InterOil

APPLICATION FOR AUTHORISATION

TO

INDEPENDENT CONSUMER AND COMPETITION COMMISSION (ICCC)

FOR

ACQUISITION OF **SHELL** PAPUA NEW GUINEA LIMITED

21 NOVEMBER 2005

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1. PURPOSE

As required by Section 82 of the Independent Consumer and Competition Commission Act 2002, **InterOil** (the "Applicant") is seeking approval to acquire **Shell** Papua New Guinea Limited ("**Shell PNG**"). Section 82(3b and 3c) of the Act provides that the ICCC shall–

b) if it is satisfied that the acquisition will result, or will be likely to result, in such a benefit to the public that it should be permitted…an authorization for the acquisition; or

c) if it is not satisfied as to the matters referred to in Paragraphs (a) or (b)…decline to give a clearance or grant an authorization for the acquisition.

This application provides background to the Proposal as well as a basis for seeking approval. The application provides a detailed outline of the competitive environment for fuel distribution in Papua New Guinea, the expected impact on competition, and a review of benefits that should accrue to the State, its citizens, and the business environment.

2. BACKGROUND

2.1. History of Domination by the Majors

Until recently, Papua New Guinea's Petroleum Products Distribution ("PPD" or "Downstream") industry has been dominated by the presence of three major oil companies: **Shell**, **Exxon-Mobil** and **BP** (collectively referred to hereinafter as the "Majors"). Establishing PPD operations in any country requires significant capital investment, experienced management, and an administrative, accounting, and legal infrastructure sufficient to comply with robust regulatory standards. It is an industry that is not well-suited for start-up enterprises, and competing with the Majors is difficult; the companies best suited to compete with the Majors are, not surprisingly, other Majors, which is why it is so common for the Majors to dominate regional and even local petroleum product distribution industries worldwide.

Shell, **Exxon-Mobil**, and **BP** are not just large oil companies; they are the three largest oil companies in the world, both in terms of revenues and profits.

THE MAJORS		
	K billions	
	Revenues	Profits
Exxon-Mobil	K 918	K 78
BP	K 909	K 50
Shell	K 817	K 57

Though large and endowed with what appear to be limitless resources, global giants face continuous pressure to grow and expand. At any given time these companies are evaluating thousands of opportunities to invest capital and management, and each opportunity, or project, must compete with all other projects. Rigorous internal "rate of return" standards are applied. Faced with continuous pressure to become increasingly efficient and cost-effective, large organisations are careful not to dissipate their limited management on projects that do not represent meaningful profitability for the overall enterprise.

In order to gain a full appreciation for Papua New Guinea's significance on the radar of these organisations…which has implications for future investment and long-term commitment to Papua New Guinea, it may be helpful to consider how important the Papua New Guinea's PPD business is to these organisations, and comparing with the Applicant:

2.2. Significance of Papua New Guinea Business For Local Operators

SIGNIFICANCE OF PNG OPERATIONS			
Barrels Oil Per Day	InterOil	Exxon-Mobil	Shell
PNG Market Volume	4,400	6,000	7,000
Global Downstream Volume	4,400	8,210,000	7,600,000
PNG As % of Company's Total	**100%**	**0.07%**	**0.09%**

Thus in terms of relative importance to each respective company's operations, it would be accurate to say that Papua New Guinea's business is more than *fourteen hundred times* as important for **InterOil** than it is for **Exxon-Mobil**, and more than *nine hundred times* as important as for **Shell**.

The Papua New Guinea market is one of many for the Majors, and they are justified in allocating their attention and capital accordingly. In contrast, Papua New Guinea is **InterOil**'s *only* market.

Similar analyses could be carried out for other major oil companies that have left Papua New Guinea entirely, such as **BP** and Chevron.

In the specific case of **Shell**, faced with internal and external pressure to rationalise operations worldwide, a decision was made to reduce its activity in Papua New Guinea, resulting in their desired exit from the downstream business in Papua New Guinea. This Proposal evolved from this process, first beginning as a planned sale-and-leaseback, foreshadowed in **InterOil**'s original filing with the ICCC on 2 April 2004, in which it sought approval to acquire **BP**'s distribution business (and for which approval was granted on 14 April 2004).[1]

3. PETROLEUM PRODUCTS DISTRIBUTION MARKET

3.1. Establishment of Terminal and Depot Operations

In the early period of their operations in Papua New Guinea, the Majors' involvement was characterised by significant capital expenditure aimed at setting up a network of distribution locations in various parts of the country. The Majors set up their own terminal and depot operations, each similar to the other, in the major commercial centres around Papua New Guinea such as Port Moresby, Lae, Madang, and Rabaul, as well as in the centres of lesser commercial activity such as Wewak, Kimbe, Kavieng, Mt Hagen, Goroka and Alotau.

Aside from their early investment in their downstream distribution activities, some of the Majors were involved in upstream exploration activities, injecting significant capital into Papua New Guinea's economy by way of exploration aimed at discovering and developing untapped oil and gas reserves within the country. Such development and investment in Papua New Guinea was a welcome contribution to the country and its economy, contributing to growth and economic

[1] In its original submission and in a follow-up letter of 8 April 2004, InterOil assured the ICCC that it would "… not enter into any key commercial terms of supply with any existing or future customer (including its own subsidiary) which are discriminatory or preferential in any way." The ICCC's approval of the submission was made on the basis of these assurances. InterOil has followed through with this commitment and no such preferential arrangements have been entered into.

expansion; moreover, these companies provided employment, training, and coaching opportunities to Papua New Guinea nationals. Papua New Guinea's workforce skills were developed and nurtured during this period.

3.2. Papua New Guinea's Importance to the Majors Declines

As the Majors' global operations expanded and their internal structures became more complex, their operations in Papua New Guinea declined in relative importance. Indeed the Papua New Guinea operations became little more than businesses of marginal significance to them in global terms. One by one, the Majors withdrew from a strategy of investing in Papua New Guinea, exiting upstream exploration activities and de-emphasising capital investment in their downstream operations. They provided what was required to maintain operations, health and safety standards, but as an attractive destination for exploration, development, and investment, Papua New Guinea was "off the radar."

The only long-standing exception may be **Exxon-Mobil**'s involvement in the proposed Gas Pipeline project, largely as a result of the 1998 merger between Exxon and Mobil.

The Applicant believes that all the Majors would exit their Papua New Guinea downstream businesses given the political opportunity to do so. This view is supported by **BP**'s recent exit, **Shell**'s willingness to divest their Papua New Guinea downstream operation, and Exxon-Mobil's handover of a portion of their downstream operations to Island Petroleum. Furthermore, none of the other multinational Majors have shown an interest in entering Papua New Guinea's downstream market with major fresh capital.

*3.3. **InterOil** is Fully Focused on Papua New Guinea*

As a major investor that is solely focused on Papua New Guinea's oil & gas Industry, the Applicant has a strong incentive to sustain, develop, and stimulate a vibrant domestic market for petroleum products. The Applicant considers the acquisition of **Shell** Papua New Guinea to be a major opportunity to strengthen its foundation in Papua New Guinea. While the existence of many smaller enterprises in the PPD industry is a healthy sign of competition, the health, strength, and long-term commitment of an "anchor company" such as **InterOil** is vital to the long-term and effective operation of the domestic market.

