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COMMERCE COMMISSION

Decision No. 345

Determination pursuant to the Commerce Act 1986 in the matter of an application for clearance of a business acquisition involving:

UNITEDNETWORKS LIMITED

and

TRANSALTA NEW ZEALAND LIMITED

The Commission:	K M Brown E C A Harrison P R Rebstock E M Coutts
Commission Staff:	A Mladenovic K C James A J Brice
Summary of the Application:	UnitedNetworks Limited (or an interconnected body corporate) has sought clearance to acquire the assets which comprise TransAlta New Zealand Limited's gas distribution network in the Hutt Valley, Porirua basin, Newlands and Paekakariki Hill Road regions.
Determination:	Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission gives clearance for the proposed acquisition.
Date of Determination:	11 March 1999

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THE PROPOSED ACQUISITION

1 Pursuant to section 66(1) of the Commerce Act 1986, UnitedNetworks Limited (UNL) gave notice to the Commission on 11 February 1999 (the application) seeking clearance for the proposed acquisition by it or an interconnected body corporate of UNL of the assets which comprise TransAlta New Zealand Limited's (TransAlta) natural gas[1] distribution network in the Hutt Valley, Porirua basin, Newlands and Paekakariki Hill Road regions (TransAlta's Gas Regions).

2 TransAlta is also offering to sell as a separate item from its gas distribution network assets, its assets and business related to customer meters and regulator sets. UNL has yet to decide whether it will offer to purchase those assets and business. However, for the purpose of its determination, the Commission has treated the customer meters/regulator assets and business as if they were included as part of TransAlta's gas distribution network assets.

THE PARTIES

UnitedNetworks

3 UNL, formerly Power New Zealand Limited (PNZ), principally owns and operates an energy networks business. Following the recent Government reform of the electricity industry, which includes a requirement for ownership separation of electricity distribution and retailing businesses, PNZ chose to remain a distribution networks[2] company, sold its electricity retailing assets (including the PNZ brand) and business to TransAlta, acquired the electricity distribution networks owned by TransAlta[3] and TrustPower Limited,[4] and changed its name to UNL. The current principal business activities of UNL are summarised in Appendix 1.

4 UNL is a public company, listed on the New Zealand Stock Exchange. Its largest shareholder is Utilicorp N.Z. Limited which holds 78.78% of the shares on issue in UNL. Power New Zealand Shareholders' Society Inc. (as trustee of the Waitemata Electricity Trust) holds 10.68%, with the public and institutions holding the remaining 10.54%.

TransAlta

5 TransAlta is an energy company with operations principally in electricity generation and wholesaling, electricity retailing, operation of an electricity distribution network[5], gas retailing, and ownership and operation of a gas distribution network. TransAlta's current principal business activities are summarised in Appendix 2.

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[1] The subsequent use of the word 'gas' in this determination refers to natural gas.
[2] PNZ was the successor to the Waitemata Electric Power Board and the Thames Valley Electric Power Board.
[3] Comprising the wider Wellington region of Wellington City, and the Hutt Valley and Porirua basin regions.
[4] Comprising the contiguous city regions of Tauranga, Rotorua and Taupo.
[5] Although it sold its electricity distribution network in the Wellington region to UNL, TransAlta still retains a 49% interest in Citipower Limited, which has a long term lease to operate the Nelson City electricity distribution network.

6 TransAlta was formed on 1 October 1996 as a result of the merger of EnergyDirect Corporation Limited and Capital Power Limited. TransAlta is also a public company listed on the New Zealand Stock Exchange. The immediate parent company of TransAlta is TransNewZealand Energy Limited and the ultimate controlling party is TransAlta Corporation of Canada. The parent company's shareholding is 66.5%, Hutt Mana Energy Trust holds 12.5%, and the general public and institutions hold 21%.

PROCEDURES

7 The application was registered by the Commission on 11 February 1999. Section 66(3) of the Commerce Act requires that the Commission, within 10 working days after the date of registration of the application, or such longer period agreed by the Commission and the applicant, gives, or declines to give, a clearance for the acquisition. The tenth working day after the registration of the application was 25 February 1999. However, the Commission and UNL agreed to two extensions of five working days each. Accordingly, a determination from the Commission was required by no later than 11 March 1999.

8 UNL advised the Commission that it did not seek a confidentiality order for the fact of the application. However, UNL did request confidentiality for specific information contained in the application. The Commission, in accordance with section 100 of the Commerce Act, made a Confidentiality Order on 17 February 1999 prohibiting the publication or communication of that information.

9 The Commission's determination is based on an investigation conducted by its staff and their subsequent advice given to the Commission.

THE INVESTIGATION

10 In the course of their investigation of the proposed acquisition, the Commission's staff have circulated and discussed the application with the following parties:

- Nova Gas Limited (Nova Gas);
- Contact Energy Limited;
- Qest New Zealand Limited (Qest);
- First Electric; and
- TransAlta.

11 In addition, staff have sought and received comment and further information from UNL to that contained in the application.

MARKET DEFINITION

12 Section 3(1A) of the Commerce Act provides that:

> "... 'market' is a reference to a market in New Zealand for goods or services as well as other goods or services that, as a matter of fact and commercial common sense, are substitutable for them."

13 In considering a proposed business acquisition in terms of section 66 of the Commerce Act, market definition is an important step towards making an assessment of the competitive impact of the acquisition.

