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COMMERCE COMMISSION

Decision No. 470

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

NATURAL GAS CORPORATION HOLDINGS LIMITED

and

UNITEDNETWORKS LIMITED

The Commission:	MJ Belgrave DR Bates QC DF Curtin
Summary of Application:	The acquisition by Natural Gas Corporation Holdings Limited and/or any of its wholly owned subsidiaries, and/or its parent Australian Gas Light Company, of the gas pipeline assets of UnitedNetworks Limited.
Determination:	Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition.
Date of Determination:	23 August 2002

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THE PROPOSAL

1. A notice pursuant to section 66(1) of the Commerce Act 1986 (the Act) was received on Friday 19 July 2002. The notice sought clearance for the acquisition by Natural Gas Corporation Holdings Limited (NGC or the Applicant) and/or any of its wholly owned subsidiaries, and/or its parent Australian Gas Light Company (AGL), of the gas pipeline assets of UnitedNetworks Limited (UNL).

THE PROCEDURES

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear a notice given under section 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. The Commission sought and was granted, two further extensions of 10 and five working days. Accordingly, a decision on the application was required by Friday 23 August 2002.

3. The Commission's determination is based on an investigation conducted by staff.

4. The Commission's approach is based on principles set out in the Commission's *Practice Note 4*.[1]

THE PARTIES

NGC

5. NGC is a company incorporated in New Zealand and listed on the New Zealand Stock Exchange. AGL and its wholly owned subsidiaries hold 66.05% of the total shares in NGC. The Hutt Mana Energy Trust and its associated Hutt Mana Charitable Trust together hold 10.19% of the total shares in NGC. The public and institutions hold the remaining 23.76% of the total shares of NGC.

6. NGC's operating subsidiary Natural Gas Corporation of New Zealand Limited undertakes the business of the acquisition, transmission and marketing of gas throughout the North Island. NGC, through this subsidiary, owns and operates the high pressure gas transmission pipelines in the North Island as well as operating the Maui gas pipeline on behalf of Maui Development Limited. In addition, NGC is a distributor and retailer of gas in Northland, Waikato, Bay of Plenty, Taupo, Gisborne, and Kapiti, and a retailer of gas in Taranaki. NGC has a 25.1% interest in the Wanganui gas distributor and retailer, Wanganui Gas Limited (WGL). NGC also owns 50% of the Kapuni Energy joint venture, which undertakes electricity and steam generation at the Kapuni gas treatment plant site.

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[1] Commerce Commission, *Practice Note 4: The Commission's Approach to Adjudicating on Business Acquisitions Under the Changed Threshold in section 47 – A Test of Substantially Lessening Competition*, May 2001.

UnitedNetworks Limited

7. UNL is a company incorporated in New Zealand and listed on the New Zealand Stock Exchange. UNL's business activities include the distribution of gas and electricity. UNL owns and operates low pressure gas distribution pipelines in Whangaparoa, Auckland, Hawkes Bay, Wellington and Palmerston North/ Manawatu. In addition, UNL owns and operates electricity lines in Wellington, Waitemata, North Shore and Bay of Plenty, and fibre-optic broadband telecommunications networks in the Auckland and Wellington central business districts.

OTHER RELEVANT PARTIES

Wanganui Gas Limited

8. Wanganui Gas Limited (WGL) is a gas retailer and network owner in the Wanganui/Rangitikei area. NGC has a 25.1% interest in WGL and the Wanganui District Council owns the balance. WGL also retails gas on the distribution networks of UNL and NGC, and has recently commenced a dual fuel retail venture with Mighty River Power, an electricity generator and retailer.

9. The Commission considers that NGC's interest in WGL raises the question of whether WGL is associated with NGC but because this point is not relevant to the analysis of this transaction, the Commission has not been required to consider this matter further.

Contact Energy Limited

10. Contact Energy (Contact) is listed on the New Zealand Stock Exchange and its majority shareholder is Edison Mission Energy, through its subsidiaries Mission Energy Pacific Holdings and Mission Energy Universal Holdings. Contact is an electricity generator and retailer, and a gas wholesaler and retailer. Through its acquisition of Orion's gas retailing business, Contact is the incumbent gas retailer in Auckland, Manawatu, Hawkes Bay and Wellington.

Nova Gas Limited

11. Nova Gas (Nova) is a subsidiary of Todd Energy Limited (Todd), and is a distributor and retailer of gas, predominantly to commercial and industrial customers. Nova has built by-pass gas distribution networks in Wellington, Porirua, Hutt Valley, Hastings, Hawera, Papakura and Manakau City. Nova also retails gas across other gas distribution networks.

FreshStart

12. FreshStart is the electricity and gas retail subsidiary of Todd, predominantly supplying residential customers in Taranaki, Wanganui/Marton, Palmerston North/Manawatu, Hutt/Mana, and Wellington.

E-Gas Limited

13. E-Gas is a privately owned gas retail company supplying gas to commercial and industrial customers across the distribution networks of NGC and UNL.

PREVIOUS COMMISSION DECISIONS

14. The Commission has previously considered a number of acquisitions pertinent to the present application. The resultant decisions are:

- 330 - NGC and Powerco, 11 November 1998;
- 333 - Contact Energy and Enerco, 10 December 1998;
- 340 – Trans Alta and Contact Energy, 12 February 1999;
- 345 – UnitedNetworks and TransAlta, 11 March, 1999;
- 362 – AGL and NGC, 10 June 1999;
- 380 - United Networks and Orion, 23 December 1999;
- 387 – NGC and TransAlta, 17 March 2000; and
- 435 - NGC and AGL, 8 June 2001.

