



**INDEPENDENT CONSUMER AND COMPETITION COMMISSION**

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## **DETERMINATION**

**APPLICATION FOR  
AUTHORISATION OF THE PROPOSED ACQUISITION OF  
SHELL (PNG) LIMITED**

**BY**

**INTEROIL PRODUCTS LIMITED**

**APPLICATION LODGED ON THE 22<sup>ND</sup> NOVEMBER, 2005**

## **Determination**

### **BACKGROUND**

#### ***Parties***

This Determination relates to the application by InterOil Products Limited (**IPL**) for authorization of its proposed acquisition of Shell PNG Limited (**Shell**) pursuant to *Section 82 of the ICCA Act 2002*.

**InterOil Corporation (InterOil)** is a company incorporated in Canada and through its subsidiary **IPL** owns and operates various oil and gas exploration companies in PNG. It is also the owner and operator of PNG's only oil refinery (Napa Napa), which came into production in 2004. The Napa Napa oil refinery is the subject of a 30 year Project Agreement between the PNG Government and InterOil which requires, among other things, that all wholesale distributors in PNG purchase their requirements of petroleum products from the refinery at Napa Napa. Furthermore, by virtue of its acquisition of the then BP (PNG) Limited which was cleared by the Commission on 15<sup>th</sup> March 2004 pursuant to Section 81 of the *ICCA Act 2002*, InterOil also operates a wholesale petroleum products distribution business in PNG.

**Shell**, as part of the Royal Dutch Shell Group of companies is a global energy and petrochemical group of companies operating in more than 145 countries. Through its wholly owned subsidiary, Shell (PNG) Limited, it operates a wholesale petroleum distribution business in PNG. It is the biggest petroleum products wholesale distributor with 41 per cent market share. Other wholesale petroleum distributors being Mobil/Islands Petroleum Limited (34 per cent), Niugini Oil Company Limited (NOC) (5 per cent), and InterOil itself (20 per cent) by virtue of its acquisition of the then BP PNG Limited.

#### **Acquisition Proposal**

Shell and InterOil have now agreed to an outright purchase of Shell's petroleum products distribution operations in PNG by InterOil instead of pursuing the initial 10 year lease-buy back arrangement as per the strategic alliance the two companies had previously announced. That proposed initial acquisition was the subject of a clearance application to the Commission. That clearance application was withdrawn, before the Commission had made a determination, when InterOil lodged this authorization application.

InterOil claims that this change in approach and strategy has become necessary and indeed provides the only option available given the commercial decision by Shell to exit the PNG market, thus, introducing a completely new element into the equation of the proposed acquisition. It therefore, argues that while the acquisition may appear to have the effect of removing a vigorous player from the market, this argument does not hold because Shell is already in the process of focusing its assets and capital in larger markets and will eventually exit the market anyway. It follows, the applicant argues further, that any negative outcome perceived to exist as a result of Shell's exiting at any time could come to pass regardless of whether the acquisition is permitted or not.

Under these circumstances, the applicant is of the view that an outright purchase of Shell is inevitable and is by far a better outcome for the local business community because it means that the Shell PNG assets will now be operated by a company that is solely focused on PNG and nowhere else and therefore will allow for optimal world-class operations and customer services.

### **Application for Authorisation**

InterOil submitted an application for Authorisation of the proposed acquisition of Shell (PNG) Limited on 22<sup>nd</sup> November, 2005, pursuant to *Section 82 of the ICCA Act 2002 ("the Act")*. Under the provisions of the Act, the Commission was to make a determination within 72 days and taking into account that these 72 days are actual days, the Commission therefore, was to make a determination by or before 2<sup>nd</sup> February, 2006. This deadline however, has been extended to 23<sup>rd</sup> February, 2006, on request by the applicant.

### **Elements of an Authorisation**

InterOil applied for an authorization of the proposed acquisition under Section 82 of the *ICCA Act 2002*, sub-section (3) of which provides that the Commission shall:

- (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, by notice in writing to the person by or on whose behalf the notice was given, give a clearance for the acquisition; or
- (b) if it is satisfied that the acquisition will result, and will be likely to result, in such a benefit to the public that it should be permitted, by notice in writing to the person by or on whose behalf the notice was given, grant an authorisation for the acquisition; or

- (c) if it is not satisfied as to the matters referred to in Paragraphs (a) or (b), by notice in writing to the person by or on whose behalf the notice was given, decline to give a clearance or grant an authorisation for the acquisition.

It should be noted that this is a two (2) staged process whereby the Commission is, first of all, required to give a clearance if it is satisfied that the acquisition will not have, or, will not be likely to have the effect of substantially lessening competition in the market. If not, then, the Commission is required to go to the next stage where it has to grant an authorisation if it is satisfied that the acquisition will result, or will be likely to result, in such a benefit that it should be permitted to proceed with the acquisition.

This required a careful analysis of the competition and wider economic effects of the proposed acquisition in accordance with the provisions of the ICCA Act 2002. At the start of this analysis, the Commission has to consider whether the acquisition would result in a substantial lessening of competition in a market. This required that the relevant market be clearly defined in order that a proper competition effect analysis be made.

## **THE MARKET**

For the purposes of the Act, the relevant market is defined under section 45(2) as:

“...a reference to a market in the whole of Papua New Guinea for goods and services as well as other goods and services that, as a matter of fact and commercial common sense, are substitutable for them, including imports”.

In its submission, the applicant defined the relevant market in terms of the product market (wholesale market for distribution of refined petroleum products) as well as geographical locality being the whole of Papua New Guinea.

It also submitted that the growth of the relevant market is a function of industrial demand particularly due to mining, petroleum and major infrastructure projects. Further, InterOil claims it included regional sub-markets as also being relevant markets and emphasized the need for and the importance of taking these into account in any competition effect analysis.

The Commission would agree that the product market and the regional sub-markets may be relevant in the competition analysis, but the

wholesale distribution of refined petroleum products is the principal relevant market in this case.

### **State of competition**

For purposes of the analysis the applicant dissected the product market into various classes of consumers and consuming industries, arguing that these reflected somewhat different competitive characteristics.

#### **(a) Aviation Sector**

The applicant submits that competition in the supply of aviation fuel in PNG has been limited to Shell and Mobil through company owned assets at the airfields throughout Papua New Guinea. The acquisition will lead to InterOil acquiring Shell's aviation assets in other parts of the country except for the facility at Jackson's International Airport which Shell will retain and operate. It is argued that there will still be two suppliers in this sector and there would be no effect on competition if the acquisition were to proceed.

The Commission notes that competition in this sector has been dominated by Shell and Mobil for many years and reflects the lack of interest that BP (previously operating in PNG and having aviation fuel interests and activities in other countries) had in entering this market. Thus Shell and Mobil have owned all the refuelling facilities around the country and have been the only suppliers to the industry. Shell and Mobil have also been prepared to invest in and meet the substantial capital and technical requirements for the supply of aviation fuel including meeting the safety specifications required of suppliers in this sector. More recently, Mobil has scaled down its aviation fuel operations at the provincial and Jacksons International Airport, and to some extent Shell has also scaled down its direct refuelling operations in the provincial airports. However, both these companies continue to remain as wholesale distributors of aviation fuel to the aviation sector in PNG. The Commission accepts that the proposed acquisition will not affect the number of fuel distributors currently in the aviation sector.

The Commission notes that the proposed acquisition will result in InterOil owning and operating Shell's provincial airport refuelling facilities which would result in InterOil undertaking refuelling operations in most provincial airports except Port Moresby. Shell will be retaining the Jacksons field refuelling arrangements as it sees it's servicing of international airlines as being part of its wider global activities which it will continue to conduct in PNG even after the proposed sale of the remainder of its business to InterOil. The proposed acquisition would mean that InterOil will continue the refuelling services to aviation

operators at provincial and outlying airfields currently serviced by Shell. This could give rise to issues about InterOil's ability to meet service delivery and quality standards, which would be of concern to the Commission if the required safety specifications were not met.