14 In order to facilitate competition analysis, the Commission's guidelines on business acquisitions (the *Business Acquisitions Guidelines*)[6] specify a relevant market to be -

> "the smallest space, defined in terms of:
>
> the products or services bought and sold;
>
> the geographic area from which those goods or services are obtained and supplied;
>
> the functional level at which the transactions take place; and, where appropriate,
>
> the time period;
>
> within which a hypothetical profit-maximising sole supplier of a good or service would impose at least a small yet significant and non-transitory increase in price (*ssnip*), assuming all other terms of sale remain constant".(p. 14)

15 The *Business Acquisitions Guidelines* draw a clear distinction between the process of defining a relevant market and assessing dominance:

> "It is important to distinguish the process of defining a relevant market from that of assessing whether a business acquisition will lead to the acquisition or strengthening of a dominant position. This first step is a hypothetical exercise which assumes the creation of a total monopoly and estimates buyer reaction to a given level of price rise. The *ssnip* approach is relevant to that process. This does not presuppose or require that such a *ssnip* would result from the actual acquisition which is then to be evaluated in terms of the relevant markets identified through that process".(p. 15)

16 In determining relevant markets, the *Business Acquisitions Guidelines* state that "the Commission will generally consider a *ssnip* to involve a five percent increase in price for a period of a minimum of one year".(p. 15)

Identifying Relevant Markets

17 To identify the markets relevant to the application, it is necessary to consider the business activities undertaken by each of the parties to the proposed acquisition.

18 The principal business activities of UNL are:

- the generation and wholesaling of electricity;
- the retailing of electricity in the Bay of Plenty region;
- the provision of electricity distribution and associated services.

19 The principal business activities of TransAlta are:

- the generation and wholesaling of electricity on a national basis;
- the retailing of electricity in various regions;
- the provision of electricity distribution and associated services in Nelson City;
- the retailing of gas in various regions; and
- the provision of gas distribution services in TransAlta's Gas Regions.

20 UNL is in the process of selling its interests in electricity generation, wholesaling, and retailing in order to comply with the Electricity Industry Reform Act 1998 (EIR Act).

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[6] Commerce Commission, *Business Acquisitions Guidelines*, 1996.

21 The Commission considers that the starting point for market analysis in the context of the application is the activities involving UNL's assets which comprise its electricity distribution network in the wider Wellington region and TransAlta's assets which comprise its gas distribution network in TransAlta's Gas Regions.

Separate Electricity and Gas Product Markets

22 The Commission has previously adopted discrete electricity and gas product markets when assessing business acquisitions in the energy sector. The Commission stated in Decision 270[7]:

> "None of the evidence presented to the Commission points to a clear cut answer to the market definition problem. However, all of the evidence is consistent with the conclusion that natural gas and other fuels, especially electricity and to a lesser extent coal, are indeed substitutes for each other, both technically and commercially – but they are at best imperfect substitutes, and cannot be regarded as being in the same market". (para129)

23 This approach is consistent with recent decisions of the courts. In the High Court judgment in *Power New Zealand Ltd v Mercury Energy Ltd* (1996) 1 NZLR 686 (*Power NZ/Mercury*), subsequently upheld in February 1997 by the Court of Appeal, the court said:

> "It is common ground that gas is not in close competition with electricity. We see no reason to question this approach". (p.704)

24 In *Shell (Petroleum Mining) Company Limited and Another v Kapuni Gas Contracts Limited and Another* (1997) 7 TCLR 463, the High Court heard a substantial amount of economic evidence on market definition. It said:

> "We accept that {light fuel oil, coal and electricity} are substitutable {for natural gas} in certain favourable circumstances, but always at the edges and seldom in response to a SSNIP". (p.527)

25 In Decision 333,[8] the Commission considered it appropriate to adopt discrete product markets for electricity and gas. Although the Commission recognised that inter-fuel competition provided some constraint on market power, it did not consider the constraint sufficiently strong to include electricity and gas in the same market. The Commission finds no reason to vary from this approach for the purposes of this analysis.

26 Accordingly, while the Commission recognises that inter-fuel competition provides some constraint on market power, it does not consider that the constraint is strong enough to place electricity and gas in the same market. The Commission will therefore adopt discrete product markets for electricity and gas in considering the application.

Defining the Relevant Electricity Distribution Market

27 Both the Commission and courts have in the past defined relevant markets pertaining to the business of electricity retailing and distribution. In recent examinations of proposed

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7 Decision No. 270, *Natural Gas Corporation of New Zealand Limited and Enerco New Zealand Limited*, 22 November 1993.

8 Decision No. 333, *Contact Energy Limited and Enerco New Zealand Limited*, 10 December 1998.

electricity power company mergers,[9] the Commission has found two relevant markets involving the retailing of electricity:

- the local markets for the supply of delivered electricity to 'small' consumers, each geographically defined by the boundaries of the electricity distribution networks owned by the electricity power companies; and
- the national electricity retail market for 'medium' and 'large' consumers.

28 The genesis of these market definitions belongs to the judgment of the High Court in *Power NZ/Mercury*. In respect of electricity retailing, the court found separate product markets in supply of delivered electricity to small consumers and in retailing to medium and large consumers.