4. EMERGENCE OF NEW ENTRANTS

As the Majors' interest in Papua New Guinea declined, a number of new (and smaller) entrants have emerged in the distribution market, including **Niugini Oil Company** (NOC), **InterOil**, and more recently, **Islands Petroleum Limited** and **Niu Petro Oil**.

New Entrants PNG Fuel Distribution Market
InterOil
Islands Petroleum Limited
Niu Petro Oil
Niugini Oil Company

Unlike the telecommunications industry, firms willing to enter the petroleum distribution market do not need special licensing or regulatory approval; the only hurdle appears to be that the capital investment requirements can be significant. The decision to enter the Papua New Guinea market will always be an *investment* decision based on entrants' assessment of the prospective risks and returns on their investment in this market, as well as the attractiveness of the Papua New Guinea market relative to competing opportunities for capital and management time.

4.1. Niugini Oil Company

Niugini Oil Company (NOC) commenced operations 10-12 years ago by establishing a bulk distribution terminal facility in Lae. NOC has also established a bulk fuel depot in Mt Hagen to service the Highlands area.

NOC has successfully evolved, starting from a low base, to distributing approximately 25 million litres per annum from their two facilities. They have become significant competitors in the Morobe and Highlands markets.

Although the Majors have effectively terminated major new capital investments in their domestic facilities, NOC has recently completed the construction of two new bulk fuel tanks at their Lae terminal facility.

4.2. Islands Petroleum Limited

Islands Petroleum ("**IslandsPet**") is an independent industry participant that has been operating in the industry for many years as an agent for **Mobil** in the Islands region. **IslandsPet** has recently taken ownership of a number of terminal and depot facilities and has thus emerged as significant independent industry participant.

While remaining closely associated with **Exxon-Mobil**, the Applicant's understanding is that **IslandsPet** has now acquired ownership of the bulk fuel facilities at Kavieng, Rabaul, Kimbe, Popondetta and Alotau. If correct, this makes **IslandsPet** a major operation within the context of the domestic PPD industry. Although the Applicant does not have specific data, it is possible that **IslandsPet**'s volume could be far in excess of NOC's volume, thus making **IslandsPet** a significant participant in the domestic PPD industry.

4.3. Niu Petro Oil

Niu Petro Oil emerged as a participant in the downstream sector of the oil industry 12-18 months ago when it established a bulk storage depot facility in Mt Hagen. Niu Petro reportedly sources Diesel and Kerosene products from the Hides fields where a small straight run processing operation produces these products from gas reserves recovered in that area.

While in the context of the domestic PPD industry this is a relatively small operation, Niu Petro's entry demonstrates that entry into the downstream sector is available to anyone who is willing to set up the infrastructure necessary to participate.

4.4. InterOil

Papua New Guinea operations are **InterOil**'s sole business. **InterOil** has become one of the major investors in development projects in Papua New Guinea. This was most tangibly demonstrated with the successful development, completion, and operation of **InterOil**'s Oil Refinery at Napa Napa.

InterOil has invested heavily in all streams of the domestic oil industry. K231 million has already been expended in upstream exploration activity. InterOil invested K863 million in the construction and establishment of the oil refinery in Port Moresby. **InterOil** has also invested further in the downstream sector of the industry, with the K62 million acquisition in 2004 of **BP**'s downstream operation.

InterOil's activities have brought Papua New Guinea onto the world financing stage as all funds invested in these projects have been raised from overseas.

InterOil has made a long-term commitment to Papua New Guinea and has plans to invest significantly more funds in the oil & gas industry. An additional K385 million in capital has been raised and committed to invest in exploration over the next two years, seeking to unlock undiscovered oil and gas reserves, representing the largest single exploration program in Papua New Guinea's history. K31 million is being invested in an upgrade of the refinery, to include expansion of the tank farm and new infrastructure. K5 billion is planned for an investment in the country's first petrochemical plant.

The **InterOil** subsidiary engaged in the PPD business may also be referred to as **InterOil Products Limited**, or simply "**IPL**."

4.5. A Market of Niche Opportunities

At a time when the Majors are focusing their attention outside of Papua New Guinea, these downstream companies are emerging new entities that will take Papua New Guinea's PPD industry forward, generating new opportunities for investment, employment, training and resource development.

5. THE INTEROIL ACQUISITION OF SHELL PNG

In April 2001, **InterOil** and **Shell** PNG entered into an agreement whereby **InterOil** would acquire the Assets of **Shell** PNG and in turn **Shell** would lease those assets back ("Sale/Leaseback"). Under the Sale/Leaseback, **Shell** was to continue to operate the assets but would retain an option to relinquish their operation to **InterOil** and exit Papua New Guinea at any point into the future. The Sale/Leaseback was negotiated and entered into prior to the establishment of the ICCC; the only considerations relevant at the time were commercial economics.

The Sale/Leaseback was identified by the ICCC as a critical part of its review of **InterOil**'s application for approval of its acquisition of **BP**'s downstream assets (the "**BP** Transaction").[2]

The Sale/Leaseback was to come into effect after "practical completion" of the **InterOil** refinery. Practical Completion refers to the point in time when all performance and reliability tests have been completed, and the refinery would be ready for full operation. Practical Completion was achieved on 31 January 2005; however, issues between **Shell** and **InterOil** remained unresolved until very recently, and the companies are now in a position to proceed; however the original agreement has been revised to become an outright purchase of **Shell PNG's** assets and business by **InterOil**.

Whereas **InterOil** would have become the owner of the **Shell PNG** assets under either scenario (a purchase/leaseback or outright purchase), an outright purchase is better for the local business community because it means that the **Shell PNG** assets will now be operated by a company that is soley focused on Papua New Guinea. Such focus is optimal for world-class customer service.

During its review of the **BP** transaction, the ICCC, in its review of the statutory factors affecting competition, considered the ability of **InterOil** to increase prices or profit margins "with relative ease," and concluded, "*…with these products being regulated under the Prices Regulation Act, that opportunity is constrained.*"[3]

[2] Cited by the ICCC, "InterOil Acquisition of BP PNG Limited, Clearance Application," 14 April 2004, p.1: "…once the InterOil refinery has been completed…InterOil acquiring most of Shell's existing wholesale distribution assets and leasing them back to Shell for 10 years."

[3] ICCC, "InterOil Acquisition of BP PNG Limited, Clearance Application," 14 April 2004, p. 5

6. MARKETS AND COMPETITION

The ICCC will assess the proposed acquisition from many angles, but at the core of the ICCC's mandate is the analysis of competitive factors:

- What is the likelihood that the acquisition would result in the acquirer being able to increase prices or profit margins?
- What is the likelihood that the acquisition would result in the removal from the market of a competitor?

6.1. Relevant Market

The relevant market for purposes of this transaction is principally the wholesale market defined as the distribution of refined petroleum products in Papua New Guinea. The buyers in such a market include, but are not limited to, retail petroleum service stations, servicers of aircraft, mining companies and other major industrial projects requiring significant fuel deliveries.

The wholesale market for refined petroleum products in Papua New Guinea is estimated to reach 1 billion litres in 2006 (**InterOil** estimates). Primary growth in the market is a function of industrial demand (mining, oil drilling, and major infrastructure projects).

