

ACCESS TO PETROLEUM PRODUCTION FACILITIES

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Abstract

The infrastructure for petroleum production is not extensive in New Zealand with only the Taranaki region having extensive facilities. These facilities include four substantial production stations and two port loading and storage facilities at Port Taranaki. There are capacity and technical limitations for some of these facilities but for others there is a capacity to handle petroleum production from a variety of different sources.

The paper addresses the economic and contractual issues that need to be considered by either the owner of the facilities or by users in relation to accessing any such facility.

In relation to the economic issues the paper addresses aspects of competition law and pricing strategy. The paper comments on the implications of the Commerce Act, the application of the so-called essential facilities doctrine and any competition law constraints that may exist on the owners and operators of production facilities when contracting with third parties.

In relation to contractual issues the paper deals with joint venture considerations, separate ownership, capacity entitlements and the transferability of capacity entitlements. At present ownership of production facilities has been the domain of those industry participants who require the facilities for their own production and processing needs. However, in the event of declining production there will be spare capacity which could be contracted out. Thus the paper comments on some of the contractual issues that must be addressed.

Introduction

Twenty years ago New Zealand had only one producing field at Kapuni. The Maui field had been discovered, a gas contract signed and the development of the field and associated processing and transportation infrastructure was well underway. But there were hardly any production facilities (other than at Kapuni) and certainly no demand or need for access to those facilities by other users.

Now in early 1994 the situation is different. There are a number of different production facilities and several oil and gas fields currently producing. There are several active exploration programmes and the hopes of the industry remain high for further discoveries. There are several production facilities which, while operating at or near capacity today, will in time have spare capacity. This paper aims to discuss the legal environment for gaining or granting access to those facilities.

Before addressing the legal issues it is necessary to put some constraints on the scope of this paper. This paper does not address the issues surrounding access to pipelines — especially the main North Island gas transmission network operated by NGC. This is a large subject that has been the subject of considerable industry debate and government interest — we will have to wait and see if transparency in setting the terms of access is sufficient to satisfy the competing interests of different users and the owner of the network.

The paper also does not address issues relating to access to the refinery at Marsden Point — again this is a large issue (which has been the subject of some litigation) and it concerns downstream issues rather than upstream issues which are more properly the focus of this conference.

The type of facilities that this paper addresses are those that are used to separate and process crude oil and gas streams before being shipped. There are four facilities that are relevant:

- The Oaonui plant owned by the Maui Mining Companies which is used to process Maui gas and associated liquids.
- The Kapuni plant owned by the Natural Gas Corporation which is used to process gas from the Kapuni field and associated liquids.
- The McKee production station owned by Petrocorp which is used to process oil and gas from the McKee field.
- The Waihapa Production Station owned by the Waihapa/Ngaere joint venturers which is used to process oil and gas from the Waihapa/Ngaere field.

In this paper the facilities are collectively referred to as the Taranaki facilities. With the exception of the McKee field the facilities are owned by joint venturers. Decision making relating to access to or use of such facilities in the absence of any other arrangements will be joint venture decisions.

Each of the individual Taranaki facilities has been specifically built for the purposes of a particular field. The capacities of each were designed and engineered around expected production levels from those fields. It is doubtful that much thought was given to the possibility of those facilities being required or able to deal with crude oil or gas production from other sources. But, as the fields progressively decline, and as other fields are discovered there is an ever-increasing possibility that at some point some other producers will want to gain access to those facilities and the owners of those facilities will have the capacity available and would value the revenue to be obtained from processing levies. How are the terms of access to be settled?

Thus we come to the object of this paper. It is to discuss two key components of access, namely, the nature and extent of any competition law constraints and the contractual issues to be addressed when granting access.

The Constraints of Competition Law

Introduction

Separation, storage and shipping facilities in the petroleum industry are generally expensive to build and run. The need for high sunk costs in building these facilities raises a number of important competition law issues. Issues arise as to what extent proprietors of existing petroleum facilities are required to offer access to those facilities to competitors and potential new entrants. Can existing proprietors refuse to deal with third parties seeking access? Can existing proprietors offer access but only at a price marginally below the cost to the third party of constructing their own facility or the cost of accessing an alternative facility, assuming one exists? Or, are there potential competition law restraints preventing a proprietor from refusing to deal or from imposing excessive terms and conditions of access?

Before looking at the potential restrictions, one must identify what it is that may be prohibited. Essentially, this part of this paper is concerned with refusing access. At its simplest, this would mean a refusal to grant access on any terms or at any price. There may, however, be a number of more subtle versions of denial, amounting in effect to "constructive denial" — that is access is granted, but on such prohibitive terms that access is not economically realistic. For example, a proprietor may charge an excessive price for access, place onerous conditions on access, change technical requirements and plant procedures with little or no notice, or refuse to provide information to those wanting access.

The issue is, if a proprietor takes all or any of the above actions, can a third party desiring access take action at law? To answer this question requires an analysis of the provisions of the Commerce Act, the cases concerning the Commerce Act and an application of the legal principles to the particular facts.

