

Understanding the impact of the Commerce Act on the exploration industry

Elisabeth Welson¹ and Tanya Thomson²

¹ Partner, ² Senior Associate, Simpson Grierson, PO Box 2402, Simpson Grierson Building, 44-52 The Terrace, Wellington. Email elisabeth.welson@simpsongrierson.com, tanya.thomson@simpsongrierson.com

Abstract

Proposed changes to the Commerce Act 1986 will alter the dominance threshold in section 36 to a standard of “substantial degree of market power”. The threshold under section 47, which prohibits certain acquisitions of assets, changes to substantial lessening of competition. Both of these require a behavioural analysis rather than the structural analysis required by the existing tests.

The exploration industry is characterised by joint venture and farm-in arrangements as parties seek to share their risk. When gas has been found, long-term supply contracts facilitate management of development costs. The aim of this paper is to identify the potential impact of the changes to the Commerce Act on the exploration industry, in particular whether, and to what extent, farm-in arrangements and exploration joint ventures may be caught by either of these amended sections and the significance of long-term contracts in a behavioural type of analysis.

The paper will focus on three aspects. These are:

1. Market definition: A critical first step in any Commerce Act analysis is to identify the relevant markets which may be affected. The extent to which exploration and interests in exploration permits comprise a separate market from production will be discussed. The Shell/Fletcher clearance decision delivered by the Commerce Commission last year will be reviewed in the context of the markets identified by the Commission.
2. Acquisition threshold: The paper will look at what impact this change has on the acquisition of interests in exploration permits and gas supply arrangements. It will also discuss the significance of the concept of associated persons which has been retained from the previous test.
3. Substantial degree of market power: The paper will look at what constitutes a substantial degree of market power in the context of the exploration and downstream industries. In particular, it will look at the impact of long-term contracts.

Introduction

Those of you who read the programme closely will have noted that this paper was advertised as a paper discussing the impact of *the changes to* the Commerce Act on the exploration industry. Since the paper was proposed, the Commission has issued the TAWN Deep Decision¹ which focuses directly on the exploration industry. The analysis in that Decision indicates that the key issues are still the same old familiar ones of market definition and market power. The changes to the Act make these key issues of wider relevance to all industry players.

Why does the Commerce Act matter?

As lawyers, one of the main challenges we face is making clients aware of breaching the Commerce Act. To do this, clients need two things:

- a reason to take the Commerce Act seriously; and
- to be well-informed as to what constitutes a breach.

On the first issue (“why does the Commerce Act matter to me?”) a number of the recent changes widen the application of the Act and thus more people are caught. The most

significant change from an industry perspective is the changed merger threshold. Previously, business acquisitions were prohibited if the acquisition was likely to result in dominance. Business acquisitions are now prohibited if they are likely to “substantially lessen competition”, which is a much lower threshold. A similar change, from dominance to a substantial degree of market power, was made to the threshold for the abuse of market power prohibition.

The effect of this is that significantly more acquisitions are now caught by the Commerce Act. Acquisitions that previously would not need to be examined now will need to be examined. At the last petroleum conference the Chair of the Commerce Commission indicated that the grant or acquisition of an exploration or mining permit was a business acquisition under the Act. We query whether an initial grant is a business acquisition but certainly any transfers of permits or farm-ins would constitute such an acquisition. Given the level of such activity in the exploration industry, and the amended thresholds, most participants will, at some point, be involved in transactions requiring a competition analysis.

It should be reasonably easy to get clients to take notice thanks to the other significant change to the Act – an increase in potential penalties for prohibited conduct such as price-fixing. The maximum penalty for a company has increased from \$5 million to \$10 million or 3 times the illegal gain, whichever is the higher figure. If it is not possible to determine the amount of the gain from the prohibited conduct, an amount equal to 10% of annual turnover is to be substituted. This is potentially a very high figure for many exploration companies, particularly if they are also producers of gas or oil.

