

Access to Third Party Facilities

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Introduction

This presentation will traverse issues surrounding access to third party facilities within the petroleum industry.

When referring to “**facilities**” in this context, I refer to inter-related components of the development of oil and gas upstream development: the processing facilities, the facilities for storage of condensate, pipelines for the transmission of gas pipelines for the transport of liquids to export facilities and export port facilities themselves.

The developer of a commercial discovery will consider the most efficient means for the development. Sometimes there will be no choice but to design, build and own stand-alone facilities for processing, condensate storage, condensate export pipeline and necessary port facilities and gas pipelines to connect to transmission pipelines. However, sometimes these new and already existing facilities have spare capacity. Access to spare capacity of existing assets can make a difference to the profitability of any development and, in some cases, can make an otherwise marginal development of a discovery, commercial.

Obviously, there is an incentive on the facility owner to maximise its return i.e. an incentive to charge the developer an access fee which in net present value terms is just less than the cost of designing, building and owning stand-alone facilities or the cost of access to other competing facilities.

In my assessment, access to other facilities is extremely limited and, therefore, to the extent there is any existing spare capacity its owner enjoys and displays monopoly characteristics and engages in opportunistic behaviour.

The policy response to monopolies is, of course, some form of regulatory intervention. This has been recognised in the case of processing facilities and I argue that further regulatory intervention is necessary.

The petroleum exploration and production industry has advocated that it is important that a viable gas exploration and production industry is sustained to generate new reserves (as an example see PEPANZ Submission on the Climate Change (Renewable Preference) Bill, paragraph 31). The benefits of enabling efficient development of discoveries (making otherwise non-commercial discoveries into commercial discoveries) include increased production, more industry participants, and an improved commercial environment for petroleum exploration and production in New Zealand.

Gas transmission pipelines already have a regulated information disclosure regime and a similar regime was adopted last year in relation to processing facilities.

It is submitted that the information disclosure regime should exist across all three facilities as all three can have monopoly characteristics and should be treated in a similar fashion. However, an information disclosure regime by itself is not sufficient; some dispute resolution mechanism is also necessary.

The status quo in New Zealand in relation to accessing gas transmission pipelines

The Gas (Information Disclosure) Regulations 1997 were designed to enable that sufficient information was put in the public domain for interested parties to make an informed assessment of the industry. Information which is published is both financial and non-financial and includes performance, capacity, access arrangements and pricing details. This regime does not provide for direct sanctions on companies who exploit the market due to their monopoly power. The regime does allow for indirect sanctions as the information provided might be investigated by the Commerce Commission if concerns are raised.

However, the application of the pipeline information disclosure regime is not universal. For example the Maui pipeline, which is the main means for transporting gas north of Taranaki, has limited disclosure requirements as their existing long-term contracts preclude the pipeline owner from seeking rents through providing access to other users. The information disclosure regime would however apply to any new contracts for the use and access to the Maui pipeline. The provisions of the Maui contracts mean that third parties cannot use the Maui pipeline until 2009. As the quantity of Maui gas is now declining, it is likely that the supply of gas will result in shortages for those north of Taranaki.

The status quo in New Zealand in relation to accessing storage and processing facilities

Similar to the pipeline information disclosure system, the implementation of an information disclosure regime for processing facilities has recently been adopted. This regime was recommended to the Minister of Energy (the “**Minister**”) by the Gas Industry Company (“**GIC**”) and will be discussed later in the paper.

The information disclosure regime effects these companies with current ownership interests in gas processing facilities including Vector, Genesis, Origin, OMV, NZOG, Shell, Todd, Greymouth and Bridge.

Is there a problem with the regulatory regime, or otherwise, if the owners of all of facilities (encompassing pipelines, storage and processing facilities) charge monopoly rents or price for the access to denying purpose of what would otherwise be a competitor, notwithstanding the existence information disclosure regime?

Commerce Act 1986

One of the general legal requirements in New Zealand governing commercial arrangements is section 36 of the Commerce Act 1986 (the “**Act**”). Access rights for third parties fall under section 36 as the section attempts to strike a balance between preventing firms with “a substantial degree of power in the market” from “taking advantage of” their market power to prevent competition while allowing these firms to trade and compete.

The relevant part of section 36 states:

- “(2) *A person that has a substantial degree of power in a market must not take advantage of that power for the purpose of—*
- (a) *restricting the entry of a person into that or any other market; or*

- (b) *preventing or deterring a person from engaging in competitive conduct in that or any other market; or*
- (c) *eliminating a person from that or any other market.”*

Section 36 is relevant if so, the owners of the facilities have “a substantial degree of power in the market” must not seek to deter or eliminate the entry or competition in the same or any other market.

