
INTEROIL ACQUISITION OF BP PNG LIMITED

CLEARANCE APPLICATION

Acquisition Proposal

S.P.I. Distribution Limited is a subsidiary or associated Company of InterOil Limited (*InterOil*) which proposes to acquire all the shares and assets of BP Papua New Guinea Limited (*BP*) from its current owner, Gas Tank Nederland BV. InterOil has sought a clearance for this acquisition, pursuant to section 81 of the *Independent Consumer and Competition Commission Act 2002 (the Act)* and made a submission to the ICCC in support of that application. InterOil subsequently supplied a supplementary submission to the ICCC on 2 April 2004, in which InterOil elaborated some of the issues in the clearance, and gave certain assurances about InterOil's future conduct in relation to its dealings with wholesale distributors and about seeking approval from the ICCC before finally executing and giving effect to its "strategic alliance" with Shell Overseas Holdings Limited (*Shell*). The Share Sale Agreement between InterOil and Gas Tank Nederland BV is subject to a condition precedent that a clearance must be granted by the ICCC for the acquisition of BP to take place¹.

InterOil will be the owner and operator of PNG's only oil refinery, which is expected to come into production within a few months and to be fully operational before the end of 2004. When that occurs, all domestic petroleum distributors will be required, through InterOil's 30 year agreement with the Government, to acquire their refined products from InterOil's refinery at a price (IPP) set by the agreement². At that stage, InterOil will be the principal supplier of refined petroleum products in PNG, where at present such product may be readily imported from any number of suppliers. InterOil does not presently operate in the wholesale petroleum distribution market in PNG, but see below in relation to its association with Shell.

BP is a participant in the wholesale petroleum distribution market in PNG, with a market share of 20%³. Other participants in that market are Shell (43%), Mobil (33%) and NOC (4%)⁴.

Strategic Alliance InterOil has what it calls a "strategic alliance" with Shell in relation to refined product. That arrangement will only take full effect once the InterOil refinery has been completed and will then result in InterOil acquiring most of Shell's existing wholesale distribution assets and leasing them back to Shell for 10 years.

¹ InterOil supplementary submission, page 4

² InterOil clearance submission to ICCC, page 5

³ *ibid*, page 3

⁴ *ibid*

The ICCC has examined several documents relating to the strategic alliance; in addition to the sale and leaseback of infrastructure and property, the arrangements include other potentially anticompetitive arrangements such as a requirement for InterOil to consult Shell in relation to any variation in prices of refined product⁵.

Elements of a Clearance

InterOil has applied for a clearance under section 81 of the Act. Section 81(3) of the Act provides that the ICCC shall either –

- (a) if it is satisfied that the acquisition will not have, and will not be likely to have, the effect of substantially lessening competition in a market.....give a clearance for the acquisition; or
- (b) if it is not satisfied that the acquisition will not have, and will not be likely to have, the effect of substantially lessening competition in a market.....decline to give a clearance for the acquisition.

While terms such as “substantially lessening competition” are relatively new to PNG jurisprudence, those concepts have been interpreted and analysed in other jurisdictions. The InterOil submission has referred to some Australian authorities and it is accepted that those decisions are relevant in this context.

The Market

In its submission, InterOil sets out the statutory market definitions in section 45 of the Act and submits that the relevant market is the market for the wholesale distribution of refined petroleum products in Papua New Guinea. It is agreed that this is a relevant market for the purposes of this acquisition, though it is not necessarily the only relevant market; it is possible that the upstream market for the supply of refined petroleum product to wholesale petroleum distributors, is also a relevant market. This is discussed later. However, the principal consideration is the wholesale distribution market.

The Effect on Competition

It is agreed that, as InterOil says, it is necessary to examine the nature of competition that will exist in the relevant market after the relevant acquisition. However, it is not appropriate to take a snapshot view of the competitive environment the day before the acquisition and compare it to the day after.