The Commerce Act 1986

There are three sections contained in the Commerce Act 1986 which may place constraints on the freedom of proprietors to deny access to petroleum facilities, or to set terms and conditions of access at what may be seen as excessive levels, namely sections 27, 29 and section 36.

Section 27 of the Commerce Act

Section 27 of the Commerce Act prohibits any person entering into a contract or arrangement, or arriving at an understanding, containing a provision that has the purpose, or has or is likely to have the effect of substantially lessening competition in a market. Similarly there is a prohibition on giving effect to any such contract.

"Person" for the purposes of the Act, includes a company.

The effect of this section will depend on the assessment of its constituent elements — what is the relevant "market", whether the person in question has in fact entered into an arrangement or contract or has arrived at an understanding, and what the purpose, effect or likely effect of that contract, arrangement or understanding is or would be.

Proprietors of petroleum facilities may fall foul of section 27 depending upon the terms and conditions contained in any

contract, arrangement or understanding that they enter into regarding the operation of their facility. These contractual aspects are further dealt with below but suffice to say that in relation to section 27 the Courts are interested in issues such as the extent to which a contract, arrangement or understanding guarantees access to certain market participants while denying access to others. Clearly, the extent to which a contract, arrangement or understanding forecloses access in what the Court considers to be the relevant market will be material to whether or not section 27 has been breached.

Importantly, a contract, arrangement or understanding may have a number of purposes, one of which may be to substantially lessen competition. However, provided the purpose of substantially lessening competition is a substantial purpose, section 27 may be breached.

Section 29 of the Commerce Act

The second important provision in the Commerce Act is section 29. As with section 27, section 29 of the Commerce Act is concerned with contracts, arrangements and understandings. Section 29 prohibits any person from entering into a contract or arrangement, or arriving at an understanding, that contains an exclusionary provision. "Exclusionary provision" is defined in section 29(1) and comprises three constituent elements:

- a contract, arrangement or understanding between persons, at least two of whom are in competition with each other
- that has the purpose of preventing, restricting or lessening the supply of goods or services to, or the acquisition of goods or services from any particular person or class of persons
- the particular person or class of persons is in competition with at least one or more of the parties to the contract, arrangement or understanding

The typical type of contract, arrangement or understanding covered by this provision would be one between a wholesaler and a number of retailers, the purpose of which was to inhibit the ability of a competing wholesaler or retailer to compete in the relevant market.

Applying Sections 27 and 29

The key element of sections 27 and 29 is the existence of a contract, arrangement or understanding relating to a market. Whether a prohibited contract, arrangement or understanding exists will always depend on the facts of a particular case and the manner in which the proprietor of the petroleum facility is operating that facility.

Sections 27 and 29 are in effect complementary. Both provisions are concerned with arrangements that parties potentially or actually affected by competitors may enter into — whether to prevent a customer from taking its business elsewhere or between two competitors who (say) set prices or terms that prevent normal competition from developing.

An example of behaviour that is prohibited by the sections would be the concluding of an agreement between (say) the Maui joint venture and the Waihapa/Ngaere joint venture whereby each would agree to only offer capacity in their respective facilities at nominated or agreed prices.

Such an arrangement would:

- be between two persons otherwise potentially in competition with one another

- be likely to have the effect (if not the purpose) of lessening competition
- accordingly be in breach of the sections

However, such an example is both obviously fictional and unlikely. Arrangements of this type would usually be more covert or may perhaps only be understandings, never reduced to writing. Proving the existence of such an arrangement would always be a difficulty for a complainant since clear evidence of such an arrangement or understanding would be needed before a court will act.

It should be noted that under section 29 the arrangement must have a purpose of preventing competition. Section 27 requires a lower test of establishing either that the arrangement had a purpose of lowering competition or had that effect.

In the absence of a more obvious type of arrangement, of the type hypothetically suggested above, it remains only to consider what other arrangements could be affected. As noted earlier most of the production facilities under discussion are owned by joint ventures. As will be seen in the discussion concerning contractual issues, any access arrangement must be made with the joint venture. Few, if any, New Zealand joint venture agreements address how access arrangements are to be included. Given that individual joint venturers will rarely have separate access entitlements then the absence of express provision will make the task for any party seeking access somewhat more difficult. However, it is a very considerable distance from noting an absence of a contractual mechanism to a conclusion that such absence of provision for access entitlements is an arrangement that has the purpose of preventing competition. Similarly, it could not easily be said that the absence of an arrangement could, on its own have the effect of preventing competition.

Thus, in the absence of particular contractual provisions there is little about the structural context of the Taranaki facilities that could lead to concerns with section 27 and 29.

It only remains to discuss the impact of a provision that could be found in a joint venture agreement to the effect that in conducting joint venture activities, including the running of a production station, the joint venture shall first ensure that the production station processes joint venture product. This would only be a problem if such a provision had the effect of lessening competition. For reasons that have more to do with the relevant market (see below) this is not expected to be a problem.