Previously, section 36 targeted those firms with a “dominant position” but has been amended by the Commerce Amendment Act 2001 to apply to firms who have a “substantial degree of power in the market”. This change in the legislation brings it into line with the equivalent threshold in the (Australian) Trade Practices Act 1974. This legislative change effectively widens the scope of the section as firms who do not have a high degree of market contract (thus not dominant) may indeed have a substantial degree of power in the market and thus be subjected to section 36 investigations. Therefore, more than one firm within an industry may have a substantial degree of market power whereas the previous wording suggested that only one firm could be dominant.

The term “substantial degree of power” was described well in the explanatory memorandum to the Australian Trade Practices Revision Bill 1986:

“... ‘substantial’ is intended to signify ‘large or weighty’ or ‘considerable, solid or big’ (Palser v Grinling [1948] AC 291 at 317). The word imparts ‘a greater rather than less’ degree of power, per Smithers J in Dandy Power Equipment Pty Ltd v Mercury Marine Pty Ltd (1982) 64 FLR 238 at 260. At the same time ‘substantial’ in this context is not intended to require the high degree of market power connoted by ... being in a position substantially to control a market, or by the reference ... to the power to determine the prices of a substantial part of the goods in a market.”

Australian case law and section 46(3) of the Trade Practices Act 1974 contains additional guidance on the meaning of a “substantial degree of power in a market” and guides that it refers to structural factors, market share, technical knowledge, access to materials of capital, and behavioural factors.

The GIC’s *Statement of Proposal: Information disclosure by owners of gas processing facilities*, published in September 2007 (the “**Statement of Proposal**”), states that “there are some practical issues [with section 36] which make it a fairly blunt instrument” (clause 3.3). In order to enforce this section an application to the High Court or the Commerce Commission needs to be filed which means that “enforcement [under section 36] is therefore time-consuming and costly” (clause 3.3).

The failings of section 36 were also highlighted in the local service access litigation between Clear Communications and Telecom where section 36 failed as a mechanism to determine access disputes efficiently. Clear succeeded in the Court of Appeal (though this decision was later overturned by the Privy Council) but all the Court of Appeal could do was order the parties to go back and negotiate:

“The parties must return to the negotiations. It is unprofitable to reflect upon the economic efficiency of the process by which they reached this point. The Court clearly has no jurisdiction to direct the negotiations for interconnection.” (Clear v Telecom (C.A.) (1993) 5 TCCR 413 at 442).

Due to the concerns raised by section 36, a need for stronger intervention, and the concern that some owners of facilities have monopoly characteristics, the GIC presented recommendations to the Minister to implement an information disclosure regime to circumvent monopolising behaviour in relation to gas processing facilities.

Gas Industry Company recommendations

GIC is a regulatory body established under the Gas Act 1992. GIC works alongside the government to effectively and realistically develop policy and processes. Under the *Government Policy Statement on Gas Governance* (October 2004) the company must develop and make recommendations to the Minister of Energy in relation to the gas industry and access to processing facilities. The Minister may choose to adopt these recommendations in official policy documents.

Statement of Proposal on Information Disclosure by Owners of Gas Processing Facilities

The GIC undertook a review of access to gas processing facilities throughout 2006. In December 2006 GIC recommended to the Minister, David Parker that a process of information disclosure should be set up so within the gas industry interested individuals or companies know what spare capacity is available for their use and other information could be obtained such as pricing. The Minister approved this recommendation on 14 March 2007 with a deadline of 30 June 2007 for obtaining industry agreement. This deadline was later extended to 30 September 2007. This culminated in GIC publishing their *Recommendation to the Minister of Energy on Information Disclosure by Owners of Gas Processing Facilities* on 28 January 2008 (the “**2008 Recommendation**”).

The rationale behind this regime is that the disclosed information can implement a commercially viable agreement for access of the facilities and puts the smaller companies on the same negotiating level as the facilities owners.

Clause 1.10 of the Statement of Proposal states that

“Information disclosure will:

- *Allow Gas Industry Co to publish basic information on gas processing facilities, including forecasts of available capacity, so as to provide an efficient means for potential access seekers to screen processing opportunities;*
- *Report information on approaches by third parties seeking to have gas processed and the outcomes of those approaches; and*
- *Provide information on the gas processing sector which will assist Gas Industry Co to make a later, and final, recommendation to the Minister on the need for, and form of, access protocols.”*

Similarly, page 3 of the 2008 Recommendation states that the:

“...Gas Industry Co is recommending rules to establish a limited information disclosure regime which will require gas processing facility owners to:

- *Make information available to Gas Industry Co, which Gas Industry Co will publish on its website, on the capability of, and availability of capacity at, gas processing facilities; and*
- *Provide information to Gas Industry Co on the gas processing facility owner’s responses to requests for third party access;*

These rules will expire after six years unless the Minister decides to extend the rules.”

