The Role of the Commerce Commission in the Gas Industry

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Good morning everyone, and thank you for the opportunity to discuss the role of the Commerce Commission in New Zealand's natural gas industry.

This is an important subject for the Commission, as its role in the industry has increased considerably in recent times.

In the last 12 months alone Commission has commenced a gas pipelines regulatory inquiry at the request of the Minister of Energy, and we have authorised a joint venture to develop the Pohokura gas field in Taranaki which raised self governance issues after being authorised. And since 2000 we have dealt with several substantial mergers in the gas industry.

Today I will look briefly at the Commission's involvement in the industry, put that work in the context of the Commission's overall role, and hopefully have time at the end to answer any questions you may have.

To set the context, I would like to start by introducing the Commerce Commission, and providing a quick overview of our role and responsibilities.

The Commission was established under the Commerce Act 1986, and is a Crown entity under Schedule Four of the Public Finance Act 1989. It is an independent, quasi-judicial body with responsibility for enforcement and regulatory control under a number of general and specific regulatory regimes.

The Commission's overriding purpose is to promote market efficiency, which it does in three main ways:

- by fostering healthy competition amongst businesses – through various activities under the Commerce Act;
- by fostering informed choice by consumers – through enforcing the Fair Trading Act, to which recently has been added the Credit Contracts and Consumer Finance Act; and
- by undertaking sound economic regulation – through various actions under the industry-specific legislation: the Electricity Industry Reform Act, the Telecommunications Act and the Dairy Industry Restructuring Act. In addition, there are the generic provisions in Part 4 of the Commerce Act.

The Commission's activities cover enforcement, adjudication, regulatory control and the provision of information.

New Zealand's principal piece of competition legislation—and the one under which the Commission has acted recently in the gas industry—is the Commerce Act. The purpose of this Act is to promote competition in markets for the long-term benefit of consumers within New Zealand.

Markets characterised by competitive structures and behaviour are promoted by the Act because they tend to generate superior outcomes for consumers, in terms of keener prices, better product quality and variety, and more efficient and innovative businesses.

The Act promotes competition by prohibiting certain forms of behaviour, or certain changes to market structure, that would significantly harm competition in a market. Specifically, it prohibits:

- the forming of contracts, arrangements or understandings that could lead to a substantial lessening of competition (price fixing by competitors is deemed to substantially lessen competition, and is therefore illegal per se);
- a business with substantial market power from taking advantage of that market power to deter or exclude competitors from the market; and
- mergers and acquisitions that would substantially lessen competition.

In those markets where competition is insufficient to protect the interests of market participants, the Act also provides for the regulatory control of goods or services. This implicit threat of control has often been seen as an integral part of the so-called "light-handed" approach to regulation in New Zealand, to enforce competitive standards of behaviour in markets that are not competitively structured.

Although the Commerce Act prohibits competitors agreeing to work together in a way that reduces competition between them, and prohibits business acquisitions that would likewise substantially lessen competition, the Act does allow for the authorisation of such anti-competitive business practices and acquisitions. For authorisation to be granted, the Commission must be satisfied that the public benefit flowing

from the practice or acquisition will be greater than the detriment attributable to the lessening of competition.

With that as the background, I will now turn to reviewing the Commission's recent activities in the gas industry.

Pohokura Gas Authorisation

The Commission last year completed an authorisation relating to the gas industry. Three companies applied to the Commission in December 2002, seeking authorisation to enter into arrangements to jointly market and sell gas produced from the Pohokura field.

The Commission followed its usual authorisation procedures, which included receiving submissions on the original Application and on the Commission's Draft Determination, holding a public conference, and releasing a final determination (in September 2003).

The Commission considered that the joint marketing of gas was likely to be anticompetitive, because it would have such effects as: restricting the number of competitors in the market; result in higher prices; lead to a more limited range of terms and conditions being offered to purchasers; and slow the evolution towards a more competitive market in the future. Against this, the arrangement was thought likely to generate a substantial benefit from the earlier development of the Pohokura field, compared to what would otherwise be likely to happen in the counterfactual with separate marketing of the gas.

The Commission authorised the application, but in order to gain some certainty that the public benefits would be achieved, and to mitigate the extent of detriment caused by the reduction in competition arising from joint marketing, it considered it was necessary to impose conditions on the authorisation.

Those conditions were that the Applicants:

- can jointly market and sell additional gas (not previously marketed or sold) jointly after 30 June 2006 only if the Pohokura field and its associated production equipment is fully operational by that date;
- can sell their interests in the Pohokura field only if providing the sale is made conditional on any purchaser(s) obtaining a clearance or an authorisation from the Commission; and
- do not prevent purchasers of Pohokura gas from reselling of gas to third parties.