15. Further, in Decision 446 - Dunedin Electricity and Otago Power, the Commission dealt with the issue of bare transfer in the context of the substantial lessening of competition test, and also discussed cross-border competition.

PROPOSED SALE OF NGC GAS RETAIL CUSTOMERS

16. On 20 August 2002, NGC announced its intention to divest its gas retail customers. NGC has advised the Commission that it proposes to sell its residential and commercial customers with annual consumption below 10TJ, but that it will continue to retail to commercial/industrial customers above 10TJ.

17. [

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18. The sale would reduce NGC's level of vertical integration in the regions in which it is the incumbent residential retailer, however, as this transaction has not yet occurred, it is not taken into account in the Commission's analysis.

MARKET DEFINITION

19. The Act defines a **market** as:

> *. . . 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.*

20. The Commission will seek to define relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration. A relevant market will ultimately be determined, in the words of the Act, as a matter of fact and commercial common sense.

21. Where markets are difficult to define precisely, the Commission will initially take a conservative approach. If the proposed acquisition can be cleared on the basis of a narrow market definition, it would also be cleared using a broader one. If the Commission is unable to clear the proposed acquisition on the basis of the narrower market, it will be necessary to review the arguments and evidence in relation to broader markets.

22. The Applicant has submitted that the markets relevant to this application are as follows:

- the high pressure gas transmission market in the North Island;
- the regional gas distribution markets in Greater Auckland, Hawkes Bay, Palmerston North/ Manawatu, Wellington, Northland, Waikato, Bay of Plenty, Taupo, Gisborne and Kapiti, and Wanganui/ Rangitikei;
- the gas retailing market for commercial and industrial consumers in the North Island; and
- the gas retailing markets for residential consumers in Greater Auckland, Hawkes Bay, Palmerston North/ Manawatu and Wellington.

Gas Transmission

23. Gas transmission is undertaken by way of high pressure gas pipeline systems: South, North, Bay of Plenty, Morrinsville and Oaonui/Huntly. The latter pipeline is operated by NGC on behalf of the Maui Joint Venture. The other pipelines are all owned and operated by NGC.

24. Consistent with past practice, the Commission has used a North Island market for its consideration of the impact of the proposal on the transmission of gas.

Gas Distribution

25. Until the time of Decision 333 (10 December 1998), the Commission considered issues affecting the distribution of gas using “delivered gas” markets. Delivered gas encompassed both the gas and the delivery of that gas. In Decision 333 the Commission recognised that divestments by some gas utilities resulting in the ownership separation of gas distribution and retail businesses, and also the potential emergence of new retailers, meant that consumers would no longer necessarily receive both their distribution services and gas from a single entity. The Commission therefore adopted separate markets for the supply of gas and the distribution of that gas.

26. The Commission reaffirmed its view in Decisions 387 and 435. The Commission considers that separate supply and distribution markets remain appropriate.

27. Gas distribution is undertaken by way of low pressure gas pipeline systems. The owners of the regional distribution networks are as set out in Table 1 below.

Table 1: Distribution Network Owners

Distribution Company	Region
NGC	Northland, Whangaparoa, Waikato, Bay of Plenty, Taupo, Gisborne, Kapiti
UnitedNetworks	Whangaparoa, Auckland, Hawkes Bay, Palmerston North/Manawatu, Wellington
Wanganui Gas	Wanganui/Rangitikei
Powerco	Taranaki, Hutt/Mana
Nova*	Wellington, Porirua, Hutt Valley, Hastings, Hawera, Papakura and Manakau City

*Nova has limited bypass networks in these areas as opposed to having a full distribution network.

28. Gas distribution networks have historically been viewed as discrete natural monopolies. The sunk cost associated with existing pipelines and the scale economies derived from the operation of gas distribution networks means that the duplication of pipelines has generally not been economically viable. However in limited areas competition for distribution to large customers has developed in recent years. This has come about principally through the limited by-pass networks constructed and operated by Nova.

29. Bypass opportunities tend to be limited to areas where there is a concentration of medium to large consumers who are close to the transmission pipeline or to an existing bypass network. Incumbent network owners usually take account of the threat of bypass when setting their network charges. However the new entrant, or its customers, may also have strategic reasons for investing in bypass pipelines even when the incumbent reduces its charges to match possible bypass charges. These reasons may include their wish to obtain greater bargaining power when negotiating future network charges with the incumbent. The threat of bypass is likely to have a greater impact on the incumbent network company if the negotiating party has a history of laying bypass pipelines.

30. The Commission remains of the view that bypass and potential bypass gives rise to pockets of competition and contestability but do not alter the overall framework, distribution networks being geographically discrete monopolies.

31. The discrete gas distribution markets previously defined by the Commission have not expanded to any great extent, and in some instances borders between distribution networks remain in excess of 100 kilometres apart.

32. However, NGC and UNL both own gas distribution pipelines at Whangaparoa. UNL's pipelines in this area are not connected to NGC's transmission pipeline, rather UNL trucks gas to Silverdale on behalf of retailers supplying customers in the Whangaparoa region, and connects to its distribution network at that point.

33. NGC submitted that Whangaparoa should be included in a Greater Auckland region. However, Whangaparoa has particular features which distinguish it from the rest of the Auckland region. In addition, UNL's network at Whangaparoa is not connected to its Auckland network.

34. For these reasons, the Commission proposes to treat Whangaparoa as a discrete market in respect of this application, as the market characteristics of Whangaparoa are quite different from those of Auckland.

