Impact of the Commerce Act on the petroleum exploration and downstream energy industry

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Abstract

This paper outlines the main provisions of the Commerce Act 1986 and gives an overview of the Commerce Commission's place in New Zealand's competition law regime. The paper then discusses areas where the Commerce Act may be relevant to petroleum exploration companies operating in New Zealand.

The Commission's main area of contact with the petroleum sector to date has been with the gas industry. The paper discusses issues relating to gas markets. It looks at changes which have taken place in the gas industry since deregulation and discusses recent Commission decisions relating to the gas industry.

Introduction

The purpose of this paper is twofold:

First, for the benefit of exploration companies which are not familiar with the competition law regime applying in New Zealand, the paper will provide some background to the regime and the role of the Commerce Commission in that regime. The paper will also comment on a few specific areas which petroleum exploration companies should be aware of in their business activities in New Zealand.

Secondly, the paper will discuss Commerce Act issues relating to gas markets. The gas industry, as a network industry, has been and is likely to continue as the main area of the Commission's contact with petroleum product markets.

The Commerce Act and the Commission

The Commerce Act came into effect as a key piece of regulation in a large range of measures designed to reform the economy in the 1980s. An important purpose of the reforms was to allow competitive market forces to play a much greater role than in the past in determining economic developments and resource allocation.

The Commission is an enforcement agency whose primary role is to bring about compliance with the Commerce and Fair Trading Acts. The aim of the Commerce Act is to promote competition in markets in New Zealand. The rationale behind this is that if the marketplace operates competitively, consumer welfare will be maximised. The concept underlying this is that of efficiency. The Court of Appeal has stated that the Act:

> "is based on the premise that societies' resources are best allocated in a competitive market where rivalry between firms ensures maximum efficiency in the use of resources".

In respect of the Commerce Act, the Commission has a role in monitoring structural changes in, and behaviour of, markets in New Zealand. The Commission is not a policy body. It does not tell firms how to behave or how to organise themselves within a market. The Commission has virtually no role in deciding on the policy the Government of the day adopts towards any particular sector. It is the Ministry of Economic Development (formerly the Ministry of Commerce), and not the Commerce Commission which advises the Government on such things as how existing competition law can be improved upon.

Specifically the Commission:

- assesses business acquisitions;
- attacks anti-competitive behaviour; and
- monitors "monopoly" pricing.

Business acquisitions

The Act prevents any business from:

- becoming dominant in a market; or
- strengthening an existing dominant position

through the acquisition of assets or shares of a business, unless that business acquisition can be justified in terms of public benefit.

The Act provides for:

- High Court action in respect of acquisitions that are anti-competitive;
- prior clearance or authorisation which protects proposed acquisitions from challenge under the Act.

Accordingly, the Commission has a surveillance and enforcement role to ensure that any unnotified acquisition that may lead to dominance concerns is "struck down" and an adjudication role in deciding on applications for clearance or authorisation.

The Commission has considered the issue of whether the acquisition of a petroleum exploration or mining permit would be a business acquisition under the Commerce Act.

Our view is that a company being granted a petroleum exploration or mining permit is acquiring an asset and hence the transaction falls within the business acquisition part of the Act. There are many companies carrying out petroleum exploration activities in New Zealand and the regulatory regime under the Crown Minerals Act provides for a competitive tender allocation process. It is not likely that a company obtaining an exploration permit would raise any dominance concerns in the gas exploration market. At present there are few parties involved in the production of gas in New Zealand and it is at this level that any dominance concerns would be likely to arise.

Anti-competitive behaviour

The Act prohibits a range of restrictive trade practices ("RTPs")which adversely affect competition. These prohibitions apply to all individuals and commercial organisations including State Owned Enterprises and government departments. The key sections of the Act dealing with anti-competitive behaviour are:

- section 27, which prohibits any arrangement between competitors which has the purpose or effect of substantially lessening competition in a market. This section covers such practices as market sharing and collusive behaviour among competitors;
- section 29, which prohibits arrangements between competitors that reduce the competitiveness of another rival;
- section 30, which deems that arrangements that lead to prices being fixed among competitors are in breach of section 27; and
- section 36, which prohibits a company dominant in a market using its dominant position for the purpose of:
  - restricting the entry of any person into a market;
  - preventing or deterring any person from engaging in competitive conduct in a market; or
  - eliminating any person from a market.