29 The court's reference in *Power NZ/Mercury* to a market for "delivered electricity" to small consumers appeared to recognise the fact that small consumers received a bundled product comprising both line services (distribution) and electricity from their incumbent retailers, who in nearly all cases were the electricity power companies owning the distribution networks. The court also agreed that there should be separate product markets in distribution within the boundaries of the local distribution networks.[10]

30 Most recently, in Decision 333, the Commission considered the changes which have occurred, and which are continuing to occur, with respect to electricity retailing, and the implications for defining the relevant markets. The Commission was, and remains, satisfied that:

> "… there is clear evidence of electricity suppliers being able to switch supplies between different categories of consumers, including small consumers, depending on market opportunities. Suppliers do not appear constrained to supplying limited geographical areas or to supplying to consumers on particular networks only. Small consumers now have, or will have in the near future, a choice of suppliers. This situation increasingly matches that of larger consumers. Therefore the Commission concludes that it is no longer appropriate to define discrete markets for the supply of delivered electricity to small consumers and to medium and large consumers. This view is based on the new dynamics in the marketplace arising from:
>
> - the lowered barriers to new entry due to the separation by legislation of electricity lines businesses and supply businesses;
> - the emergence of significant new players in the marketplace who have signalled their intention to compete against incumbent retailers; and, most significantly,
> - the Government's stated commitment to ensuring that small electricity consumers benefit from competition, and its expectation that deemed profiling be introduced (either by the industry participants or, if necessary, by itself) in the near future." Para 40

31 The Commission accordingly concluded that the relevant market in respect of electricity retailing is the national electricity retail market. The Commission also found it no longer necessary to combine distribution services and the supply of electricity to small customers in a separate product market.

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9 See, for example, Decision No. 302, *Powerco Limited and Egmont Electricity Limited*, 21 July 1997 and Decision No. 317, *Mercury Energy Limited and Power New Zealand Limited*, 26 February 1998.

10 Presumably the distinction recognised that it was possible for medium and large electricity consumers to contract separately with the lines business for distribution services while being supplied their electricity by a third party.

32 Thus electricity distribution is appropriately considered separately to electricity retailing. The relevant distribution activities related to the proposed acquisition are those owned and operated by UNL in TransAlta's Gas Regions:

Table 1	*Incumbent Gas Retailer*	*Gas Distribution Network Owner*	Incumbent Electricity Retailer	Electricity Distribution Network Owner
Wellington	*Contact*	*Qest NZ Ltd*	TransAlta	**UNL**
TransAlta's Gas Regions	*TransAlta*	*TransAlta* *Nova Gas*	TransAlta	**UNL**

33 Therefore, for the purpose of analysing the proposed acquisition, the Commission concludes that the relevant electricity market is a separate product market in distribution that is geographically defined by UNL's electricity distribution network in the wider Wellington region (the electricity distribution market).

Defining the Relevant Gas Distribution Market

34 In the past five years, the Commission has determined a number of significant applications involving the gas sector, most recently Decision 333.[11] In Decision 333, the Commission moved away from the "delivered gas" market which represented the bundling of both the distribution service and the supply of gas to small commercial and domestic consumers connected to a particular gas distribution network. This shift recognised recent divestments by gas utilities resulting in the ownership separation of gas distribution and retail businesses which meant that small consumers would no longer necessarily receive both their distribution services and gas from a single supplier. This was already the case for medium and large industrial consumers.

35 The relevant gas distribution activities related to the proposed acquisition are those owned and operated by TransAlta in TransAlta's Gas Regions:

Table 2	Incumbent Gas Retailer	Gas Distribution Network Owner	*Incumbent Electricity Retailer*	*Electricity Distribution Network Owner*
Wellington	Contact	Qest NZ Ltd	*TransAlta*	*UNL*
TransAlta's Gas Regions	TransAlta	**TransAlta** Nova Gas	*TransAlta*	*UNL*

36 TransAlta's Gas Regions are located within the geographical area of the electricity distribution market. The areas of overlap include the Hutt Valley (including Wainuiomata and Eastbourne), the Porirua basin (extending from Tawa to Plimmerton), and a small area in Newlands. UNL has estimated that there are approximately 78,000 electricity customers and 25,800 gas customers in TransAlta's Gas Regions (ie: in the areas of overlap). Approximately 27,000 electricity customers front the gas distribution network but are not connected.

37 Gas distribution networks have historically been viewed as natural monopolies. The sunk cost associated with existing gas pipelines and the scale economies derived from

[11] See Decision 333 for a discussion of the Commission's recent determinations in relation to gas markets.

the operation of gas distribution networks means that the duplication of pipelines was generally not economically viable.

38 However, in this instance there is direct competition to incumbent gas distributors (TransAlta and Qest) from Nova Gas. Nova Gas commenced gas distribution network operations in TransAlta's Gas Regions in 1996, with the construction of a methane gas processing plant at the Porirua landfill. A pipeline was laid by Nova Gas to supply the landfill gas to Kenepuru Hospital in Porirua. In late 1997 and in 1998, Nova Gas laid further pipelines in TransAlta's Gas Regions, effectively extending its operations from Porirua to Petone. This network is connected to NGC's high pressure gas transmission system and distributes natural gas. In addition, Nova Gas is laying pipelines in Wellington City (to compete with Qest's distribution network), has laid a pipeline in Hawera to connect a meat-works, and is looking at opportunities elsewhere in the North Island.