However, section 36 is more directly concerned with the structural context of the industry and raises more problematical issues.

Section 36: use of a dominant position in a market

Section 36 provides:

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

- (a) restricting the entry of any person into that or any other market; or
- (b) preventing or deterring any person from engaging in competitive conduct in that or any other market; or
- (c) eliminating any person from that or any other market"

Section 36 has a series of thresholds or tests that must be satisfied before conduct will be prohibited; the use of market dominance for a prescribed purpose.

The initial issue that must be assessed in a case brought under section 36 is that of identifying the relevant market. This is

dealt with in more detail below but at this point in the paper it suffices to say that "market" is a multi-dimensional concept, involving dimensions of product, functional level, space and time. There can be little doubt that a market exists in New Zealand for crude oil and gas processing. Whether this argument would ultimately succeed in court would depend upon the in-depth economic analysis that must be made when identifying a particular market. A key notion in that assessment would be that of "substitutability" — the extent to which goods or services are substitutable for each other. This concept involves both demand and supply substitutability. In the area of separation between condensate and gas, the issue would be the extent to which condensate/gas mixtures could be sent to separation facilities within and outside New Zealand. From a practical perspective, separation is only possible within New Zealand and, as relevantly, usually quite close to the relevant field. An owner of a field with no production facility has limited choices and little substitutability. If substitution did not occur outside a certain area the geographic market would be restricted accordingly.

Once the relevant market has been defined, a court is then required to determine whether a particular person is in a dominant position in that market. Section 3(8) of the Commerce Act sets out the definition of dominant position and provides as follows:

"(8) For the purposes of sections 36, 66 and 67 of this Act, a dominant position in the market is one in which a person as a supplier or an acquirer of goods or services either alone or together with any inter-connected body corporate is in a position to exercise a dominant influence over the production, acquisition, supplier, or price of goods or services in that market and for the purposes of determining whether a person is in a position to exercise a dominant influence over the production, acquisition, supplier, or price of goods or services in a market regard shall be had to —

- (a) the share of the market, the technical knowledge, the access to materials or capital of that person or that person together with any inter-connected body corporate;
- (b) the extent to which that person is constrained by the conduct of competitors or potential competitors in that market;
- (c) the extent to which that person is constrained by the conduct of suppliers or acquirers of goods or services in that market."

The core element of the concept of a dominant position is the possession of "dominant influence" which, in itself, is assessed by referring to a number of factors such as share of market, technical knowledge, access to materials or capital, constraints of competitors or potential competitors, and constraints of acquirers of goods or services in the relevant market.

Whether an owner of a petroleum facility was in a dominant position would depend on these abovementioned factors and any other factors which a court considered relevant. It is in relation to dominance that the sunk costs of building a petroleum facility became relevant. A court would take into account the cost and time required to build a facility in assessing whether a particular proprietor was in fact constrained by potential new entrants in the market. Whilst dominance will be assessed in more detail below, the nature of the legislation is such that consideration needs to be given to whether a court may hold that one or more of the proprietors,

of the existing four Taranaki facilities in New Zealand may be in a dominant position in the market for the provision of services for separating gas from condensate.

The second element of section 36 is the use of market dominance. Mere possession of dominance does not alone constitute an infringement of the section. The court in the *Port Nelson*¹ case referred to the word "use" and held that it indicates something more than a neutral "act". The court stated that "if a person simply acts in a normal competitive fashion, as he would whether dominant or not, that person hardly can be said to be using dominance".

The final test is that market dominance is being used for one or more of the three prescribed purposes. Hence a refusal to deal for other reasons, such as poor reputation or credit worthiness, or poor past contractual performance would not breach the section. More relevantly to the Taranaki facilities, a refusal to deal because of a lack of capacity would not be actionable. A prescribed purpose need not be the sole or exclusive purpose but merely a substantial one. Importantly, this section is concerned with purpose rather than effect. Therefore, even if the actions of a dominant player in a market do not result in any of the events stipulated in the section occurring, provided the actions have one or more of the prescribed purposes, section 36 will have been breached.

Cases in New Zealand Under Section 36

There have been a number of cases where section 36 has been successfully relied upon to challenge refusals to deal. In the *Auckland Regional Authority*² (ARA) case the Auckland Regional Authority's refusal to negotiate with Dominion Budget Rent A Car regarding granting a concession to operate rental car services at Auckland airport was held to be in breach of section 36. In the *Port Nelson* case, the charging of new wharf users a fee designed to prevent competition in stevedoring services in Nelson's shipping port was also held to be in breach of section 36.

More recently the Court of Appeal has upheld a claim of misuse of dominance under section 36 in the *Clear v Telecom*³ case. That case involved a desire by Clear to establish local telephone services. For Clear to do so, it was essential for it to make use of Telecom's existing telephone network so that Clear customers could call Telecom customers and vice versa.