Concerns have been expressed by the industry suggesting that InterOil may need to make substantial progress in the areas of meeting strict aviation service and product standards before it is able to gain the confidence of the industry. The industry believes this was illustrated in 2005 where a number of Air Niugini flights had to be cancelled and planes grounded after fuel supplied from the InterOil refinery did not meet Shell's quality control standards. During that time, alternative fuel was sourced by Shell from overseas to ease the supply shortages in PNG although there was extensive disruption to airline services in the country.

In these circumstances, especially for refuelling outside Port Moresby, the Commission would view the reported training of InterOil staff by Shell on handling and quality control testing of Jet A-1 fuel as a step in the right direction in addressing the industry concerns on this matter. Moreover, the Commission understands that Shell will continue to undertake quality control testing of Jet A-1 which it is to supply to the aviation companies, including Air Niugini, via the JUHI facility at the Jacksons International Airport.

### **(b) Mining Sector**

Suppliers to this sector in PNG are Mobil and Shell. This reflects the international relationships that these two companies have with the international shareholders of most of the major mining activities being undertaken in PNG and the outcome of the awarding of supply contracts that are usually offered for public tender by this industry. As a consequence, Shell and Mobil are the only operators in PNG which have sufficient storage capabilities to be able to maintain supplies to these mining facilities.

It is submitted by InterOil that, based on volume, this sector is dominated by 3-4 large customers of which OK Tedi (OTML) and Porgera Joint Venture (PJV) are serviced by Shell. Currently, OTML is serviced ex Shell's Port Moresby terminal, and if approved, the acquisition will lead to this volume being sourced direct ex the Napa Napa refinery and therefore open to competitive bids from all incumbent wholesalers as well as any potential new entrants because availability of domestic storage facilities will no longer be a constraint on ability to supply. PJV is serviced ex Lae and also restricted to Mobil and Shell due to storage capacities and shipping schedules. Due to change in logistics of supply

with supply now coming from the refinery instead, other distributors now have the potential to provide competition to Shell and Mobil for this customer.

The Commission acknowledges that the market shares currently enjoyed by Shell and Mobil in this sector are subject to change as they are negotiable upon renewal of the supply contracts. As such, there is a possibility of new entrants entering the market and thus supplying the mining sector. However, this will depend on the entrant's ability to have either its own storage capacity or can negotiate for an access arrangement with existing suppliers to the mining sector. Further, to supply mines such as OTML and PJV, an additional cost would be to put in place a cost effective shipping arrangement. The Commission notes that currently Shell, Mobil, IPL and NOC have a joint shipping arrangement for the delivery of petroleum products from Napa Napa to ports around PNG and any new entrant seeking to distribute product from the refinery would need either to join this shipping arrangement or put in place a separate arrangement. The Commission has been involved in the oversight of this shipping arrangement, and would take an active role in ensuring access for other new distributors to this shipping arrangement. For the period of the current contracts, Shell and Mobil will continue to be the only suppliers to the mining sector although their position will be weakened by the existence of storage facilities at the refinery from where some existing and future mining operations could be supplied direct without the need for intermediate storage.

The Commission is of the view that the proposed acquisition would result in InterOil owning and operating Shell's assets used in servicing this sector. Therefore, the proposed acquisition would merely replace Shell in the mining sector while there will still be continued competition with Mobil and the possibility of new entrants coming into this segment of the market.

**(c) Retail sector**

In its submission the applicant submits that retail volumes are either tied to head leases or site ownership and therefore where head lease is with the oil company, retail sites could be regarded as company owned. However, where the head lease or ownership is with a dealer, the site owner makes an independent decision regarding supply; thus, the acquisition will result in InterOil owning only those retail sites where the head lease is owned by Shell.

It is the Commission's view that while this may be true, post acquisition, InterOil as the biggest wholesale distributor will still be in a position to influence the supply decisions of the site owners, where the head lease or

ownership is with a dealer. For those sites which are not directly owned by Shell/InterOil, they will have some opportunity to seek to take supply from Mobil or in some locations, from NOC. However, in reality they will have little alternative options in terms of from whom they take supply. This will mean that there is one less distributor in the market with whom a site owner might negotiate supply of petroleum products. To what extent this has an impact on the retail sector is difficult to determine as normally little change between distributors occurs at the retailer level. However, there may be issues of 'rationalisation' of service stations as InterOil takes over the branding of all Shell service stations and consideration is given to the number of sites required when InterOil branded sites are located in close proximity to one another.

**d) Commercial sector**

The applicant submits that competition in the supply of refined petroleum products to the commercial sector is not determined by ownership of the storage and pump assets tied to existing supply contracts. The value of small tanks and pumps usually tied to supply contracts in this sector is not significant compared to the value of fuel that is purchased pursuant to new fuel supply agreements. Upon expiration of supply contracts and change of suppliers, these storage and associated assets are either purchased by the customer or by the new supplier.

From the information that is available, it is the Commission's view that the existence of current supply contracts and assets owned by the distributors but located in commercial customer premises, would not act to limit the degree of competition in the supply of product to this sector. The Commission notes that when the current fuel supply contracts cease, commercial customers will all look for competitive bids from suppliers such as Mobil, NOC, Islands Petroleum Limited and InterOil. The Commission notes that the entry of Island Petroleum Limited and Niu Petro Oil into the distribution market potentially increases competition in this sector, although these distributors are localised in their operations. Consequently, any increase in competition from these new, small operators will, in the short term at least, only apply in limited localities, not across the country. NOC is also currently highly localised, focusing primarily on Lae/Highlands locations. However, NOC is showing signs of seeking to enter the Port Moresby market which, after Lae, is the largest single commercial customer market.

The acquisition of Shell by InterOil will reduce the number of established national suppliers to the commercial sector, but will do so in a market where there is evidence of new market entry and the barrier to entry are not so high as to prevent new competitors emerging.

**(e) Marine sector**

As in the other sectors dealt with above, currently this sector is serviced by Shell and Mobil only through company owned bunker facilities attached to the Idubada terminal and main wharf respectively. There will still be two suppliers competing post acquisition and therefore the applicant submits that the acquisition will not result in a lessening of competition in this sector. Further, the applicant submits that there could be a possibility of a new player(s) competing in the market.

Information before the Commission suggests that although the acquisition would not result in the reduction in the number of players in the marine sector; InterOil is likely to establish a bunkering facility at Napanapa which may be restricted only to IPL. This would result in IPL customers having access to lower prices compared to customers of other distributors. For example, it is possible that Mobil customers would be forced to pay higher cost due to the transshipment costs that would be incurred by Mobil for transporting fuel from the refinery to its bunker facility at the main wharf. (Alternatively, Mobil could carry the cost and still match the IPL price, which it would need to do in a competitive market.)

In the absence of non-discriminatory assurances or undertakings by the applicant, this would pose some serious competition concerns in the market. Having said that, the Commission notes that InterOil's earlier assurance that it will not enter into any key commercial terms of supply with an existing or future customer (including its own subsidiary) which are discriminatory or preferential in any way<sup>1</sup> would alleviate this concern.

Further, the applicant claimed that bunkering by road is also possible and both incumbents and new entrants have this possibility available to them if they choose to source supply in this way.

Information before the Commission suggests that although bunkering by road is possible, this will depend on the road conditions which would need to be addressed. Currently, road conditions are such that this is not a viable proposition although this may be overcome some time in the future. Furthermore, it would still involve a higher cost that has to be recovered from customers than an option available to IPL which would deliver supply direct from the refinery to IPL customers.

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<sup>1</sup> InterOil's supplementary submission to the Commission of 2<sup>nd</sup> April 2004 and its letter of 8<sup>th</sup> April 2004

## **THE EFFECTS ON COMPETITION**

In assessing the competition effect in the market resulting from the acquisition, it is necessary to examine the nature of competition before and after the proposed acquisition bearing in mind that the competition effect after the proposed acquisition is not necessarily the effect immediately after the proposed acquisition but rather, what is likely to happen in the future.