39 [ ]

40 In TransAlta's Gas Regions, Nova Gas presently provides a distribution service and supplies gas to 10 former large customers of TransAlta. TransAlta has stated that [ ] In addition, Nova Gas supplies gas to several other customers in TransAlta's Gas Regions using TransAlta's gas distribution network.

41 The Commission concludes that there is evidence that Nova Gas competes with incumbent gas distributors for distribution services and that it has successfully acquired a number of large customers to which it supplies both distribution services and gas. This is particularly the case in TransAlta's Gas Regions.

42 The Commission therefore considers that it is now arguable that there are two separate markets for gas distribution services. These markets would reflect the fact that gas distribution services have become contestable for large industrial consumers, with large consumers located on or close to Nova Gas's pipeline having the choice of two gas distributors. For small commercial and domestic consumers, however, gas distribution services are not likely to be contestable. These consumers will continue to be reliant on the incumbent distributor.

43 The Commission will monitor market developments closely and may adopt market definitions involving two discrete gas distribution markets in the future. In terms of the competition issues arising from the current application, the Commission does not consider it necessary to do so.

44 For the purpose of analysing the competition effects of the proposed acquisition, the Commission concludes that the relevant gas market is a separate product market in distribution that is geographically defined by TransAlta's gas distribution network in TransAlta's Gas Regions (the gas distribution market).

COMPETITION ANALYSIS

45 Competition analysis assesses competition in the relevant markets in order to determine whether or not the proposed acquisition would result, or would be likely to result, in an acquisition or strengthening of dominance.

46 Competition in a market is a broad concept. It is defined in section 3(1) of the Commerce Act as meaning "workable or effective competition". In referring to this definition the Court of Appeal said:[12]

> "That encompasses a market framework which participants may enter and in which they may engage in rivalrous behaviour with the expectation of deriving advantage from greater efficiency."

47 Section 3(9) of the Commerce Act states:

> "For the purposes of sections 47 and 48 of this Act, a person has … a dominant position in a market if that person as a supplier or an acquirer … of goods or services, is or are in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market and for the purposes of determining whether a person is … in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in a market regard shall be had to-
>
> (a) The share of the market, the technical knowledge, the access to materials or capital of that person … :
>
> (b) The extent to which that person is … constrained by the conduct of competitors or potential competitors in that market:
>
> (c) The extent to which that person is … constrained by the conduct of suppliers or acquirers of goods or services in that market."

The Electricity Distribution Market

48 Electricity distribution networks are, prima facie, natural monopolies. In most cases, it is not economically viable to duplicate existing electricity lines due to the sunk cost associated with the existing lines and the economies of scale derived from the operation of networks. The Commission considers that UNL currently has a dominant position in the electricity distribution market. Therefore, the focus of the analysis is on whether, as a result of the proposed acquisition, UNL's dominant position in the electricity distribution market would be, or would be likely to be, strengthened.

49 Although they are natural monopolies, the Commission has previously noted that electricity distribution networks are constrained in respect of their market power to some extent. In Decision 302[13] and Decision 317,[14] the Commission stated:

> "Notwithstanding their natural monopoly characteristics, the distribution businesses of power companies are likely to face some constraints on their behaviour. Generally, these arise from:
>
> - the ability for a customer close to the border between two distribution networks to connect to the adjacent network;
> - the ability for a customer close to a Trans Power point of supply to arrange a direct line of supply;
> - the Electricity (Information Disclosure) Regulations which require power companies to disclose information to assist in the monitoring of power companies and recourse to the provisions of the {Commerce} Act;

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12 *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554, 564-565

13 Decision No. 302, *Powerco Limited and Egmont Electricity Limited*, 21 July 1997 (section 67 application).

14 Decision No. 317, *Mercury Energy Limited and Power New Zealand Limited*, 26 February 1998.

- potential government regulation of pricing by power companies;
- new networks (developments or sub-divisions) within the relevant distribution markets; and
- competition from other fuels."[15]

50 Considerable change has occurred in the electricity industry since Decision 302 and Decision 317 which likely strengthen, or will likely strengthen, the extent to which market power is constrained in markets involving electricity distribution. These changes include:

- enhancements to the Electricity (Information Disclosure) Regulations 1994 and Handbook for Optimised Deprival Valuation of Electricity Line Businesses designed to increase the effectiveness of information disclosure;
- an increased threat of price control on electricity distribution businesses with the Government proposing to introduce a price control regime replicating competitive pressure on distribution businesses which, as monopoly services, face weak downward pressures on costs, profits and prices; and
- the requirement, by legislation (the EIR Act), for ownership separation of electricity lines businesses from electricity retailing and generation businesses (supply businesses).

51 The Commission considers that, with the exception of the inter-fuel constraint on electricity provided by gas, none of the above constraints in the electricity distribution market will be lessened as a result of the acquisition.

Constraint from Inter-fuel Competition

52 While the Commission does not consider electricity and gas to be close enough substitutes to be included in the same product market, it does recognise that inter-fuel competition, involving the two, provides some constraint on market power.

<u>Decision 302</u>

53 In Decision 302, the Commission considered Powerco Limited's (Powerco) application for an authorisation under section 67 of the Act to acquire Egmont Electricity Limited (Egmont). In that determination, the Commission discussed inter-fuel competition in detail and whether the acquisition by Powerco would result in the lessening of any inter-fuel constraint imposed by Powerco's gas business and Egmont's electricity business, on each other, in the South Taranaki area.