Fines are not just an issue for exploration companies but also for their officers, as penalties for price-fixing (of up to \$500,000) can be applied to individuals. Industry participants may brush this off thinking that because they do not fix the price of outputs (ie, gas or oil produced) price-fixing is not relevant to them. However, you should be aware that the Commission has the view that agreeing on any aspect of inputs is also price-fixing. In particular, agreement on payments for land access is, in the Commission’s view, an offence.

The second part of the lawyers’ task – keeping clients informed about the risks of breach - is more difficult. Unfortunately the Commerce Act does not, for the most part, provide a clear set of prohibitions which are either easy to recognise or easy to avoid. Almost every Commerce Act inquiry necessitates an analysis of the market and the behaviour of all market participants as well as the firm in question. This analysis extends not just to the immediate activity (such as exploration) but also explores the impact on downstream activities (e.g. production). There are two key questions in relation to any acquisition or activity:

- what are the relevant markets?; and
- how will the acquisition/activity affect market power in those markets?

When a firm wants to acquire a licence or an interest in another exploration company, the first step is to identify what market the acquirer and target are in. Defining the market provides a framework within which to assess the competitive impact of any activity.

Defining the market

Ask an industry participant what market they are in and they will usually have a clear and quick answer. Unfortunately the “market” under a Commerce Act analysis is often quite different from the commercial definition. As a general rule the Commerce Commission tends to take a narrower view of the market than an industry participant might.

The Commission has not needed to consider acquisitions in the upstream petroleum industry until recently. Under the former test of dominance the existence of two major market participants meant that (unless they combined) any other acquisition activity would be unlikely to breach the Act. The first significant acquisition decision affecting the industry resulted from a proposal involving those two major players: the proposed acquisition of Fletcher Challenge Energy by Shell Exploration Company BV. This was considered by the Commission in late 2000 in its Decisions 408 and 411. Both Shell and FCE were active explorers as well as producers of gas, oil and LPG. Twelve months on, and in the context of the new acquisition threshold the Commission was asked to consider a proposal by Shell Overseas Holdings Limited to acquire rights in the TAWN mining licences. These comprise all formations lying below the existing known reservoirs from which all current TAWN gas and LPG production is derived and are referred to as “TAWN Deep”.

In the Shell/FCE Decisions, the Commission identified three relevant markets all of which it considered to be national markets. These were:

- the current gas production market
- the post-2009 gas production market
- the LPG production market.

Due to the fact that TAWN Deep is not yet producing, the focus in the TAWN Deep Decision was on exploration. The Commission reached the following findings on market definition:

- there are separate oil and gas product markets
- exploration is a separate market from production (thus there is a gas exploration market and an oil exploration market as well as production markets for each)
- the gas exploration market is a national one.

In this paper we explore the market definition used by the Commission in the TAWN Deep Decision, and query whether its conclusions are correct. In reaching its conclusions on market the Commission applied its standard tests, starting with the “*ssnip*” test² and then looking at supply

substitutability. In our view, these standard tests are not particularly well suited to evaluating the specific features of the exploration industry.

Markets are conventionally defined by analysing three “dimensions”: product, functional level (i.e. producer/wholesaler/retailer) and geographic. It is worth looking briefly at the way the Commission analysed each dimension to reach its conclusion on market definition in the TAWN Deep Decision.

Product dimension

Defining the “product” market sounds like an easy step. Everyone knows what their product is. However, most products can be defined in a number of ways, e.g. are bananas in a banana market or a fruit market? Are Porsches in a car market, a luxury car market or a sports car market?

The Commission struck a similar problem in the TAWN Deep Decision – although it did not seem to realise it. In finding that the relevant product was “gas”, the Commission focused on the end product, ie oil or gas. The Commission has previously found that oil and gas form separate product markets based on the *ssnip* test directed at the end use consumer. The Commission has frequently stated that while different forms of energy provide some competition to each other, it is not sufficient to include them in the same market. A similar conclusion was reached by the High Court in the Kapuni litigation.³

Oil and gas therefore comprise separate end product markets. But does this make sense in an exploration context? Applying the *ssnip* test certainly does not make sense in this context. In a practical sense, an explorer may be looking for gas but find oil, or may find oil and gas, or may just find gas. There are no guarantees the end result of any exploration activity will be anything other than a dry well, and there are no guarantees that what is found is what was expected to be found.