The Commission notes that there is already a high level of vertical integration resulting from the fact that InterOil is the owner and operator of the only refinery in PNG and by virtue of its acquisition of BP PNG Limited in 2004, InterOil does have a direct control and influence over a major petroleum distribution business in PNG. This raises serious competition effect issues should InterOil afford preferential treatment to its own subsidiaries over the other competitors.

Should InterOil also acquire the Shell business, which for the sake of this proposal refers to the domestic distribution of retailed petroleum products, but importantly does not include the supply of Jet A-1 at Jacksons or the contracting for supply to major mining operators (6 per cent), InterOil will potentially have a combined market share, on its own estimates, of about 55 percent of the total market. The remaining competitors at the distribution level will be Mobil, NOC and the smaller operators, Islands Petroleum and Nui Petro Oil.

In the absence of mitigating factors, possession of such a high percentage of market share would of itself be a strong indication of a situation which would have the effect or the likely effect of substantially lessening competition in that market. Furthermore, with the exception of the legal constraint on Inter-Oil raising prices, resulting from the *Prices Regulation Act*, and the legal constraints under the approvals previously given and in the Agreement with the Government for the operation of the Napa Napa facility which require InterOil to provide access to product from the refinery without favour to any individual distributor, it is questionable as to whether the other factors required to be taken into account under Section 69(5) of the ICC Act would significantly mitigate the anti-competitive effect of the high market share controlled directly by InterOil post the proposed acquisition. This anti-competitive impact was foreshadowed in the Commission's decision granting clearance for the acquisition of BP by InterOil.

These arguments remain as valid today in the context of the current application as they were during the deliberations involving the BP acquisition.

## ***Arguments advanced by the Applicant***

In arguing that the acquisition will not have or would not be likely to have the effect of substantially lessening competition in the market, InterOil advanced a number of points. These are identified below with comments from the Commission on the points raised.

### ***Applicant***

1. The market in PNG is not perfectly competitive. This is illustrated by the fact that there are currently only six (6) players in the market and the price in the market is determined by the ICCC. Although the proposed acquisition will lead to a reduction in the number of firms in the market from six (6) to five (5), this, however will not affect competition in the market as the distribution margins are regulated and controlled by the ICCC. Further, in most sub-markets (aviation, marine, mining) there will continue to be competition from Mobil and other independent emerging operators such as NOC, Niu Petro Oil, Islands Petroleum Ltd.

### ***Commission***

The Commission accepts that the market is not perfectly competitive and that there are regulatory arrangements in place controlling the wholesale and retail margins on petroleum products in PNG. Anti-competitive behaviour can take other forms which are currently outside of any regulatory arrangements in PNG. For example, a dominant player could act to constrain the availability of petroleum products in certain locations if there was insufficient reason for a competitor to set up in competition to that dominant player, and the dominant player was able to conduct its affairs in such a way as to maximise its long term position without necessarily encouraging competitors to supply into that area. In the PNG context, there are parts of the country where there is limited competition between the competing distributors even in the current market situation. For example, Manus Province is solely supplied by Shell and this arrangement would presumably transfer to InterOil under the proposal before the Commission. While the opportunity exists for other distributors even now to enter the Manus market, the demand is insufficient to warrant the initial set up cost, and thus this area is dependent on one supplier.

The fact that this situation exists at present raises the question as to whether the loss of one of the principle distributors would further worsen the situation. It can only be concluded that it would remove at least one extra potential competitor from the market although in actual fact that distributor may not actually compete in a particular part of the country. Although a reduction of players

in the market will continue to ensure competition, the competition landscape would not be the same as before where both Shell and Mobil provided competition to InterOil. The acquisition will result in one less main competitor

The Commission also notes that Shell has announced its intention to withdraw from distribution/retailing activities throughout the Pacific island region, and as a result there would be one less player operating in the PNG market regardless of the outcome of this application. The Commission has considered the possibility of one of the existing smaller players acquiring the Shell operations in PNG. However, the Commission has not received any indication from these existing, albeit smaller, operators that they would be interested in taking up the Shell operation. However, the Commission has noted that Island Petroleum has acquired the Mobil distribution activities in the Islands region, which suggests that there may be buyers who would be willing to take up parts of the Shell activities.

### **Applicant**

2. One of the most important factors that determine the competition landscape in the market in this case is the current regulatory pricing arrangement enforced by the ICCC. Under this arrangement, the ICCC continues to review the IPP components of fuel products on a monthly basis and the wholesale margins and distribution cost on an annual basis. It also determines the sea freight differential and sets the retail margins for the service stations. Wholesale fuel distributors pay the same price for refined products when purchasing from InterOil. Neither InterOil nor any other player in the market will be able to raise the wholesale or retail margins as these are controlled by the ICCC. This arrangement benefits consumers and puts pressure on distributors to rationalize their assets and maintain low cost structures in order to ensure a profit.

### **Commission**

The Commission acknowledges that under the *Prices Regulation Act*, there is a legal constraint on InterOil's ability to raise the prices of its products. The price cap on the wholesale and retail margins of refined petroleum products are maximum allowable margins within which prices can be charged. The Commission also monitors the price of product ex the refinery on the basis of the pricing formula agreed in the Agreement with the Government for the establishment of the refinery.

The Commission notes the potential for non-price anti-competitive behaviour as discussed above. The removal of one of the larger competitors will heighten the opportunity for the dominant distributor/retailer to exercise this power. However, the Commission acknowledges that with the planned withdrawal of Shell from the market regardless of the outcome of this application, there would still be the loss of a significant competitor to counter any non-price anti-competitive behaviour that could be undertaken by InterOil.

### ***Applicant***

3. Other important factors which affect competition in the market include:
  - Deteriorating infrastructure that affects assets of transport operator;
  - Entry cost of sub-optimal infrastructure, price regulation and a perception of sovereign and currency risk;
  - Cost of public utility; and
  - Freight and transport costs.

### ***Commission***

It is acknowledged that the factors inhibiting competition are not unique to the petroleum industry. All industries and business suffer from the same fate but, for big businesses, it is expected that they would fare better due to the advantages they have in size and scale, etc.

### **Views from Industry Participants and Others**

Views were also sought from industry participants as well as other interested parties and these are summarized as follows:

***National Fisheries Authority*** - Shell's exit was always inevitable due to the market for fuel and petroleum products being stagnant, providing limited opportunity for expansion. The acquisition will allow InterOil to be the market leader in the petroleum industry which will result in it effectively buying off competition. This will create a duopolistic market condition in the market.

***Department of Trade and Industry*** - The eventual acquisition of Shell by InterOil will result in a monopoly due to InterOil's previous acquisition of BP. The acquisition of Shell will mean that there would be limited price alternatives available in the market.

**Ok Tedi Mining Ltd** - Although Ok Tedi has the ability to import fuel from overseas, there are number of practical and economic impediments to InterOil's claim of credible threat of imports being made by mining companies. This is because Ok Tedi does not have the distribution facilities to import and store fuels and it is not in its interest to procure petroleum products and manage the logistics to have the products delivered to the site.

**Department of Finance and Treasury** has expressed the following views:

- The proposed acquisition of Shell would be likely to lead to a significant reduction in competition in one or more domestic markets while there would not be a reduction in others;
- InterOil's ability to exercise any market power would be mitigated (at least in part) by the on-going setting of maximum retail and wholesale margins by the ICCC;
- InterOil's application has largely failed to address the question of potential public benefits of the proposed acquisition, except that this will lead to greater efficiencies, which would in turn be passed on to consumers;
- Many of InterOil's justification for the acquisition refer to the company's already significant investment in the midstream business, and suggestion of major investment in the petrochemical plant. Although this is welcome, Treasury cannot see how these are linked to the proposed acquisition of Shell;
- In assessing InterOil's application, consideration should also be given to the competition issues surrounding Shell's exit from the market.

