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Gas Joint Ventures and Competition

Court battle over production limits at New Zealand's largest gas field

The New Zealand High Court completed a nine week trial earlier this year of what many have called a 'David and Goliath' battle between joint venture partners Todd Energy, and multinationals Shell and OMV, over how much gas can be taken from New Zealand's largest gas field. However, unlike David's fatal slingshot, the Court has had to deal with an array of complex commercial, economic and legal issues which will have major effects on the gas industry in New Zealand and elsewhere. This note focuses on the competition issues raised by the case.

The Dispute

The dispute centres on how much gas Todd was and is entitled to lift from the Pohokura gas field. The Pohokura joint venture (JV) partners failed to agree a Gas Balancing Agreement (GBA) when they decided to separately market their gas entitlements. They sold initial tranches of gas to fund field development, but at some unspecified date Shell and OMV determined by absolute majority vote that the joint venture partners could only lift an annual maximum of 70PJs, some 16 PJs below the field's production capacity (although this is in dispute).

Todd objected to this production constraint (called the 'Offtake Rules') imposed on it by its JV partners. Todd asks the court to agree that the JV agreement allows it to take up to its full annual equity entitlement of capacity production, and/or that the Offtake Rules imposed by Shell and OMV are anticompetitive as they withhold supply which substantially lessen competition under the *Commerce Act 1986*. It claims damages in excess of NZ $300m.

Market definition

As one would expect defining the relevant market was a crucial matter - is it gas, gas plus coal, gas in New Zealand or wider; and/or should it embrace production, exploration and field development.

The disagreements centre on two empirical issues: 1) how to treat the 35% reduction in New Zealand's estimated gas reserves (the so-called 'Maui Redetermination') which dramatically increased the price of gas; and 2) whether the court should focus on the gas market or some more complicated set of market relationships which required it to take into account not only gas but other fuels and upstream activities.

On the first issue econometric evidence was adduced by the Respondents' expert that the demand for gas in New Zealand was very price elastic - above -1 and perhaps as high as -4 (although during trial this figure fell to -1 or less). This finding was not consistent with independent published estimates which found that the wellhead demand for natural gas is inelastic, suggesting that it constituted a self-contained relevant product market rather than a wider interfuel market. Indeed, the high estimated elasticities put forward by the Respondents' expert suggested that the demand for gas was the same as for a restaurant dinner, which was implausible. Furthermore, the data used for these estimates was flawed and pointed to the dangers of slavish reliance on econometrics, especially given that the legislation requires market definition to be based on fact and 'commercial common sense' (perhaps the only piece of legislation that requires lawyers and economists to exercise common sense).

Another issue raised but not exhaustively treated by the economist witnesses was over what time period markets should be defined. The widely used SSNIP test is often treated as a short term test (one to three years). However, the long run elasticity of a product is usually greater than the short run elasticity of demand, and hence market definition may differ depending on the time period chosen. The Respondents' suggestion that the relevant time period was the life of the field (perhaps 25 years) was equivalent to the claim that the relevant market was not gas production but effectively a market for gas and oil joint ventures inclusive of exploration activity. This approach to market definition did not seem to address the competition complaint. It also defined away any possibility that a JV could act anticompetitively since any alleged supply constraint or other abuse would have taken place in a very broad market. Unfortunately New Zealand law is relatively silent as to the time period to be used, and Australian precedent is uncertain with courts and tribunals stating that a long time period should be used where appropriate. It is hoped that the Court will shed some light on this issue.

Joint venture economics

There were sharp differences as to the legitimacy and effects of judicial intervention in joint venture agreements. The Respondents characterised Todd's decision to litigate as a minority shareholder seeking to expropriate the majority JVers property rights through the courts. Todd claims that its JV partners engaged in actions which breached the JV agreement and are anticompetitive. Clearly, competition law has an interest in the actions of joint ventures, especially production joint ventures which increase gas reserves and future competition, if the allegation is that the JV is now restricting production e.g. OPEC. These are issues which in other jurisdictions would be covered by the ancillary restraints doctrine (US) or essentiality requirement (EC), but on which NZ competition law is fairly silent.

From an economic/competition law viewpoint the differences involved a number of interrelated issues. The first is whether competition issues should treat the joint venture as the basic unit i.e. the analysis should take a cradle-to-grave perspective by taking into account the impact on production decisions on future gas and oil exploration and field development. The proposition advanced by the Respondents was that if the court sided with Todd it would reduce the return and increase the risks of gas and oil exploration, and therefore was inherently anticompetitive.

The alternative, and it is suggested more robust, view is that markets and time periods should be defined with respect to the competition complaint. If a JV acts in a way that substantially lessens competition this cannot automatically be justified because of broader upstream efficiency concerns even assuming these were empirically established. The correct economic test is that the *ex ante* (impact on exploration and joint venture formation) should be balanced against the *ex post* (adverse impact on competition in the gas market) effects to come to some overall assessment. Also the Respondents' position (and the one just stated) assumes that the competition law standard is economic efficiency rather than consumer welfare. However in New Zealand law the former is a public benefits/authorisation test rather than competition test.

The NZ Commerce Commission (the authorisation Decision 505) considered similar claims to the Respondents and rejected these. It concluded that the *ex ante* effects (impact on exploration) did not automatically trump any adverse *ex post* conduct which substantially lessen competition, and moreover competition law intervention had to be viewed in probabilistic terms (i.e. in terms of the probability of *ex post* intervention) and was therefore likely to impose a small expected cost relative to the high returns to gas and oil exploration.

Gas contracts and swing

One issue to emerge late in the proceeding was swing. This referred to intra-annual variability in the demand for gas to satisfy peak demand. The Respondents argued that its major customers (mainly electricity generators) demanded swing, and that this attracted a price premium. As a result, as they further argued, gas fields had to operate below production capacity to accommodate peak demand. The issues here boil down to a factual one (whether swing was important and valuable?), and a Commerce Act one (whether those selling 'swing contracts' should be able to impose a production constraints on a shareholder (Todd) with a flat gas profile able to sell more gas?).

Gas balancing

One critical issue was how a jointly owned oil and gas field where the JV partners separately sell their gas entitlements is to balance uplifts over the life of the field. If each party uplifts are not balanced annually, there will need to be some arrangements in place which allow each JVer to obtain its full equity entitlements over the life of the field. If one party takes out more gas early in the life of the field, this increases reserve risks for the others with the prospect that they may not receive their full equity entitlements.

This problem raised contentious issues of alleged confiscation of JVers property rights, option value and reserve risks, together with how if the production constraint was declared void and/or a violation of the Commerce Act the parties' were to balance, either physically or monetarily, their gas take over the life of the field. There are no easy answers to these questions given that some fields were producing at capacity, some parties wanted to expand production, and the customer profiles of the parties differed, as did their ability to manage swing.

The judicial answer to all these questions will have to wait for the court's decision expected in late 2010

Dr Cento Veljanovski was an economist expert for Todd on the competition issues raised by the dispute. Todd was represented by Russell McVeagh and James Sweeney QC.

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