54 In referring to the Draft Determination leading to Decision 302, the Commission noted in Decision 302 that it had:

> "expressed {there} its view that competition between electricity and natural gas provides some constraint on market power. When considering inter-fuel competition, the Commission believed it was necessary to recognise that:
>
> - applications in which electricity and natural gas are particularly substitutable include water heating and space heating;
> - applications in which electricity and natural gas are not substitutable include motive power, electronic equipment and the provision of bulk industrial drying or heating;
> - in many instances, energy consumers have a choice of fuel only within the limited time frames during which decisions about the replacement of domestic appliances or

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[15] Decision 302, paragraph 132 and Decision 317, paragraph 110.

> industrial energy using equipment are being made. However, consumers may be protected against the use of market power by an energy utility at other times by competition for new customers, or by long term supply contracts;
>
> - electricity is essential fuel for some applications. Consequently, all energy consumers are required to meet the fixed costs of electricity supply. Therefore, consumers considering switching to natural gas for part of their energy requirements are likely to compare the total costs of natural gas with the variable cost of electricity;
> - where power companies have a variable or partly variable line charge, inter-fuel competition impacts on both distribution and retail markets." Para 186

55 The Commission considered a number of factors which indicated an inter-fuel constraint provided by gas on electricity. For example, it discussed that in an earlier determination:

> "... the Commission noted that the benchmark for natural gas competition is the variable element in the delivered price of electricity. This is because there are some applications for which there is no substitute to electricity. This would suggest, in the absence of other constraints on tariff structures (such as resistance to fixed charges), that power companies are able to structure tariffs in a way which protects their revenues irrespective of potential competition from natural gas. The Commission has received complaints from natural gas suppliers that power companies have implemented tariff structures which target natural gas consumers by, for example, setting a higher unit charge for residential users without electric hot water heaters." Para 217

56 Ultimately, the Commission reached the view in Decision 302, in respect of the inter-fuel constraint on electricity, that:

- natural gas places some constraint on power company activities;
- such constraint is less than the constraint that electricity places on the activities of natural gas companies; and
- there is minimal constraint on the distribution business of power companies.

57 The Commission therefore concluded in Decision 302 that the acquisition would remove the inter-fuel constraint on electricity and that the effect of that removal in the relevant "delivered electricity" market (for both the provision of distribution services and supply of electricity to small consumers) was likely to be such that it was not satisfied that the removal would not result, or would not be likely to result, in a strengthening of the dominant position of the merged entity in that market. The Commission was of the view, however, that there is minimal inter-fuel constraint on the distribution businesses of power companies. Accordingly, it was satisfied that the acquisition would not result, and would not be likely to result, in the acquisition or strengthening of a dominant position in the relevant post-merger electricity distribution market (for the provision of distribution services to medium and large consumers).

<u>Price Discrimination</u>

58 UNL has noted in the application that any inter-fuel competition issue that may exist does not arise in the area where UNL's electricity distribution network and Qest's gas distribution network overlap in the wider Wellington region, suggesting therefore that UNL's electricity distribution charges to its customers located in Qest's gas distribution network would be constrained by Qest through inter-fuel competition. UNL maintains that it does not foresee that it would price discriminate in respect of its electricity distribution services to its customers in TransAlta's Gas Regions and those located in Qest's gas distribution network or in the overlap area. Accordingly, UNL argues, electricity customers in TransAlta's Gas Regions would benefit from competition

between UNL and Qest in the overlap area. UNL states that it would also be prevented from price discrimination as a result of resistance from electricity retailers and the risk of regulatory intervention.

59 The Commission considers that, should the proposed acquisition proceed, price discrimination by UNL between its electricity customers located in TransAlta's Gas Regions and those located in Qest's gas distribution region, is a possibility in response to varying competitive conditions.

60 Dealing with this issue in Decision 302, the Commission, in respect of Powerco's argument that it could not, and would not, adopt differential pricing to consumers connected to Egmont's network if the acquisition proceeded, stated:

> "The Commission agrees that the administrative costs may make it difficult for power companies to target differential prices to a low level. However, in general, the Commission believes that power companies can and do adopt differential prices targeted at the geographic location or intended electricity usage of the customer. Powerco itself operates different prices for each of its three electricity networks... . ... In this case, the significant number of consumers affected by the acquisition and their geographical grouping suggests that maintaining price differentials in response to varying levels of competitive constraints is possible." [Para 224]

61 Notwithstanding UNL's need to consider the risks of any price discrimination behaviour, the absence of sufficient competitive and/or regulatory constraints on UNL would leave it with the same ability as any network owner to price discriminate.

<u>Conclusion on Constraint from Inter-Fuel Competition</u>

62 Consistent with Decision 302, the Commission considers that gas continues to place some constraint on power company activities, but that there is minimal inter-fuel constraint from gas on UNL's distribution business in the electricity distribution market.

Conclusion on the Electricity Distribution Market

63 The Commission is satisfied that the proposed acquisition would not result, and would not be likely to result, in the strengthening of UNL's dominant position in the electricity distribution market.