Defining exploration by reference to end products creates a number of difficulties in defining the parameters of the market. Most obviously, how can we assess whether a particular transaction takes place in the gas exploration market or the oil exploration market? Unless this distinction can be made, it will be extremely difficult to assess the competitive impact of the transition. Exploration permits are granted for the exploration of “petroleum resource potential” and do not make any distinction between oil and gas. Without reasonably extensive information on the likely potential of a permit area, it will be almost impossible to identify whether a transaction should be considered in the context of an oil exploration market or a gas exploration market.

The Commission did not have to deal with this issue in the TAWN Deep Decision as the TAWN fields are all well explored and the Commission had access to such information. On the basis of this information it was able to conclude that the depth of TAWN Deep made it more likely to produce gas than oil. However, for most permit areas, such detailed information is unlikely to be available and distinguishing

between oil and gas as the appropriate product dimension of the market will simply not be possible.

The Commission also considered “supply substitutability” in defining the product market. In doing so it seems to have made a leap of logic to substitutability of production, when the functional level that it then went to identify was not production but exploration.

Another possibility is that there is a market for “exploration rights” (i.e. essentially a permit market). Is this what the Commission meant? The Commission does refer to “exploration rights” in the TAWN Deep Decision but its analysis does not focus on permits. The Commission’s discussion of additional factors, such as likely success of any exploration activity, suggest a wider focus than simply a rights market. Furthermore, the Commission has found “rights” markets previously⁴ and so presumably if it wished to do so here it would have articulated it expressly. Therefore it is impossible to draw a clear conclusion that the Commission intended to identify an exploration rights market.

Even if the Commission intended a finding of an exploration rights market, such a finding results in many of the same problems of measuring market power as finding a separate exploration market. These problems are discussed further on in this paper.

Functional dimension

The second dimension is the functional level. This is perhaps the most difficult conceptual level to isolate. Essentially, the functional dimension of a market describes a series of transactions, usually vertical, in the production chain from manufacture or import, through wholesale/distribution level(s) and the retail level. The Court in *Telecom Corporation of New Zealand Ltd v Commerce Commission*⁵ describes functional level as follows:

“If we ask what functional divisions are appropriate in any market definition exercise the answer, plainly enough, must be whatever will best expose the play of market forces, actual and potential, upon buyers and sellers. Wherever successive stages of production and distribution can be co-ordinated by market transactions, there is no difficulty: there will be a series of markets linking actual and potential buyers and sellers at each stage. And again, where pronounced efficiencies of vertical integration dictates that successive stages of production and distribution must be co-ordinated by internal managerial processes, there can be no market.”

Prior to the TAWN Deep Decision the Commission had assessed the gas product market within discrete production, transmission, distribution, wholesaling and retailing functional markets. Interestingly, in the Shell/FCE Decisions both parties were engaged in exploration activities but the Commission did not regard exploration as a distinct market from production. Its analysis of exploration was simply in the context of it being an entry condition to the production market.

In the TAWN Deep Decision the Commission explained its earlier failure to identify a separate exploration market in the Shell/FCE Decisions as resulting from its assessment of the circumstances at the time, that there was very limited potential for the merged entity to obtain excessive market power from exploration activity given the number of other firms engaged in gas exploration and the relatively low barriers to entry. If this had been the Commission's assessment at the time, it would be usual to expect that it would have made at least some articulation of this assessment in the decisions themselves.

Does it make sense to isolate exploration as a separate market from production? On the one hand, exploration is clearly a separate activity, with different expertise required from that needed for production. It is not necessary for exploration and production to be carried out by the same companies, although in New Zealand they usually are.

However, a market must be more than merely an activity. For a start, a market must involve transactions between buyers and sellers. The Commission does not appear to have clearly articulated what it regards the transactions in the exploration "market" to be.

The Commission appears to have differentiated exploration from production on the basis that acquiring an exploration permit does not provide the ability to produce gas. While this is true, exploration has no point other than to ultimately produce gas, and just because it does not always succeed in this aim does not seem like a good enough reason to identify it as a different market.