35. Accordingly, the Commission considers that the relevant markets for considering the gas distribution issues raised by the current proposal are the markets for the distribution of gas in the geographic regions defined by NGC's and UNL 's gas networks; that is Whangaparoa, Auckland, Hawkes Bay, Palmerston North/ Manawatu, Wellington, Waikato, Bay of Plenty, Taupo, Gisborne, Kapiti and Wanganui/Rangitikei.

Gas Retailing to Residential Consumers

36. The average residential consumer may take around 25 GJ (0.025 TJ) of gas per annum, while a large residential consumer may take 90-100 GJ (0.09-0.1 TJ).

37. For residential consumers the Commission has concluded in the past that gas retailing falls within localised geographic markets, each corresponding with the geographic boundaries of the relevant distribution network.

38. In its application, NGC advised that it is willing to proceed on the basis of the relevant markets as defined by the Commerce Commission in Decisions 387 and 435, being discrete regional markets for distribution. NGC, however, raised the issue of the appropriateness of a wider geographic market encompassing both commercial/industrial and residential customers in relation to the retailing of gas.

39. As the proposed acquisition would not give rise to any horizontal aggregation in the gas retailing markets, the Commission does not consider it necessary at this time to reach a view on whether gas retailing to residential consumers is now part of a North Island gas retailing market. Therefore the Commission has adopted the same retail market definitions that it adopted in Decisions 387 and 435.

40. NGC is the incumbent retailer on each of its regional networks and Contact is the incumbent retailer on UNL's networks, as shown in Table 2 below.

Table 2: Gas Residential Retail Incumbencies

Region	Distributor	Incumbent Retailer
Northland	NGC	NGC
Whangaparoa	NGC/UNL	NGC/Contact
Auckland	UNL	Contact
Waikato	NGC	NGC
Bay of Plenty	NGC	NGC
Hawkes Bay	UNL	Contact
Wanganui/Rangitikei	WGL	WGL
Taranaki	Powerco	NGC
Palmerston North/Manawatu	UNL	Contact
Kapiti	NGC	NGC
Wellington	UNL	Contact
Hutt/Mana	Powerco	NGC

41. For the purposes of this application, the relevant geographic markets for retailing gas to residential customers are Whangaparoa, Auckland, Hawkes Bay, Palmerston North/Manawatu and Wellington.

Gas Retailing to Industrial and Commercial Customers

42. In Decision 387, the Commission noted that:

> Large industrial and commercial consumers may be on individual contracts, have particular meter requirements, and have greater numbers of suppliers competing for their business, but now both large and small industrial and commercial consumers are likely to have competitive options available to them from retailers based in different parts of the country. Many firms operating on multiple sites in various regions now arrange their purchase of gas through one supplier. The past situation where the local incumbent retailer could often unilaterally increase prices to small industrial and commercial consumers without fear of a competitive response does not now appear to exist.

43. This situation has continued, with competition for commercial/industrial customers having increased throughout all areas. [ ]. All gas retailers interviewed by the Commission advised that the market for commercial/industrial customers remains competitive, with retailers supplying commercial/industrial customers throughout the North Island. In addition, they considered the market for gas retail to commercial/industrial customers to be distinct from the market for gas retail to residential customers.

44. Therefore, the Commission believes that it is appropriate to define a discrete gas retail market for industrial and commercial consumers. This market is North Island in scope.

Conclusion on Market Definitions

45. The Commission concludes that the relevant markets for the analysis of the proposed acquisition are:

- the market for the transmission of gas in the North Island;
- the regional gas distribution markets in Whangaparoa, Auckland, Hawkes Bay, Wellington, Palmerston North/ Manawatu, Northland, Waikato, Bay of Plenty, Taupo, Gisborne, Kapiti, and Wanganui/Rangitikei;
- the market for the retailing of gas to residential consumers in Whangaparoa, Auckland, Hawkes Bay, Wellington and Palmerston North/Manawatu; and Wellington; and
- the market for the retailing of gas to industrial and commercial consumers in the North Island.

COMPETITION ANALYSIS

Substantially Lessening Competition

46. Section 47 of the Act prohibits particular business acquisitions. It provides that:

> A person must not acquire assets of a business or shares if the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market.

47. Section 2(1A) provides that substantial means "real or of substance". Substantial is taken as meaning something more than insubstantial or nominal. It is a question of degree.[2] What is required is a real lessening of competition that is not minimal. The lessening needs to be of such size, character and importance to make it worthy of consideration.[3]

48. Section 3(2) provides that references to the lessening of competition include references to the hindering or preventing of competition.[4]

49. While the Act defines the words "substantial" and "lessening" individually it is desirable to consider the phrase as a whole. For each relevant market, the Commission will assess: the probable nature and extent of competition that would exist in a significant section of the market, but for the acquisition (the counterfactual);

- the nature and extent of the contemplated lessening; and
- whether the contemplated lessening is substantial.[5]

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[2] *Commerce Commission v Port Nelson Ltd* (1995) 6 TCLR 406, 434; *Mobil Oil Corporation v The Queen in Right of NZ* 4/5/89, International Centre for Settlement of Investment Disputes, Washington DC, International Arbitral Tribunal ARB/87/2 (paras 8.2, 19, 20).

[3] *Dandy Power Equipment Ltd v Mercury Marina Pty Ltd* (1982) ATPR 40-315, 43-888; *South Yorkshire Transport Ltd v Monopolies & Mergers Commission* [1993] 1 All ER 289.

[4] For a discussion of the definition see *Commerce Commission v Port Nelson Ltd*, supra n 6, 434.

[5] See *Dandy*, supra n 5, pp 43–887 to 43-888 and adopted in New Zealand: *ARA v Mutual Rental Cars* [1987] 2 NZLR 647; *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [1988] 2 NZLR 352; *Fisher & Paykel Ltd v Commerce Commission* [1990] 2 NZLR 731; *Commerce Commission v Carter Holt Harvey*, unreported, High Court, Auckland, CL 27/95, 18/4/00.