The information disclosure regime was firstly only implemented by way of an industry arrangement and by agreement. Clause 4.2 of the Statement of Proposal states that this arrangement “is consistent with Gas Industry Co’s commitment to pursuing industry arrangements where that is the most practical and efficient option”. However in September 2007 GIC proposed a regulated information disclosure regime because, as written on page 4 of the 2008 Recommendation, “despite early indications that an industry-based disclosure agreement was well supported by facility owners, Gas Industry Co could not obtain formal commitments from all of them.”

This regime is limited to processing facilities only; the information disclosure scheme does not include storage facilities. This is a significant gap in the framework of the information disclosure regime.

Statement of Proposal on Transmission Access Framework

In October 2007, the GIC released a further Statement of Proposal (“SoP”) on Transmission Access Framework. This SoP provided a full description of why transmission access warrants regulatory intervention, the proposed policy prescription for addressing the issues identified, the analytical process which has led to that proposal, and the proposed regulations.

Clause 1.3 of the SoP provides that the objective of the work undertaken by the GIC in its review of gas transmission access issues is:

“To define a transmission access framework that facilitates competition in the upstream and downstream gas markets, recognising the natural monopoly characteristics of gas pipelines. The access framework will address matters such as:

- *New entrant access rights to pipeline services;*
- *The management of multilateral arrangements; and*
- *The management of conflicts of interest”*

Further, at clause 1.13 of the SoP, the GIC considers that the benefit of the regulations will be the implementation of an open access regime which achieves objectives in both the Gas Act and the GPS.

Most submitters expressed a preference for a low level of regulation, and some thought that the option proposed in the SoP was too prescriptive. Although the SoP did not assume any regulatory approval of the existing codes (the Maui Pipeline Operating Code and the Vector Transmission Code), most submitters considered that to reduce uncertainty, some form of approval was needed.

It was also suggested by some submitters that since the Gas Act only allows for the prescription of terms and conditions of access, it might be outside the GIC’s powers to recommend the ‘framework’ approach proposed in the SoP. At present, the GIC is preparing a detailed analysis of the submissions, and further consultation is expected before a recommendation is made to the Minister. The full submissions analysis is not expected to be available until late April 2008.

Problems with the status quo

There are two underlying problems with the status quo in New Zealand since the Minister adopted the GIC recommendations implementing an information disclosure regime.

First, the information disclosure regime is only limited to gas processing facilities and does not have storage facilities and export facilities. A separate regime exists for pipelines. As the owners of all these facilities may have the same monopoly characteristics, the regime should be extended to include these facilities as well.

Secondly an information disclosure regime is inadequate to address the concerns of access for third parties in the context of a development of an oil and gas discovery. First, the security and cost of access may determine whether a discovery is in fact commercial. If not, the security and cost of access may influence the final investment decision. Certainly, a final investment decision which is made without security and loss of access might render a commercial project significantly sub-optimal. Section 36 is simply not a viable sanction against opportunistic behaviour by facility owner in this context. A threat of holding a monopoly facility owner to account under section 36 is empty unless the threat is credible. The threat is not credible because the time taken to obtain a positive result in the courts is too long. Section 36 cannot provide an outcome on the time scale needed for commercial decision making for development of a commercial (or marginally commercial) discovery. Even if a positive result is obtained; it does not provide guaranteed access – the commercial terms still have to be negotiated.

In practice, the problem does not seem to extend to access to port export facilities. A port owner has no incentive to “hold up” the development of a petroleum discovery by engaging in opportunistic behaviour; indeed, it is incentivised to assist in order to maximise use of its facilities and associated revenue. However, in practice, the problem may extend to pipelines for the transport of gas from processing facilities to transmission pipelines or the transport of liquids from storage facilities to an export port where land which must be traversed is owned by a competitor.

Solutions

The GIC recommendation for an information disclosure regime for gas processing facilities has been adopted as has a similar regime regarding pipelines. However by simply initiating an information disclosure regime, this does not stop facilities owners from charging monopoly rents or onerous conditions on those wanting access to their facilities designed to deter entry. As an example, Nova have come out and said that they have been able to construct by-pass pipelines in some locations because pipeline owners have charged excessive prices (see “National Monopoly in Gas Transportation”, paragraph 37,).