The Commission enforces the RTP provisions of the Act and can stop an RTP by court action (through the High Court) or through administrative settlements. The penalties for a breach are significant (up to $5 million for an organisation and up to $500,000 for an individual) and the Courts are showing an increasing tendency to impose higher penalties on offenders.

I would like to mention a particular case taken by the Commission to the Courts recently which is relevant to the petroleum industry.

The Commission had alleged that Caltex New Zealand Limited, Mobil Oil New Zealand Limited and Shell New Zealand Limited colluded to jointly withdraw a discount from the price of petrol at more than 50 Auckland petrol stations. The discount was in the form of a free car wash offered to customers who spent $20 or more on fuel. In October 1999 the Court found that the Commission had proved its case.

In February this year, the Auckland High Court ordered Caltex New Zealand Limited, Mobil Oil New Zealand Limited and Shell New Zealand Limited to pay penalties totalling $1.175 million for breaching the Commerce Act by price fixing.

I believe that this is the first time anywhere in the world that it has been proved that a group of major oil companies acted anti-competitively over the price of petrol. There have been successful cases against individual oil companies, but not against a group of major companies.

An important aspect of this case was that it reinforced to businesses that price fixing covers all parts of a price, not just the final retail price. Formal and informal agreements among competitors about discounts, commissions, mark-ups and all other parts of prices are strictly prohibited.

Authorisation process

An RTP (excluding a practice under section 36) can be authorised by the Commission if it can be shown that the public will ultimately benefit, even though there is a lessening in competition. Applications for authorisation should be made before commencing a practice or entering into an arrangement, as the Commission is unable to grant an authorisation to an RTP which is already in operation.

If an authorisation is granted, the prohibitions in the Act do not apply to that practice and the practice is protected from legal action. The Commission has found that this adjudication role involves a significant use of resources. The Act sets out procedures for dealing with applications for authorisation, including:

- notifying interested parties;
- inviting submissions;
- producing a draft determination; and
- holding a conference of interested parties where necessary,

before the issuing of the final determination.

This process has been used by parties in the electricity sector when entering into self-regulatory arrangements, for example the New Zealand Electricity Market rules and the grid security rules on common elements of quality for electricity transmission.

Price control

I would note that, although section 36 prohibits the use of dominance to restrict competition, it does not prohibit the charging of "monopoly prices". This does not mean that dominant firms are totally immune as the Act does, however, contain the threat of price control.

The Commerce Act provides for the introduction of price control by the Government. The Commission can recommend the imposition of price control or alternatively may be asked by the Government to report on the necessity or desirability of such a step.

At present there are no items under price control. The last one, which was natural gas, was removed from control in April 1993.

The provisions remain, however. The threat of regulation is an important and necessary part of the light-handed regulatory regime.

The Government has underway at present Ministerial Inquiries into the electricity sector and the telecommunications sector looking at the regulatory frameworks for these industries.

The Commission's procedures

The most important thing for participants in the petroleum industry (or any industry) to realise, is that the Commission is not an industry-specific regulator. The Commission does not attempt to 'tilt' the playing field in anyone's favour, or 'manage' the emergence of competitors, as do the majority of specialist regulatory bodies in other countries.

What this means is that, unless an issue has implications under one of the Acts the Commission enforces, the Commission cannot and should not do anything about it. The Commission is not in the business of attempting to design optimal market structures. In addition, the legislation foresees that many disputes between competitors may be best dealt with by negotiation between the parties, without Commission involvement. For that and other reasons, the Acts are relatively narrow in scope.

Assuming there appears to be a prima facie breach of the Commerce Act, the next criterion in deciding whether to carry out an investigation is whether private action has been undertaken or is likely to be undertaken. The statute and Parliament always envisaged that, in some instances, private action under the Act would be more appropriate than publicly funded enforcement. If the complainant is well funded, and its complaint refers to a dispute between itself and another well-funded party, it may be that the Commission (and hence the taxpayer) need not get involved in order for the Act to be effectively enforced. An example of this was the Kapuni litigation between Shell/Todd on the one hand and Kapuni Gas Contracts Ltd and NGC on the other, which looked at the question of whether the Kapuni contract was anti-competitive. The Commission could see no public gain arising through its involvement in a matter which the parties themselves were taking to the Courts.