The Commission considered the issue of exploration in the first Shell/FCE Decision but did so in the context of constraints to entry into the production market. This seems like a more logical approach, particularly when the impact on competition is assessed as what really matters in the end is who produces, not who explores.

Market definition is not an end in itself but a framework for measuring competitive impact of an acquisition. We consider that identifying exploration as a separate market does not assist in providing such a framework. The problems the Commission had in assessing the competitive impact in the TAWN Deep Decision (discussed further on in this paper) partly arose from the attempt to define exploration as a separate market.

Geographic dimension

In both the Shell/FCE Decisions and the TAWN Deep Decision, the Commission concluded that the relevant geographic markets were all national markets. In the Shell/FCE Decisions, the Commission did not provide any detailed analysis of why it considered the production market to be a national one. Because all production takes place in the Taranaki Basin there was no consequence in finding either a national market or a smaller regional market. In the TAWN Deep Decision the Commission noted that there were three recognised petroleum provinces in New Zealand: western,

southern and eastern. Most exploration activity takes place in the Taranaki Basin, but exploration activities are also conducted in the East Coast Basin and in the South Island in the Great South, Canterbury and Western Southland Basins.

In the TAWN Deep Decision, the Commission accepted Shell's submission that the increase in product transmission costs outside Taranaki (due to the lack of transmission infrastructure elsewhere) did not rule out production and exploration elsewhere. However, it seemed to jump from accepting that costs were not prohibitive to wider exploration to concluding that it must be a national market. We dispute this conclusion.

The Commission also commented that from a supply perspective, it would be relatively easy for an exploration company to shift its efforts from one region to another. That is correct but as the Commission noted in the Shell/FCE Decisions, the fact that infrastructure already exists in the Taranaki region is one of the reasons that exploration activity has been concentrated in that area. Exploration companies discovering product in areas not serviced by current infrastructure face significantly greater constraints in getting that product "to market" than explorers in areas where infrastructure exists. In our view, these constraints are so great as to distinguish markets on a regional basis.

Intuitively, and many in the industry would no doubt concur, a gas field in the South Island quite simply does not compete with a gas field in the North Island. The costs and difficulties of transporting gas make sale to a North Island customer base a practical impossibility. At the very least we consider there are separate North Island and South Island markets for both gas exploration (if that is a separate market) and production. The supply substitutability argument seems flawed: just because The Warehouse can easily shift its retail stores from Auckland to Invercargill, does not create a national retail market. In the same way, to identify a national market for exploration solely by reference to the inputs to that activity and without reference to the ultimate outputs (ie production, albeit that success rates are not 100%) is misconceived.

In our view the geographic boundaries of exploration are dictated by the production market whether or not exploration and production are viewed as a single functional level or not. No-one will explore where they cannot produce. We consider that production is geographically limited, either to regions or at least to North and South Island. Thus the exploration market (if it exists) must also be delineated along regional or North/South island lines.

Market power

Once a market is defined, it is usually necessary to evaluate the degree of competition in that market and in particular the market power of the relevant firm. From the firm's perspective, this is the "Do I need to be worried?" question.

In assessing market power the starting place is usually market share. Market share is not a synonym for market power and

the Commission (and Courts) have always been at pains to emphasise this. However, in practical terms market share is used as a rough guide of market power. The Commission's own safe harbour guidelines for acquisitions have (both under the old and new tests) focused on market shares (with the addition now of market concentration as well). This reliance on market share as a guideline is problematic in relation to exploration as it is almost impossible to measure market share in the exploration market in a meaningful way. Share of what? Market share is usually measured by a percentage reference based on revenue or number of customers or some other objective measure. It is dependent on knowing the total volume of the relevant goods or services in the market.