50. In interpreting the phrase "substantially lessening competition", the Commission will take into account the explanatory memorandum to the Commerce Amendment Bill (No 2). The memorandum notes that:

> Two of the 3 key prohibitions are strengthened to bring New Zealand into line with Australian competition law, which will facilitate a more economic approach to defining anti-competitive behaviour.

and, in relation to s47:

> This proposed new threshold is the same as the threshold for these types of acquisitions in section 50 of the Trade Practices Act 1974 (Australia).

51. For the purposes of the analysis, the Commission takes the view that a lessening of competition and a strengthening of market power may be taken as being equivalent, since they are the two sides of the same coin. Hence, it uses the two terms interchangeably. Thus, in considering whether the acquisition would have, or would be likely to have, the effect of substantially lessening competition in a market, the Commission will take account of the scope for the exercise of market power, either unilaterally or through co-ordination between firms.

52. When the impact of enhanced market power is expected predominantly to be upon price, the anticipated price increase relative to what would otherwise have occurred in the market has to be both material, and able to be sustained for a period of at least two years, for the lessening, or likely lessening, of competition to be regarded as substantial. Similarly, when the impact of increased market power is felt in terms of the non-price dimensions of competition, these also have to be both material and able to be sustainable for at least two years for there to be a substantial lessening, or likely substantial lessening, of competition.

The Counterfactual

53. The Commission uses a forward-looking, counterfactual type of analysis in its assessment of business acquisitions, in which two future scenarios are postulated: that with the acquisition in question, and that in the absence of the acquisition (the counterfactual). The impact of the acquisition on competition can then be viewed as the difference between those two scenarios. It should be noted that the status quo cannot necessarily be assumed to continue in the absence of the acquisition, although that may often be the case. For example, in some instances a clearly developing trend may be evident in the market, in which case the appropriate counterfactual may be based on an extrapolation of that trend.

54. Given that a number of parties have indicated to UNL that they intend to bid for UNL's gas pipeline assets, in the current case, it appears that the most likely counterfactual will be those gas assets under ownership of another party.

55. It is important to note that the current level of market power attributable to NGC's ownership of existing gas transmission and distribution networks would be unchanged by the proposed acquisition.

56. The Commission therefore has adopted the counterfactual as UNL's gas pipeline assets being owned by a third party independent of NGC.

The Competitive Impact

57. The competitive impacts within each market from any loss of actual or potential competition are considered below. The Commission has then considered whether the greater level of vertical integration of the markets give rise to any competition concerns.

Distribution Markets

58. As discussed in the market definition section, the Commission has previously defined gas distribution networks as natural monopolies, apart from limited bypass. Bypass provides only limited competitive constraint on the network owner, as bypass opportunities tend to be limited to areas where there is a concentration of medium to large consumers who are close to the transmission pipeline or to an existing bypass network. In two markets, Whangaparoa and, to a much more limited extent, Auckland, a certain amount of alternative network has been developed by one or other of the merging parties, which could potentially impact on the likelihood of bypass in these areas. Therefore, these markets are considered separately below

<u>The Market for Gas Distribution in Whangaparoa</u>

59. At Whangaparoa, NGC and UNL both have gas distribution networks that deliver gas to residential consumers. Approximately one third of the area has an overlap of UNL and NGC network pipelines. In 1998, anticipating that the Whangaparoa region would be a growth area, NGC commenced laying gas pipeline. Shortly after, Enerco (a previous owner of UNL's gas distribution networks) began constructing its distribution network, laying pipes predominately down major streets, as well as in some strategic areas. Both parties were competing to become the major network owner in the region. It appears that NGC was more successful in this regard than Enerco, as its network is significantly more extensive. Some of those sections of pipe laid by Enerco remain unconnected to a gas supply.

60. NGC's pipelines run out of the Waitoki transmission delivery point. NGC has [ ] connections to the NGC distribution network off this delivery point. As previously mentioned, UNL's pipelines are not connected to the transmission pipeline; instead it trucks gas to its Silverdale connection point. UNL has [ ] connections to the UNL distribution network off this delivery point. In one part of this area, (the Gulf Harbour end of the Whangaparoa Peninsula) UNL's pipelines are not connected to a gas supply and the pipeline is therefore not used.

61. In the area of overlap at Whangaparoa, NGC and UNL have pipelines running down the same streets in some instances. Although NGC has some connections on both sides of these streets, NGC contended that in many areas in which the networks overlap, it is uneconomic to lay a service across the road.

62. In residential areas such as Whangaparoa, gas appliance retailers are generally the first point of contact for a customer wishing to connect to a gas supply. For this reason, gas retailers focus on building strong relationships with gas appliance retailers in order to expand their residential retail customer base. Once selected, the gas retailer contacts the appropriate distribution network company to arrange physical connection. Staff were advised that a typical residential customer would not therefore know through whose pipes their gas is transported.

63. Contact confirmed this situation and added that there is virtually no competition between distribution companies in Whangaparoa. To this extent, it appears switching between distribution companies does not occur in this region.

64. Furthermore, distribution prices at Whangaparoa are in line with distribution prices in the Greater Auckland region, which suggests that competition for distribution customers in Whangaparoa has not had any noticeable impact on distribution prices.

65. NGC advised that the situation of both NGC and UNL (previously Enerco) duplicating pipeline in the Whangaparoa region was largely historic and "a ludicrous and expensive" exercise which was unlikely to continue. UNL confirmed this view.