Should a complaint pass the screening process, it will then be investigated. This can be a long and sometimes painstaking process. This process often frustrates complainants and others, but as the Commission cannot give 'rulings', but must instead take actions to the High Court to prove whether a breach has occurred, the process is time-consuming.

If, at the end of an investigation, the Commission finds that there is likely to have been a breach of the Act, it has a number of options, the most obvious of which is taking court action. Again, this can be a time-consuming and costly exercise. The Commission has experienced difficulties gaining hearing times that are reasonably close in time to alleged breaches of the Act. It has also faced numerous interlocutory applications that delay proceedings until the eventual outcome is less relevant than it might have been. Even though the Commission attempts to work efficiently to gain pro-competitive outcomes, opposing parties, and inefficiencies inherent in the court process may sometimes limit its effectiveness. Previous chairs of the Commission have gone on record as being unhappy with the delays that can be imposed on the court procedure, and I am of that view also.

Given the resources involved, and the cost to the complainant and the economy in terms of delay that can result from attempting to take court action, the Commission also considers giving warnings, or entering into settlements, with persons who appear to have breached the Act. A warning is a written indication to parties that, if they continue to behave in a certain manner, they will be at risk of breaching the Act. A settlement usually involves a party formally agreeing with the Commission that it will alter particular elements of its behaviour to ensure that it is no longer at risk under the Act. The effects of all warnings and settlements are monitored, and a second chance is not usually offered.

The Commission's role

The Commission's role is summed up in its statement of purpose, namely to bring about awareness, acceptance and compliance with the Commerce and Fair Trading Acts. The Commission is primarily an enforcement agency, and it operates under strict guidelines in a limited sphere.

The Commission believes that it should not take action against alleged breaches of the Act unless there is a substantial "welfare gain" to be achieved by taking that action. In seeking to ensure that the benefit of taking an action outweighs the cost to the public, the Commission is keenly aware that the Commerce Act aims to promote the competitive process, not

the rights of individual competitors. The Act does not include a concept of protecting small players from large ones, or ensuring that everyone who enters or participates in a market survives.

Instead it aims to promote efficiency through the competitive process (which obviously envisages winner and losers), with the end result being better choice, service and prices for consumers. Speaking generally then, the independent role of the Commission is to promote consumer and economic welfare through the competitive process.

The Commission's specific role in utility markets

I would like to focus briefly on the special issues arising in the area of utilities. The term 'utility' is difficult to define precisely but is traditionally applied to the communications, energy, transport, and 'public amenities' sectors, including telecommunications, broadcasting, electricity, gas, railways, sewerage and water.

Utilities provide a distribution, transmission, or transport service through a network of cables, pipes or other facilities which tend to enjoy such large scale economies as to become natural monopolies.

Utility markets are treated in a similar manner to all other markets. That is, utility markets are subject to general competition law. However, to encourage competition some additional steps may be taken by the Government in regulating some utility markets. Those steps include:

- the separation of natural monopoly and contestable elements of the firm or industry, at least in accounting terms, by ring-fencing or by ownership;
- the use of industry-specific disclosure regulations which require the disclosure of information designed to make transparent anti-competitive behaviour, inefficiency or monopoly pricing; and
- the threat of price control or other forms of regulation.

As you know, the more heavy-handed approach of requiring ownership separation has been adopted in regulating the electricity sector. Electricity is the first sector to be specifically targeted since the passing of the Commerce Act as general competition legislation in 1986. The Government passed the Electricity Industry Reform Act (EIR Act) in 1998, and by doing so gave the Commission an additional role in enforcing this Act.

The Commission has been given jurisdiction over three enforcement areas:

- the ownership separation rules requiring existing companies to separate their generation and retailing businesses from their line businesses;
- the arms length rules that restrict future relationships between these businesses; and
- the duty imposed on all parties not to defeat the purposes of the Act.

The Commission has stated that it is unlikely, at least in the near future, to attack situations where a technical breach of the EIR Act may have occurred, but where competition effects are negligible. A complete analysis of the Commission's interpretation of its role under the EIR Act is contained in Practice Note 3, copies of which are available from the Commission or from our website.

I am aware of some suggestions that this type of regime with ownership separation between lines and supply businesses should also apply to the gas industry.