6.2. New Entrants

As set forth above, a number of new entrants have emerged in the wholesale market, including **Niugini Oil Company** (NOC), **InterOil**, and more recently, **Islands Petroleum Limited** and **Niu Petro Oil**.

For purposes of setting forth approximate market shares, the Applicant is grouping its estimate of **Islands Petroleum Limited**'s volumes (which are unknown) with **Exxon-Mobil**'s, due to the former's close association with the latter:

Market Share	
	% of Mkt
Shell PNG	41%
Exxon-Mobil/IslandsPet	34%
InterOil	20%
NOC	5%

The smaller and relatively new entrant is **Niu Petro Oil**. At present, NPO's volumes are not large enough to have a material impact on market share calculations. It should be noted that 6% of Shell's Market share is comprised of two major mining accounts, OkTedi & Porgera. Supply to these accounts is by way of a cyclic tender basis and thus any supplier has the capacity to tender for and supply these accounts. Thus the "base" market share, when these "open for tender accounts" currently serviced by Shell are excluded, is approximately 35%

6.3. Ensuring a Competitive Marketplace

In analysing the competitive framework in Papua New Guinea, it should be recognised that the market in Papua New Guinea is not "perfectly competitive."

Perfect competition—the most competitive market possible—occurs when there are a large number of sellers and buyers of a homogeneous commodity, and each seller supplies and each buyer purchases only a small fraction of the total supply of the commodity. As a result, no single seller or buyer can influence the market price. The sellers earn only normal profits (the minimum profit necessary to keep them in business). If sellers earn excess profits, other sellers will enter the market, boosting the supply and thus driving down the price of the commodity, until only normal profits are possible.

In the Papua New Guinea downstream market, neither buyers nor sellers are numerous. A majority of the sellers provide a large fraction of total supply. Several buyers purchase meaningful fractions of total supply. "Supply" itself is not a long-term concern because any shortage in domestic supply can readily be made up by an efficient import market. The commodity, oil, is priced in world markets and the domestic distributor margin is controlled by the ICCC.

Thus it is essential, in any analysis of the effect on competition, to acknowledge that Papua New Guinea is not a perfectly competitive market, a position that the ICCC has acknowledged in prior statements. Nevertheless, the Applicant respects and appreciates the ICCC's role in assuring a "level playing field" for everyone who wants to participate in Papua New Guinea's markets.

6.4. Industry Concentration

Papua New Guinea has six (6) oil companies engaged in wholesale distribution. This is not uncommon in world markets. The high capital costs, need for experienced management, and, most importantly, the foundation of local demand for refined product, each serve to limit the number of companies that can effectively compete in a market.

6.5. Price Competition

The dominating factor impacting the competitive environment for refined petroleum products is the Pricing Regulations Act, which came into effect in September 2004:

> "Under the revised pricing arrangements that commenced in September 2004… Apart from being mainly a monitoring process, the Commission's role insofar as fuel pricing is concerned also involves some price control activities. Specifically, *the wholesale and retail margins wholesalers and retailers of fuel products can charge are price controlled*. The Commission also monitors freight charges that are factored into the final pump prices of fuel products."
>
> (ICCC, http://www.iccc.gov.pg/monitoring)

The government has declared the following petroleum products for price control purposes:

- Motor Spirit (Petrol or Mogas)
- Distillate (Diesel)
- Kerosene (Home cooking Kerosene)
- Aviation Gasoline (Avgas)

The effect of the regulation makes analysis of the "pricing" side of the competitive equation moot: all wholesalers pay the same price for refined product when purchasing from the **InterOil** refinery; furthermore, the margin that distributors may charge is specifically capped at a current rate of 24 toea per litre. Competition for the larger industrial contracts usually keeps the wholesale distributor margin well below 24 toea; in fact, if an industrial end-customer does not like the service they receive from any distributor in the market, there is nothing to stop them from becoming a distributor and bypassing *all* competitors in the market.

Thus the answer to one of the two main questions faced by the ICCC in evaluating the Applicant's Proposal, *"What is the likelihood that the acquisition would result in the acquirer being able to increase prices or profit margins?,"* is clear: **There will be no ability by InterOil or any other distributor to raise wholesale or retail margins as these are controlled soley by the ICCC.**

The government, through the ICCC, continuously monitors prices in conjunction with **InterOil**, pursuant to the refinery project agreement:

> "Final IPP changes and other relevant data are sent to the Commission by **InterOil** Ltd at the end of each month. Upon confirmation of the data by the Commission the price changes are then passed through to the final pump price incorporating excise duties, freight charges and GST. Domestic fuel prices in PNG are primarily influenced by world crude oil price movements"
>
> (ICCC, http://www.iccc.gov.pg/monitoring)

6.6. Freight Costs

The final market price paid by a consumer is significantly influenced by the cost of delivery to the consumer. Such costs include sea freight, port handling costs, demurrage costs, road freight, depot and terminal handling costs and insurance. The ability of the wholesaler to distribute efficiently is very important; in Papua New Guinea wholesalers do not own or operate shipping or road transport fleets; therefore, wholesalers and their customers rely on third-party shipping and road transport operators to provide transport services. Large transportation companies with economies of scale can have some influence over freight and transportation costs.

6.7. Other Factors that Affect Competition

The number of firms in a given industry is one factor in the competitive landscape; there are others. For example, in Papua New Guinea there are a diminishing number of participants in the transport sector. Until the internal road structure is upgraded significantly, giving confidence to prospective operators that their transportation assets can be both utilised and protected, this is unlikely to change in the near future. Prospective new entrants to the Papua New Guinea transportation market face a combination of barriers to entry: sub-optimal infrastructure, price regulation, and a perception of sovereign and currency risk.

Most observers would agree that infrastructure (roads, bridges, airports, power lines, water supply, energy, telecommunications and information) is one of the most critical factors influencing economic competitiveness. Lack of proper infrastructure can contribute significantly to reduced competition in Papua New Guinea and is more of a real barrier to the entry of new firms. Coping with high transportation costs raises the bar for entrants to any industry; fuel distribution is no exception. The Applicant believes freight and transportation costs, and not pricing of the core product, represent the most significant impediment to new entrants. More competition in the transport industry would be a welcome change for all market participants in Papua New Guinea, strengthening the competitive landscape across the board.

6.8. Government Regulation

Whereas government regulation can be a significant impediment to a smoothly functioning, competitive marketplace, the Applicant believes the current regulatory environment is working efficiently and is well structured. The degree of control that the government is exerting over the economy has been measured and appropriate for the market's nascent stage of development. The government has consistently demonstrated a keen interest in stimulating economic activity, while taking care not to allow abuses of market power.

6.9. Market Segmentation

The PPD market in Papua New Guinea should not be viewed as a single, integrated market; rather, it should be seen as the sum of individual regional markets, with many significant individual markets located quite remotely from other markets. Indeed, competition in many of Papua New Guinea's market segments is driven more by logistics than by price competition. The logistical hurdles of conducting business in many parts of Papua New Guinea are sufficiently high that it is rare to see more than one or two players in any given market with the exception of Port Moresby and Lae.