That is not an appropriate way to assess competition. The test in the Act is a prospective one: “.....the acquisition will not have, and will not be likely to have, the effect of substantially lessening competition.....” requires consideration of what will occur or is likely to occur in the future, and that future is not confined to the future immediately after the acquisition has occurred, otherwise the phrase “likely to have” would not be needed. The state of competition in the market extending into the future is what must be assessed.

In assessing what the state of competition will be in the market in the future, whether the Shell/InterOil Strategic Alliance is or is likely to be in effect, will be a relevant consideration.

⁵ Marketing Services Agreement, clause 3(d)

While the Shell/InterOil strategic alliance may not be fully operational on the date the acquisition takes place, it is contemplated in the “letter agreement” between InterOil and Shell that the arrangements comprising the Shell/InterOil Strategic Alliance would be triggered to come into effect once the InterOil refinery has reached the stage of practical completion, which InterOil expects to be later this year. The essence of that arrangement is that InterOil will have, at the least, a close commercial relationship with Shell, the largest participant in the market, whereby InterOil owns the infrastructure used by Shell, it will provide drumming facilities for Shell at the refinery, it must refer prospective new customers to Shell ahead of other distributors and it must consult Shell closely on any price variations or supply issues. And in return, Shell will purchase all of its product requirements, to the maximum extent practicable⁶

This arrangement would, if and when it came into effect, put Shell in a different, and more privileged, position from the other wholesale distributors in its dealings with what will at that stage be the sole supplier of product to those wholesale distributors. That arrangement must have an effect on competition – apart from anything else, it includes a requirement for the monopoly supplier to consult its largest customer (but not other customers) on price, the one thing which is most central to competition in any market.

Shell has stated⁷ that in its view the Shell Deal (the Shell/InterOil Strategic Alliance) itself will have no impact in wholesale or retail petroleum markets in PNG and that the parties therefore do not intend to seek any authorisation or approval from the ICCC before bringing the Shell Deal into effect. The Shell Deal does not have any condition precedent requiring ICCC approval before it can come into effect, unlike the InterOil/BP Share Sale agreement.

As a consequence of this, Shell believes that the BP Proposal must be considered by the ICCC in the context of the Shell Deal having been concluded and on the assumption that the conditions precedent to the Shell Deal being brought into effect will be met and that it will be brought into effect⁸.

InterOil takes a completely opposite view to that of Shell. In its supplementary submission, InterOil says⁹:

It is conceded that, if InterOil was presently a party to executed contractual documents under which it will become the owner of Shell assets subject only to the satisfaction of certain conditions precedent, then the existence of that transaction would be a relevant matter to be taken into account in considering the present application. However, that is not the case.

The Shell transaction agreements are executory, not executed. The letter agreement obliges related entities of InterOil and Shell to procure the execution of the agreements, but that obligation is a future obligation.

The Shell transaction is, like all acquisitions of shares or assets in Papua New Guinea, subject to section 69 of the ICCC Act.

⁶ Marketing Services Agreement clause 2(a)(ii)

⁷ Shell submission to the ICCC on the BP acquisition, March 2004

⁸ *ibid*

⁹ at pages 1 and 2

If the Shell transaction has, or is likely to have, the effect of substantially lessening competition in a market, then it will infringe section 69. In that case, a clearance or authorisation must be obtained. If it is not, then the transaction will be illegal and subject to the sanctions available under the Act.

It is inevitable therefore that the Shell transaction must come before the ICCC, before it comes into contractual effect. If the present application is successful, then InterOil will acquire effective ownership of BP's assets. That change in the structure of the market makes it unarguable that the Shell transaction cannot be completed without clearance or authorisation under the Act.

The ICCC will have the opportunity to consider the Shell transaction before it comes into contractual effect. It will do so in the context of the BP acquisition having already come into effect.

In these circumstances, it is inappropriate for the ICCC to deal with the present application on the assumption that the Shell transaction will, as a matter of fact, come into effect at a future time. As demonstrated above, the Shell transaction will be subject to the ICCC Act and the overview of the ICCC before it comes into effect, as is the case with any such acquisition. We [InterOil] submit that the appropriate course is to consider the present application on its own terms, without regard to the Shell transaction.

