being glossed over. Even assuming that the subsequent economic arguments were sound, there are a number of technical assumptions in the report driving the conclusions that should still be challenged:

        i. The common pool problem discussed hinges largely around individual behaviours when large reserve uncertainties exist. It is our understanding that the Pohukura prospect is currently classed as a depletion reserve. Unlike Maui therefore, which is a water driven field, the change in pressure profile as the reserve is mined will give a reasonably clear picture on the fields' estimated recoverable reserves with reasonable confidence within 3-5 years of running. Given that the field life is estimated to 2020 this gives ample opportunity to negotiate to avoid the "underfill" problem.

        ii. Secondly the economic analysis avoids the issue that the field also contains condensate. The initial reserve estimate indicated about 53 million barrels of recoverable reserve. Assuming a low benchmark price of oil at US$25/ barrel (our understanding is that condensate has a higher value), and a proportionally downgraded estimate to 32 million barrels (on the basis that the 53 million barrels was associated with 1000 PJ of gas which has more recently been downgraded to 600 PJ), the field contains over NZ$1.5 billion of condensate. This compares favourably with the marginal increment in gas price that might be achieved under a joint marketing arrangement. If the common pool problem is relevant for gas it should also be relevant for condensate yet no proposal to jointly market the condensate has been sought by the partners. The decision to exploit the Pohukura field does not therefore hinge solely on gas price. In fact, because there is a ready and deep spot market for condensate, there is a powerful incentive to develop the field sooner rather than later. Our understanding is that the high proportion of condensate in the Kapuni field was one of the incentives for the development of the field. We consider that the 3-year delay or non-development possibility is a questionable argument and therefore overestimates the detriments of separate marketing.

        iii. The report also dwells on the balancing issue and assumes that gas cannot be stored. There is discussion on why it is uneconomical to use Maui as a repository for Pohukura gas. However, the application avoids the discussion on the potential of the Pohukura field itself to be a store for gas. We understand that the Resource Consent application for Pohukura discusses gas reinjection into the Pohukura field. This is to facilitate maximum condensate recovery (again underscoring the importance of extracting the value of condensate) and clearly demonstrates the capacity of the field itself to store gas to address the balancing, demand variability and pipeline investment issues. Furthermore our understanding from talking to people in the industry is that the structure of the Kapuni field is suitable to reinject gas and that in fact there is proven capability to inject up to 120 million cubic feet per day into this field alone. In addition there are already 3 gas compressors available and serviceable to do the task. Shell and Todd (two of the applicants) also own this field, so access to the field should not present a problem. The Tariki and Ahuroa structures are apparently also capable of around 40 million cubic feet per day re-injection, although agreement with the owners (Swift) and a modest capital investment is required. Lack of storage is therefore not necessarily an impediment to early development of the field.

iv. The argument of delay (and hence welfare loss) is in our opinion essentially an argument for the ability to exercise market power. In other words, it is because the partners cannot accept each other's position unless they effectively "collude", that is being put forward as a reason for the JV. There appears to be nothing significant, apart from the partners' interests, that is impeding the early development of the field. In the absence of alternative suppliers as pointed out earlier, we believe that this behaviour is exactly what the Commerce Act 1986 was designed to protect the consumer against.

b. Ignores the detriment to the public of extracting economic rent by virtue of market power. This has two sources; loss of national economic benefit of existing users, and loss of consumer welfare with monopoly pricing.

   i. Overcharging for gas makes the gas unaffordable for the petrochemical industry and they therefore exit production in this country. The economic benefit of Methanex alone remaining in the market has been estimated by Business and Economic Research Ltd (BERL) at $1,300 million pa (refer to pdf file on www.taranaki.info/news/vn_may2002.htm). This is in addition to a number of other regional and national strategic benefits not included in this figure, including; regional industrial strength and fiscal contribution, export diversity, national fiscal contribution, foreign direct investment, incentive for exploration industry, and positive contribution to Kyoto CO_2 emission targets. Ballance through its multiplier effect, the critical mass that it provides to the Petrochemical service industry in this country, as well as it's returns to its 80% New Zealand farmer shareholders, might not unreasonably account for at least 10% of this figure or $130 million pa with similar regional and national strategic benefits as outlined for Methanex. An annual estimate of $1,500 million for the combined Ballance and Methanex economic benefit would not be an unreasonable sum to compare against the partners' counterfactuals.