The Commission made reference (in the TAWN Deep Decision) to market penetration by land area but concluded, correctly, that land area holdings are not an accurate measure of the likely success of the exploration of those areas. In fact the converse is more likely as the larger permit areas tended to be in frontier areas. Permits for the Taranaki area tend to be amongst the smallest land areas. It is incredibly difficult to measure the "worth" of an exploration permit as there is no direct correlation between the land area a permit relates to and the reserves of gas or oil likely to be found. By its nature, the exploration market does not fit this analysis as the volume of end product is unknown. The Commission was faced with an almost insurmountable difficulty and one for which we have no suggestions short of redefining the market.

If exploration is analysed as part of the production market the analysis of market power is much easier. Obviously market share figures are easier to establish in production as it is a measurable activity. Exploration can then be viewed as one factor impacting on competition in the production market, and the fact that it is only a part of the equation means that it is not as important that the value of any particular exploration activity cannot be measured. It seems to us to be a little odd that the Commission not only defined exploration as a separate market but declined to consider the impact of exploration on production. The basis for this decision appeared to be that the outputs of exploration are too uncertain to be useful in an analysis of production. We consider that at the very least it needs to be recognised that exploration activity is the pool from which potential new entrants to the production market are drawn (as acknowledged in the Shell/FCE Decisions).

Substantial lessening of competition

The next step in the competition analysis is considering whether the acquisition will substantially lessen competition.

The Commission concluded that the TAWN Deep proposal would not involve a substantial lessening of competition

based on various factors, including lack of market participants' ability to co-ordinate market power and the constraint provided by existing and potential competitors in the exploration market.

We regard those factors as useful in assessing competitive impact once market power is ascertained. However, in the absence of that market power information, these factors do not provide a sufficient basis for a thorough analysis of competitive impact. As a result, it is difficult to see how the Commission could ever find a substantial lessening of competition in the exploration market.

Conclusion: What does the TAWN Deep Decision mean for the exploration industry?

If the market analysis is correct, we have separate national gas and oil exploration markets. Given the inability to assess market share and thus market power, it is very difficult to think of circumstances where an acquisition could be found to result in substantial lessening of competition in the exploration market. Furthermore, given the Commission's apparent belief that exploration is so divorced from production that it cannot affect it, an exploration acquisition could not be found to lessen competition in the production market.

Larger industry participants might think these conclusions are a good thing. Smaller ones may not. Regardless of your perspective, certainty is always a positive as it allows strategic decision-making. In our view, the TAWN Deep Decision does not provide this certainty because there are so many issues that have not been fully addressed.

Going forward, what we can say is:

- Although the changes to the Act will supposedly block more acquisitions, based on the TAWN Deep Decision it appears unlikely that the Commission (based on current reasoning) would investigate or block any acquisition in the exploration industry.
- However, if different facts were put in front of the Commission it could easily reach a different decision on markets, and therefore on its competition analysis and thus the result of a potential acquisition.
- Anyone (most likely an industry competitor) could take a Court action to try and block a potential acquisition. A Court may take a different view of the markets and competitive impact than the Commission has done.

In conclusion, we do not think the TAWN Deep Decision delivers any certainty to the industry upon which it can rely in its decision-making.

- ¹ *Decision No. 443.*
- ² *This test asks whether purchasers would switch to a substitute product if there was a small yet significant non-transitory increase in price (5% for a year).*
- ³ *Shell (Petroleum Mining) Company & Anor v Kapuni Gas Contracts Limited & Anor (1997) 7 TCLR 463*
- ⁴ *For example, a market for rights to acquire player services in Decision 281.*
- ⁵ *(1991) 4 TCLR 473, 502.*

Author

ELISABETH WELSON is a partner in Simpson Grierson's Corporate and Energy market groups. She has extensive experience in a wide range of commercial and energy matters, both in New Zealand and Australia. Elisabeth has a strong background in competition law issues and provides Commerce Act advice to a wide range of corporate clients, with a particular understanding of the issues relevant to networks and natural monopolies. Elisabeth has a broad energy practice and has been involved with the Petroleum and Exploration Association of New Zealand (PEANZ) Executive Committee for the last four years. She is also been involved in the development of all of the electricity industry agreements - NZEM, MARIA and MACQS - and most recently the development of a self-regulatory governance structure for the industry. Elisabeth has LLB(Hons) from Auckland University.