

# THE ESSENTIAL FACILITIES DOCTRINE AND OIL AND GAS DEREGULATION: TOWARDS EFFECTIVE COMPETITION

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## Abstract

The gas industry in New Zealand is characterised by the presence of a number of monopolies. Gas production is dominated by the Maui field. Gas wholesaling is controlled by one major company and gas transmission is also a natural monopoly. Earlier this year, deregulation proposals for the gas industry were examined and discussed by Government officials and members of the gas industry. The Government then announced a number of gas reforms including removal of price control, the removal of existing gas franchises and the obligation to supply, and the repeal of the common carrier provisions in the Petroleum Act 1937.

In the context of these reforms, the Government has recognised the potential for abuse of the natural monopoly in the transmission and distribution of gas, and proposes to introduce an information disclosure regime similar to that proposed for electricity. The other central element of the Government's policy is reliance on the Commerce Act 1986, and in particular, section 36 which deals with the use of a dominant position in a market.

The essential facilities doctrine originated in the United States and has application in a situation where a natural monopoly exists over a particular facility. The doctrine requires the owner to share the facility with other would-be users on fair terms. The paper will examine the present essential facilities doctrine in the gas industry. It will consider whether the essential facilities doctrine can be effectively introduced in New Zealand through section 36 of the Commerce Act.

## Introduction

Most of New Zealand's major energy facilities have recently been removed from direct government control and merged into the national economy. This has been achieved either through direct asset sales to the private sector (e.g. Petrocorp) or through the establishment of state owned enterprises (e.g. Electricorp). As a result of this restructuring, essential distribution systems, such as the North Island natural gas pipeline network, are now dominated by monopoly ownership.

Indeed, the whole gas industry in New Zealand is characterised by the presence of monopolies. Gas production is dominated by the Maui field. Gas wholesaling is controlled by one major company, and gas transmission is a natural monopoly. In the context of the essential facilities doctrine, this paper will focus on the example of gas transmission.

Natural Gas Corporation (NGC) owns all the high pressure gas transmission lines, with the exception of the Oaonui to Huntly line which is owned by Maui Developments Limited. NGC has a monopoly at the core of the transmission system and competition is possible only by way of duplication of the existing transmission network. However, such duplication seems highly improbable given the natural monopoly characteristics of the industry, the costs involved in duplicating the transmission lines, and the fact that all the known commercial fields are in Taranaki.

The issue of monopoly ownership is one of growing significance, particularly in the light of the Government's

proposal to deregulate the gas industry. The proposed reforms include the removal of price control, the removal of gas franchises and the repeal of the obligation to supply. The Government has already passed legislation which will repeal the common carrier provisions in the Petroleum Act 1937. These provisions will be repealed when the Crown Minerals Act comes into force on 1 October 1991.

The common carrier provisions gave the Minister of Energy the power to settle access disputes by authorising the use of a pipeline by a party other than the pipeline holder. The Minister could also regulate the charges for that transmission. After 1 October 1991, producers must use the remedies available under the Commerce Act 1986 if they are unreasonably denied access to the pipeline.

The Government also proposes to introduce a new information disclosure regime to provide safeguards for producers seeking access to the pipeline and to act as a deterrent to unreasonable practices. Under the information disclosure regime, NGC will be required to account separately for the transmission side of its business. Legislation will provide for the public disclosure, by NGC, of information in connection with line charges, terms and conditions of transmission, capacity, costs and pricing policies. Use of this information will, in theory, enable an assessment of whether or not the price being levied for access to the pipeline is reasonable.

The rationale for the information disclosure regime is that if the conditions for access required by the pipeline operator are onerous, and anti-competitive in purpose, then the

disclosed information should be sufficient to enable the discriminated party to take action under the Commerce Act.

Any action of a discriminated company is most likely to be taken under section 36 of the Commerce Act. The object of section 36 is to prevent dominant firms from using their power for anti-competitive purposes. This paper will consider whether the essential facilities doctrine can be effectively introduced in New Zealand through section 36 of the Commerce Act.

## What is the Essential Facilities Doctrine?

The essential facilities doctrine applies when a firm controls something "essential" for competition in a particular market. If access is essential, denial of access to that facility may be anti-competitive and illegal.