66. The Commission considers that due to the relatively small numbers of customers in the areas where duplication of distribution pipelines occurs, the absence of switching, and the fact that distribution prices in those areas of overlap are consistent with those across the wider region, compared to the counterfactual, it is likely the current proposal will have no, or a *de minimis*, effect on competition in the market for gas distribution in Whangaparoa.

<u>The Market for the Distribution of Gas in Auckland</u>

67. UNL is the incumbent in the Auckland distribution market. Within the Auckland distribution market there are three areas where both NGC and UNL own distribution pipes. These are Papakura, Drury and Ramarama.

68. The overlap in Papakura and Drury represents a small proportion of the market in terms of load, connection and area served. In these areas, retailers have contracted with NGC or UNL for longer terms (of approximately 5 to 10 years) for the predominantly horticultural commercial loads. NGC's and UNL's networks in these areas overlap for a short distance (no more than 400 metres) and then diverge. The overlap in Ramarama is an overlap in theory only and does not exist in practice. The length of network pipeline that NGC inherited from WEL in this area has never been commissioned nor used to supply any consumer, nor connected to the Ramarama transmission delivery point. This length of pipeline is damaged and considered by NGC to be obsolete.

65. In Papakura, UNL's principal bypass line is the 300mm steel ex-transmission line running north to Otahuhu in Auckland. UNL also has a local distribution network in the area. NGC's distribution pipe running west from Papakura along Hingaia Rd runs parallel to UNL's network for approximately 400 metres. NGC does not currently supply any consumers from this stretch. It built its line to supply [ ], which represents less than [ ] of the estimated number of connections in the Auckland market. NGC's network load in Papakura is [ ] GJ/pa, [ ] of the load in the Auckland market which is [ ] GJ/pa, excluding the power generation demand at the Otahuhu and Southdown Power Stations.

66. In Drury, NGC has a distribution network running west along Karaka Rd (SH 22). There is no UNL network which overlaps with this network. NGC has also built a network extension east from Drury along Waihoehoe Rd to supply a greenhouse operation. This runs in parallel with a UNL line for 200-300 metres, before the UNL line branches off. No consumers exist in the area of overlap, as the lines run past farmland. NGC supplies gas to [ ] consumers in this area, [ ], representing less than [ ] of the

estimated number of connections in the Auckland market. NGC's network load in Drury is [ ] GJ/pa, [ ] of the load in the Auckland market.

67. The Commission concludes that there is minimal competition either at Papakura or at Drury, and that the proposed acquisition would have no, or a *de minimis*, effect on competition in the market for gas distribution in Auckland.

68. A possible issue arises with respect to the removal of potential cross-border competition between NGC and UNL. In the present case the geographic borders of the two gas distribution companies intersect in some parts of the Auckland market. In some instances there is a potential for some limited cross-border competition on the geographic fringe of markets although, it is noted that the High Court in *PNZ v Mercury* was extremely sceptical of the degree of cross-border competition, with respect to electricity. The Applicant and UNL advised the Commission that in reality, distribution customers on the borders of their respective networks in the Auckland market do not switch networks. Therefore, consistent with the view of the High Court, the Commission has concluded that any loss of cross-border competition in this instance would be minimal at most.

<u>Markets for the Distribution of Gas in Hawkes Bay, Palmerston North, Manawatu, Wellington, Northland, Waikato, Bay of Plenty, Taupo, Gisborne, Kapiti and Wanganui/Rangitikei</u>

69. Apart from in the Whangaparoa and Auckland regions discussed above, NGC and UNL are not in competition with each other in relation to their distribution networks. Consequently no aggregation of market share would arise from the proposed acquisition.

70. NGC and UNL are natural monopolists in their respective geographic areas for the business of the provision of gas distribution networks. Arguably, the concept of natural monopolies is tempered by the opportunity to bypass. This is discussed in more detail in the section on vertical integration below. With respect to the distribution networks, the Commission notes that the number of customers for whom bypass is a viable option within any given network is small. It is also the case that the opportunity to bypass is, in principle, not altered by the ownership of the network. Therefore the Commission considers the potential to bypass does not alter the fundamental characteristic of the networks as natural monopolies.

71. The acquisition by NGC of UNL will result in the expansion of NGC's monopoly over a larger geographical area. In essence, the proposed transaction will give rise to a 'bare transfer' of monopoly power in the affected regions. The bare transfer of monopoly power was discussed in respect of electricity lines (distribution) businesses in Decision 446, Dunedin Electricity and Otago Power. The Commission considers that discussion to be relevant to the proposed acquisition by NGC of UNL's gas distribution networks

72. In Decision 446, the Commission noted that the competitive effect of the acquisition by one electricity lines company of another was examined by the Court of Appeal in *Power New Zealand Limited v Mercury Energy Limited* [1997] (*PNZ v Mercury CA*) 2 NZLR 669. In *PNZ v Mercury CA* the competition analysis was under the previous threshold of dominance. It was held that the transfer of Power New Zealand's monopoly the North Shore region to Mercury (Auckland region) and the consequent

expansion of Mercury's monopoly over a larger geographical area did not alter the character of its existing market dominance.

73. The Court held that section 48 (now repealed) which allowed for a bare transfer of a dominant position, applied to the acquisition. The Court noted that section 48 allowed a technical acquisition of dominance when it was in effect only a bare transfer of dominance, with no increase in market power arising from the acquisition. Of most relevance to the present application is the finding of the Court that there would be "no effect on competition".

74. The analysis under Section 48 in *PNZ v Mercury CA* remains relevant. As the Court found that the acquisition of the North Shore electricity network by the owner of the Auckland electricity network would amount only to a bare transfer of dominance, it was effectively saying that the acquisition at that time would not affect the existing level of competition or market power in the relevant market. It follows that the Commission can be satisfied that the proposed acquisition by NGC of UNL's gas pipeline assets will not have the effect of substantially lessening competition.