The Gas Distribution Market

64 In Decision 302, the Commission, having concluded that suppliers of delivered gas to small consumers had “substantial market power”, identified that suppliers are likely to face constraints on their behaviour from:

- the potential for cross border natural gas network competition bypassing the incumbent’s natural gas network;
- the possibility of by-pass directly from an NGC transmission pipeline in respect of large users situated close to such a pipeline;
- the (then proposed) gas information disclosure regulations;
- the potential for government regulation of unreasonable pricing by power companies; and
- competition from other fuels.

65 In the period since Decision 302, a number of changes have occurred relating to constraints on market power in gas distribution networks. The Commission considers that the following principal changes are likely to strengthen the extent to which market power is constrained:

- the appearance of direct competition for gas distribution services by Nova Gas;
- the divestment by some gas utilities of their gas retailing or gas distribution businesses, leaving them as essentially separate distribution network or energy retailing businesses;[16]
- the requirement, by legislation, for ownership separation of electricity lines businesses from electricity retailing and generation businesses (supply businesses), facilitating competition in the national electricity retail market and, as considered in Decision 333, helping to ensure that inter-fuel competition is not lost in any geographical market where the incumbent electricity retailer and gas retailer is the same person;
- the requirement for mandatory information disclosure following the introduction of the Gas (Information Disclosure) Regulations 1997;
- the introduction of a pipeline access code by the gas industry, designed to facilitate neutral and non-discriminatory access to pipelines; and
- the increased threat of price control on electricity distribution businesses with the Government proposing to introduce a price control regime that could, relatively quickly and easily, be applied to gas distribution businesses.

66 The Commission considers that, with the exception of the inter-fuel constraint on gas provided by electricity, none of the above constraints in the gas distribution market will be lessened as a result of the acquisition proceeding. In addition, as a result of the acquisition, UNL would provide the gas distribution services and TransAlta would be the incumbent gas retailer in TransAlta’s Gas Regions. This raises the possibility of countervailing power from retailers.

[16] For example, Enerco recently sold its gas supply business (except its very large supply customers) to Contact Energy Limited and TransAlta has decided to sell its gas distribution business. Enerco, which was renamed “Qest”, is now primarily a distribution network company currently providing gas distribution services. Contact Energy and TransAlta (after it sells its gas distribution network) are gas and electricity retailers and electricity generators.

Constraint from Inter-fuel Competition

Decision 302

67 In Decision 302, the Commission arrived at the following view in respect of the inter-fuel constraint on gas:

- electricity places a constraint on the activities of natural gas companies;
- this constraint applies to both the energy and distribution business of natural gas companies;
- the degree of that constraint varies by application. The Commission believes that the acquisition will have only minimal competitive impact on the supply of natural gas to large industrial users. For large industrial users, this is based on the degree of possible substitution with electricity, proximity to the natural gas transmission system and the viability of other fuels such as coal. However, for domestic and commercial users where, generally, electricity is a viable alternative for natural gas applications, the situation is less clear; and
- therefore, on balance, the Commission believes electricity is likely to provide a constraint on the supply of natural gas to domestic and commercial consumers.

68 The Commission concluded in Decision 302 that the acquisition would remove the inter-fuel constraint of electricity on gas and that the effect of that removal in the "delivered gas" market was likely to be such that the Commission was not satisfied that the removal would not result, or would not be likely to result, in a strengthening of the dominant position of the merged entity in that market.

69 The Commission sees no reason to change its views from Decision 302 and, accordingly concludes that:

- UNL's electricity business places a constraint on TransAlta's gas business, and that constraint applies to both the energy and distribution elements of the gas industry; and
- the proposed acquisition will have only minimal competitive impact on the provision of distribution services to large industrial consumers in TransAlta's Gas Regions.

70 The Commission considers that TransAlta is currently dominant in providing distribution services to small commercial and domestic consumers in TransAlta's Gas Regions.

71 In comparison with Decision 302, which dealt with the inter-fuel constraint in relation to the supply of "delivered gas" to small commercial and domestic consumers, the current application only deals with the inter-fuel constraint in relation to the provision of gas distribution services. The Commission must consider whether any inter-fuel competition relating to gas distribution services changes as a result of common ownership of electricity and gas distribution networks, as opposed to separate ownership.

72 The Commission needs to address this question to determine whether the proposed acquisition will result in a strengthening of TransAlta's current dominant position in the gas distribution market, or, alternatively, whether there is merely a bare transfer of that dominant position.

Constraint from Acquirers

73 UNL has emphasised to the Commission its belief in the importance of the separation of gas distribution and gas retailing activities in TransAlta's Gas Regions which will result if the proposed acquisition proceeds. For example, they state:

> "The significant difference, in competition terms, is that the distribution and retailing functions relating to both forms of energy {gas and electricity}, will be under separate ownership." Para 9.5

74 And:

> "It is important to note that the transaction {i.e., completion of the proposed acquisition} will cause deintegration of TransAlta's gas distribution and retailing businesses." Para 10.1

75 And also:

> "... ownership separation of gas distribution and retailing brought about by the transaction will result in a significant increase in constraints on both functions." Para 27

76 UNL argues that ownership separation of gas distribution and retailing services will place a new constraint on the distribution service, and that this constraint should be recognised in assessing dominance issues. UNL has stated that, following the proposed acquisition, it would be required to sell its distribution service to large, sophisticated, and knowledgeable retailers (in particular to TransAlta as the incumbent retailer). These retailers would likely seek to increase their profits by reducing their costs, including distribution charges, and/or increasing their sales and volumes. Thus, UNL argues, the acquisition would place a new downward pressure on gas distribution charges as retailers, using their countervailing power, act to resist the distributor's attempts to increase its charges and thus reduce their profits.