**Air Niugini** put forward the following arguments:

- The acquisition would not only lessen competition but remove it because in addition to its level of vertical integration, InterOil would have nearly 100 per cent of the aviation fuel market; which would allow it to control the market and prevent others from entering;
- Due to its level of vertical integration and the possibility of cross-subsidization, InterOil would be in a position to increase prices and profit margins;

- Currently, there is a transparent pricing mechanism for Jet fuel in existence to make the competition accountable and transparent. The acquisition would result in no tangible benchmark to ensuring transparency of pricing;
- There are no public benefits due to InterOil's deficient quality testing standards and its lack of capacity to maintain minimum stock levels in events of fuel shortage. Further, InterOil does not have alternative emergency supply sources of aviation fuel.

**Mobil Oil Niugini Limited** has expressed the following views:

- The proposed acquisition would result in a substantially lessening of competition in the market;
- The majority of the public benefits alleged to result from the proposed acquisition are either unlikely to eventuate or are not outcomes that are attributed to the proposed acquisition;
- If there are public benefits, this must outweigh the resultant anti-competitive detriment;
- InterOil's authorisation application contains vital market information which is erroneous; and thus should not be relied upon in making the determination;
- Should authorisation be granted, this must be conditional to ensure a level playing field and non discriminatory conduct by InterOil.

**PNG Power Ltd (PPL)** submitted that if the number of potential bidders becomes more restricted than at present, most of PPL's isolated centres are likely to have only one supplier of fuel available and it would be difficult to monitor if the delivery cost is reasonable. Thus, if the proposed acquisition is permitted, a mechanism must be established to protect the margin in areas where the potential suppliers are restricted.

**The Deputy Prime Minister and Minister for Petroleum and Energy** has submitted the following views on behalf of the Government:

- Government has been involved in detailed discussion with InterOil on a number of downstream processing activities, including the manufacture of petrochemicals and LNG;
- Amongst others, InterOil has expressed strong interest to take part in the Government's proposed Konebada Petroleum Park. An MoU/ framework agreement would be entered into in the near future;

- InterOil's planned downstream activities supports the Government's gas commercialization strategy, the MTDS and the public interest on PNG;
- The petrochemical plant would create jobs, boost income, export, the Government's tax base and stimulate expansion of firms;
- It is reasonable to assume that the acquisition would put InterOil in a better position to secure the necessary finances and thus invest into new areas of downstream processing;
- The proposed acquisition is not a hostile takeover bid calculated to remove a competitor from the market. It is Shell's global strategy to exit relatively small markets such as PNG. If the acquisition is not approved, it is possible that Shell may simply close its retail outlets, either immediately or as they fall into disrepair through a lack of maintenance expenditure. This possible outcome would be detrimental to consumers and industry alike, especially to those in rural areas, and clearly counter to the public interest;
- The sale of Shell (PNG) Ltd as a going concern to a committed company such as InterOil offers the best prospect for ensuring that Shell's exit strategy does not result in a damaging contraction in PNG's fuel products retail network, with subsequent job losses and inconvenience to consumers and the private sector. The lack of interest in the PNG fuel products market by the major corporations, as evidenced by the recent exit of BP, adds weight to this assessment;
- This is a case where there will be material public benefits resulting from InterOil's acquisition of Shell;
- Further, there is merit in putting in place the following safeguards;
  - InterOil to guarantee the adequate distribution of Kerosene, at a reasonable price, to all parts of PNG;
  - InterOil to guarantee the adequate distribution of Jet A-1, at reasonable price, to all parts of PNG, especially at the "up-country" sites that are currently supplied by Shell PNG;
  - InterOil to guarantee that it will continue to provide fuel products to competitor retail outlets throughout PNG;
  - InterOil to give a guarantee on non-discriminatory conduct.
- The Government is considering conducting a review of the IPP arrangement for locally refined fuel products, to ensure that the arrangement is in the best interest of PNG consumers and the economy.

### **Statutory Factors taken into account in Assessing Competition**

In addition to the assessment of the arguments by the applicant and others, Section 69(5) of the *ICCC Act 2002* sets out a number of non-exclusive factors that need to be considered.

**(a) The actual and potential level of import competition in the market**

The applicant did not address this factor adequately but from the information provided in the submission, it is acknowledged that all wholesale distributors will now be getting their fuel supplies from the Napa Napa refinery and in the event that InterOil cannot supply the required fuel, the distributors are allowed to obtain their supplies from overseas. The Commission notes that all distributors are currently sourcing their fuel supplies from the refinery except for some products relating to the aviation sector and some lubricating oil products. For instance, in the aviation sector, Shell and Mobil being the only suppliers, continue to import avgas and other oil derivatives in small quantities from Australia. This is mainly due to InterOil's inability to produce avgas at the Napa Napa refinery. However, all the main petroleum products used in PNG are produced at the refinery and distributed nationally from this source under the terms of the *Project Agreement* entered into with the Government which sets the pricing arrangements and the supply requirements.

In the event that InterOil produces avgas and lubricating oils at the Napa Napa refinery at some time in the future, distributors would be required under the *Project Agreement* to source these products from InterOil. As such, there is no import competition at present in the market and there would not be any change in the level of competition from imports as a result of the proposed acquisition. However, there would be one less international firm operating in PNG to act as an emergency supplier of fuel products should InterOil be unable to supply from the Napa Napa facility. An example of this was seen when Jet A-1 fuel was allegedly found to be below specifications, and Shell diverted product to PNG to meet the short-term lack of supply.

It should be noted however, that with the withdrawal of Shell from the Pacific islands nations, in all probability this additional back up supply arrangement will not be available regardless of the proposed acquisition of Shell by InterOil.

**(b) The Nature and Effect of Barriers to Entry to the Market**

From the information supplied in the application, the applicant argued that there may be high barriers to entry to the PNG wholesale distribution market due to high freight and transportation costs, price regulation by Government and cost of public utility. The applicant claimed that the establishment of the refinery has enhanced access to the Port Moresby market for all players and the recent entry of Islands

Petroleum Ltd and Niu Petro Oil are an indication of the ease of entry by small players.

The Commission has considered the barriers to entry by new entrants, and notes the following:

- A new distributor has the right to access fuel from the Napa Napa facility, but must then transport the product to the particular region and outlets being serviced. Currently all road transport in the Moresby area is handled by a single operator (Port Moresby Transport) and it could be expected that transport terms could be negotiated. The Commission would use its powers should discrimination be exercised by Port Moresby Transport who is the sole operator of the appropriate form of transport. Transport to other locations would involve shipping from Napa Napa. There is a joint industry shipping arrangement operated by the industry, which the Commission has implicitly approved and oversights. The Commission would require that other distributors had access to this arrangement subject to the normal safety and pre-booking of shipping space requirements. Thus, from a transport and access to supply perspective, the barriers to entry are not insurmountable
- Access to storage facilities in other ports would involve a capital investment by a new entrant, either by way of construction of appropriate facilities, or the acquisition of existing assets no longer required by current distributors. While current distributors cannot be forced to sell their surplus assets to a new entrant, the reality has been that Mobil has sold its surplus assets to a new entrant and Shell has sold its assets on Manus to the local Provincial Government. Also, NOC has recently completed building new storage facilities in Lae to meet the safety requirements that now apply to all distributors using the common transport system from the refinery.
- New entrants would be seeking to find retail outlet sites for their product. Again, there is evidence to support the view that with the rationalisation of sites by InterOil, some sites are now becoming available which an independent distributor could service. The recent experience in the Highlands where NOC continued to supply into the region following the withdrawal of Mobil and Shell supports the view that retailers are prepared, where the retail outlet is owned by the operator, to change suppliers in order to maintain supply.
- Sub-distributors are a characteristic of the PNG market. Islands Petroleum is an example of a sub-distributor who has taken over

the distribution of Mobil products throughout the Islands region and down in to Bougainville. There is opportunity for other new entrants to buy into the market in this fashion, and in the process acquire the infrastructure for the storage and distribution of product in regions within the total national market.

**(c) Number of Buyers and Sellers in the market**

There are six (6) participants in the market, namely InterOil Products, Shell, Mobil, NOC and more recently Niu Petro Oil and Islands Petroleum Limited. InterOil is the sole supplier of refined petroleum products to these participants.