The *Clear v Telecom* case involved a 38-day hearing in the High Court and a 100 page judgment. The Court of Appeal sat for 9 days on the case and the main judgment in the case (that of Gault J.) runs to 50 pages. Thus any attempt at a summary runs a risk of not stating the decision accurately or, as Gault J. himself put it "There is peril in summary". Suffice to say that the Court had little difficulty in concluding Telecom was in a dominant position with attention focused on the terms and conditions of access offered by Telecom to Clear to gain access to Telecom's network. The Court was at pains to point out that it is the statutory test that is important, not abstract analyses of economic principles and theorems.

However, the Court concluded that charging of a monopoly price to a competitor must have the effect of reducing competition and therefore was in breach of section 36. In addition the Court also concluded that there were several other aspects of Telecom's approach to the inter-connection negotiations at the heart of the case that were inconsistent with a fully competitive market.

There have, however, also been unsuccessful attempts to invoke section 36 in cases involving a refusal to deal. In the *Chatham Islands Fisherman's Co-Op*⁴ case Justice Eichelbaum declined an application for an interim injunction brought by the Co-Operative to gain access to a wharf at Kaingaroa in the Chatham Islands. The judge held, in that case, that the Co-Operative went into the new enterprise with its eyes open, and could not have expected the defendant to allow it to use its wharf. However, the case contains an interesting analysis of section 36 with the judge having little difficulty in concluding that the defendants in that case were in a dominant position, were not constrained by competitors and were exploiting that position. It was for other reasons (balance of convenience, etc.) that the judge declined to grant an injunction.

The cases emphasise

- the importance of defining the market
- that the facts used to demonstrate improper exercise of dominance are all-important

Thus while important principles can be extracted it is always necessary to apply the statutory rules to the facts.

The Essential Facilities Doctrine

In the various cases involving issues of refusing to deal with competitors and potential new entrants, a doctrine sometimes referred to is the "essential facilities doctrine". For the sake of completeness and the possible application of the doctrine to the Taranaki facilities it needs to be examined.

The doctrine originated in the United States in the early 20th century. It was developed in conjunction with sections 1 and 2 of the United States Sherman Act. While courts have formulated this doctrine in a variety of ways, in general terms a person was guilty of monopolisation under section 2 of the Sherman Act if it controlled an "essential facility" and refused to allow a third party access to that facility on reasonable terms.

In 1983 a US Court in *MCI v AT&T*⁵ formulated the following elements.

"The case law sets forth four elements necessary to establish liability under the essential facilities doctrine:

1. Control of the essential facility by a monopolist.
2. The competitor's inability practically or reasonably to duplicate the essential facility.
3. The denial of the use of the essential facility to a competitor.
4. The feasibility of providing the facility."

Whilst a number of cases have attempted to formulate this doctrine since 1983, the MCI formulation is the test most frequently referred to in case law.

1. *Union Shipping New Zealand Ltd v Port Nelson Ltd* [1990] 2 NZLR 662.

2. *Auckland Regional Authority v Mutual Rental Cars (Auckland Airport) Ltd* [1987] 2 NZLR 647.

3. *Clear Communications Ltd v Telecom Corporation of New Zealand Ltd* (unrep, CA 2593, 17 December 1993).

4. *Chatham Islands Fisherman's Co-operative Co Ltd v Chatham Islands Packing Co Ltd* (unrep, Wellington, CP 874/88, 22 November 1988).

5. *MCI Communications v American Telephone & Telegraph Co* 708 F2d, 1081, 7th Circuit (1983).

As with any legal test, the identification of elements leads to the uncertainty of applying those elements to the facts of a particular case. The first requirement to be determined is whether or not a particular facility is essential. Unfortunately, the meaning of "essential" is not settled. In some cases courts have viewed facilities as essential when duplication of those facilities was not economically feasible. Other cases have referred to the duplication of a facility being economically infeasible for a particular competitor. It has also been suggested that to be essential a facility need not be indispensable. A further statement that has been referred to in the courts is that a facility is essential if denial of access places a severe handicap on potential entrants. To date there has been no settled test of what is "essential".

Another factor relevant to the essential facilities doctrine is the feasibility of providing access to the facility in question. The rationale underlying this element is that courts would hesitate to order access where this would not be possible without detrimentally affecting the business operations of the proprietor. For example, if the facility was already operating at full capacity the courts would take this into account in determining whether access ought to be granted.

The court in the *ARA* case referred to the essential facility doctrine with approval. Mr Justice Barker took the view that this doctrine could assist in a case brought under section 36 in that if a facility was identified as being essential it was likely that it would amount to a separate and identifiable geographic market and further that exclusion from that market by means of a denial of access would, at least initially, indicate anti-competitive intention unless the exclusion could be explained by reference to reasonable constraints in the circumstances (such as a lack of capacity).