Thus while Shell says that the BP acquisition must be considered in the context of the Shell transaction having been concluded and will therefore be in effect, InterOil says that the Shell transaction agreements are executory, not executed, and cannot be completed without clearance or authorisation under the Act. Therefore, InterOil says, it is inappropriate for the ICCC to deal with the present application on the assumption that the Shell transaction will, as a matter of fact, come into effect at a future time.

The assessment of the competitive effect of the BP acquisition, discussed below, is likely to produce very different conclusions when considered in the context of the Shell transaction, and when considered in isolation from the Shell transaction.

Statutory factors used in assessing competition

Section 69(5) of the Act sets out a number of non-exclusive factors to be taken into account when assessing the post-acquisition effect on competition in the market. InterOil has addressed these factors in its submission and they are also addressed here, though not necessarily coming to the same conclusion. The significance of some of these factors also varies depending on whether the Shell/InterOil Strategic Alliance is taken into account or disregarded.

- (a) The actual and potential level of import competition in the market:** While all wholesale distributors currently arrange their own product imports, either alone or in collaboration, there is no competition or threat of competition to the existing four wholesale distributors from ad hoc or other direct imports.
- (b)** More particularly, after the InterOil refinery comes on stream, all wholesalers will be required to buy from InterOil, all their requirements for products produced at the InterOil refinery and not import direct unless InterOil cannot supply domestic product from its refinery. Thus there is no import competition for much of the market.

- (c) **The nature and effect of barriers to entry to the market:** With the small size of the PNG market, high infrastructure cost and four players long established in that market, barriers to entry from new competitors are conceded by InterOil to be high¹⁰. Thus new competitors are unlikely to emerge in the medium term. The close relationship between either one (BP) or two (BP and Shell) of the main market participants and the principal supplier, raises those barriers.
- (d) **Number of buyers and sellers in the market:** There are only four participants in the market and one primary supplier to those four. That makes it a highly concentrated market which is very sensitive to any competitive constraints.
- (e) **Degree of countervailing power in the market:** Customers of wholesale distributors have little if any countervailing market power, and on the supply side, InterOil is itself the countervailing power, or at least will be after its refinery comes on stream.
- (f) **Likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices or profit margins:** If the Shell transaction is taken into account, InterOil and its associates, with a combined market share of 66%, should be able to increase prices or profit margins with relative ease. However, with these products being regulated under the *Prices Regulation Act*, that opportunity is constrained. If the Shell transaction is disregarded, InterOil's ownership of one market participant with a 20% market share is, of itself, unlikely to enable InterOil to significantly and sustainably increase prices or profit margins, in addition to the restraints arising from the prices being regulated.
- (g) **Extent to which substitutes are available or are likely to become available in the market:** Nil.
- (h) **Dynamic characteristics of the market, including growth, innovation and product differentiation:** The market is mature, with little growth, innovation or product differentiation likely.
- (i) **Likelihood that the acquisition would result in the removal from the market of a sustainable, vigorous and effective competitor:** If the Shell transaction is disregarded, the acquisition should result in merely a change of ownership of one competitor, which would not remove a competitor from the market. However, if the Shell transaction is taken into account, while the acquisition would leave BP as a participant in the market, it would be unlikely to wish to compete vigorously with the largest market participant, Shell, which, post-acquisition, would have a close association with InterOil, BP's owner.
- (j) **Nature and extent of vertical integration in the market:** In its own submission, InterOil concedes that the acquisition will result in vertical integration. This is discussed below.

There are two aspects to competition in this market, horizontal and vertical, and the InterOil submission recognises this.