The applicant argued that the market share of Islands Petroleum Limited and Niu Petro Oil are unknown but maintained that they are smaller and relatively new entrants in the market. The Commission notes that Niu Petro Oil is a small local distributor operating out of Mount Hagen; while Islands Petroleum Limited is a supply customer of Mobil which has been established through an existing supply arrangement. On balance, the Commission does not discount the possibility of new entrants into the market in light of Shell's voluntary withdrawal.

In terms of the number of suppliers of service in the industry, the Commission notes that there are essentially three main operators, IPL, Shell and Mobil, and despite the entry of NOC, Nui Petro and Island Petroleum, the three main distributors hold the largest share of the total national market. For the retailing of petroleum products, many of the retail outlets are owned by the main distributors. However, there are interdependent retailers who own their own facilities and can contract with the different distributors, adopting their product livery and other signage.

The withdrawal of Shell will reduce the number of distributors in PNG regardless of the decision of the Commission on the proposed acquisition of the Shell business by InterOil. While some of the retailers who currently operate under the Shell brand may have adopted other brands if Shell had simply withdrawn, the reality will be that InterOil will only want to retain a limited number of the existing Shell retail outlets as some are likely to be in direct competition with existing InterOil Products outlets. Thus it can be expected that there will be some owner operated retail outlets that will be looking for new suppliers following the cessation of the Shell business, and some Shell owned sites may also be offered for sale to other suppliers, or simply closed. This would occur regardless of the Commission's decision on the InterOil/Shell proposal.

**(d) Degree of Countervailing power in the market**

The applicant submitted that the Government exerts a strong hand in the regulation of petroleum industry and therefore the willingness of market participants to cooperate with government has led to an effective countervailing power.

Countervailing power is the bargaining power of customers to negotiate on prices, quality and service arrangements with suppliers. Where there is potentially only one supplier, the countervailing bargaining power of customers may be very small.

In terms of this industry, there is limited countervailing power held by retailers (as consumers of the services provided by the distributors) and final consumers who purchase their fuel supplies from retailers of the fuel. Ultimately, as noted by InterOil, the Government through the ICCC and the *Agreement*, controls the price for petroleum products. This will remain unchanged regardless of the ownership of the Shell business or the potential withdrawal of Shell from the PNG market.

Service standards (in terms of driveway service and convenience of retail outlets) may suffer as a result of the withdrawal of Shell, but this would occur regardless of the decision on the InterOil/Shell proposal, reflecting the decision by Shell to withdraw from the market.

For larger customers (commercial, mining, aviation), as discussed above, there will remain some competition in this market while Mobil remains as an operator. Furthermore, Shell will remain as a potential contractor of fuel supplies to major international businesses such as mining companies and airlines. The supply of product from the InterOil facility is a constant in this scenario, and thus it does not detract from the fact that there will continue to be some degree of countervailing power that these consumers can exercise in terms of negotiating with international fuel suppliers for their fuel needs.

The Commission notes the comments made by Ok Tedi and Air Niugini in terms of their perceived ability to either source fuel direct or to obtain competitive quotes. The Commission acknowledges the desire by Ok Tedi, and presumably other mining companies, to avoid the need to become their own suppliers of fuel with associated transport and storage problems. It is understood however, that Shell will continue to tender for these contracts when they come up from time to time. Shell has already been a major supplier into this market. Furthermore, for some (few) mining ventures, such as Lihir, the option of obtaining supplies direct from overseas is one that can be applied, and is the approach that Lihir has used to meet its fuel requirements.

For Air Niugini, the current fuel supply tender is held by Shell who negotiated an arrangement with Air Niugini such that Shell became the exclusive supplier to Air Niugini. As a consequence, Mobil has partially withdrawn from the aviation market in Port Moresby. Air Niugini have it within their own power to address this issue and ensure that they have competitive bids for future tenders for the supply of fuel.

For smaller domestic commercial users or even larger single users such as PNG Power, the degree to which they can exercise countervailing power will be reduced a little by this proposal as a result of the withdrawal of one competitor from the market, because their ability to switch suppliers will be diminished. However, as Shell was going to withdraw regardless of the Commission's decision, it is inevitable that the number of distributors of sufficient size and financial capacity to supply commercial customers of this size will be reduced in PNG.

**(e) Likelihood that the acquisition would result in the acquirer being able to significantly and sustainably increase prices and profit margins**

The Commission is of the view that InterOil will not be able to significantly and sustainably increase prices or profit margins for products sold through retail outlets because the products in the market are being regulated under the *Prices Regulation Act*. Given also that as a condition of being granted a clearance for the acquisition of BP (PNG) Ltd, InterOil had given assurances that it will supply all its customers at the refinery on a non-discriminatory basis and hence, there ought to be no scope for InterOil to differentiate on price between its customers at that stage.

However, to the extent that there is a reduction in the number of potential competing suppliers for certain commercial customers (including potentially PNG Power), there may be the possibility for an increase in margins to occur. The margins that the distributors charge these customers are usually below the rates approved by the Commission for normal retail sales purposes. Thus, to the extent that there is limited opportunity for alternative suppliers, some of these customers may find that the margin on their purchases increases. However, it cannot increase to be greater than the margin approved by the Commission under the *Prices Regulation Act*.

Again, the Commission notes that with the withdrawal of Shell, there is the possibility that this market outcome would have occurred regardless of the InterOil/Shell proposal.

**(f) Extent to which substitutes are available or are likely to become available in the market**

InterOil claims that there are limited opportunities for substitutes in this industry. The Commission is of the view that there are no substitutes of refined petroleum products in the market.

**(g) Dynamic characteristics of the market including growth, innovation and product differentiation.**

The applicant submitted that innovation and product differentiation may be available for demand in developed countries as there is rarely demand in developing countries. While it is difficult to deduce what the applicant is asserting here, it is the Commission's view that the market for petroleum products in PNG is largely determined by external factors; that is, the type of fuel required to operate certain types of machinery, transport equipment etc. There is some 'product innovation' occurring in PNG in the area of the use of coconut oil as a partial substitute for diesel fuel. A mixture of coconut oil and diesel is being used to fuel machinery in Bougainville and is being promoted across PNG. However, these are 'cottage industry' activities, and are unlikely to be major competitors with the supply of fuel products from the Napa Napa facility.

Thus, from the perspective of a dynamic and innovative market, PNG is a follower rather than a leader and there is no indication that changes in the petroleum and fuel industry is likely to impact the market position of the current oil based fuel supply chain.

**(h) Likelihood that the acquisition would result in the removal from the market of a sustainable, vigorous and effective competitor**

InterOil claims that Shell is indeed an effective and vigorous competitor in the wholesale distribution of refined petroleum product. Although the acquisition appears to have the effect of removing Shell from the market, it is a fact that Shell is in the process of focusing its assets and capital in larger markets and as such is withdrawing from the PNG market and that of the other Pacific island nations. It is therefore argued by InterOil that the acquisition merely ensures that the assets are taken over by a competent local management, and by a company with a long-term vested interest in PNG.

The Commission accepts that Shell is the biggest of the distributors in the market making it a vigorous competitor to InterOil and, for the reason that Shell is voluntarily pulling out of the market, also accepts that, while the proposed acquisition would result in the removal of a

vigorous player in the market, this vigorous player of its own volition is withdrawing from the market regardless of the outcome of this proposal.

**(i) Nature and Extent of Vertical Integration in the market**

The applicant concedes that the acquisition will lead to a vertical integration in the market by reason of its ownership of the refinery and its investment in the exploration of oil and gas in PNG. This will result in InterOil being the largest wholesaler and distributor of oil-based products in PNG as well as the sole refiner of petroleum products which, by agreement with the government, is to be the only source of these products for the PNG market. However, the acquisition will not have any impact on the prices of refined petroleum products, which is price controlled.