The Market for the Retailing of Gas to Residential Customers in Auckland, Hawkes Bay, Palmerston North/ Manawatu and Wellington

Existing Competitors

75. Currently, NGC, Contact, and WGL retail gas to residential customers in each of these geographic markets, with Contact being the incumbent retailer on each of the networks. In addition, FreshStart retails gas to residential customers in the Hawkes Bay, Palmerston North/Manawatu, and Wellington markets. Auckland Gas is a small retailer in the Auckland region. E-gas has advised the Commission that [

].

76. UNL provided to the Commission, on a confidential basis, a table illustrating the level of activity by entrant retailers on its networks since September 2000. The table is annexed to this Decision as Appendix 1 and the graphed results are shown in Appendix 2. [

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77. The proposed acquisition will not give rise to a change in market shares as UNL is not involved in the retail of gas.

Entry Conditions and other Competitive Constraints

Access to Gas Network

78. The ability of retailers to access the transmission and distribution networks is an important factor in the consideration of competition in retail markets. NGC's ownership of the transmission and distribution networks is therefore potentially relevant to the analysis of competition in the retail markets. NGC has submitted that it is compelled to provide non-discriminatory access to its transmission and distribution networks by the voluntary regime set out in the New Zealand Gas Pipeline Code of July 1998 (the Code) to which it is a signatory.

79. NGC has submitted:

> The Code is a voluntary code of practice designed to promote the development of competitive gas markets by establishing minimum standards of disclosure and conduct for pipeline owners and facilitating neutral and non discriminatory access. NGC is a signatory to this Code. UNL is not. Elements of the Code include:
>
> - owners of pipelines shall supply any user that meets prudential requirements with any service offered, subject to available capacity;
> - owners shall offer terms and conditions that facilitate access to all capacity and shall act in a neutral and non-discriminatory manner;
> - terms and conditions must be declared in a publicly available memorandum and constitute a binding offer;
> - each owner is required to issue an information memorandum which sets out declared terms and conditions under which the system may be accessed, a description of the capacity available, engineering specifications, gas specifications, etc;
> - owners are obliged, where practical, to unbundle services; and
> - confidentiality and ring fencing obligations must be observed to ensure that confidential information is secure.

80. Although the Code is voluntary and not all parties are signatories to it (UNL, Powerco and Nova are not), industry participants advised the Commission that the industry tends to abide by the general principles of the Code. The Commission notes that to date, at least, it has received no complaints of denial of access by gas network owners, whether vertically integrated or not.

81. In addition, Network Services Agreements are negotiated between NGC and network users. Those agreements govern the conduct, rights and obligations of NGC and a network user. An Information Memorandum forms part of the terms and conditions of the Network Services Agreement and describes the pricing, technical and procedural details for transport of gas on the network.

<u>Gas (Information Disclosure) Regulations 1997</u>

82. The Gas (Information Disclosure) Regulations came into force on 7 August 1997. The Regulations require separate financial statements for the transmission, wholesale, distribution and retail businesses; disclosure of contract prices, terms and conditions; publication of financial, efficiency and reliability performance measures, pipeline capacity information and line charge methodologies.

83. Although Contact and E-Gas stated that disclosure was not fully transparent, they were of the view that to some degree, such disclosures enabled them to benchmark pricing across the networks. To this extent, Contact and E-Gas considered that the regulations provide some constraint on NGC.

<u>Threat of Government Regulation</u>

84. On 15 March 2001, the Ministry of Economic Development commissioned a review of the performance of the natural gas sector. The resultant report, the ACIL Report,[6] was recently released. The main points made in the report in respect of competition issues are:

    - NGC's pricing arrangement for access to its transmission pipeline system is cost reflective.

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[6] ACIL Consulting, Review of the New Zealand Gas Sector 2001-2002.

- Bypass pricing in gas distribution has introduced competition in areas where bypass is potentially a threat.
- Despite allegations by Contact and Todd Energy that NGC leverages its upstream monopoly power in transmission and distribution into retail, the retail sector is relatively competitive. However, some concern exists over impediments to customer switching.
- A recommendation that the Government encourage vertically integrated gas businesses to strengthen the ring fencing of the natural monopoly elements of their natural gas businesses.
- A preference for industry self-regulation with a recommendation that the industry be reviewed again in 3 – 4 years time.

85. The Government has yet to respond to this report. At this time, the Commission considers the current regulatory framework is the appropriate reference point for its competition analysis.

86. However, industry participants are aware of the ACIL Report and, under threat of more stringent Government regulation, have formed a working group to discuss ways in which the industry can strengthen its self-regulation.

87. Contact, WGL, E-Gas, Powerco and UNL, all stated that the gas industry is well aware of the need to strengthen and enhance its voluntary regimes in order to avoid an inquiry such as the Electricity Lines Business Thresholds inquiry, which the Commission is currently conducting.

88. The Commission is of the view that the threat of further Government regulation would continue to provide some constraint on the merged entity.

Inter Fuel Competition

89. The Applicant has submitted that other forms of fuel such as electricity, LPG, coal, diesel and waste oil provide a degree of constraint on gas distributors. The Commission[7] and the High Court[8] have previously concluded that gas and competing fuels are substitutes both technically and commercially - but they are at best imperfect substitutes and cannot be regarded as being in the same market. While the Commission acknowledges that in the residential gas retail markets some constraint is provided by electricity, it considers that constraint to be limited due to, inter alia, the cost of switching appliances such as water heaters and stoves.