This adjudication is an example of where the Act allows arrangements that might otherwise breach the restrictive trade practice provisions of the Commerce Act, provided the arrangements generate net economic benefits over what would happen in the more competitive setting without the arrangement.

This suggests that the primary goal of the Act is to promote economic efficiency, rather than competition, since competition can be overridden in circumstances where economic efficiency would be enhanced by less competitive arrangements. This provision in the Act probably reflects the small size of many markets in New Zealand, and the need to balance competition concerns with business efficiency considerations.

Gas Pipelines Control Inquiry

I will now move on to an overview of the Commission's gas control inquiry.

The Minister of Energy requested the Commission to make recommendations on whether or not the supply of gas (transmissions and distribution) services should be controlled, and to do so by 1 November 2004.

This is the Commission's second control inquiry. You may recall the Minister of Commerce requested the Commission to report on whether the supply of airfield activities (essentially, involving landing charges) at Auckland, Wellington and Christchurch International Airports should be controlled. The Commission reported to the Minister in August 2002, recommending control at Auckland Airport only. The Minister decided not to impose control.

As I mentioned earlier, Part IV of the Commerce Act envisages the possibility that control may be introduced over goods and services where competition is limited in a market. This part of the Act is relevant to those industries and activities where assets or facilities may be difficult and expensive to duplicate because of great economies of scale or small size of market, and where the good is not internationally tradable, so import competition cannot be relied upon. In these circumstances, efficiency considerations may dictate that supply be provided by only one or a very few businesses, and competition may naturally tend to be limited or even non-existent.

Looking ahead, the introduction of control in the gas pipelines industry would require the Governor-General to declare, by an Order in Council, that specified goods and services are to be controlled. The Governor-General may only do so on the recommendation of the Minister of Commerce.

The Minister of Commerce may only make a recommendation for control if satisfied that the goods or services are supplied or acquired in a market in which two conditions are met:

- competition is limited or likely to be lessened; and
- control is necessary or desirable in the interests of acquirers or suppliers of the services.

In making its recommendations to the Minister, the Commission has to consider exactly these issues. The Minister has also asked the Commission for specific advice on:

- whether gas services may be controlled in terms of section 52 of the Act;
- the methodology that the Commission considers appropriate for valuation of pipeline assets for the purposes of its advice on the matters covered in the Minister's letter;
- the net benefits to the public of control; and
- any other matter that the Commission may think relevant to a decision on whether control should be introduced.

The Commission has structured the inquiry into two phases. The first phase was to prepare a Draft Framework Paper, and invite submissions on it. That paper set out the Commission's preliminary views on the scope of the inquiry, the process it would follow during the inquiry, and the analytical framework it would employ. In preparing the draft framework, the Commission drew heavily on its experience with the inquiry into airfield activities.

The Draft Framework Paper was released in mid-July last year. Written submissions were received and a conference was held, with further submissions being received shortly afterwards.

The second phase is to apply the framework and prepare a report setting out the Commission's draft recommendations, and explaining its reasons. The Commission will then invite written submissions on the draft report and hold a conference on it, before finalising its recommendations to the Minister by 1 November.

The Draft Report is scheduled to be released within a month. It would be premature for me today to disclose any details of the draft recommendations, or even to signal broadly what they might be. However, there are some more general matters relevant to the inquiry that I would like to comment on.

The first condition to be met before a company can be subject to control is a competition threshold, and it is a relatively low threshold. The requirement that competition is limited or likely to be lessened is not very demanding, and it seems likely that quite a number of industries in New Zealand could potentially be caught by this provision.

The second condition is that control is necessary or desirable in the interests of acquirers or suppliers of the services. This condition needs careful consideration. If control were to result in excessively high prices being reduced, this would indeed seem to be a benefit to acquirers, even though in economic terms it would be merely a transfer from suppliers to acquirers. The actual efficiency gain, called the deadweight gain, would typically be small. In addition, control would be expected to impose direct costs on both the regulated business and the regulator, as well as indirect losses to efficiency resulting from distortions caused by regulation itself. The Commission might have to ask itself whether the transfer to acquirers is worth the direct and indirect costs involved.

So far the users of pipeline services, whether gas producers, retails or end consumers, have provided limited detailed evidence to the Commission that control should be declared in respect of gas pipeline services. It is possible, given the limited stocks of natural gas currently available for production, that users of gas pipeline services are focusing their attention on the future supply of gas rather than its transport.

However, this is not to say that there is no interest in the Commission's inquiry from gas pipeline users. The Commission is aware that some concerns about gas pipeline services were raised during the Ministry's earlier gas sector review, and the Commission has also taken account of submissions made during that review. Moreover, some users of pipeline services have made the point that they simply do not know whether they should be concerned about gas pipeline services and they are therefore looking for the Commission's inquiry to shed some light on the matter.