However, later cases in New Zealand have taken a more hesitant approach to the essential facilities doctrine. In the *Port Nelson* case, it was argued that the wharf facilities at the Port of Nelson were an essential facility. The court in that case considered US authority on the doctrine, and in particular the MCI formulation. The court took the view however that it would hesitate to incorporate the entire doctrine "as is" into New Zealand competition law. Five reasons were given for this hesitation:

- The essential facility doctrine derives from a distinctively American social, commercial and constitutional setting, ... careful adaption may be needed if it is to translate without causing distortions.
- The doctrine is based on a different statutory regime, namely the Sherman Act.
- The court was reluctant to unreservedly import a doctrine which was still controversial in the United States.
- The Full Federal Court of Australia had recently decided a case, the *Queensland Wire*⁶ case, that on its facts could have been dealt with under the doctrine. The Court, however, rejected the use of the doctrine in that case. On appeal the High Court made no reference to the doctrine or the Federal Court's rejection of it. The court in *Port Nelson* stated that the silence of the Australian High Court on the doctrine seemed "enigmatic". The court noted that "given the desirability of alignment with

Australia... there may be wisdom in awaiting further developments".

- The court also held that it was not its task to import common law doctrine, but to interpret and apply the Commerce Act.

The hesitancy identified in the *Port Nelson* case was repeated in the *Fisher & Paykel*⁷ case. Moreover, in two recent Court of Appeal cases involving access to what could be viewed as essential facilities and resources, no mention was made of the doctrine. The *Electricity Corporation*⁸ case involved, amongst other things, competition for access to energy resources. The case was brought under section 36, and the Court of Appeal made no reference to the essential facilities doctrine. Similarly, in the recent *Clear v Telecom* case the essential facilities doctrine was not used to determine the issues regarding access to what is a "one of a kind" fixed telephone network.

The Court in the *Clear* case emphasised that there is no substitute for dealing with the requirements of Section 36 but, of the essential facilities doctrine, said:

"The so-called "essential facilities" doctrine, ... although invoked well beyond its usefulness in some cases, is not totally discredited."

It would seem, therefore, that the position in relation to this common law doctrine is at best uncertain in New Zealand and, almost certainly of limited potential application. In view of the absence of mention in recent important cases, it can tentatively be concluded that the essential facilities doctrine is not a relevant consideration when addressing the Taranaki facilities.

Misuse of a dominant position: the Taranaki facilities

Obviously, the most important aspect of this discussion for those participating in the petroleum industry is whether or not the Taranaki facilities could fall within the scope of section 36. In terms of the Taranaki facilities, a number of factors would need to be taken into account in assessing the relevant market. Each facility would need to be examined for any unique traits which could not be replicated or substituted by another existing plant or by a plant produced by a new entrant. Similarly, the time and costs associated with building a duplicate plant would also need to be taken into account. Any factors which create entry barriers for new entrants would need to be considered when identifying the time dimension of the relevant market.

In terms of market dominance, factors such as entry barriers and co-ownership of facilities would need to be taken into account. The ability of one company to foreclose more than one substitutable facility to competitors or potential new entrants would be a factor the courts would take into account.

In relation to the elements of "use" and "purpose" factors, such as the reason for refusing access or for charging particular terms and conditions, will be relevant. For example, a lack of capacity would be a factor courts would take into account when assessing a proprietor's refusal to deal. A refusal to deal for this reason would not be an abuse of a dominant position.

6. *Queensland Wire Industries Pty Ltd v The Broken Hill Proprietary Co Ltd* (1988) ATPR 40-841.

7. *Bond and Bond Ltd v Fisher & Paykel Ltd* (1987) 1 NZBLC 102,622.

8. *Electricity Corporation Ltd v Geotherm Energy Ltd* [1992] 2 NZLR 641.

Finally, an issue could arise as to whether a "person" would be exercising a dominant position by refusing access to a petroleum facility. The four separation facilities are owned by more than one company. However, in most cases there is a commonality of interest between those companies. A court may well hold that co-owning firms are caught individually by section 36 if they dominant a market and co-operate so as to not compete with each other. Each company could then, taken individually, be seen to be in a position of dominance where, because of their co-operation, there is an absence of effective competition in the market.

Appropriate remedies

In the event that the courts held a proprietor of a petroleum facility to be in breach of section 36, the court is faced with a difficulty of determining whether to set the terms and conditions on which access ought to be provided. There is also the difficulty of determining what those terms should be. The position derived from US cases is far from settled. Various courts in the United States have referred to various standards of terms of access. For example, "reasonable", "fair", "similar", and "non-discriminatory". The courts in New Zealand have in the past been very unwilling to specify the terms of commercial contracts. In the *ARA* case only a declaration was sought, and obtained. In the *Port Nelson* case the court reserved leave for the parties to apply to settle the form of judgment. Whilst in that case the court accepted in principal the possibility of an independent cost accountancy analysis being used upon which an acceptable future charging regime could be determined, stating and applying are two entirely different matters. Similarly, in the recent *Clear v Telecom* case, the Court of Appeal referred the matter back to the parties for negotiation after stating that Telecom was entitled to a fair commercial return for granting Clear use of its network assets. As the President pointed out, the court is "not a price-fixing authority".

Are the current facilities vulnerable to Section 36?

In considering the application of section 36 to the Taranaki facilities the first issue is considering the relevant market.