That is not a decision for the Commission to make. I would note, however, that any difficulties which users experience in obtaining access to pipelines will no doubt be relevant to any Government decision to impose further regulation on the gas industry.

Gas industry

The Commission has had a number of dealings with the gas industry, both before and after its deregulation. Before deregulation, the Commission was responsible for setting the price of natural gas, which was at that time under price control.

Exclusive franchises, giving the holder a monopoly in the retail supply of gas in its area, were abolished by the passing of the Gas Act 1992, on 1 April 1993. At the same time, price control on gas was removed.

With the advent of a deregulated gas industry, a major issue confronting the Commission was the wholesale supply contracts between the Natural Gas Corporation (NGC) and retailers which were entered into in 1980, during the era of exclusive franchising. They contained a number of restrictive provisions which, by affecting the ability of both NGC and its utility customers to compete in new markets, were likely to breach provisions of the Commerce Act. These included an arrangement for the exclusive supply of gas from NGC; considerable restrictions on NGC competing with retailers; the requirement that new delivery points for gas be mutually agreed; and the 15-year rolling term of the contracts. All parties involved agreed that the contracts were inappropriate under the new light-handed regime. Nevertheless the replacement of the 1980 supply contracts occurred only after protracted negotiations.

The Commission had put considerable effort into pressing the parties to reach agreement on new supply contracts. Its approach had been that it was up to the parties to find suitable alternatives to the old contracts. The Commission warned them that if they did not, then it would have to consider taking court action against them. Fortunately that was not necessary.

The gas information disclosure regulations, aimed at underpinning light handed regulation in the gas industry, came into force on 7 August 1997. The regulations require separate

financial statements for the transmission, wholesale, distribution and retail businesses; disclosure of contract prices, terms and conditions; publication of financial, efficiency and reliability performance measures, pipeline capacity information and line charge derivations.

The regulations are currently subject to a review by the Ministry of Economic Development, aiming to improve the transparency and usefulness of the information disclosed.

The Commission has considered a number of gas industry business acquisition matters, some of which have occurred along with the electricity reforms, as a number of companies decided to divest gas retailing or distribution businesses to become either retailers of gas and electricity or owners of gas and electricity networks.

The Commission considers that the separation of the gas retailing and distribution businesses has been a significant factor in encouraging the entry of new retailers.

Other major changes in the gas sector have also resulted from changes occurring in the electricity sector. For example, Contact Energy Ltd, now one of the major gas suppliers, was formed when the Government decided in 1995 to split ECNZ into two generating businesses. At the time, Contact was seen as providing competition in electricity generation rather than as a gas supplier, but significantly, Contact acquired as part of its assets the rights to purchase 42.8% of the gas from the Maui field. These gas purchase obligations, which are on a take-or-pay basis, provided a strong incentive for Contact to increase its sales of gas.

Until the advent of Contact, NGC had been the dominant gas wholesaler, supplying to industrial gas users and retailers.

Contact has also entered the retail market by acquiring from Enerco New Zealand Ltd approximately 105,000 residential and commercial gas customers based in Auckland, Wellington, Hawkes Bay, Horowhenua and Manawatu. The sale by Enerco of its retail business was part of the separation of lines and retailing I mentioned earlier.

This acquisition was the subject of an application to the Commission under the business acquisition provisions of the Act.

The Commission found that competition would remain in the North Island gas wholesale market, preventing Contact acquiring a dominant position.

The Commission concluded that Enerco was dominant in the relevant retail gas markets, and that the proposed acquisition would involve that dominance being transferred to Contact but with no strengthening occurring. The Commerce Act does not prohibit what it describes as "bare transfer of market dominance", that is, business acquisitions that involve dominance being transferred to a new owner but not being strengthened.

Until the Contact/Enerco Decision (Decision No. 333), the Commission considered issues affecting the distribution of gas using "delivered gas" markets. Delivered gas encompassed both the gas and the delivery of that gas. In Decision 333 the Commission recognised that divestments by gas utilities resulting in the ownership separation of gas distribution and retail businesses meant that consumers would no longer necessarily receive both their distribution services and gas from a single supplier. The Commission therefore adopted separate markets for the supply of gas and the distribution of that gas. The Commission considers that separate markets remain appropriate for these functions.