77 The Commission considers that a new constraint is now likely to apply to gas distribution businesses. That is, the potential ability of gas retailers, as acquirers of gas distribution services, to apply some degree of pressure, or countervailing power, on the behaviour of distributors.

78 The Commission has previously considered such countervailing power. In Decision 270, the Commission considered an application by Natural Gas Corporation of New Zealand Limited (NGC) for an authorisation under section 67 of the Commerce Act to acquire Enerco New Zealand Limited (Enerco). NGC was dominant (in terms of the Commerce Act) in the provision of gas transmission services through its ownership of high pressure gas pipelines. Enerco was a gas supply utility and NGC's major customer for transmission services. The Commission considered that the major constraints on the behaviour of NGC in the transmission market were, or potentially were, mandatory information disclosure, the threat of regulation and, "possibly, the countervailing power of major customers".[17] While concluding that a merged NGC/Enerco would remain constrained by the same information disclosure requirements and threat of greater regulation as NGC was without the acquisition, the Commission said the following in respect of countervailing power:

> "The only significant impact the acquisition would have in this market would be the loss of Enerco as a customer able to exert a constraining influence on the behaviour of NGC. The Commission accepts that this constraint is limited, and falls far short of the constraint an effective competitor might apply. It also recognises that other utilities also have some ability to provide a constraining influence. Nevertheless the Commission does not consider that the loss of Enerco's countervailing power would be inconsequential. Enerco has a level of resources,

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[17] Decision 270, paragraph 179.

> expertise and commercial clout well beyond that available to the other utilities which, together, have only half the level of Enerco's gas sales. A major dispute with Enerco could have serious consequences for NGC." Para 186

79 And:

> "... the Commission considers that Enerco, as an independent utility, would also be likely to have an incentive to constrain NGC's behaviour in a way that would reduce its effective market power. This could be by acting as a regulatory watchdog as suggested by Professor Hay. It could also be by ensuring that the healthy interaction between supplier and customer which provides benefits in competitive markets, could be undertaken on more equal terms. ... In any event, the Commission considers that the removal of Enerco as an independent force would remove a small but real constraint on NGC in this market." para 187

80 With respect to the proposed acquisition, UNL has stated:

> "A fundamental change to both the electricity and gas industries is, of course, the emergence of independent retailers of electricity and gas, and in many cases, combined electricity and gas retailers. The new commercial reality will be that these retailers will undertake the marketing of their products to induce new customers to buy gas. Network companies, such as UNL, will be an input supplier to the final delivered retail product, alongside other inputs such as a generation and transmission. The interposed structure that has emerged will also mean that the company's actual customers, with whom it must do business, will be mainly a small number of quite large, able and informed companies. These factors are relevant to the issues of the constraints on network companies." [18]

81 While the Commission considers that ownership separation of gas distribution businesses and gas supply businesses has resulted in acquirers of gas distribution services potentially providing some degree of constraint over providers of distribution services, gas distribution networks nevertheless remain with a high degree of market power in operating their networks. The Commission, as in Decision 270, therefore considers the constraint from acquirers[19] as small, but real, and that it falls far short of the constraint an effective competitor might apply.

Assessment of Strengthening of Dominance in the Gas Distribution Market

82 The effect of the proposed acquisition is to bring under common ownership the electricity distributor and the gas distributor. The Commission does not consider that this would strengthen UNL's dominance in the electricity distribution market. However, as a result of the loss of inter-fuel constraint, it is possible that there will be a strengthening of dominance in the gas distribution market, notwithstanding the slight countervailing power from acquirers that would occur as a result of the acquisition.

83 UNL has stated that the proposed acquisition will not result in the strengthening of the dominant position in gas distribution. It argues that strengthening is unlikely as it will retain a strong financial incentive to promote new connections to, and expansion of, its gas distribution network. UNL contends this is because of the significantly higher margin available from selling gas distribution services than selling electricity distribution services. Moreover, UNL contends, a combined gas and electricity distributor has a much higher incentive to encourage electricity customers to switch to gas consumption than does a combined gas and electricity retailer. The margin differential for the retailer relative to the financial reward of the distributor is small.

[18] Letter to the Commission dated 5 March 1999.
[19] Retailers and/or large consumers.

84 The Commission has considered how the changes in the electricity sector are likely to affect UNL's market power in gas distribution. Electricity distribution businesses contract with retailers who retail electricity to consumers using the distribution network. These contracts generally have the same terms applying to all retailers, as there is no incentive for distribution businesses to discount the distribution charge to a particular retailer.

85 In a situation where UNL raised the price of its gas distribution service to the level where some customers decided to disconnect their gas connection and only use electricity, UNL would be constrained from recouping its loss on gas distribution. It would be unable to recover the decrease in gas revenue from increased revenue from particular electricity consumers. Should UNL attempt to increase its electricity distribution charge to a particular electricity retailer, consumers have the ability to switch to another electricity retailer. While it would be possible for UNL to increase its electricity distribution charge across the board, it is not likely to be able to increase these charges to a higher level than a separate electricity distribution business with no gas network.

Conclusion on the Gas Distribution Market

86 The Commission concludes that it is satisfied that the proposed acquisition will not result in the strengthening of a dominant position in the gas distribution market.