Conclusion on the Residential Retail Gas Markets

90. The Commission concludes that currently there is competition in this market which is likely to continue post acquisition. In addition, the merged entity would face constraint from the voluntary pipeline access code, current information disclosure regulations, and the threat of further regulation. Accordingly the acquisition will not have the effect, or likely effect, of substantially lessening competition in the market for the retailing of gas to residential customers in Auckland, Hawkes Bay, Palmerston North/ Manawatu and Wellington.

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[7] Decision 270, *Natural Gas Corporation of New Zealand Limited and Enerco Limited*, 22 November 1993

[8] Shell (Petroleum Mining) Co Ltd v Kapuni Gas Contracts Ltd (1997) 7 TCLR 463

Market for the Retailing of Gas to Industrial and Commercial Consumers in the North Island

Existing Competitors

91. Currently, NGC, Contact, E-Gas, Nova and WGL retail gas to industrial and commercial customers. WGL uses the brand Direct Energy NZ in areas other than its traditional franchise region, Wanganui.

92. As discussed above, E-Gas [ ]. E-Gas advised the Commission that it considers the commercial/industrial market to be highly competitive. The Applicant, WGL, and Contact supported this view.

93. NGC and WGLcompete with each other for commercial/industrial customers. [ ]

94. Mr Chips, an Auckland based manufacturer of potato chips, is a relatively large consumer of gas, using [ ] TJ/pa. Mr Chips informed the Commission that it considers the commercial/industrial market to be very competitive. Mr Chips advised that [ ]. Mr Chips did not consider that the proposed acquisition would give rise to any lessening of competition in this market.

95. Nova is principally a retailer of gas to industrial and commercial customers. Some of these customers are supplied over Nova's own distribution bypass networks. It has constructed and operated these bypass networks where it believes the incumbent network company is charging excessive distribution charges and it is possible and viable to construct an alternative pipeline to the customer from the gas transmission pipeline. In the main, bypass is only possible where there are a significant number of large customers in close proximity to each other and to the gas transmission pipeline.

96. All parties that retail gas to commercial/industrial consumers, including Todd, advised the Commission that bypass pricing has led to an increased level of competition in this market.

97. Although Nova has not bypassed any of the NGC networks, the Commission notes that Nova has negotiated user agreements with NGC for transmission and distribution services and competes for commercial/industrial on those networks.

98. As with the residential retail markets, the Commission considers that the merged entity would face constraint in the commercial/industrial market from the voluntary pipeline access code, current information disclosure regulations, and the threat of further regulation.

Conclusion on the Industrial and Commercial Retailing Market

99. The Commission concludes that currently there is strong competition in this market which is likely to continue post acquisition. In addition, the merged entity would face constraint from the voluntary pipeline access code, current information disclosure regulations, and the threat of further regulation. Accordingly the acquisition will not

have the effect, or likely effect, of substantially lessening competition in the market for the retailing of gas to industrial and commercial consumers in the North Island.

Vertical Integration

Potential Competition Concerns from Vertical Integration

100. NGC is vertically integrated in the transmission, distribution and retailing of gas. The Applicant accepts that the proposed acquisition would result in a strengthening of that vertical integration through the acquisition of further distribution networks.

101. The Commission's Practice Note 4 states that: [9]

> "in general, the vertical aspects of acquisitions leading to vertical integration are unlikely to result in a substantial lessening of competition in a market unless a situation of a substantial degree of market power exists at one of the functional levels affected by a vertical acquisition. Where such a situation is found to exist, the Commission will examine the acquisition to determine whether that position is likely to be strengthened or extended to other markets, and whether that will substantially lessen competition."

102. The Practice Note goes on to outline the competition concerns that may be raised by vertical acquisitions. These include: [10]

- Vertical integration may facilitate coordination effects. For example, the efforts of a group of manufacturers to collude may be undermined by the competition between the downstream retailers. This might be prevented if each retailer were to be acquired by a manufacturer.
- Vertical integration may foreclose entry into one or other of the vertical levels affected. For example, a commodity processor that vertically integrates with upstream suppliers of the commodity may be able to foreclose others from the processing market. Likewise, a manufacturer that gains control of a downstream distribution level of the market may be able to foreclose others from the manufacturing market.
- Vertical integration may increase entry barriers. Foreclosure as just described may raise barriers to entry, by requiring an entrant at one functional level of the market to enter simultaneously at the other, foreclosed, level.
- Vertical integration may raise access concerns. A vertically integrated firm which owns an essential facility to which others need access in order to compete at a downstream level, has the ability to discriminate in favour of its own affiliated activities in the downstream market. Those affiliated activities could also benefit from information gained about rivals through those rivals requiring access at the upstream level.

Impact of Vertical Integration in Relevant Markets

103. Of the markets relevant to the present application, NGC currently has a substantial degree of market power in the market for the transmission of gas in the North Island, and in the markets for gas distribution in Northland, Waikato, Bay of Plenty, Taupo, Gisborne, and Kapiti. This leaves the question of whether this market power could be strengthened in any way by the proposed acquisition, and whether this would represent a substantial lessening of competition, again relative to the counterfactual. The

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[9] Page 44, Practice Note 4.
[10] ibid.

question of whether the Applicant would have an increased ability to leverage its market power in any of those markets to affect downstream retail markets will depend on factors such as access and constraints.

104. A vertical acquisition of the type being proposed may give rise to a substantial lessening of competition in a number of ways, such as those outlined in the Commission's Practice Note and referred to above.

105. The first concern is that vertical integration may facilitate coordination effects. However in the present case this is considered unlikely as NGC is the only party increasing its vertical integration. Therefore, there does not appear to be any increase in the risk of collusive behaviour, compared to the counterfactual.