The Commission accepts the applicant's claim on the basis that, currently, InterOil is a vertically integrated refiner and a wholesale distributor of refined petroleum products following its acquisition of BP (PNG) Limited. The acquisition of Shell will add to the existing distribution activities in the vertical integration of the InterOil group.

Further, in light of InterOil's assurances given to the Commission on the acquisition of BP and its position in the current acquisition of Shell, the Commission accepts that while vertical integration is a potential problem with the proposed acquisition, the Commission cannot conclude that the acquisition would or would be likely to result in a substantial lessening of competition, simply as a result of increased vertical integration alone.

**CONCLUSIONS ON LESSENING OF COMPETITION**

Under the provisions of Section 82(3)(a) of the Act, the Commission is required to consider whether a notified proposal is likely to result in a substantial lessening of competition. The facts are generally agreed. After the acquisition, InterOil will own and operate Shell's distribution assets on a nation wide basis. InterOil is already a significant player in the distribution market and is also the only supplier of refined fuel to these distributors.

InterOil submitted that there are various individual regional markets in PNG and the impact on competition at the regional or sub-markets must be considered in determining the effect of competition in the overall market. In this respect, InterOil claimed that sub-markets that will be unaffected by the acquisition should not be included in the analysis and that in no sub-markets will the number of competitors be reduced from two to one.

The Commission has considered this argument and acknowledges that on the evaluation of the evidence available, the 'sub-markets' identified by InterOil will probably see none having their existing competitors decline from currently two to one.

However, the Commission is required to have regard to the definition of the market as provided in the legislation. Thus the Commission must consider the concept of market from a national perspective. Within the national perspective there is no doubt that there will be a reduction in the number of active competitors in the market place. Even at the sub regional level that InterOil would have the Commission consider, there is likely to be a reduction in competitors. As noted from the discussion above, for commercial customers in particular, there is likely to be a decline in competitive pressure for the supply of product to these customers, and as the Commission has noted, although there is a cap on the margins that can be charged, the discount on that cap that is currently given to many of these customers is likely to be reduced or withdrawn completely in response to the lessening of competition.

Furthermore, the Commission has noted in its analysis of the market and the likely effects of the proposed acquisition, there will be a reduction in competition across the nation, and although there will be the potential for new entrants, these new entrants are likely to be relatively small in their operations and limited in their ability to compete at a national level. If new entrants do emerge, they are more inclined to operate in one of the sub regions identified by InterOil rather than nationally.

The impact on consumers is likely to vary. For normal retail customers, the Commission notes that its current prices regulation will ensure that the wholesale and retail margins are controlled under a cap arrangement. However, this will not prevent possible non-price competition being influenced. For example, the convenience of multiple retail outlets will be impacted by this acquisition and this is likely to force customers in the larger cities and Port Moresby in particular, to have to travel further to find an operating service station. For commercial users and even large organisations such as PNG Power, there will be less opportunity for competitive tenders for the supply of product and the opportunity for any discount on current regulated margins to be reduced or withdrawn.

The Commission has noted the argument that Shell is, of its own volition, leaving the market and withdrawing from this region in terms of distribution activities to retail outlets and to many of its commercial customers. The Commission acknowledges that this decision by Shell makes it, in part, inevitable that there will be a reduction in the number

of distributors in the PNG petroleum products market. However, the Commission notes that Mobil, as it has sought to restructure its own operations, has been able to develop a strategy whereby it has remained in operation while at the same time providing the opportunity for other smaller distributors to acquire the relevant assets that it owns and continue with the supply of product effectively through a related but new independent supplier. This option has not been attempted by Shell, and thus the opportunity to retain at least other competing distributors albeit in sub regional areas, will be lost with the approval of this proposal. As this is a possible solution to the restructuring of the industry while at the same time retaining competing suppliers with the potential to expand into other regions and possibly nationally at some future time, it can only be concluded that the inevitability of Shell's withdrawal from PNG does not necessarily mean that that it is inevitable that there will be a lessening in competition in the industry from Shell's withdrawal.

Thus, taking into account these factors, the Commission is not satisfied that the proposed acquisition will not have, or will not be likely to have the effect of substantially lessening competition in the market and therefore declines to grant a Clearance for the proposed acquisition.

### **PUBLIC BENEFITS**

This leads to the need to make an assessment on the second part of Section 82(3)(b) relating to whether or not the ICCC is satisfied that the acquisition would result, or, would be likely to result in such a benefit to the public that it should be authorised.

In its application to the Commission for authorisation, the applicant submits, in accordance with the wording in the Act, that the acquisition will result, or will be likely to result in, such a benefit to the public that it should be permitted by way of authorisation to proceed with its proposed acquisition of Shell. To support this claim, the applicant has provided the following public benefit arguments to the Commission.

#### ***(a) Proposed establishment of a petrochemical plant in Papua New Guinea***

The applicant is leading an international consortium of investors and industry participants, planning to establish a petrochemical plant in PNG. This major project involves risk and will require capital in excess of K5 billion. It is claimed that the acquisition of Shell will enable InterOil to further diversify its activities into the downstream business of wholesale distribution of refined petroleum products. It is submitted that by doing so, InterOil will broaden its financial base and together with Government

support, it will be in a position to secure the necessary finances for the petrochemical plant.

The establishment of a petrochemical plant would provide a benefit to the public. This view has been strongly supported by Government through a submission from the Deputy Prime Minister and Minister for Petroleum and Energy when he said:

“I can assure the Commission that InterOil’s interest in investing in other downstream processing activities accords fully with the Government’s gas commercialisation strategy, the Medium Term Development Strategy and, indeed, the public interest. Downstream processing of PNG’s hydrocarbon resources will directly create jobs and boost export income, expand the Government’s tax base and stimulate the expansion of firms in PNG’s services, manufacturing and construction sectors.”

This view is also put, though not quite so forcefully, by the Department of National Planning and Monitoring (DNPM) in its submission:

“DNPM recognise that the low levels of investment that characterised the country’s recent past explain why the country’s asset portfolio is currently so limited. We also recognise the importance of investment for generating PNG’s future development, in particular productive investment and labour absorbitive investment, given the high levels of unemployment. The oil sector is earmarked as a key industry for PNG in the Government’s Medium Term Development Strategy (MTDS), as it is capable of attracting large levels of investment if the right incentives exist.”

The views in the DNPM submission were endorsed by the Minister for National Planning and Monitoring.

Such projects can produce national benefits, or public benefits, in a number of ways. Perhaps the most obvious is through increased employment, both in the construction phase and, more importantly, in the creation of permanent, continuing employment once the project is operational. Whilst the InterOil claim of 7,000 direct jobs and 50,000 indirect jobs coming out of the petrochemical facility is probably much too high<sup>2</sup>, and how those figures were arrived at is not explained, it is nevertheless clear that such a project would create significant new employment in the longer term, to the benefit of Papua New Guinea.

Similarly, the establishment of such a facility, including the investment in its construction and operation as well as the output, would generate

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<sup>2</sup> Authorisation application 22 November 2005, page 34

very significant economic activity, to the considerable benefit of the PNG economy overall. While the InterOil claims of a 300% rise in GDP and a potential doubling in value of the kina<sup>3</sup> as a result of the establishment of the petrochemical plant appear somewhat fanciful, there would undoubtedly be a significant boost to PNG's economic activity once the petrochemical plant was established, to the benefit of PNG as a whole (as well as to InterOil).

The indirect benefits of major oil industry projects like the petrochemical plant are referred to, with somewhat less hyperbolic claims about employment and GDP than in the InterOil submission, in the DNPM submission:

“Like any large sector, the oil sector is served by a large number of supporting markets whose business is a function of activity within the nominal sector. These include input markets, transport and other service sector markets and the array of markets that serve those employed in the nominal sector, from housing to food produce. Supporting markets often take the form of SMEs, are labour intensive (unlike the oil sector) and disproportionately involve the poor. The greater the size of the distribution sector and the degree of competition, the greater the demand for the supporting markets.”

Such a project would also be likely to produce export income, a particularly useful economic attribute for the PNG economy, as recognised by the Deputy Prime Minister in his submission, quoted above.