The term "market" is defined at section 3(1A) of the Commerce Act to mean "a market in New Zealand for goods or services as well as other goods and services that, as a matter of fact and commercial common sense, are substitutable for them". This definition, introduced in the Commerce Amendment Act 1990, is much the same as the test of substitution which has been a feature of Australian trade practices law for some time.

The leading case on market definition is the judgment of the Australian Trade Practices Tribunal in *QCMA*⁹. The market definition principles in this case have already been adopted on a number of occasions by the High Court of New Zealand. *QCMA* will be all the more authoritative under the 1990 amendment because its principles are framed in terms of substitutability.

In the *QCMA* judgment it was said:

"A market is the area of close competition between firms or, putting it a little differently, the field of rivalry between them... within the bounds of a market there is substitution — substitution between one product and another, and between

one source of supply and another, in response to changing prices. So a market is the field of actual and potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive".

The New Zealand Commerce Commission has defined the market in the energy sector (particularly in relation to natural gas) but has identified no separate market for processing facilities. However, this is not to say that such processing facilities could not constitute a separate functional level of a market. However, in what is a reasonably close analogy, the Commerce Commission held that the processing and wholesaling of milk was a separate market on the particular facts (*New Zealand Co-operative Dairy Co Ltd — Auckland Co-operative Milk Products Ltd; Re The*).¹⁰

Accordingly it is suggested that a substantial argument can be made out that there is a separate market for the processing of crude oil and gas condensate but this market is characterised by there being no actual sale of the services offered by any of the facilities to any external customer other than the owners of the facilities. However there is in existence an environment where there are a number of potential external customers who may wish to have access to such facility given acceptable terms and conditions.

The writer concludes that the Taranaki facilities cater to two markets — a market for gas processing with some liquids capability and a market for crude oil processing and water disposal with some gas processing capability. Thus the Kapuni and Oaonui plants cater to a different market to the Waihapa and McKee plants.

The customers of such a market would be any parties who discovered gas or oil and who wished to access the processing facilities to be able to better market and sell their production. There can be little doubt that, applying the principles from (most recently) the *Clear v Telecom* case an arbitrary setting of terms and conditions of access designed to or which have the effect of protecting monopoly profits would, if the other elements are satisfied, give rise to a breach of section 36 since it would have the effect of preventing or deterring the party seeking access from engaging in competitive conduct in the other markets.

However, the essential requirement before section 36 can be invoked, the existence of dominance, will be very difficult to establish.

The Kapuni and Oaonui gas treatment plants process practically all of New Zealand's gas supplies and accordingly could be said to have a dominant share of the market as it presently exists. However, as suppliers of gas processing facilities the owners of those plants are significantly constrained by the relative ease with which any other party requiring gas processing facilities can build their own facility. While construction of such facilities could not be described as easy the technical knowledge is readily procurable, the materials readily available and, given buyers for the gas, capital would not, of itself, be a significant impediment. Furthermore, the owners of the facilities would be significantly constrained from overcharging because of the more than just technical possibility of another purpose built

9. (1976) 25 FLR 169.

10. (1988) 1 NZBLC (Com) 104, 320.

facility being constructed. Finally, the operators of the Kapuni and Oaonui facilities would be obliged to price the terms and conditions of access in such a way that the user did not construct their own facility or use another facility. Thus, while presently having a large position in the market those operators do not dominate the market because of the real alternatives available to a customer.

In short it is unlikely that the owners of the Kapuni and Oaonui plants, having regard to the criteria set out in section 3(8), would be considered in a dominant position. Simply put, the facilities are too easily duplicated.

The same analysis also applies to the crude oil processing market. Crude oil separation and stabilisation need not be done on a large scale. Small skid-mounted separation facilities while not necessarily as efficient as a large facility, are a significant constraint on the ability to charge monopoly prices for access. Moreover, there is no technical impediment that would make it difficult for a competitor to enter the market.

However, if this view is incorrect and the owners of the Taranaki facilities are considered dominant in their markets this is not enough to allow Section 36 to be invoked. That dominant position must be *used* to restrict, prevent or eliminate competition.

As noted earlier, restricting access by others because of capacity constraints would not give rise to an actionable breach of section 36. There is little doubt that the owner of a facility will be allowed to use that facility first and foremost for their own uses, especially in the face of capacity constraints.

The mechanisms used to price access also need not give rise to concern. The owners of the facilities are entitled to fair returns on their investment — it is only the attempts at obtaining monopoly profits that could give rise to difficulties.

Thus, on a factual level, first establishing the existence of dominance in this market and then establishing misuse of that dominance will, except in extreme or particularly egregious cases, be very difficult.

The Contractual Environment

The analysis described above of the competition law constraints broadly suggest that the Commerce Act is something of an empty threat in relation to gaining access to a production facility. Moreover, given the high sunk costs in relation to a facility, the relatively low operating costs and in particular the even lower marginal costs associated with handling additional throughput leads one to the conclusion that there is more than a little economic incentive for the owner of production facilities to make any spare capacity available to third parties. If price can be settled, and this will always be the issue, attention will then turn to the other contractual issues.