In assessing this submission it should be noted that **Shell** currently does not have a presence in many of Papua New Guinea's markets. Specifically, **Shell** does not operate in the following areas: Oro Bay, Wewak (non aviation), Alotau, Vanimo, Daru, and Bougainville.

Markets With No Shell PNG Presence
Alotau
Bougainville
Daru
Oro Bay
Vanimo
Wewak (non-aviation)

A re-branding of **Shell**'s business entity will thus have no impact in these areas. In areas where **Shell** is the sole supplier, the rebranding of **Shell**'s business by **InterOil** would yield no change in the number of competitors.

*6.10. The **Shell** POM Terminal*

Shell's POM Terminal will become redundant once ex-road sales commence from the refinery. Thus in a re-branding of **Shell**'s downstream business, even though control of the terminal assets would pass to **InterOil**, these assets will have no impact on competition. In fact, *additional* distributors are likely to enter the market as one of the primary barriers to entry (storage facilities) will no longer be an impediment. As set forth in other parts of this submission, **InterOil**, as operator of the refinery, will always be a major supporter of stimulating the maximum possible demand for refined products, as well as a more diversified base of customers…which means greater competition among buyers of refined product from the refinery.

*6.11. **Shell** Lae / Madang / Rabaul / Kimbe / Kavieng Terminals*

Volume currently cannot support three terminal infrastructures (four in Lae) in each of these locations and rationalisation of terminal facilities is likely to occur regardless of whether **Shell**'s business is re-branded. Although not readily visible to market participants, excess infrastructure such as these terminals, impose a cost on the market and consumers. While that cost may not affect product pricing directly, it makes its way into the market through other cost control measures necessitated by the inefficient carrying of sub-optimally utilised assets. Rationalising these assets means greater volume will drive down the cost of operating these terminals, which in turn will mean lower costs to consumers. The passing to **InterOil** of excess terminal control may speed such rationalisation, but is unlikely to affect competition for the provision of refined product to consumers.

6.12. Aviation Sector

In the case of aviation, current supply is via **Shell** and **Mobil** through company-owned assets at airfields. In the InterOil/Shell agreement under consideration in this application, InterOil will acquire Shell's aviation assets at all "up-country" sites (all sites other than the international facility at Port Moresby) Thus future supply would be via IPL (**InterOil**'s downstream division) at the up-country sites and via **Mobil**, so the competitive structure would not change. There will still be two suppliers and there would be no effect on competition.

6.13. Mining Sector

The mining sector, in volume terms, is dominated by three or four large mining customers with two of them currently being supplied by **Shell**, namely OKTedi Mining Limited (OTML), and Porgera Joint Venture (PJV). It should be noted that the OTML account is serviced ex POM and therefore this volume will be sourced ex the refinery wharf and therefore open to competitive bids from all incumbent marketers or new marketers. In the past only **Mobil** and **Shell** could supply due to storage capabilities. Now any distributor can structure a supply arrangement ex the refinery as **Shell** currently does.

With reference to PJV volume which is serviced ex Lae, it is important to emphasise that in the past only **Shell** and **Mobil** could supply due to storage capabilities and shipping schedules. In this regard nothing will change as there will still be two distributors readily able to contest for supply to this account. In fact it may be easier for other distributors to compete given the change in logistics of supply with the Port Moresby refinery being of much closer proximity than previous overseas sources of supply.

6.14. Retail Sector

Retail volumes tend to be tied to head leases or site ownership. Where the head lease is with the oil company, retail sites could be regarded as "company-owned" and a **Shell** exit would mean a switch of that asset to IPL. Where the head lease or ownership is with a dealer, the site owner makes an independent decision regarding supply, and thus a **Shell** re-branding would not necessarily mean a switch of that volume to IPL.

Competitors contest for supply agreements to dealer-owned sites based on their reputation as reliable suppliers, and their ability to manage relationships with customers. If individual distributors, including IPL, do not handle relationship management in an effective manner, they will struggle to maintain customer loyalty regardless of how many entities they are competing with.

6.15. Commercial Sector

Commercial assets which form part of a supply agreement typically consist of small tanks and pumps and are tied to supply contracts of short to medium duration. The value of such assets is usually not significant relative to the prospective value of fuel to be purchased pursuant to a new fuel supply agreement. As these contracts expire, and if a change of supplier is decided upon, the equipment is customarily either purchased by the customer or by the new supplier. Thus competition is not impacted by ownership of commercial assets tied to existing supply contracts.

6.16. Marine Sector

In servicing the marine bunkering sector business the most notable point of differentiation between **Shell** and other existing competitors is the existence of the dedicated bunkering facility that **Shell** operates in Port Moresby. In other locations, competitors have developed a similar ability to bunker ships should they so choose, with bunkering by road being a common method adopted.

In Port Moresby, **Shell**'s marine customers are currently serviced via a bunker facility attached to **Shell**'s Idubada Terminal[4]. **Mobil** also operates a dedicated **Mobil** bunkering facility at the main wharf in Port Moresby harbour. Thus a re-branding of **Shell**'s downstream business would simply mean a different competitor in the bunker facility portion of the business, not fewer competitors.

6.17. State of Competition and the Effect on Competition

At present there are six downstream companies in the market. The proposed acquisition will reduce the number of firms in the market to five.

[4] The Applicant believes the Idubada Terminal is in need of upgrading to modern standards and expects to carry out such an upgrade as part of its overall capital expenditure plan.

The reduction in the number of firms competing for PPD business is not likely to effectively reduce competition primarily because distributor margins are regulated and monitored by the ICCC. Oil-based products (motor spirit, diesel, kerosene and aviation gas) are declared products for price control purposes, and these products represent over 90% of the product consumed in Papua New Guinea. The number of firms in the market influences neither the cost of product to distributors nor the distributor margins earned upon sale to consumers.

The only impact likely to be seen by consumers and customers of downstream operations is the rationalisation of terminal assets, which will improve the cost structure of the industry by removing redundant and underperforming assets from the market.

6.18. Capped Distributor Margins Limit Pricing Power

The government's regulatory framework regarding pricing is the most critical factor underlying the competitive landscape. Distributors are currently limited to a gross profit margin of 24 toea on the sale of any refined product. While this limit has positive implications for the cost to end-users, it puts more pressure on distributors to rationalise their assets, taking care not to allow their cost structures to grow out of line with the profitability allowed by the government.

Even if there were a concern that the government may reduce its control over pricing in the wholesale market at some point in the future, a look to other markets worldwide would demonstrate that the PPD market becomes efficient to the point where it is impossible for distributors to impact prices. A look to the United States, for example, where there are no price controls on allowable distributor margins, shows a robust competitive market for distribution contracts, and remarkably consistent pricing throughout the country, despite a total lack of government intervention in pricing.

The current regulatory arrangements under the Prices Regulation Act allows the ICCC to review the Import Parity Price components of fuel products on a monthly basis and wholesale margins and distributions costs on an annual basis. ICCC also determines the wholesale margin, the sea freight deferential and also sets the retail margin for service stations.