Generally, the doctrine stipulates that if a person holds a monopoly over some facility that is essential for competition, and if a potential competitor cannot reasonably duplicate it, then the person who controls that facility may be required to make it available on a fair and reasonable basis. The purpose of this requirement is to promote competition.

In the *Hecht v Pro-Football Inc.*, [1977] 570 F. 2d 928, the US Court of Appeal stated: "The essential facilities doctrine, also called the "bottleneck principle", states that where facilities cannot practicably be duplicated by would-be competitors, those in possession of them must allow them to be shared on fair terms. It is illegal restraint of trade to foreclose the scarce facility."

The statement continued:

"To be "essential" a facility need not be indispensable; it is sufficient if duplication of the facility would be economically infeasible and if denial of its use inflicts a severe handicap on potential market entrants."

Over the years various courts have identified several factors and issues which must be considered in order to establish liability under the doctrine. The following list describes them in general terms.

(i) A facility must be an "essential facility". The term "essential" means that it is not possible for the facility to be practically or reasonably duplicated by the would-be competitor. NGC's high pressure natural gas pipeline is a good example of such a facility.

(ii) The essential facility must be controlled by a monopolist.

(iii) There must be a denial of use or reasonable access to the facility even though it is "feasible" for the monopolist to provide access to the facility. The "feasibility" element protects a monopolist's legitimate interests by considering factors such as available capacity, and technical compatibility of equipment or product.

(iv) The doctrine does not require that an essential facility be shared if the sharing would be impractical or would inhibit the monopolist's ability to serve its customers adequately.

(v) Denial of the facility must inflict a severe handicap on potential market entrants.

(vi) Those claiming access rights to essential facilities must be bona fide competitors. But they need not be existing competitors. It is generally sufficient that the party seeking access has indicated an intention to enter the business and has demonstrated its ability to do so.

## The United States Experience

The Supreme Court first dealt with the essential facilities doctrine in *US v Terminal Railroad Association* 224 US

383 (1912). Although there is no explicit reference to an "essential facilities" doctrine or any anti-trust principle, in that case it appears that the principle has its origins there.

In that case the Court held that:

"combination of terminal facilities, which is an illegal restraint of trade by reason of the exclusion of non-proprietary companies, may be modified by the Court by permitting such non-proprietary companies to avail of the facilities on equal terms".

Later in *US v Griffith* (1948) 334 US 100 it was said that:

"the use of the monopoly power, however lawfully acquired, to foreclose competition, to gain a competitor's advantage, or to destroy a competitor, is unlawful".

A number of relevant anti-trust cases were heard in the 1970s and 1980s. The first was *Otter Tail Power Company v. US* 410 US 366 (1973). In this case the Otter Tail Power Company (Otter) used its dominance over electrical transmission lines to prevent local towns from obtaining power from other sources. When Otter's franchises in several towns terminated, the towns decided to establish their own distribution systems. To do this they needed access to Otter's transmission lines. Otter unconditionally refused.

In that case, the Court emphasised that Otter was not simply refusing to deal, but was maintaining its monopoly control by inhibiting the new power companies. The essential facilities doctrine was applied. The Court held that Otter Tail had "violated a settled rule that a firm may not use its monopoly power in one market to foreclose competition in another market". The Court said that although companies are able to conduct their business in their own manner, including refusing to supply, an exception is made in situations involving essential facilities. The owner of an essential facility is obliged to share that facility unless there is a legitimate business reason not to do so. Otter was ordered to allow access to the transmission lines at reasonable rates.

*Town of Massena v Niagara Mohawk Power Corp.* 1980-82 Trade Cas. 63, 526 is a case in which there was a legitimate business reason for refusing access to an essential facility. Niagara Mohawk's refusal to provide an electrical transmission service for the town of Massena was not unconditional. Niagara Mohawk was concerned that the electrical characteristics of arrangements sought by the municipality were unsafe and unreliable. Its conditional refusal was not seen as a means of preserving its market power. It was held that the conditions imposed by Niagara Mohawk were based on legitimate business considerations and did not reveal an underlying scheme to stamp out competition.