From this it is clear that the establishment of a sizeable petrochemical plant in PNG, were it to proceed, would, over time, generate significant economic activity and jobs growth. This would be to the considerable benefit of Papua New Guinea overall, and would constitute a benefit to the public within the meaning of section 82 of the *ICCC Act*.

**(b) Relationship between the petrochemical plant and the Shell acquisition**

The fact that the establishment of a petrochemical plant would give rise to benefits to the public is not, in itself, particularly relevant to the authorisation application, unless there is some link between the establishment, or likely establishment, of the petrochemical facility and the acquisition of Shell's distribution business by InterOil.

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<sup>3</sup> supra

InterOil claims that there is indeed a link between the two activities. It claims:<sup>4</sup>

“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.*”

In other words, InterOil appears to be saying that its acquisition of the Shell distribution business, if permitted, would demonstrate to potential financiers of the petrochemical project, that InterOil’s business base was sufficiently strong to justify those financiers investing in InterOil’s petrochemical plant.

This view is shared in the Deputy Prime Minister and Minister for Petroleum and Energy’s submission:

“In my opinion, the viewpoint that InterOil’s acquisition of Shell PNG Ltd would facilitate the company’s capacity to invest in other downstream processing activities, as outlined above, is credible. It is reasonable to assume that by expanding and diversifying its asset base and revenue stream, InterOil will in time be better placed to secure the finance necessary to invest into new areas of downstream processing. As well, by expanding its operations through the proposed acquisition, InterOil will further strengthen its reputation with international lending institutions as a company with a track record of successfully operating in the PNG market place.”

From that it is clear that the Deputy Prime Minister is of the view that the establishment of a petrochemical plant would be a significant public benefit, and that the Shell acquisition, if permitted, would facilitate such a project getting off the ground through the provision of international finance.

The DNPM submission is not quite so enthusiastic:

“IPL imply that the proposed acquisition will enable them to invest heavily in new projects. Details of the new jobs these will create are provided in the IPL application. The inference that this

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<sup>4</sup> Supra, page 25

investment is dependent on the acquisition being approved is not entirely convincing or sufficiently elucidated.”

The Commission has carefully considered whether InterOil’s claims of a linkage between the Shell acquisition and finance for the proposed petrochemical plant, are plausible. While InterOil is a large firm in the PNG market, as far as international oil companies are concerned (being the companies who would typically be involved in petrochemical plants), InterOil is quite a small company. Thus it is not surprising that InterOil would claim that it needs extensive external financing in order to proceed with its petrochemical plant and the Commission accepts that this is the case.

It is also plausible that such financiers would take into account the size, stability and effectiveness of InterOil’s existing businesses, especially those in PNG, in assessing the desirability of financing the petrochemical plant. However, the strength of any link between the Shell acquisition and availability of finance for the petrochemical plant, will always be somewhat speculative. The Commission has not spoken to any potential financiers and even if it had, those financiers would be highly unlikely to tell the Commission, other than in the most general terms, whether their lending decisions would be affected by the Shell acquisition.

The Commission is not in a position to say that if the Shell acquisition did not proceed, this would cause the abandonment of the petrochemical project for lack of finance. However, the Commission does accept that there is likely to be some linkage between the Shell acquisition and the availability of finance for the petrochemical plant project. In reaching this conclusion, the Commission has given weight to the Deputy Prime Minister’s statement that:

“...InterOil’s acquisition of Shell PNG Ltd would facilitate the company’s capacity to invest in other downstream processing activities.....is credible”.

In this regard, the Commission has also taken account of the Deputy Prime Minister’s comment that his views are shared by the Government:

“All told, I am confident that the commercial interests and objectives of InterOil are closely aligned to the economic objectives of the Government. I am also confident that this view is shared by the Prime Minister and my Cabinet colleagues.”

In summary, the Commission is of the view that there is some linkage between the proposed acquisition and the capacity to secure financing for the petrochemical plant.

**(c) Loss of Shell's distribution business**

Perhaps the strongest claim is that, if InterOil did not buy the Shell business, Shell would just close it down anyway and that it is more beneficial to the people of PNG to have the Shell distribution business operated by InterOil than it would be if that business were just abandoned.

Shell's desire to exit the PNG fuel distribution market regardless is a consideration in determining the competitive impact as well as in public benefit terms. The DNPM submission says:

“If the acquisition is refused and Shell mothball, dismantle or remove their existing assets, IPL may nevertheless seek to expand their distribution business in the areas left vacant by Shell. Such an expansion would likely prove a much less productive investment than the direct acquisition of Shell's assets.”

Similar comment is made by the Deputy Prime Minister:

“In this instance, the proposed acquisition is not a hostile takeover bid calculated to remove a competitor from the market. It is Shell's global strategy to exit relatively small markets such as Papua New Guinea. If the acquisition is not approved, it is possible that Shell may simply close its retail outlets, either immediately or as they fall into disrepair through a lack of maintenance expenditure. This possible outcome would be detrimental to consumers and industry alike, especially to those in remote areas, and clearly counter to the public interest.”

The Commission again carefully considers the views put forward by the Deputy Prime Minister and by DNPM, and accepts that there is some public benefit in the acquisition if the alternative were the closure, mothballing or abandonment over time of the Shell distribution business.

**(d) Employment**

InterOil claims another public benefit from the acquisition would be increased employment, through the acquisition providing 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.

InterOil's claim of increasing employment is non-specific, and depends on perceptions of its having an improved and strengthened corporate profile. On the other hand, InterOil has also referred to the “rationalisation” of its oil distribution business post acquisition, with

integration of the Shell distribution business with InterOil's existing (formerly BP) distribution business. InterOil has said that where "job rationalisation" is inevitable, InterOil will redeploy affected individuals elsewhere in the company. While the Commission accepts InterOil may attempt to avoid any job losses, experience around the world where acquisitions of competing businesses results in their integration into one business (as would be the case here) this would very likely result in some job losses as efficiencies are realised through the rationalisation process.

Thus while there may be some unquantifiable employment in the longer term, any employment advantage would appear to be offset by the likelihood of some job losses in the short term. Accordingly, the Commission does not see the acquisition producing any significant public benefits from increased employment.

**(e) Greater efficiencies and terminal access**

InterOil claims that after the acquisition, it 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". It also says that additional cost savings may be achievable with more efficient transport arrangements following the rationalisation of terminal and depot facilities.

Further, the applicant claimed that the rationalisation of these facilities would allow InterOil to offer access to its main port terminals (Port Moresby, Madang, Lae and Rabaul) at commercial rates, to qualified operators that meet IPL's operational and HSE standards. InterOil claims that this arrangement would allow distributors to expand their operations into locations that, logistically, were impossible to pursue previously and thereby lead to enhanced competition among buyers of refined products from the refinery.

While one should be cautious about the extent of the benefits which may flow to competitor distributors from their having access to main port terminals (for example, shipping product across the harbour from Napa Napa to Port Moresby terminal may impose practical commercial constraints on use of that facility by some competitors), the Commission accepts that granting access to main port terminal facilities is a positive potential benefit to competitors, and thus to the public.

Rationalisation savings are quoted worldwide as a justification for, and a benefit of, acquisitions of competitors. Passing on those savings to consumers, to justify a public benefit from the acquisition, is notoriously hard to quantify and to put into practice. In this case, InterOil has

offered, in its supplementary submission<sup>5</sup>, to undertake a number of steps to ensure the transfer of rationalisation savings to consumers, through a rebate on fuel prices at the pump, monitored by the Commission.

While the extent to which any rationalisation savings are passed on to consumers will be very difficult to quantify, the Commission is satisfied that, with the rebate arrangements proposed by InterOil in its supplementary submission, there will be some public benefits from rationalisation savings arising from the acquisition being passed on to consumers.

***(f) National security and supply security***

The applicant submitted that in the absence of the Napa Napa refinery, PNG faces a potential fuel supply disruptions, thus the establishment of the refinery has fulfilled a vital national security interest integral to the energy supply of the nation.