The key contractual issues are

- the nature of the contracting parties
- the nature of the capacity entitlements made available or acquired
- the nature of the product being processed
- price

The contracting parties

As noted above three of the Taranaki facilities are owned by joint ventures. The usual position will be that individual

joint venturers have an undivided interest in the whole of the relevant facility with all decision-making regarding that facility being made by a joint venture committee. The operator of the relevant joint venture would usually be in a position to be able to enter into contracts with third parties but only after having first obtained the approval of the joint venture.

It is unlikely to be the case that production facilities will be owned by a vehicle separate from the relevant joint venture although this is an issue that is debated from time to time because of the potential at least for such a facility to become a revenue earner long after the relevant field has ceased production. However, as will be noted below, the overall contractual complexity of such a separation is daunting and thus far seems to have dissuaded any such full separation.

Accordingly, for the most part a third party seeking access to a production facility will be required to negotiate with the operator of a joint venture owning the facility which operator will seldom have the ability to make decisions that bind the joint venture without first obtaining joint venture approval.

With the exception of the McKee field, all petroleum production in New Zealand is through joint ventures. Accordingly, the parties seeking access will also almost always be a joint venture with the relevant operator of the joint venture seeking to lead negotiations on behalf of the joint venture. However, given that separate ownership and entitlement to petroleum product is a conspicuous feature of the typical joint venture in New Zealand there is no reason why individual joint venturers could not uplift any petroleum product that they gain from the producing field and separately deal with that product for further processing themselves. However, considerations of economic efficiency are such that this is unlikely to be pursued except in cases involving substantial joint venturers with very substantial production interests.

Thus, we can conclude that the contracting parties are, for the most part likely to be the applicable operators, on behalf of the joint ventures for which they operate.

Separate ownership

As noted above the Taranaki facilities are owned by joint ventures and have not been separated from other joint venture assets. Thus, for example, the Waihapa production station is not contained in any legal vehicle separate from the other important assets of the joint venture such as the licences, the producing wells themselves, pipelines etc. From time to time consideration has been given to the desirability or otherwise of separating ownership of production facilities to order to establish those production facilities as separate revenue vehicles that would be available for outside users (subject to capacity being available).

To date this approach has not found favour. There are two principal reasons for this:

1. There are only marginal advantages in such separate ownership and certainly not sufficient to justify taking the necessary steps.
2. There is considerable legal and contractual complexity that would require to be dealt with in order to make separate ownership feasible.

The contractual complexity arises because as soon as ownership is separate then it will become necessary for there to be a new contractual environment whereby the owners of the production station would enter into arrangements whereby

they would agree to process the production of the joint venture at a nominated price. The terms and conditions of ongoing access would then need to be settled and agreed such that both the owners of the petroleum product could be assured that their production would be processed and that the owners of the production station would receive sufficient revenue to justify the capital investment.

Theoretically if such separate ownership could be carried out it would then enable the joint venture owners of that separated production facility to sell their interest in the production facility to a third party on the basis of the capitalised value of the ongoing tolling fees that could be expected from the facility. However, there does not appear to be a convincing economic argument that the value thus obtained would be any greater than the value lost as a result of the requirement to meet ongoing tolling fees.

Of course the situation could change in the event of significant declines in output and the need of a third party or parties to have their own production processed (subject to there being no technical constraints). However, it is probably the case that this is a situation that would be dealt with as and when it arose and according to the best economic result available in the circumstances then prevailing.

Capacity entitlements

Because a production facility is owned by a joint venture each individual joint venturer will only have an undivided interest in that facility with no separate capacity entitlement. In the absence of any express provision in the relevant joint venture agreement granting to joint venturers specific capacity entitlements proportionate to their interest in the joint venture, then no such capacity entitlement can be implied into any joint venture arrangement. Thus, if there is a facility with spare capacity the holder of an interest in that joint venture will not have any as-of-right entitlement to dispose of any of that spare capacity to a third party. This absence of a separate capacity dealing right could, in the appropriate economic circumstances, act as an incentive to separate production facility ownership.

There may be situations that arise where separate entitlement to capacity could be considered. In a well-developed market with extensive infrastructure, many buyers and sellers of product and no significant capacity constraints, separate, negotiable capacity entitlements can work. Accordingly, they will commonly be found in the United States environment. However, they will be rare in the absence of such well-developed infrastructure and well-developed markets.

One of the problems of spare capacity is that that spare capacity will inevitably be subject to the prior demands of the joint venture owning the facility. Thus, for example, there may exist a situation where there is spare capacity at a particular production station. Any party seeking access to that capacity would usually do so on the basis that they will be deferring or avoiding altogether committing to substantial capital expenditure on their own production facility. However, the owners of the facility would not wish to find themselves precluded from being able to process any additional production they may obtain as a result of further discoveries. Accordingly, a feature of any negotiations will be the tension between the desire of third parties seeking access to have assured ongoing access and the desire of the owner of the facility to be able to demote the party gaining

access to something akin to a second class citizen should there be an additional discovery requiring greater production capability.