   ii. The other dominant users of gas are the electricity generation and domestic and retail consumers sectors. Economic rent is effectively extracted out of this sector. With a Pohukura field size estimation ranging from 500 – 1200 bcf (P85 – P15 range say) every $1/ GJ of economic rent exacts $500 million - $1200 million from the consumer on this gas field alone.

   iii. If remaining reserves on Kapuni, McKee, and Mangahewa are added to this figure this equates to a further, undiscounted NZ$629 million (P50 estimate) of economic rent.

   iv. The precedent which could be set if this application is allowed, could further add to the economic costs for all other fields under exploration or development. Given the under-explored, high prospectivity, of all New Zealand's petroleum basins the potential for economic rent is enormous. As an example, based on international statistics it is estimated that the Taranaki basin alone has the potential for a further 13 tcf of *yet to be discovered* reserves. This equates to NZ $13 billion for every $1/ GJ of economic rent.

18. Taken together and allowing for uncertainty in the estimates, on a discounted basis, these figures exceed the numbers presented in the economic report as representing a welfare loss if joint marketing was not allowed. Consequently in our opinion detriment outweighs benefit, not the reverse.

The necessity for joint selling

19. Our submission is that the difficulties of separate marketing of Pohukura gas have been overstated and is largely determined by the partners anyway.

20. It is also our contention that the delays from separate marketing are largely speculative and there exists a strong counter argument that delays are actually against the self-interest of the JV partners.

    a. Delays may cause exit of up to 47% of the current demand that won't easily return. It has already been noted that the gas market is "thin" or concentrated. The growth potential on the remaining market is slow at best (1-2% pa) and the sudden loss of 47% of demand is not easily met from any other sector. Furthermore a loss of this market represents a potential future disincentive to exploration, not only for new explorers, but also the partners in this application.

    b. Delays promote the switch to alternative fuel fired generation. A recent article on Solid Energy for example noted comments by its chief executive that New Zealand has enough coal to support its economy for over 1000 years and that the efficiency of coal based electricity has improved from 25-40% to 50% plus with pollutant emissions able to be reduced to near zero. As recently as 27 February 2003, an article in the NZ Herald had Contact's General Manager of Sales and Marketing, urging industry to actively consider investing in dual fuel systems for their sites to remove reliance on gas.

    c. Although the Minister for Energy might welcome conservation principles being practised by consumers, generally it is not in the best interests of those selling energy. Brown-outs or black-outs would cause shifts in consumer behaviour to the detriment of gas producers and also allow the quicker adoption of non-fossil based energy sources further weakening the gas producer dominance.

    d. Delays in development create further uncertainties in the domestic retail gas market. To the extent that this crimps the enthusiasm for consumers to invest in gas appliances this is a detriment to gas producers, particularly where this market sector returns the highest revenue on a per unit energy basis.

    e. As noted, any delay in gas field development also delays the selling of the condensate reserve. The value of this condensate is of similar magnitude as the potential value of gas and the market to sell into is deep and immediately available. With investment already sunk into the Pohukura field (including the whole exploration diversification strategy) a rational decision is to achieve early rather than late cash inflows.

    f. For similar reasons of sunk investment costs the gas field needs to be exploited earlier rather than later.

21. We are not familiar with the Australian decisions promoted as an argument for joint marketing in the application. Without exploring this in some depth, in the end the question must surely be whether in the New Zealand context joint marketing would substantially lessen competition and that the public benefits would not outweigh the detriments.

22. The essential problems outlined in paragraph 24 of the application we believe to be severely overstated. In line with the comments above:

    a. Coordination is a behavioural decision of the parties alone. They need to do this in good faith. The prisoner's dilemma, a gaming theory used to describe oligopolistic behaviour, and used as a basis for arguing for joint marketing, is rooted in the premise of "no trust". If this indeed holds for the partners then it's difficult to see why the consumer should need to pay the price for cooperation.

    b. The uncertainties in costs, revenues, deliverability and recoverable reserves are overstated.

i. Costs are always uncertain, but the capital investment and transportation issues are considerably eased by the close proximity to on-shore infrastructures and the front end engineering already underway for the field development.

ii. Revenues are entirely certain once long term contracts are in place, and offer greater certainty than a spot market would. There is also a pent-up demand with the imminent depletion of the Maui reservoir that guarantees a substantial immediate interest in this field. Furthermore there is a certain base load for gas usage in this country and volatility is considerably reduced with the impact of the Petrochemical industry. Even considering the dominant Maui field as a swing producer to meet demand in the market the variability of its output has been remarkably consistent over the last 10 years. The combination of these factors suggests a reasonably predictable revenue stream for Pohukura.

iii. Reserve estimation is more certain with a depletion reservoir, which is what we understand Pohukura to be.