6.19. Size of Papua New Guinea's Market and Nature of PPD Industry Assures Competition

Papua New Guinea's market, with total industry demand of approximately 1 billion litres per annum means that a healthy competitive environment will be assured with the remaining competition that exists in the industry. **Exxon-Mobil**, who continues to operate a network of depots and terminals in Papua New Guinea, will provide a major competitive force. In addition, there are existing and emerging independent operations such as NOC, **Niu Petro Oil** and Islands Petroleum Limited who collectively operate a number of depots and terminals throughout the country. As detailed below, these and other aspiring entrants will have significant opportunities to grow their market presence through initiatives that **InterOil** is proposing in the Wholesale sectors.

To address lingering competitive concerns, **InterOil** intends to adopt a number of measures to ensure that a healthy competitive environment will emerge within the industry's downstream activities.

Competition in the "up-country" Aviation, Marine and Mining sectors, where effectively there are only two players operating, will not be affected because **Shell** will be replaced by **InterOil** and **Exxon-Mobil** will still be in the market. Thus two firms remain in those segments of the market where two firms currently service local demand.

6.20. Horizontal and Vertical Integration

InterOil concedes that its proposed acquisition will augment horizontal integration by reducing the number of firms in the wholesale market by one player. The ICCC should bear in mind, however, that **Shell** PNG has concluded it is in their best interest to exit. The horizontal integration does not have much effect on competition in markets where **Exxon-Mobil** is the other competitor, as is the case in the aviation sector, and in a number of seaport locations. It is also important to note that **Shell** does not have a presence in many parts of the country.

How effective will **Exxon-Mobil** be as a competitor to **InterOil**? A quick review of the relative size of these companies leads to an easy conclusion:

Exxon-Mobil and InterOil		
	K Millions (2004)	
	Exxon-Mobil	InterOil
Revenues	K 918,436	K 219
Assets	K 616,400	K 1,190
Cash on Hand	K 77,050	K 133
Market Value	K 1,248,210	K 1,849
Countries	100	1
Refineries	45	1

InterOil is neither a match nor a threat to Exxon-Mobil. Exxon-Mobil has the financial capacity to do whatever it wants around the world. InterOil can only hope to provide meaningful competition to a K918 billion (revenues) company.

7. STATUTORY FACTORS UNDER SECTION 69(5) OF THE ACT

In addition to the Applicant's position that the acquisition will not substantially lessen competition in the market under a regulated pricing regime, the Applicant understands that the following matters will be taken into account when assessing this submission and the Applicant's views are as follows:

7.1. Import Competition in the Market

By government mandate, all distributors must source their supplies from the refinery in Papua New Guinea; however, distributors may continue to import refined products not produced by the refinery.

7.2. Barriers to Entry

Although barriers to entry exist, they are not product price-related. Even the large differential in financial resources between competitors, which could allow some to gain internal cost efficiencies as they spread costs across larger enterprises, is not a factor in a market where the product price is controlled by the government.

The establishment of the refinery in Port Moresby has enhanced access to the Port Moresby market for all players. New players can enter the Port Moresby market with minimal capital requirements for stock holding facilities. The recent entrance into the market by Islands Petroleum Limited and **Niu Petro Oil** demonstrate that entry is possible by non-Majors.

Although **Exxon-Mobil**'s (2004) downstream net income was more than *1,500 times* that of **InterOil**'s (2004) downstream net income, **InterOil** hopes to provide healthy competition for **Exxon-Mobil**.

Exxon-Mobil and InterOil DOWNSTREAM PROFITS (2004) (K millions)	
EXXON-MOBIL	K 17,567
INTEROIL	K 11

7.3. Number of Buyers and Sellers in the Market

There are currently six players in the market, and the proposed acquisition will reduce the number of participants to five.

As set forth earlier, the Papua New Guinea market is sharply segmented in geographical terms; players do not operate in all parts of the country, with each player picking and choosing which markets make economic sense for them. Historically, in the outer ports, there have only been two firms in competition with each other, and this situation will not change after the proposed acquisition. The number of firms in the important sectors like aviation, commercial and marine are unlikely to notice any change in the number of firms supplying refined products.

7.4. The Degree of Countervailing Power[5] in the Market

The Papua New Guinea Government exerts a firm hand in the regulation of the petroleum market. With a relatively small number of players, and with communication between the players and the government being very good, the government has been successful in bringing industry into voluntary compliance with pricing and supply mandates. A strong desire among market participants to cooperate with government's stated desire to stimulate economic growth has led to an effective countervailing force: government regulation and the willing compliance with those regulations by industry. An example would include industry shipping arrangements entered into to minimise freight costs, leading to lower costs to consumers.

*7.5. **InterOil** Cannot Increase Distributor Margin*

The government, through regulation, controls prices of motor spirit, distillate, kerosene and aviation gasoline. On the sales price side, where distributors are selling products to their customers, the government regulates the distributor margin, currently capped at 24 toea per litre.

7.6. Substitutes

There are limited opportunities for substitutes in this industry. Any new refined petroleum product which has a likelihood of being demanded by the local market will in time become available through the refinery in Papua New Guinea.

7.7. Characteristics of Growth, Innovation, and Product Differentiation

Oil-based products are a global commodity; innovation and product differentiation may be available at the "high performance" end of fuel demand in developed nations, such as Formula 1 racing; however, these fuels are rarely in demand in developing countries.

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[5] **Countervailing power** is the theory of political modification of markets. In the classic liberal economy, goods and services are provided and prices set by free bargaining. Modern economies give massive powers to large business corporations to bias this process, and there arise 'countervailing' powers in the form of trade unions, citizens' organizations etc, to offset business's excessive advantage. Source: J K Galbraith, The Anatomy of Power (London, 1984)

7.8. Potential Removal from the Market of a Competitor.

Shell is by any measure a vigorous and effective competitor. The Applicant has no doubt that **Shell**, if they wanted to, could dominate the Papua New Guinea market. However, **Shell** has to contend with global industry and economic pressures like any other Major, and of course they are not required to remain in Papua New Guinea. Indeed, none of the Majors are required to stay in Papua New Guinea. They stay as long as it makes economic sense for them to stay. While it may be argued that the acquisition *appears* to have the effect of "removing" **Shell** from the market, the fact is that **Shell** is in the process of focusing their assets and capital in larger markets. The acquisition merely insures that the assets are taken over by competent local management, and by a company with a long-term vested interest in a robust Papua New Guinea economy.

7.9. The Nature and Extent of Vertical Integration in the Market.

The acquisition of **Shell PNG** will make **InterOil** the largest wholesaler and distributor of oil-based products in Papua New Guinea; however, as set forth throughout this submission, the Applicant does not believe this will have any significant influence on prices (which are capped by the government-regulated distributor margin) or supply.

The acquisition will result in market share growth from **InterOil**'s existing 20 percent of the market. Assuming that there is no movement in the customer base, it is anticipated that **InterOil** after the acquisition will have the majority market share, but purely dedicated to the national interest of Papua New Guinea.

The acquisition will also have an element of enhanced vertical integration by reason of **InterOil**'s ownership of the refinery and its investment in exploration of oil and gas in Papua New Guinea. It is important to note, however, that all oil companies are free to invest in upstream exploration activities. There is no restriction and there are no barriers to entry. **Shell** and **BP** operate refineries in other countries and sell their refined products through their own network of companies. **BP**, for example, refines petroleum at its Bulwer Island refinery in Brisbane, then delivers its own refined products to its own retail outlets within the same market in Brisbane. Indeed, there is nothing to prevent any of the majors from proposing an additional refinery in Papua New Guinea and doing the same thing.