CONCLUSION

87 The Commission has considered the impact of the proposed acquisition in two relevant markets:

- a separate product market in distribution that is geographically defined by UNL's electricity distribution network in the wider Wellington region (the electricity distribution market); and
- a separate product market in distribution that is geographically defined by TransAlta's gas distribution network in TransAlta's Gas Regions (the gas distribution market).

88 Having regard to the factors set out in section 3(9) of the Commerce Act and all the other relevant factors, the Commission has concluded that it is satisfied:

- that, as a result of the proposed acquisition, UNL's dominant position in the electricity distribution market would not be, or would not be likely to be, strengthened; and
- that TransAlta is currently dominant in the gas distribution market and that, in terms of section 48(b), the proposed acquisition will not result in the strengthening of that dominant position in the gas distribution market.

DETERMINATION ON NOTICE OF CLEARANCE

Accordingly, pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission gives clearance for the acquisition by UnitedNetworks Limited, or any interconnected body corporate, of the assets which comprise TransAlta New Zealand Limited's gas distribution network in the Hutt Valley, Porirua basin, Newlands and Paekakariki Hill Road regions.

Dated this 11th day of March 1999

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The Commission

APPENDIX 1: PRINCIPAL BUSINESS ACTIVITIES OF UNITEDNETWORKS LTD

Electricity Generation and Wholesaling	Electricity Distribution Network
UnitedNetworks Limited (formerly Power New Zealand Limited) owns the 24MW geothermal station at Rotokawa, near Taupo, which is currently under a conditional contract for sale to TransAlta New Zealand Limited. UnitedNetworks has a 50% interest in a joint venture with the Tauhara North No. 2 Trust which owns a steamfield supplying the 24 MW geothermal station at Rotokawa. UnitedNetworks owns 74.9% of the shares in Salamanca Holdings Limited which holds 50% of the shares in Pacific Energy Limited. Pacific Energy is a wholesale supplier of electricity to its shareholder customers and larger commercial and industrial customers and independent power companies.	UnitedNetworks was the successor to the Waitemata Electric Power Board and Thames Valley Electric Power Board, and owns the electricity lines business in the former Waitemata Electricity and Valley Power areas. In addition, UnitedNetworks has recently purchased the electricity distribution network assets of TransAlta New Zealand Limited located in Wellington City and the Hutt Valley and TrustPower Limited located in the contiguous city regions of Tauranga, Rotorua and Taupo. UnitedNetworks provides contracting services for the design, construction and maintenance of its network businesses and to external customers. UnitedNetworks has a 52.3% shareholding in Bay of Plenty Electricity Limited which owns an electricity lines and supply business in the Bay of Plenty area, and several generation facilities. Bay of Plenty Electricity has entered into an agreement to sell its supply business and generation assets to Todd Energy and Pacific Hydro.

APPENDIX 2: PRINCIPAL BUSINESS ACTIVITIES OF TRANSALTA NZ LTD

Electricity Generation and Wholesaling	Electricity Retailing	Electricity Distribution Network	Natural Gas Retailing	Natural Gas Distribution Network
TransAlta owns a 47.5% interest in the Southdown Co-generation Joint Venture which owns the 131 MW Southdown gas-fired power station in Auckland. The output from Southdown is sold under long-term fixed price contract to Mercury Energy Limited. TransAlta owns a $33^1/_3$% interest in the "Taranaki Combined Cycle Partnership", which has built, and now owns and operates, a 376 MW gas fuelled power station in Stratford, Taranaki. The output from TCC is sold at long-term fixed prices to Mercury Energy (176 MW), Fletcher Challenge (76 MW), and TransAlta (76 MW). TransAlta has the right to purchase the remaining two-thirds of TCC and is currently talking to the other two parties involved (Mercury Energy and Fletcher Challenge). TransAlta owns a 46.5% interest in the 1.7 MW Silverstream landfill site in the Hutt Valley which uses landfill gas to produce electricity. TransAlta has entered into a conditional contract to acquire the Rotokawa Geothermal Power Station from UnitedNetworks Limited (formerly Power New Zealand Limited). TransAlta owns 25% of Pacific Energy Limited which purchases and sells electricity on behalf of its customers at the wholesale level.	TransAlta has electricity retail contracts with a number of large use, half hourly metered customers throughout New Zealand. TransAlta is the incumbent supplier of electricity to non half hourly metered customers in the Wellington region, being Lower Hutt, Upper Hutt, Porirua and Wellington cities, formerly owned by EnergyDirect Limited and Capital Power Limited. In addition, TransAlta has recently purchased electricity retailing businesses, including meters and metering equipment and trade marks from Southpower Limited (Christchurch region) and Power New Zealand Limited (North Shore and Waitakere in the Auckland region).	TransAlta recently sold its electricity distribution network in the Wellington region to Power New Zealand Limited (now UnitedNetworks Limited). However, TransAlta still retains a 49% interest in Citipower Limited, which has a long term lease to operate the Nelson City electricity distribution network.	TransAlta supplies gas to customers, mainly in the Hutt Valley, Porirua basin, Newlands and Paekakariki Hill Road areas of the Wellington region.	TransAlta owns and manages the low-pressure gas pipelines that distribute gas to customers' premises in the Hutt Valley, Porirua basin, Newlands and Paekakariki Hill Road areas.