In the case of *MCI Communication Corporation v American Telephone and Telegraph Company* (1983) 708 F.2d 1081 7th Circuit, MCI, which was engaged in providing telecommunication services for businesses and government agencies in different cities, sued AT&T and its affiliated companies (Bell) for a conspiracy in restraint of trade and monopolisation. MCI claimed that the facilities of Bell's local operating companies were essential, and that AT & T had refused to provide interconnection with these facilities on a reasonable basis.

The refusal was held by the court to be unlawful:

"... a monopolist's control of an essential facility ... can extend monopoly power from one stage of production to another, and from one market to another. Thus, the antitrust

laws have imposed on firms controlling an essential facility the obligation to make the facility available on non-discriminatory terms".

The Court concluded that AT & T's refusal to provide the interconnections was an act of monopolisation.

The Court set out four necessary elements for establishing liability under the essential facilities doctrine:

- (i) Control of the essential facility by a monopolist.
- (ii) A competitor's inability, practically or reasonably to duplicate the essential facility.
- (iii) The denial of the use of the facility to a competitor.
- (iv) The feasibility of providing the facility.

## New Zealand Competition Legislation

The Commerce Act 1986 aims to "promote competition in markets within New Zealand".

Part II of the Commerce Act prohibits anti-competitive behaviour. Action against an owner of an essential facility is most likely to fall under section 36 of the Act, although it may also be taken under sections 27 and 29.

Section 27 prohibits a person from entering into a contract, arrangement or understanding which has the purpose, or likely effect, of substantially lessening competition in a market. Section 29 prohibits any arrangement between two or more competitors which has the purpose of preventing or restricting another person from competing with them.

Section 36 of the Commerce Act states:

"No person who has a dominant position in a market shall use that position for the purpose of:

-Restricting the entry of any person into that or any other market; or

-Preventing or deterring any person from engaging in competitive conduct in that or any other market; or

-Eliminating any person from that or any other market".

Determining whether a company has dominance in a market is generally relatively straightforward. However, proving that any of those purposes have been breached is much more difficult. Anti-competitiveness need not be the only purpose - so long as it is a "substantial" reason for taking the action.

As mentioned above, the Government has decided that the Commerce Act 1986 should provide the basis for guaranteeing access to essential facilities in New Zealand.

The wording of section 36 (and like the wording of section 46 of Australia's Trade Practices Act 1974) suggests that proving anti-competitive purpose is going to be extremely difficult. At this stage there are no New Zealand cases concerning the application of the provisions to network facilities, so there is no certainty that section 36 will solve the problem of access to the natural gas transmission lines for producers.

The dominant question now in the minds of competition lawyers on both sides of the Tasman is whether the dominant position provisions are wide enough to bring the essential facilities doctrine into competition law. If so, the substantial body of United States case law could provide useful guidance.

One school of thought suggests that section 36 is sufficiently broad to enable the New Zealand courts to introduce the doctrine. One New Zealand case which appeared to do this was **Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Ltd** [1987] 2 NZLR 647.

In that case, collateral contracts between the Auckland Regional Authority (ARA) and the Avis and Hertz rental car organisations effectively prevented other operators, in particular Budget, from operating rental car booths at Auckland Airport. The ARA brought proceedings to determine whether it was bound by the contracts to limit the number of rental car operators at the airport.

Barker J determined that the ARA was dominant in the market of concessions for rental car operators at Auckland Airport. Furthermore, the contracts in question had the purpose, in breach of section 36, of substantially lessening competition for rental car services at the airport. It was held that the ARA was using its dominant position to exclude competitors of both Avis and Hertz.

In reaching its conclusion, the court referred to numerous United States cases dealing with access to essential facilities. It was widely believed that this case marked the introduction of the doctrine to New Zealand.

The next major decision in this area was made in 1987, in Australia, in **Queensland Wire Industries Pty Limited v BHP and Anor** [1987] ATPR, 48, 806. The case was initially considered in the Federal Court and went to the High Court on appeal.

The case concerned a refusal by BHP, which was held to be dominant in the manufacture and supply of "Y-Bar", to supply that product to the plaintiff company for use in the manufacture of star picket fencing.

QWI, relying on United States authorities, proposed that whilst as a general rule a monopolist may deal or refuse to deal with whom it pleases, exceptions are made if the monopolist controls an essential facility. QWI submitted, the monopolist is under a duty to give competitors access to that facility. BHP's control of Y-Bar was likened to control of an essential facility.