Public Benefits

23. Paragraph 81 in the application discusses the claimed public benefits of joint marketing. The arguments against these have to some extent already been covered in our submission. We would submit that:

  a. The welfare loss of joint marketing to the public exceeds the welfare loss of separate marketing, even allowing for the basic premises and analysis to go unchallenged.

  b. Regarding lower production and transaction costs it is our contention that the partners have not indicated that these would actually be passed onto the consumer. Rather it appears to be the intent to price the product to what the market might bear. Any lowering in costs in this regard is essentially a private benefit, not a public one.

  c. Optimal pool depletion is a function of the field characteristics. We've already contended that Pohukura is geologically more favourable to longer term planning than a water driven field like Maui might be.

  d. The increased exploration incentives of joint marketing have not been a major driver for exploration in New Zealand. Rather it will be driven by the demise of Maui and its inherent structural problems that have acted as a disincentive to exploration in the last 25 years (dominance, fixed contract price). We do acknowledge that joint marketing can be an incentive and perhaps even necessary for the exploitation of small gas fields where there can be a lot of competition to supply gas and transaction costs of separate marketing are relatively significant to the value of the field. Pohukura in our opinion does not fall into this category.

  e. The environmental impacts are easily addressed by the early development of the field and as already indicated there is no substantive reason why this is not achievable with separate marketing.

Conclusions

24. This submission can be extended in detail on a point by point basis against the application. However we submit the key issues have already been pointed out to the Commission:

    a. The joint marketing proposal would contravene the Commerce Act
    b. The detriments to the public of joint marketing have not been included in the application for weighing against the detriments of separate marketing.
    c. In our view, and initial estimation, the detriments of joint marketing exceed the detriments of separate marketing. (Economic rent pricing causing loss of valuable Petrochemical industry at approximately $1.5 billion pa plus welfare loss of $1.2 billion - totalling $15 billion on actual and yet to be discovered reserves). In comparison the applicants submit a total welfare loss of $0.2 - $0.4 billion on their speculative assumptions for benefits of joint marketing.
    d. The welfare losses are based on assumptions on delays that are only speculative and self-serving in the application. We believe there are compelling arguments that suggest that the opposite view might be taken. That is, that there is every incentive for the partners to expedite the development of Pohukura, not to delay it.
    e. The application, including the economic analysis, is by its very nature inherently prejudiced towards the applicants. There is no balance or exposing of issues that may prejudice their application. Ballance submits that even at a superficial level there are significant omissions in the technical premises of the economic report that lead to erroneous conclusions.
    f. Granting the application may set an unfortunate precedent to enable anti-competitive behaviour of other petrochemical acreage under current and future permits.
    g. It is also noted that the partners with extensive other investments in exploration and mining permits have a substantial vested interest in this precedent. This includes a vested interest in setting a high benchmark price for gas for developed reserves (McKee, Mangahewa, and Kapuni)
    h. The pro-competitiveness of joint marketing is overstated. There are many factors influencing exploration in New Zealand and lack of precedent in allowing joint marketing has not stopped New Zealand in recent years climbing the international rankings in attractiveness to invest in.
    i. Furthermore joint marketing might equally be argued as being a disincentive for competition if it is seen to encourage undue leverage or influence of minor partners in exploration.

25. We therefore submit that there is no justified case for the joint marketing of the Pohukura Gas.

26. Our initial inspection of the counter factuals suggests there may be some value in exploring the impacts of Scenario 1 Marketing. We would draw the distinction in that this proposes a splitting of coordination of Production from Marketing. We believe that this may best address the issues of sub-optimal field development whilst addressing the anticompetitive aspect of joint marketing. We don't believe that Production coordination will result in delay as the issues are essentially technical and commonly handled in the industry. The Commission will however need to consider to what degree Production Coordination enhances market power.

27. We would be happy to meet with the Commission to discuss our submission if that would assist. We would also appreciate it if you could keep us informed in relation to this matter.