8. BENEFITS AND POSITIVE OUTCOMES OF THE PROPOSED ACQUISITION

8.1. *InterOil in Papua New Guinea*

8.1.1. *InterOil Follows Through*

InterOil is the only oil company in Papua New Guinea that has followed through on significant, diversified domestic investment, not only in upstream exploration activities, but also in midstream and downstream operations. **InterOil** was the first company to establish an oil refinery in Papua New Guinea, and they did so in the face of fierce opposition from well-established refineries in the region, especially Singapore and Australia. No one in the oil industry wanted to see a refinery in Papua New Guinea, because it provided competition for a well-entrenched group of major refineries elsewhere. It was a bold decision by InterOil to invest in Papua New Guinea given the competitive landscape, outside perception of enormous political risk, lack of precedent for a refinery existing in the country, and the lack of industry support for such an investment.

8.1.2. *InterOil Brings Capital into Papua New Guinea*

InterOil brought capital into the country at a time when demand for the Kina had evaporated. At a time when the Papua New Guinea economy and its currency, the Kina, had nearly collapsed, InterOil was buying Kina and investing money throughout this period. The result was a significant contribution toward the rise in the Kina from US$0.17 to US$0.32. By some estimates, this saved Treasury over K200 million in lower effective external debt service payments. The effective result was a substantial indirect benefit for Papua New Guinea consumers.

In establishing the refinery, **InterOil** has successfully brought to Papua New Guinea new international financing facilities for its refinery project. OPIC (Overseas Private Investment Corporation), an agency of the US government, provided a K262 million debt-financing facility for the construction of the refinery.

BNP Paribas provided a K 462 million working capital facility to buy crude for the refinery. These investments have stimulated considerable activity in the domestic economy for the overall benefit of the Papua New Guinea consumer. Now that these two banks have been exposed to Papua New Guinea, they are looking at other project opportunities in Papua New Guinea. Having external managers of capital focused on Papua New Guinea will allow more capital to enter the country as Foreign Direct Investment, further stimulating the economy.

*8.1.3. **InterOil** Established Foundation for Future Industrial Growth*

The refinery based in Port Moresby is now a core industry that will drive further investments in secondary and service industries related to the energy and resource sector. Papua New Guinea has an opportunity to move from being a net importer to a manufacturer in the energy and resource sector.

*8.1.4. More **InterOil** Projects on the Horizon*

InterOil has proven its ability to successfully complete projects as demonstrated by the development and successful operation of the Oil Refinery in Port Moresby. In addition to the refinery, **InterOil** is also planning to develop downstream processing such as LNG and petrochemical activities near the refinery in Port Moresby. These major projects will each require additional investment in Papua New Guinea in excess of K5 billion. (See Section 8.1.6 for more information about petrochemical plant). Further downstream processing will secure major revenues for the state and also create huge employment opportunities throughout the country. The Applicant estimates that the project will create 7,000 jobs for the different plants and related services. A vast majority of Papua New Guinea nationals will be employed and trained for these projects.

8.1.5. Importance of a Strong, Healthy Player

It is in Papua New Guinea's national and security interest to encourage and support a healthy **InterOil**. Unlike the Majors, who enjoy widely diversified cash flows from every major country, vast economies of scale and virtually unlimited resources, **InterOil** is fully committed to the success of its Papua New Guinea refinery, a very capital-intensive, margin-sensitive, and regulation-intensive business. Although **InterOil** exerts its best efforts to counteract negative events which might put its refinery business at risk, **InterOil** does not have limitless resources, and with only one major line of revenue producing business, is at risk in case that business does not perform. For this reason, **InterOil** needs to diversify its activities. A stronger downstream business will provide additional stability and cash flow, underpinning the company's ability to grow, withstand external market-driven events, and, importantly for the Papua New Guinea economy, continue to attract foreign capital to the country.

8.1.6. Petrochemical Plant

InterOil has made no secret of its desire to see a petrochemical complex built in Papua New Guinea . Such a complex, along with a downstream gas processing plant, are an integral part of the **InterOil** business plan for its operations in Papua New Guinea . A domestic petrochemical facility will, at long last, generate a domestic demand for Papua New Guinea 's vast natural gas resources. Financing such a massive project will require at least K5 billion, all sourced overseas. With no precedent for a petrochemical plant operating successfully in Papua New Guinea, **InterOil** will need to demonstrate a strong commercial base of business in order to successfully attract the financing necessary to follow through with the petrochemical plant. *The proposed **Shell** acquisition underpins the success of **InterOil**'s downstream business operation and a successful downstream business in turn underpins the success of existing and proposed midstream and upstream operations*.

Benefits that will accrue to the State and its citizens from InterOil's plans to develop a petrochemical plant are dramatic and quantifiable. Successful examples of such effects may be seen by similar developments in Trinidad and Equatorial Guinea. These small nations undertook similar petrochemical projects, unlocking the value of gas resreves, while producing dramatic results for their populations' employment and national wealth.

Papua New Guinea PETROCHEMICAL PLANT
Timeline

<u>2006</u>

January - February	Passage of Economic Development Zone-enabling legislation.
February – May	Financing with overseas investors arranged. Visits to Papua New Guinea by international investors. Immediate benefit realised in international financial markets as investors start to view higher likelihood of unlocking "stranded" Papua New Guinea natural gas.
May – August	Earthworks construction begins. Infrastructure elements designed.

September – December	Tenders sought for construction of road infrastructure, pipeline and plant construction, and personnel facilities. Likely to have at least three international consortia to bid for a lump-sum engineering, procurement and construction contract for plant and associated product export facilities. Contracts to include installation of gas turbines, pumps, pipeline systems, related control and electric equipment. Boost of international travel visits begins, as construction designers, engineers, and construction executives make frequent visits to Papua New Guinea to assemble proposals, conduct onsite research and assessments. It is estimated that 2,000 people will be required for construction of the project.

Papua New Guinea Petrochemical Plant
Specific Benefits

There is a long list of benefits to be gained by the State and Papua New Guinea's citizens from the construction and operation of the nation's first petrochemical plant:

- Landowners earn 2% royalty on gas sales.
- Government earns multiple streams of revenue
    1. 22.5% participation on gas sales.
    2. 15% to 30% Corporate Income Tax from all related businesses that sell gas
    3. 30% Corporate Income Tax from all related businesses that support construction and development of Petrochemical Plant
    4. Income tax [15-20%] from all construction and related industry personnel
    5. 30% Corporate Income Tax on natural gas liquids and condensate
    6. 30% Corporate Income tax on natural gas sales
    7. 30% Corporate Income tax on increased oil production as a result of gas being produced
- Option created to lower personal tax rates (as achieved in other producing countries around the world)
- Lower personal tax rates increases personal discretionary income
- Higher personal discretionary income leads to higher consumer spending, higher demand for local goods
- Higher demand for local goods leads to opportunities for new businesses and employment, less need for imports
- New source of value-added product for export
- Rising export revenues generates additional source of foreign exchange, strengthening Kina.
- Domestic production of fertilisers, reducing cost of agricultural pest control, increasing food production
- Nation's GDP could rise 300%