Horizontal Integration

If the Shell transaction is disregarded

In assessing horizontal competition, InterOil claims¹¹ that following the acquisition there will be the same number of participants in the relevant market with the same relative

¹⁰ Clearance submission page 6

¹¹ Clearance submission, page 3

market shares; the difference will be a change of ownership of one of those participants. In ordinary circumstances, the acquisition of an existing competitor, with nothing more, should not result in any substantial lessening of competition. There is no suggestion that BP is being acquired to close it down, nor is there any indication that the existing BP distribution business will be significantly changed. InterOil is a much smaller company in global terms than any of Shell, Mobil or BP and thus is not in the position of a “deep pockets” purchaser, likely to threaten other, less well funded participants in the market.

BP, with a stable market share of about 20%, is the third largest player in the market and a change in its ownership is unlikely to greatly affect the market.

Thus, if the Shell transaction is disregarded, the acquisition of BP by InterOil is unlikely to significantly increase any horizontal integration in the market.

If the Shell transaction is taken into account

Prior to the acquisition, InterOil, which will shortly become the principal supplier of product to all wholesale distributors of refined petroleum in PNG¹², has, through its strategic alliance with Shell, the prospective ownership of Shell’s wholesale distribution infrastructure (leased back to Shell as the operator) and arrangements for close consultation and cooperation on a range of competitively sensitive issues, including as the sole or preferred supplier for all product sold by Shell. After the acquisition, InterOil would have ownership of the third largest player in the market, BP, as well as its relationship with Shell.

Thus, in considering market shares post acquisition, InterOil will have direct control of 20% of the market (BP) and partial control, through its strategic alliance with Shell, of a further 46% of the market, giving an aggregate of 66% market share. Put another way, InterOil will have, post acquisition, direct or indirect control of two of the three main market participants (NOC, with 4% market share, is not in a position to exert a strong competitive influence and in any event, NOC operates only in limited areas of Papua New Guinea).

By any international standard, this is a very high market share which must raise competitive concerns. Large market share can be an indicator of market power. As was stated in the seminal Australian case on market power:

“A firm possesses market power when it can behave persistently in a manner different from the behaviour that a competitive market would enforce on a firm facing otherwise similar cost and demand conditions.”¹³

Access to 66% of the market, and a monopoly in the supply market for domestically produced product, would give InterOil that sort of market power capability.

While Mobil, with 30% market share, may be able to provide a strong competitive influence, it will be faced with a competitor, InterOil, with effectively up to double Mobil’s market share.

¹² Clause 19.1 of the Project Agreement between InterOil and the Government requires all distributors to source product first from InterOil’s refinery, though they may still import products which are not available from the refinery

¹³ *Queensland Wire Industries v BHP Ltd* (1989) ATPR 40-925, per Dawson J at 50,015

While we note that Mobil has announced its intention to remain in the PNG market, its competitive position may become more difficult over time. Certainly, in the medium term, Mobil would be likely to find the competitive environment disadvantaging it, because of its lack of links to its primary supplier, in comparison to the close links between Mobil's competitors in the wholesale distribution market and InterOil.

Thus if the Shell transaction is taken into account, the acquisition of BP is likely to significantly increase horizontal integration in the market, to the extent that InterOil would have direct or indirect control of competitors having a two thirds share of the market.

Vertical Integration

While conceding that the acquisition will result in vertical integration, InterOil argues¹⁴ that such vertical integration is the normal practice throughout the world, at least in the oil industry. Certainly there is a significant measure of vertical integration in the oil industry around the world, though in many cases that integration would be upstream integration between crude oil production and refining, with less vertical integration on the downstream side.

There is, however, one very significant difference between vertical integration in this case and downstream vertical integration in other parts of the world. In other countries, a number of oil refiners may have some vertical integration in their supplying their own wholesale or retail outlets, but typically there would be several refiners, each supplying their own outlets and, more often than not, also supplying refined product to other outlets.

In this case, InterOil will be a monopoly supplier of much of the product needed by all wholesale distributors in PNG, none of whom will be permitted to purchase their requirements of domestically produced refined product from anyone else. Post acquisition, InterOil would be vertically integrated with one of the wholesale distributors, while at the same time it would be the sole supplier to all other wholesale distributors. It would be natural to expect that, over time, InterOil would favour its own subsidiary over other customers which are not associated with InterOil. If the Shell transaction does proceed, this favouring may well extend to Shell as well, as a result of the "Strategic Alliance", but Mobil and NOC would be left out of this favourable treatment. The negative competitive implications of this in the wholesale distribution market are obvious.