Some pipeline users have stressed that open access to the Maui Pipeline is the most pressing issue in the market for pipeline services. Although the price of such access is clearly important to those seeking access, other terms and conditions are also important.

The Maui joint venture partners have recently announced the terms and conditions, including prices, under which they will provide access to the Maui Pipeline for the transport of gas other than that covered by the Maui Contract. This is good timing from the Commission's perspective, as it will be able to provide its views on that regime in its draft recommendations shortly to be released before the regime comes into effect, and before significant investments are committed on the basis of that regime.

The situation for other pipeline services is somewhat different to that for the Maui Pipeline. Here, the Commission's recommendations could have the potential, if they were to lead to a change in the industry's regulatory environment, to cause shifts in revenue streams and asset values, relative to what was expected by investors in the past when they made decisions in what they may have perceived to be a different regulatory environment. This situation is never easy for the Commission, because of the risk that such regulatory decisions are perceived as creating regulatory uncertainty for future investment in New Zealand, whether in this sector or more generally. The minimalisation of such risk is of critical concern to the Commission and the Commission can and does factor in dynamic efficiency considerations.

The Commission will have more to say on this matter in its draft recommendations paper.

Mergers and Acquisitions

I'll now move on to discuss some of the Commission's recent work regarding merger and acquisition activity in the sector.

The Commission investigates, either through our adjudication (clearance) or enforcement processes, around 50

mergers and acquisitions each year. The Commission is able, upon application by the parties, to clear a proposed business acquisition where it finds that it would not lead to a substantial lessening of competition in any market. The acquisition can then proceed with immunity from attack by the Commission or any other party. An acquisition that would lead to a substantial lessening of competition cannot be cleared, and can be attacked by the Commission in the courts if it were nonetheless to proceed.

In the last few years, some of the more complicated clearances considered by the Commission concerned the gas industry. These included the sale of Fletcher's gas interests and the Todd Pohokura acquisition of OMV New Zealand Limited.

- In November 2000, the Commission cleared Shell Overseas Holdings to acquire Fletcher Challenge Energy Limited, subject to Shell divesting a range of assets currently owned by Shell and FCE. The Commission was satisfied that, subject to the divestment undertakings, Shell would not breach the competition threshold (at that time the acquiring or strengthening of dominance) in any of the relevant markets. The Commission identified the markets as:
  - current gas production,
  - gas production after 2009, and
  - production of liquified petroleum gas (LPG).
- Clearance was recently granted to Todd Pohokura Limited to acquire an additional 9.8% interest in the Pohokura gas field from OMV New Zealand Limited. Petroleum Exploration is a joint venture between Shell Exploration NZ Limited, Todd Petroleum Mining Company Limited and OMV New Zealand Limited.

This clearance was received as a requirement of the conditions mentioned in connection with the Pohokura decision. The Commission's investigation found that the increase in Todd's participating interest in Pohokura did not result in a substantial lessening of competition in the market for natural gas production. The Commission specifically considered that the acquisition would not affect the likelihood and ability of any of the parties to delay development of the field.

Government Policy Statement

The Commission is independent, and does not advise Government on policy matters. However, section 26 of the Commerce Act provides a formal and transparent mechanism for the Minister of Commerce to communicate its economic policies to the Commission. The Commission is required to have regard to such policy statements, but they are not a directive.

In March and April 2003, the Government issued two section 26 policy statements in relation to the gas industry. The second policy statement set out the Government's policy on the importance of the Pohokura gas field for energy security. The Commission has regard to that statement in coming to its decision on the Pohokura authorisation application.

The first statement, however, set out the Government's generic policy for the development of New Zealand's gas industry and its expectations for industry action.

Here you can see the Government's overall policy objective for gas.

It stresses:

- industry-led solutions;
- ongoing monitoring of the industry's progress in developing arrangements; and
- an expectation that efficient industry arrangements will be put in place by December 2004.

The Government has said that if progress towards the measurable milestones is unsatisfactory, it already has legislation drafted.

In responding to the Government's requirements, it is possible that the industry could come up with a solution that includes potentially anti-competitive arrangements, which might then require them to seek an authorisation from the Commission.

I was previously asked if the Commission has difficulties with industry led governance solutions. My response was that in principle, markets that function well and preserve the benefits to consumers will out perform regulated outcomes. If the industry is able to devise an industry led governance regime that meets the net public benefit test, then the Commerce Commission would have no difficult authorising such an arrangement if it came to the Commission.

Thank you for the time today to update you on the Commission's role in this area.

I hope it has been useful and provided a valuable overview of the work we have recently completed and currently are working through.