While it may be argued that the refinery ensures security of supply, the Commission is of the view that these are benefits that the applicant and the Government had taken into account when considering the establishment of the refinery in 1997. The Commission notes that under the current proposed acquisition application, this claim cannot be considered as a public benefit because it refers to the company's existing investment in the midstream business. It would be erroneous to suggest that the establishment of the refinery resulting in security of supply of fuel products would arise from the proposed acquisition. The existence of the refinery, prior to the current proposed acquisition in itself guarantees PNG's refined fuel needs to some extent and therefore the proposed acquisition will not lead to any change in the situation.

***(g) Assurances safeguarding supply and competition***

The Deputy Prime Minister concluded that there will be material public benefits from the acquisition, but then went on to note:

“In my view, and in the event that the Commission was to approve the acquisition, there would be merit in ensuring the following safeguards:

- InterOil to guarantee the adequate distribution of Kerosene, at a reasonable price, to all parts of Papua New Guinea,
- InterOil to guarantee the adequate distribution of Avgas, at reasonable price, to all parts of Papua New Guinea,

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<sup>5</sup> InterOil supplementary submission of 16<sup>th</sup> December 2006, page 2

especially at the ‘up country’ sites that are currently supplied by Shell PNG,

- InterOil to guarantee that it will continue to provide fuel products to competitor retail outlets throughout Papua New Guinea, and
- InterOil not to engage in any anti-competitive behaviour that would inhibit the entry of new entrants into PNG’s fuel products retail market in the years ahead. .... InterOil must accept and adhere to the Government’s position that the fuel products retail market must be a competitive market that facilitates the entry of new competitors and/or the expansion of smaller retailers.”

In response to the Deputy Prime Minister’s comments, and discussions with the Commission, InterOil has given the following assurances<sup>6</sup>:

- **Distribution of Kerosene:** On the matter of distribution of kerosene, InterOil Products Limited (IPL) commits to an adequate distribution of kerosene at a reasonable price to all parts of Papua New Guinea in which IPL operates. A key issue with the distribution of Kerosene is the safety factor surrounding the management and handling of the movements of this product, particularly in the public sector.
- **Distribution of Avgas:** On the matter of the demand for the distribution of Avgas, IPL commits to an adequate distribution of Avgas at a reasonable price to all parts of Papua New Guinea in which IPL operates. This product will continue to be imported in drums.
- **Continuity of Supply to all domestic distributors:** InterOil Limited commits to the continued supply of petroleum products produced by the refinery to all domestic distributors in keeping with existing or future supply agreements between InterOil Limited and each domestic distributor.
- **Bunkering facility at the refinery:** As per our discussions, IPL is close to a decision to construct a marine bunkering facility adjacent to the InterOil refinery. On the basis that we proceed with this bunkering facility, IPL will provide access to this facility for domestic distributors. We propose this access to be on the basis of a fee-for-use, based upon the capital required to establish and operate this facility.
- **Possible retail site divestment:** As and when we divest any IPL or Shell-owned retail sites, IPL commits to an open-market sale of

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<sup>6</sup> Letter to the Commission dated 17 February 2006

such retail site, providing any interested financial qualified third party with an opportunity to acquire it on normal commercial terms.

The Commission considers the assurances contained in the InterOil letter of 17 February to be sufficient to address the matters raised by the Deputy Prime Minister, though it notes that compliance with these assurances as to future conduct will need to be monitored by the Commission.

## **SUMMARY AND CONCLUSIONS**

The applicant seeks authorisation from the Commission for the proposed acquisition of Shell (PNG) Limited under Section 82 of the ICCA Act.

Section 82(3)(a) requires that, if the Commission is satisfied that the acquisition will not have, and will not be likely to have, the effect of substantially lessening competition in a market, it shall give a clearance for the acquisition.

Section 82(3)(b) requires that, if the Commission 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, it shall grant an authorisation for the acquisition.

Issues to be considered under section 82(3)(a) for clearance, are whether the acquisition raises competition questions, while issues under section 82(3)(b), for authorisation, are about public benefits arising from the acquisition. If the competition issues are resolved so that a clearance is granted, the question of authorisation does not arise.

### ***Competition issues – section 82(3)(a)***

The competition questions which arise from the acquisition are dealt with in detail in the first part of this determination, with the conclusion<sup>7</sup> being reached that the Commission 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. Thus the Commission will not give a clearance for this acquisition under section 82(3)(a).

### ***Public benefit issues – section 82(3)(b)***

Having concluded that clearance should not be given on competition grounds, the Commission must then consider whether the acquisition

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<sup>7</sup> See page 22 above

will result in, or be likely to result in such public benefits that it should be permitted. These issues are canvassed in the second part of this determination.

The Commission has concluded that the establishment of a petrochemical plant, if it were to proceed, would result in benefits to the public. In considering whether those public benefits would result or be likely to result from the acquisition of Shell, the Commission considers that, on balance, there is a linkage between the Shell acquisition and the proposed establishment of the petrochemical plant sufficient to justify those future public benefits as being likely to result, at least in part, from the Shell acquisition. In reaching this conclusion, the Commission has given weight to the strong statements in support of the acquisition and its benefits to the public, contained in the letter from the Deputy Prime Minister and Minister for Petroleum and Energy.

It is important to note that the proposed acquisition arises because Shell is determined to exit from the Papua New Guinea fuel distribution market regardless, as part of its global strategy. If InterOil did not acquire that business, and no other ready and willing buyers could be found, it is likely that Shell would either close down its operations or gradually wind them down over time. In light of these circumstances, and again carefully considering the views put forward by the Deputy Prime Minister and by DNPM, the Commission accepts that there is some public benefit in the acquisition by InterOil, if the alternative were the closure, mothballing or abandonment over time of the Shell distribution business.

In relation to rationalisation, the Commission is satisfied that the rebate offer put forward by InterOil should allow for at least some of the savings from rationalisation to be passed on to consumers and would thus amount to a public benefit. As far as access to main port terminals is concerned, this access offer should be of use to at least some distributors and thus benefits competition, and can thus be regarded as giving some benefit to the public.

In relation to employment and to national security and security of supply, the Commission does not agree with InterOil's claims that public benefits will arise in these areas from the Shell acquisition.

### ***Should the acquisition be permitted?***

While the Commission is satisfied that there are some benefits to the public which would result, or be likely to result, from the acquisition, would those benefits outweigh any detriment to the public from a

lessening of competition arising from the acquisition, such that the acquisition should be permitted?

In assessing the extent of the detriment to the public from the lessening of competition, the Commission has taken into account the fact that Shell's determination to exit the market regardless means that there would be some lessening of competition in the distribution market, over time, whether the InterOil acquisition proceeded or not. The Commission has also had regard to the assurances given by InterOil as to its future conduct set out in its letter of 17 February 2006 and quoted above, as well as to InterOil's offer of access to main port terminals for competing distributors. All of these factors ameliorate, to a certain extent, any lessening of competition arising from the acquisition.

In assessing the public benefits arising from the acquisition, relating to the proposed petrochemical project, in particular, and also from InterOil continuing to operate the Shell business rather than it being mothballed, along with the other benefits from rationalisation savings and terminal access, the Commission notes and gives weight to the Government's comments supporting the benefits to the public arising from the acquisition, particularly those contained in the Deputy Prime Minister's letter.

Consequently, the Commission accepts the view expressed by the Deputy Prime Minister and Minister for Petroleum and Energy when he says "In sum, I am of the view that there is a case that there will be material public benefits from InterOil's acquisition of Shell PNG".

The Commission is satisfied, on balance, and considering the assurances as to future conduct provided by InterOil, that the acquisition of Shell PNG by InterOil will result, or will be likely to result, in such a benefit to the public that it should be permitted.

The authorisation is therefore granted.

		
<b>Thomas Abe</b> (Commissioner)	<b>Paul Baxter</b> (Associate Commissioner)	<b>Chris Gideon</b> (Associate Commissioner)

22 February 2006

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