The ICC's concerns about the anticompetitive effects arising from vertical integration have been addressed in InterOil's supplementary submission.

InterOil claims that, because of the requirements of the Project Agreement with the Government, InterOil will have no power or ability to discriminate in respect of the pricing of its products out of the refinery¹⁵. The non-discrimination requirements of the Project Agreement do not necessarily extend to products not produced at the refinery (since InterOil is to be the some supplier to distributors), nor to non-price discrimination, for example preferential allocation in times of short supply.

¹⁴ *ibid*, page 6

¹⁵ Supplementary Submission, page 3

In this respect, InterOil states that it will not provide any customer, including its own subsidiary, with preferential commercial terms of supply¹⁶. InterOil has provided a written assurance¹⁷ that it will not enter into any key commercial terms of supply with any customer (including its own subsidiary) which are discriminatory or preferential in any way.

The Shell/InterOil strategic alliance, should it come into effect, will create a measure of vertical integration in the market. The acquisition of BP by InterOil would significantly increase that vertical integration. However, on the basis of the assurances given by InterOil to the ICCC in its supplementary submission of 2 April 2004 and in its letter of 8 April 2004, that it will 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 increase in vertical integration in the market arising from the acquisition of BP should not result in a substantial lessening of competition.

The Upstream Market

The market for the supply of refined petroleum product to wholesale distributors in PNG is currently international, with each distributor arranging its own supply of refined product from the world market. However, after the InterOil refinery has been brought on stream, InterOil will, pursuant to its Project Agreement with the Government, become the sole supplier of domestically produced refined product to wholesale distributors in PNG. Accordingly, at that time the upstream market will become one with a single supplier, and no competition for much of the product in the market. That could only change if the Government were to revise its approach and either allow other refiners/producers into the market, or allow the wholesale distributors to source their product from whomever they like – if that were permitted by the Project Agreement.

If InterOil were to acquire BP, that acquisition, if taken in the context of InterOil's strategic alliance with Shell, would put InterOil in such a strong position in all parts of the petroleum products supply chain in Papua New Guinea, that it may be able to force the Government to give InterOil even greater protection from competition than it already has, because of the critical need for an assured supply of oil products within Papua New Guinea.

It could thus be argued that the acquisition may produce a lessening of competition in the upstream market. However, because that market is or will shortly become a monopoly supply market for those products produced at the InterOil refinery, any lessening of competition in that upstream market would be unlikely to substantially lessen competition.

Summary and Conclusion – Competition in the Wholesale Distribution Market for Refined Petroleum Products

The ICCC shall grant a clearance for an acquisition under section 81(3) of the Act if, and only if, it is satisfied that the acquisition will not have, and will not be likely to have, the effect of substantially lessening competition in a market. Whether an acquisition may have benefits for the public is not a relevant consideration when considering a clearance; the test is solely one of the competitive effect of the acquisition.

¹⁶ *ibid*

¹⁷ Letter dated 8 April 2004 from InterOil to the ICCC

In the present case, the relevant market is agreed to be the market for the wholesale distribution of refined petroleum products in Papua New Guinea. That market has four participants, Shell (46% market share); Mobil (30%); BP (20%); and NOC (4%). InterOil, which is proposing to acquire BP's wholesale distribution business, is not currently a direct participant in that market, though it will shortly become the principal supplier of product to all participants in that market.

The acquisition of BP would give InterOil ownership of the third largest player in the market, with 20% market share. If the Shell transaction is not taken into account, the acquisition of BP by InterOil would not, of itself, create horizontal integration in the market which would amount to a substantial lessening of competition.