- 7,000 direct jobs
- 50,000 indirect jobs
- Major influx of trained, educated professionals which leads to
    1. Construction of new schools
    2. Development of Centres for Higher Learning (Labs, Universities)
    3. Intellectual Property Development for the State and its Enterprises
- K5 billion cash investment in facility
- New demand for Kina, pushing value of Kina higher. Kina should double in value.
- Higher Kina leads to lower prices of fuel for consumers (crude is priced in U.S. dollars). A doubled Kina would lead to a 50% drop in fuel prices for consumers.
- Higher Kina leads to lower cost of servicing external debt.
- Infrastructure dramatically improved to accommodate transportation and communication
- New housing for construction and post-construction employees

One of the most significant long-term benefits for the economy and Papua New Guinea's citizens, and one that will impact the nation for decades to come, results from what is actually produced in a petrochemical plant: *domestic production of finished petrochemical materials creates new opportunities for new domestic industries that can use these materials.*

A list of such materials makes it clear that a petrochemical plant creates a foundation for dozens of new industries to develop in Papua New Guinea, diversifiying the country's industrial base, and replicating all of the above benefits, with compound effect, across a broad slate of industrial developments. Examples of such products are too numerous to provide an exhaustive list, but include the following:

Papua New Guinea Petrochemical Plant
New Potential Product Slate
Petrochemical-based, Value-Added Products

- Adhesives
- Ammonia
- Caustic soda
- Coatings
- Conveyor Belts
- Explosive Caps
- Feed Additives
- Fertiliser
- Fibres
- Foam Plastics
- Food Additives
- Formaldehyde
- Fungicides
- Herbicides
- Insecticides
- Magnetic Tape
- Paint
- Phosphorus
- Plastic Packaging and Vessels
- Plastic Resins
- Plastic Sticks and Pipes
- Printing Inks
- Radial Belts

- Rubber Footwear
- Rubber Hose
- Tyre Cove

*8.1.7. A Successful **InterOil** = More Foreign Investment*

InterOil's progress in Papua New Guinea is being closely watched, especially in the United States due to its recent listing on the American Stock Exchange. A successful **InterOil**, as the only overseas company with all of its operations based in Papua New Guinea, will create a precedent in world financial markets: major companies can succeed in Papua New Guinea. Attracting companies and capital to Papua New Guinea can positively alter the development landscape for decades.

Through the success of **InterOil**'s total integrated activities in Papua New Guinea, cost savings will flow through reduction of redundant facilities, higher business volumes, and lower administrative costs as a percentage of total revenues. These cost savings are shared with consumers and allow capital to be added for new infrastructure, maintain or repair declining assets, allowing the company to improve customer service. More foreign investment has already flowed into the country since completion of the refinery, in the form of additional working capital credit lines (K462 million) and capital expenditure on the refinery (K31 million).

8.2. Proposal Represents Another Investment in Papua New Guinea

Construction of the refinery represented only the beginning of capital investment by InterOil.
At a time when the Majors are looking to divest or downsize their interests in Papua New Guinea, **InterOil** continues to demonstrate its faith in the future of the country by proposing further investment by way of this acquisition proposal.

8.3. Alternatives Not Attractive

BP has divested its interest in the country and **Shell** has decided that its best interest are served by transferring its business operations to **InterOil**. If this proposed transaction does not proceed, and **Shell** is forced to continue its business operations, they will find an alternative way to downsize their investment and involvement in Papua New Guinea. Thus any negative outcome perceived to exist as a result of **Shell**'s exit at this time could come to pass regardless of whether the acquisition is permitted. The loss of a market participant through disinterest and eventual liquidation of interests is rarely an attractive outcome for the economy.

It is also possible that **InterOil** may find it necessary to invest further in the same kind of terminal and depot facilities currently owned by **Shell**, if the acquisition is not approved. While initially providing what appears to be economic stimulus, the true long-term result would be inefficient capital expenditure and duplication of facilities, driving higher costs and prices to consumers.

8.4. Stable and Increasing Employment

InterOil already is a major employer in Papua New Guinea with 320 direct jobs being made available to Papua New Guinea nationals throughout its exploration, refinery and downstream distribution operations; the upstream exploration activities actually employ many more people, through contractors and service provider companies employing an additional 400 people. In total, it is estimated that direct and indirect employment by InterOil exceeds 1,000 people.

With the successful completion of the **Shell** transaction and the proposed petrochemical development, **InterOil** will continue to provide or create many more employment positions. This will benefit a wide range of Papua New Guinea citizens and provide additional opportunities for people throughout the country.

InterOil, as a diversified and integrated oil company operating solely in Papua New Guinea, will increasingly have the ability to move employees to other parts of the company when specific market conditions require personnel reductions in some areas. The **Shell** Acquisition will provide an additional level of scale and stability to **InterOil**'s operations, strengthening **InterOil**'s ability to absorb increasing numbers of workers at all skill levels.

8.5. Greater Efficiencies

Following the successful completion of the proposed **Shell** transaction, **InterOil** will be in a position to carry out a facility rationalisation program that should allow for resultant cost savings to be passed through to the consumer.

The three oil Majors who historically operated in Papua New Guinea have established downstream distribution facilities in most commercial centres throughout Papua New Guinea. In most locations this resulted in three similar bulk fuel storage depots or terminals being established, often adjacent to each other, all developed for the same activity of distributing product to the surrounding customer base.

Each of these distribution facilities come at a cost to the operating company, referred to as the depot or terminal overheads costs. These costs are normally calculated on a Toea Per Litre (TPL) basis with such costs included in the total cost build-up of servicing a customer and recovered on a pass-through basis from the customer in the cost of product delivered to the customer location.

These costs can vary from facility to facility depending on value of assets employed, outgoings, labour costs, repairs and maintenance costs and the throughput at each location. The actual TPL rate can range from around 1 toea per litre to 10 toea per litre, and sometimes exceeding 10 toea per litre at some low-volume locations.

It should be noted that the intention of completing such a rationalisation is to phase out unproductive physical *assets*, not *people*. Where job rationalisation is inevitable, **InterOil** will provide employment positions for affected individuals in other areas of the company's operations such as in its refinery, exploration, or development operations.

Additional cost savings may be achievable with more efficient transportation arrangements following the rationalisation of terminal and depot facilities. Logistical analysis will be necessary to determine the scope and magnitude of any such savings, as well as providing a blueprint for future steps to be taken in this regard.

8.6. New Access to Selected Terminals

Following the rationalisation of terminal and depot facilities, a period expected to take 18 months to complete, **InterOil** will offer access to selected terminals to suitably accredited oil industry operators. This will provide a new opportunity for companies like NOC and other independents to expand their operations into locations that, logistically, were impossible to pursue previously.

Non-Majors currently have no ability to be involved in the Port Moresby bulk fuel distribution market. By **InterOil** allowing access to its newly acquired Port Moresby bulk fuel Terminal, smaller companies will have the ability to enter the Port Moresby market and compete with other industry players.

8.7. Security of Supply

InterOil operates a refinery in Port Moresby with a peak production capacity of 34,500 to 36,500 barrels per day. This is nearly 100% in excess of the required domestic demand from Papua New Guinea. **InterOil** also has a supply agreement with **BP** (Singapore) for the supply of crude oil feedstock for the refinery, guaranteeing crude supply as necessary to meet refinery production requirements.