The court did not agree:

(i) The doctrine was not readily accommodated by the terms of section 46, the section governing the case. The "essential facility" doctrine evolved as a gloss on the terms of the Sherman Act.

(ii) The court found it difficult to apply the concept in cases where a monopoly of electric power, transport, communications or some other "essential service" was not involved (By implication the door was left open for a narrower use of the doctrine in the future).

(iii) There was also force in BHP's claim that the "essential facility" cases chiefly involve discriminatory refusals to deal, rather than (as in the present case) a "vertically integrated" monopolist who refused to deal at all in an immediate product, and committed it solely to its own manufacturing operations. In the United States this has been described as a "largely unexplored area".

The court derived assistance from the United States authorities by comparing and contrasting them with section 46, but did not find them to be "compelling guidance as to the construction of that provision". There was an appeal to the High Court, but no judge took these issues any further.

In the end, the Federal Court decided that BHP had done no more than decline to sell products which had not been previously sold and which it desired to keep for further processing. Thus, it had not taken advantage of its dominant position in the market in terms of section 46.

On appeal, the High Court held that BHP had used its market power for a prohibited purpose under section 46

**Queensland Wire Industries Pty Ltd v BHP Co Ltd and Anor** [1989] ATPR 50,000). They reasoned if BHP had lacked market power, it would have been unlikely that BHP would stand by and allow QWI to obtain Y-Bar from a competitor. Secondly, BHP did not offer any valid reasons for refusing to sell.

There is now uncertainty as to the status of the doctrine in Australian competition law. The **Queensland Wire** case was probably not an appropriate situation to apply the doctrine because in that case there was a refusal to supply a product, and not a facility. Arguably, the doctrine could still apply in the fields of energy, transport and communications i.e., highly visible essential facilities.

In the recent case of **Union Shipping New Zealand Limited and Union Stevedoring Services Limited v Port Nelson Limited** (1990) Unrep Wgtn CP 101/89, the New Zealand High Court did address the issue of whether or not the essential facilities doctrine should be incorporated into section 36 of the Commerce Act.

This case involved a claim by a stevedoring company (Union Stevedoring) against Port Nelson Ltd (Port Nelson). The dispute arose when Port Nelson tried to require that the plaintiffs use port company forklifts and port company employee drivers on the Nelson waterfront. The plaintiffs successfully claimed that Port Nelson, as sole supplier of harbour or port facilities in the Nelson area, was in a dominant market position.

Citing section 36 of the Commerce Act, the plaintiffs alleged that Port Nelson's conduct had the purpose of preventing competition by Union Stevedoring in the markets of stevedoring services and equipment, and of cargo receiving and delivery. The Court held that by its conduct, Port Nelson was in breach of section 36.

In the course of his judgment, McGechan J said in the trade practices area, the New Zealand Commerce Act follows in a general way a number of approaches adopted in Australia under the Trade Practices Act 1974. And, in some areas, the Australians had adopted principles developed under United States anti-trust legislation. The judgment is noteworthy for its cautious approach to a wholesale adoption of the essential facilities doctrine under section 36:

"The doctrine is a controversial one, both as to precise formulation, and justification in some applications. There is particular controversy as to its applicability or otherwise outside the area of combinations, or single natural monopolists acting purposefully against competitors." He continued:

"With respect to the obviously considered utilisation of the doctrine by Barker J, in **ARA v Mutual Rental Cars** supra, we hesitate to incorporate the entire doctrine "as is" into New Zealand competition law at this point."

His Honour went on to cite five reasons for this decision.

- (i) The differences in social, commercial and constitutional life in America and New Zealand.
- (ii) The doctrine was originally based on the United States Sherman Act. The American essential facility doctrine originated from a different statutory base.
- (iii) The doctrine is as yet largely untested and relatively controversial.
- (iv) Some five months after delivery of the judgment in **ARA v Mutual Rental Cars**, the doctrine was criticised sharply in the **Queensland Wire v BHP** case. While the court did not necessarily share all criticisms made, given the

desirability of alignment with Australia in this area, there may be wisdom in awaiting further developments.

(v) His Honour said that it is the duty of the Court to interpret and apply the New Zealand Commerce Act 1986. The starting point is to look at the requirements of section 36: market dominance, and use for specified anti-competitive purposes. The American experience may give valuable insights, and assist with assessment of potential section 36 solutions.