The subsequent coming into effect of the Shell/InterOil "Strategic Alliance" would, however, need to be examined under the Act and may well contravene the Act, unless approved by the ICCC. The ICCC notes the statement by InterOil¹⁸ that if the BP acquisition proceeds, it is unarguable that the Shell transaction cannot be completed without clearance or authorisation under the Act.

If the Shell transaction is taken into account, the conclusion about horizontal integration is different. Shell is the largest participant in the market. While the Shell/InterOil arrangement is currently inchoate, it will come into effect in the near future after the InterOil refinery reaches practical completion. That means InterOil would, post acquisition, have a direct or indirect ownership and interest in two of the four firms in the market, with a combined market share of 66%.

In the absence of mitigating factors, possession of such a high percentage of the market would of itself be a strong indication of a situation which would have the effect or likely effect of substantially lessening competition in that market. In further assessing the post acquisition competitive effect, the following factors, set out in section 69(5) of the Act, are relevant:

- The actual and potential level of import competition will be low, after the InterOil refinery comes on stream.
- Barriers to entry to the market are agreed to be high.
- There are only four firms in the wholesale distribution market and there will soon be only one principal supplier to them, making it a concentrated market.
- There is little countervailing power on the demand side and InterOil itself has countervailing power on the supply side.
- The acquisition may not necessarily enable InterOil to significantly and sustainably increase prices or profit margins, for as long as prices are controlled under the *Prices Regulation Act*.
- Substitutes are not available in this market.
- The market is static, with little opportunity for growth, innovation or product differentiation.
- While the acquisition would not result in BP being removed from the market as a vigorous and effective competitor, competition is likely to be inhibited between BP and Shell, the party having a strategic alliance with BP's new owner, InterOil.

¹⁸ Supplementary Submission, page 2

With the exception of the legal constraint on InterOil raising prices, arising from the *Prices Regulation Act*, none of the other factors noted above would significantly mitigate the anti-competitive effect of the high market share controlled, directly or indirectly, by InterOil post acquisition; rather they would tend to exacerbate the anti-competitive effect.

Therefore, the acquisition of BP by InterOil, when taking into account InterOil's "Strategic Alliance" with Shell, would result in a high level of horizontal integration in the market which would have, or would be likely to have, the effect of substantially lessening competition in the market.

While the ICCC notes the views expressed by Shell, it accepts the submission from InterOil that the assessment of the effect on competition of the proposed acquisition of BP by InterOil should be considered in isolation from the Shell transaction, on the clear understanding and assurance from InterOil that the Shell transaction cannot be completed without clearance or authorisation under the Act, which will be sought by InterOil prior to that transaction being completed.

In those circumstances, and on the basis of those assurances, the ICCC is satisfied that the acquisition of BP by InterOil would not, of itself, create horizontal integration in the market which would amount to a substantial lessening of competition.

The final factor in section 69(5), vertical integration, is also important in assessing the competitive impact of this particular acquisition. In this case, the vertical integration would be between one firm in the market (BP) and the principal supplier to all participants in the market, including BP. The likelihood of all firms in the market getting and continuing to get competitively neutral treatment from InterOil, notwithstanding the Project Agreement, may therefore be low, and be diminished further if the existence of the "Strategic Alliance" between InterOil and Shell is taken into account.

However, on the basis of the assurances given by InterOil to the ICCC in its supplementary submission of 2 April 2004 and in its letter of 8 April 2004, that it will 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 is satisfied that any increase in vertical integration in the market arising from the acquisition of BP should not result in a substantial lessening of competition.

Decision

In those circumstances, and on the basis of the assurances from InterOil referred to above, the ICCC is satisfied that the acquisition of BP by InterOil will not have, and will not be likely to have, the effect of substantially lessening competition in the market for the wholesale distribution of refined petroleum products in Papua New Guinea and, in accordance with section 81(3)(a) of the Act and pursuant to Section 17 of the Act, I hereby grant clearance for the acquisition to proceed.

.....
HON. BART PHILEMON, MP
MINISTER FOR FINANCE & TREASURY

14th April 2004