Thus, a central feature of any access arrangement will be the nature and extent of assured access entitlements and the protocols for determining priority in different circumstances. Contractual complexity would be a virtual certainty and clearly price will have a big part to play.

However, this is not to say that capacity entitlements could not become a type of separate negotiable instrument. Pursuant to such an instrument, a joint venturer may be able to sell its spare capacity entitlement to third parties who, depending on the overall contractual environment, would then step into the shoes of the vendor joint venturer owning the facility and gain access as if they were a joint venturer. Alternatively the vendor joint venturer may simply seek a tolling fee or some other form of throughput charge.

At any event, what can be concluded is that in the absence of express and detailed provisions in a joint venture agreement relating to capacity entitlements no individual joint venturer can sell that capacity. Before individual tradeability of capacity entitlements could proceed there would need to be extensive contractual arrangements put in place between co-venturers so that the rules by which access was made available to third parties were clear and transparent. Only then could a third party commence negotiations over access terms.

Co-mingling of product

An overarching practical requirement will be the suitability of the third party's product for processing at the relevant production station and the technical ability of that plant to process the relevant product.

Thus, the production facility operated by the Maui partners at Oaonui would be singularly ill-suited to deal with crude oil and gas production from the Waihapa/Ngaere field (even if capacity were available). However, the Oaonui facility may be able to process gas and associated liquids from (say) the Kupe South field. An essential issue then becomes one of determining the exact chemical composition of the different input gases and ensuring that the output from the facility still produces specification gas for transport through any applicable pipeline network or other transportation mechanism. This will largely be a technical issue but nevertheless it can impose a severe constraint.

Similarly, some crude oil production may have greater or lesser amounts of associated produced water and gas. A production facility designed to handle and separate large volumes of crude oil, some volumes of produced water and only small quantities of produced gas will be ill-suited to dealing with production from a reservoir that had different ratios of oil and gas. In short, rather than co-mingling of product being a contractual issue, it is an issue that goes to the very heart of whether or not access to the production facility can, on a technical level, be made available at all.

Leading on from such an arrangement is the importance of ensuring that there are accurate metering facilities to record exactly the volume of production arriving from the third party so that appropriate tolling fees can be recorded. However, a not atypical position is that input metering facilities are poorly equipped to accurately measure the precise quantities of oil, gas and water. Production is usually only measured as output from the relevant production station.

Thus, if there is to be any co-mingling and joint processing of two different production streams then there could be considerable problems associated with determining exactly who has produced what and ownership of the final product. This would have to be addressed in detail in the relevant contract and in light of the particular factual circumstances that the parties either have encountered or expect to encounter as processing continues.

Pricing

Finally we turn to pricing. Settling the price debate will depend upon the nature of the arrangement the owners of the facility would prefer to enter into. Depending on the circumstances, there may be considerable temptation to sell partial ownership of the facility to a third party with ownership attracting a pro rata share of responsibility for operating costs and providing assured access entitlements on specific contractual terms. The price at which the facility would be offered would likely be calculated by reference to the cost to that third party of their next best alternative. In short, capacity would be purchased if that was cheaper than building their own capacity. For the vendor, who would inevitably have to have spare capacity in the first place, the opportunity for a sale of a partial interest would represent an attractive receipt of capital from a facility that may very well have been significantly amortised against earlier production prior to sale. In short it could represent an attractive windfall gain to the owners of the facility.

On the other hand, if the owner of the facility was disinclined to sell any share in the ownership the usual arrangement for making access available would be a throughput charge calculated by reference to the capital cost of the facility, its operating costs and the inevitable economic consideration of the cost to that third party of any alternative facility. The economic constraint facing the owner of the facility would

be the desire to obtain the revenue from the tolling operations and the impact that such revenue would have on lowering the costs otherwise payable on a per unit basis for any other production being handled by the owners through the facility.

Accordingly, it can be seen that there are a number of options and many considerations to be assessed when considering the pricing of access. It is an entire separate topic in its own right and we need look no further than the Clear case (involving the price of gaining access to the Telecom telephone network) to appreciate that the accounting and economic principles can rapidly become very complex and not readily capable of universally accepted conclusions.

Conclusion

As noted above the present position is that the Taranaki facilities are used by their owners for their own production. However, as we look to the future there will inevitably be declines in production from the existing fields but hopefully new fields discovered and new production requiring to be processed. Accordingly, the issues relating to access, while not a live issue today, may well become live in years to come.

It is hoped that this paper demonstrates that there are no significant competition law constraints and the forces of the market will largely prevail. Furthermore, there are numerous ways in which access to capacity can be made available and the only limitation would appear to be the imagination or ingenuity of the parties either making access available or seeking access. However, gaining access will necessarily be contractually complex and may well involve difficult negotiations, especially if significant quantities in sums of money are involved. However, given the right balance of economic incentives there is every reason to believe that such arrangements can be satisfactorily concluded.

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