Should for some unforeseen and exceptional circumstance, the **InterOil** refinery be unable to produce all the domestic requirements of the country, alternative supply arrangements will immediately be sought from regional supply centres such as Singapore, East Asia and/or Australia. This is no different than the situation in existence prior to the construction of the refinery in Papua New Guinea.

As the nation's largest distributor of petroleum products, **InterOil** intends to maintain distribution, depot, and terminal facilities in all major commercial centres in the country.

As a more active player in domestic distribution, which will become possible after acquiring **Shell**'s Papua New Guinea assets, **InterOil** will be very closely involved with consumers who use its refined products. As the major distributor to domestic customers, **InterOil** expects to improve its role as a corporate citizen in developing new uses for fuels, as well as diversifying the appetite for different fuels, thus providing consumer with new options and opportunities for cost savings and enhanced fuel-based performance.

8.8. National Security

Prior to construction of the refinery, in the event of a worldwide refined product shortage, Papua New Guinea faced potential fuel supply disruptions. The failure of a third-party ship to reach

Papua New Guinea's harbour could have meant an interruption in the supply of fuel to Papua New Guinea . InterOil, by constructing Papua New Guinea's first and only refinery, has fulfilled a vital national security interest for Papua New Guinea: a captive domestic supply of refined petroleum products. Papua New Guinea is now fully self-sufficient in the production of refined product to meet its needs. In fact the InterOil refinery is producing nearly double the amount of refined product needed in the domestic market, exporting the balance and making Papua New Guinea a net exporter of fuel. In the event of a regional supply shortage of refined product, InterOil will always supply Papua New Guinea's needs first. **Thus the refinery now represents a vital national asset, integral to the energy supply of the nation.**

9. SUMMARY

9.1. Acquisition Will Maintain Competition

Refined product prices and distributor margins are regulated and monitored by the government and as such the acquisition of **Shell** will not have any significant influence on prices. Firms in the distributor market are unable to set prices regardless of their market share. The only path to higher net profit margins is through more efficient operations.

*9.2. **InterOil**'s Plan to Provide Access to Terminals will Enhance Competition*

InterOil will provide access to selected facilities not currently open to non-Majors. The acquisition will encourage more competition by enabling smaller oil companies to enter markets previously inaccessible to them, such as Port Moresby.

9.3. No Change in the Number of Competitors in any Major Industry Sector

In most sectors like aviation, commercial and marine, there will not be any change to the number of firms supplying products. There are also many ports that **Shell** is not servicing and its exit will make no difference to these markets.

9.4. No Loss of Jobs Resulting from the Acquisition

Although some redundant facilities will be closed, it is not **InterOil**'s intention to terminate jobs as a result of the acquisition. One of the advantages of having the **Shell** assets acquired by an in-country, integrated firm like **InterOil** is that there will be other opportunities for employment within different departments and divisions of **InterOil**. InterOil is currently needing additional staff in two areas of the company: exploration and logistics. The Shell staff will have the first opportunity to fill these positions, following a positive approval by the ICCC.

9.5. Acquisition Provides Opportunity for Asset Rationalisation

The acquisition of **Shell PNG** will provide **InterOil** with the opportunity to rationalise key assets in the wholesale distribution of oil products, allowing the company to reduce average costs that will result in pass-through cost savings to the public.

9.6. No Change in Barriers to Entry

Any firm with adequate capital can be a player in the domestic fuel distribution industry. **InterOil**'s proposal to allow access to its holding facilities will make it possible for smaller firms to compete in this market. The acquisition of **Shell**'s business in this context actually decreases barriers to entry.

*9.7. **InterOil** has Invested Heavily in Papua New Guinea*

InterOil is the only oil company in Papua New Guinea that is bringing significant foreign investment capital for downstream processing into the country. Specific examples cited elsewhere include:

- K863 million invested in Papua New Guinea refinery, which includes OPIC facility, exposing a major international lending agency of the U.S. government, to Papua New Guinea

- K231 million invested in the largest exploratory drilling program in Papua New Guinea's history
- K462 million working capital line of credit which provided exposure for Papua New Guinea to international banks
- K62 million for completion of the BP downstream acquisition
- K31 million refurbishment program for refinery

Total Capital Invested by InterOil in Papua New Guinea: K1.6 billion

*9.8. **InterOil** Actively Pursuing Construction of Petrochemical Facility*

The plans by **InterOil** to invest in excess of K5 billion in a petrochemical facility will create employment and a new, value-added activity with significant export potential. Further downstream processing will secure additional tax revenues for the country, replace imports, and strengthen foreign currency. Other advantages that will accrue to the country include:

- ❖ Landowners royalties on gas sales
- ❖ Government earns substantial additional tax revenues
- ❖ Lower personal tax rates
- ❖ Increased discretionary income
- ❖ Increased demand for local goods
- ❖ Opportunities for new businesses
- ❖ Reduced imports
- ❖ Increased exports
- ❖ Strengthened Kina
- ❖ Feedstock for New Domestic Industries
- ❖ 300% rise in GDP
- ❖ 7,000 direct jobs
- ❖ 50,000 indirect jobs
- ❖ Influx of trained, educated professionals
- ❖ K5 billion cash investment
- ❖ Potential double in value of the Kina
- ❖ A doubled Kina would lead to a 50% drop in fuel prices for consumers.
- ❖ Higher Kina leads to lower cost of servicing external debt.
- ❖ Transportation and Communications infrastructures receive massive upgrades.
- ❖ New housing for construction and post-construction employees.

9.9. Competition Remains

Exxon-Mobil, a company with (Downstream) net income that is over 1,500 times the size of **InterOil**, remains in the market and will provide **InterOil** and the distribution market in general with competition. **Exxon-Mobil** is the largest and most well-financed oil company in the world. InterOil can only hope to be competitive to such a dominant world player.

9.10. Papua New Guinea Needs a Strong, Effective and Efficient Firm in this Market

Papua New Guinea's economic environment is characterised by high infrastructure costs, high transportation costs, limited access to foreign capital, and a cycle of investment followed by stagnation in the oil industry. While exploration activity is being conducted in Papua New Guinea, with the hope that domestic production can continue and grow, there can be no guarantees that Papua New Guinea can count on consistent future production. Thus it is in Papua New Guinea's best interests to at least insure a strong, vibrant, domestic market for refined product. This requires the presence of at least one strong, committed company.

InterOil, through its aggregate investments of K1.6 billion, has proven it is a solid and committed company, and should be encouraged to strengthen itself when opportunities present themselves. It is in the country's national interest to support **InterOil** in becoming a strong and stable company, able to withstand the risks inherent in all aspects of the oil industry. As the international oil industry has demonstrated its unwillingness to back major petroleum downstream infrastructure projects in Papua New Guinea, a healthy **InterOil** is essential to the long-term national and strategic security interests of the nation. InterOil has already helped secure for the country a proven and sufficient source of refined fuel supply to provide for nearly double the nation's current needs.

The proposed acquisition represents an opportunity to achieve all of the above, and the Applicant respectfully requests that the ICCC consider this proposal in its assessment.

END OF SUBMISSION