The Court went on to say that while its decision was consistent with the essential facilities doctrine, it was not based upon it. "While we do not adopt and apply the doctrine as such, nor do we ignore help which it may offer in achieving some sensible resolution."

The **Port Nelson** case does not entirely discount the adoption of the essential facilities doctrine in New Zealand. Rather, it indicates that the Courts would prefer to look to legislation on the matter. The problem with the doctrine is that it is still very uncertain. Decisions must be made on a case-by-case basis. In New Zealand it seems that decisions will be made by looking first at section 36 of the Commerce Act 1986, and then, when necessary, by looking to American and Australian authorities for any additional assistance.

## The Essential Facilities Doctrine and Gas Deregulation

According to the Government, the objective of deregulating and restructuring the gas sector is "to increase the economic efficiency of the sector through exposing the sector more fully to the operation of market forces". The Government has been looking at access to natural gas pipelines, both at the transmission and distribution levels. It has expressed concern about vertical integration, and about the regulation of natural monopolies as they apply to the gas sector.

The Government has been looking at three options:

- (i) The provisions of the Petroleum Act for common carriage over the transmission system.
- (ii) Reliance on general competition legislation for access (section 36 of the Commerce Act).
- (iii) A network or sector-specific response which recognises some "special nature" of networks and fits with the Government's aims of neutrality.

At present, reliance on general competition law appears to be the Government's preferred approach for guaranteeing access to essential facilities. This is clearly the position with regard to the natural gas pipeline network with the removal of the common carrier regime.

However, experience to date (both in New Zealand and Australia) suggests that section 36 cases are expensive, time consuming, and extremely difficult to pursue and resolve successfully. In particular, the difficulty lies in proving the anti-competitive "purpose". Although direct evidence of an anti-competitive purpose is not essential, and the Court may draw inferences from conduct or from other circumstances, it is clear that proving the requisite "purpose" is far from easy.

The difficulty lies in distinguishing between legitimate commercial conduct by a dominant firm, and conduct aimed at eliminating competition. For example, NGC could assert that all of the pipeline capacity is required for Maui and Kapuni gas and that there is no available space for other producers' gas. This difficulty is highlighted in the recent

Australian High Court decision in **Queensland Wire Industries Pty Limited v The Broken Hill Pty Company Limited** (1989) ATPR 40-925.

United States courts have held that if a firm controls a facility essential for competition and which cannot be readily duplicated, that firm cannot exploit its monopoly over the facility by unreasonably refusing to allow competitors to have access to that facility.

However, in the gas industry, adoption of the essential facilities doctrine with general rules for guaranteeing access at "reasonable" costs does not appear likely. Major problems with the essential facilities doctrine are that it is not consistent, and that it is based on American law. In the United States, the doctrine, although begun in 1912, is still relatively uncertain. Like us, the Australians have not made a final decision on the applicability of the doctrine and its relationship to section 46 of the Trade Practices Act 1974.

In New Zealand, the High Court has stated the need for careful adaptation of American law if distortions are to be avoided. Section 36 of the Commerce Act is the preferred starting point, although the doctrine may be helpful in some circumstances. It appears that the courts prefer to look to the present legislation when considering access to facilities

controlled by a monopolist - see McGechan J's judgment in the Port Nelson case.

The Government, however, has indicated that should section 36 of the Commerce Act prove inadequate to deal with the problem of natural monopolies it would be prepared to introduce industry specific regulations.

Given the monopoly characteristics of the gas industry there is a strong argument for a separate code to guarantee access to an essential facility. This could take the form of an Order in Council, declaring the natural gas pipeline network an essential facility, and subject to the monitoring of a specialist body, e.g. the Commerce Commission. If the owner of the essential facility denies access unreasonably, or charges excessive prices, then the specialist body may intervene to regulate access. An essential facility regime such as this could also establish the criteria for priority in respect of pipeline access.

There is no competition for transmission services in the gas industry so it is unlikely that market forces will operate to guarantee access to the pipeline network. Where the more general provisions of the Commerce Act do not operate effectively, the designation regime for the gas transmission network appears to be the best way to provide access to that facility, and to promote competition.

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