As was the case with electricity, the segmentation of gas consumers into "small commercial and domestic" and "medium and large industrial" within the relevant market definitions recognised that small consumers were able to economically be supplied with gas only by their incumbent retailers retailing in their local gas distribution networks. Over time, as competition has developed, the Commission has revised its market definitions to reflect the fact that progressively more customers have competitive supply options.

In summary, since deregulation, competition has developed in the gas wholesale market and in the retailing of gas to industrial and commercial gas users.

The Commission is pleased to see that some initial competition for residential customers is now beginning to occur, particularly with the entry of Fresh Start in some regions of the North Island.

However, the Commission's view is that the gas industry has not yet reached the stage of the electricity industry, where the Commission has defined a national electricity retail market for consumers of all sizes. While the Commission anticipates that most domestic consumers can look forward to more competitive markets, it is not satisfied that this situation will necessarily flow through to all areas in the immediate future. The Commission considers that competitive issues associated with domestic retailing on each network must still be considered on a network by network basis.

These issues were considered most recently in the application by NGC to acquire a 75.8% shareholding in TransAlta New Zealand Limited. The Commission gave a clearance on the basis that NGC's parent company, The Australian Gas Light Company (AGL), would divest its gas distribution system in the Hutt Valley and Porirua area by 1 October 2001. Alternatively, AGL is not required to divest the gas network if TransAlta sells its residential gas business or at least 50% of its residential gas customers.

The main issue for the Commission in this case was the effect of the vertical integration which would occur between TransAlta as the gas retailer and AGL as the gas distributor. Taking the divestment undertaking into account, the Commission was satisfied that the acquisition would not give rise to any competition concerns from vertical integration.

Kupe case

In discussing the Commission's dealings with the gas industry, I would mention that the Commission has one case before the Courts which relates to this industry. This case relates to the acquisition by Fletcher Challenge Energy (FCE) of the dominant part of the ownership in the Kupe gas field, which the Commission considered would result in the acquiring or strengthening of its dominance in the production of gas and the downstream markets.

The Commission filed a statement of claim in the High Court on 19 December 1997 against FCE and ECNZ, and expanded it to include Genesis earlier this year. The case is still working its way through the court process.

Maui pipeline

A current issue which the Commission is monitoring is the possibility of a change in ownership of the Maui pipeline. Any such change would be of interest to the Commission as it would affect the gas transmission market. FCE said in its 1999 annual report that there had been considerable interest in purchasing its interest in the Maui pipeline and that it would be pursuing the sale in the current year. I note that in its financial results for the six months ended 31 December 1999, it stated that approval of the sale by the Maui joint venture had yet to be received.

The Commission has considered whether or not the common ownership of the Maui pipeline and the NGC high pressure transmission system would result in a strengthening of NGC's current dominant position in the transmission market.

The Maui pipeline has been used for transporting Maui gas only and access to it is not currently available to other users. Hence the Maui pipeline does not provide any constraint at present on NGC in the transmission market. The Commission's view is that there is potential, however, for gas to be transported through the Maui pipeline in competition with the Kapuni pipeline as gas production from the Maui Field runs down.

At the time of a proposed restructuring of NGC in 1999, the Commission advised NGC of its view that the acquisition of the Maui pipeline would be likely to strengthen NGC's dominance in gas transmission.

Conclusion

I hope that this has provided some guidelines on the kinds of issues where you may need to look more closely at whether you comply with the Commerce Act. The Commission does not give legal advice but we are happy give any information we can on the legislation in general or on particular provisions.

In conclusion, I would like to reiterate two points:

- The Commission's role is that of an enforcement agency, and I think that all here would agree that it is of paramount importance that such a role is, and is seen to be, independent.
- The Commission's responsibility is to enforce the legislation it enforces with an even hand – this is the case in the petroleum sector as in all other sectors of the economy.

References

Practice Note 3: Electricity Industry Reform Act 1998, Commission's Role, Processes and Procedures.

Author

JOHN BELGRAVE was appointed Chair of the Commerce Commission in August 1999 for a term of three years. He is also Chair of the Standards Council of New Zealand, and the Director of the State Services Commission's Y2K project office. Mr Belgrave has been the Chief Executive of four government departments including the Ministries of Commerce and Justice. He has also been the Executive Director of the New Zealand Bankers Association and the Electricity Supply Association of New Zealand.