The same problem was highlighted by the Privy Council in *Telecom Corporation of New Zealand Ltd v Clear Communications Ltd* [1995] 1 NZLR 385 at 390:

“In the absence of guidance as to the principles applicable, the parties were, as the High Court said, “negotiating in a fog”. It is a regrettable fact that the decision of this appeal will only decide whether, in the past, Telecom has abused its dominant market position. It will not decide whether Clear’s past stance in negotiations was reasonable, let alone fix the terms for interconnection.”

All three types of facilities – pipelines, processing and storage facilities – form a vital part of the production chain for the gas industry. All three facilities are fundamental and are needed to process the products. Therefore access to all three facilities should be treated similarly. Under the status quo, access to these three facilities is treated differently and third party access to both the facilities and relevant information is regulated to different degrees. Access rights and being able to gain information needs to be standardised throughout the industry.

It is helpful to consider the policy environment as evidenced by the Crown Minerals Act 1991 (the “CMA”). Under the CMA, the Minister of Energy has published the Minerals Programme for Petroleum (2005). It notes that the fundamental policy is:

“To promote the responsible discovery and **development** of New Zealand’s petroleum resources that contribute substantially to our economy, consistent with... the Crown obtaining a fair return from the extraction of petroleum...” (section II, 5).

In relation to the meaning of the term “fair financial return”, the Minerals Programme notes that the attractiveness of the petroleum regime to investors is a relevant consideration (chapter 2, 2.13). Also, it records that, in particular, the Crown wants to ensure that there will be sound management of petroleum resource extraction, including the avoidance of unnecessary waste.

The point here is that these policy objectives cannot be met by regulatory regime for exploration and production *per se*; it has to be also met by a regulatory regime for other components in the supply chain upon which production is dependent *e/g/* access to processing, storage and export facilities.

Another way to look at it is to consider the way the CMA deals with others who may by chance have a monopoly position and engage in opportunistic behaviour. Under section 53 of the CMA, the holder of a petroleum permit cannot enter upon the land subject to the permit to exercise rights under the permit (for other than minimum impact activities) otherwise than in accordance with an access agreement agreed with the owner or determined by an arbitrator in accordance with the Act. Here, the CMA recognised that the land owner would (but for the permit holder’s access to compulsory arbitration) by chance have a monopoly and engage in opportunistic behaviour which could frustrate the policy objectives of responsible development of New Zealand petroleum resources, ensuring that the regime is attractive to investors and sound management of the resources.

Conceptually, is there any difference between the land owner who, by good luck or good management has monopoly rights to control access to a petroleum discovery and can render its development inefficient or uneconomic and the facility owner who again, by good luck or good management, has monopoly rights to capacity of facilities and can render the development of a petroleum discovery inefficient or uneconomic?

Notwithstanding, the facility owner must be rewarded for its investment in capacity. It always remains open for the owner to invest in “just enough” capacity or “more than enough capacity”. However, if the regime ensured a fair financial return on investments by appropriate asset valuation and rate of return methodology, the owner might well be encouraged to invest. After all, New Zealand has substantial experience in incentive based regulatory intervention *i.e.* Part 4A Commerce Act 1986.

If the Government is indeed serious about its objectives and, indeed, if the oil and gas sector is serious about promoting the efficiency and effectiveness of the regime for investment in petroleum exploration and production, then both need to look at extending the information disclosure regime beyond processing facilities and supplement the regime by compulsory arbitration.

After all, this is not without precedent. The Australian Trade Practices Act 1974 (the “Act”) is a key piece of legislation to support the development of a competitive environment for the operation of key infrastructure facilities. Part IIIA of the Act establishes a regime in which third parties can obtain access to services provided by owners or operators of key infrastructure facilities. In the event that a private commercial arrangement cannot be negotiated between the parties, either party

can request the Australian Competition and Consumer Commission to arbitrate the dispute and make a determination through the application of specific statutory criteria.

However, are oil and gas sector participants reluctant to promote such regulatory intervention, because one day they might be the “would be” developer seeking access and, on another day, be the owner of facilities with excess capacity and able to engage in opportunistic behaviour by offering access at monopoly rent?

In my view, all stand to benefit if the “blunt instrument” provided by section 36 of the Commerce Act 1986, is supplemented by the narrow instrument of an extended information disclosure regime, compulsory arbitration which requires pricing by reference to modern and realistic asset valuation and rate of return methodologies. They all stand to benefit as they can be “winners on both days” and be part of a sector which has a more certain regulatory regime (which provides fast and pragmatic results) and, therefore, is more attractive to investors.

Author

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