106. The other concerns relate to market foreclosure and access. The ability of the merged entity to foreclose entry into the regional gas retail markets or to discriminate in favour of its own retail operations will depend on the provision of access to the transmission and distribution networks at a reasonable price.

107. The Applicant has submitted that it currently provides transmission and distribution services at cost reflective levels on those networks where it is already fully integrated. It argued that the constraints posed on it by the Voluntary Gas Pipeline Access regime, the Gas (Information Disclosure) Regulations, the threat of by-pass, the inter fuel constraint posed by electricity, LPG, coal, diesel and waste oil, and the threat of further Government regulation, will continue to constrain the merged entity and ensure that it continues to afford access to other retailers.

108. Most parties spoken to by Commission staff did not raise concerns that non-contestable charges such as those for transmission and distribution may be used to cross-subsidise NGC's contestable residential retail operations. For example Contact and E-Gas advised the Commission that the Applicant is constrained by a number of factors which are discussed below. However, Todd expressed concerns about the potential cross-subsidisation of the commercial and industrial retail customers. These concerns are discussed further below.

Ability to Compete on Vertically Integrated Networks

109. Decision 435 established that vertical integration was not necessarily a barrier to competing in residential retail markets. The fact that gas retailers continue to compete on both NGC and UNL networks is consistent with this position. Contact and E-Gas confirmed that a level of competition exists on both networks and that it is no more difficult to compete for retail customers on NGC's networks than it is on those of UNL.

110. The Commission notes that Contact, who would arguably be the most affected by the proposed acquisition, being the incumbent retailer on UNL's networks, was not opposed to the proposal.

111. Nevertheless the Commission notes that Todd Energy expressed concerns about the potential for the proposed acquisition to limit competition in various gas markets, and has instanced the possible impact on its subsidiary, Nova.

112. Nova is the only firm engaged to any extent in bypass. Its entry appeared to have an important influence on network companies' pricing behaviour by forcing them to recognise bypass opportunities when setting their distribution charges. They now recognise that they face the real possibility of losing some customers to competing gas

pipelines if they overprice, with the resulting risk of part of their network becoming stranded.

113. As previously mentioned, to date Nova has only engaged in bypass in competition with non-NGC networks. While it competes as a retailer against NGC, it does so by using NGC's network to carry its gas.

114. Todd has argued that Nova has not attempted to engage in bypass competition against NGC because of the extent of NGC's vertical integration and the potential Todd believes this gives NGC to foreclose, or inhibit, Nova's competitive activity. Among the reasons it believes that this could arise are:

- Prior to building bypass pipelines, Nova must arrange for connection with NGC Transmission. This would provide NGC Transmission of early advice of Nova's intentions and, if it passed this information on to the retail side of its business, it would allow NGC Retail to "lock up" the key customers before Nova actually entered the market.

- NGC could be uncooperative and difficult on interconnection and a range of other matters, which while difficult to be shown to be in breach of the Commerce Act, would add costs to Nova and could make it uncompetitive.

- NGC could use monopoly profits earned on transmission to undercut Nova once it attempted to enter the retail market.

115. Todd advised Commission staff that [

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116. These matters were put to NGC by Commission staff. It argued:

- The reason why Nova has not built bypass on NGC's network is because, unlike the situation with other network companies, NGC has set its prices to reflect bypass opportunities, and consequently bypass is not a sensible option.

- NGC complies fully with industry access codes and protocols, and no discriminatory behaviour disadvantaging competing retailers has occurred, or would be likely to occur in the future. It has pointed out the close Government scrutiny and the real threat of regulatory intervention it faces.

- Todd has no evidence to support its assertions about NGC behaviour – rather they are a continuation of Todd's hostile approach towards NGC.

117. The Commission has considered Todd's arguments. It considers that it would be a matter of concern if the threat of bypass was lessened by an actual or perceived increase in NGC's market power. However it considers that Todd has not demonstrated that this would necessarily occur for the reasons discussed below.

118. Firms other than Todd and Nova would have equal potential to engage in bypass competition where this might be viable. The fact that Todd states that it, and Nova, would not engage in new bypass competition in the future does not rule out the possibility that others would. Contact advised the Commission that it engages in bypass pricing when negotiating distribution charges, and that it would consider physical bypass of an incumbent's network if distribution pricing was sufficiently high.

119. Todd and Nova have not suggested that bypass competition using its existing pipelines would cease with the proposed acquisition; only competition which requires it to construct new pipelines.

120. Current bypass opportunities are likely to be limited as network operators become more sophisticated in their pricing strategies. As NGC and others have pointed out, bypass is generally wasteful of resources and is only likely to be viable when a network owner prices inefficiently.

121. The Commission has received no satisfactory evidence to date of NGC attempting to inhibit bypass competition. To date, at least, indications are that industry protocols are working effectively.

122. In any event, under any circumstances bypass opportunities would only be available to limited numbers – mainly large users situated close to gate stations on the main transmission pipeline.

123. The Commission accepts that it is not just actual bypass which provides a constraint on distributors, but also the extent to which bypass threat is perceived to be real. Anything which reduces the perception of bypass threat could have some competitive impact. However, in this case the Commission considers that some threat would continue to exist post acquisition, it currently affects only a limited number of customers, and while the acquisition would have some impact it would not be such as to materially change the market power held by the network owner.

124. Having considered all the above issues, the Commission considers that the greater level of vertical integration arising from the acquisition would not result in a substantial lessening of competition in any market.

OVERALL CONCLUSION

125. The Commission is therefore satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in:

- the market for the transmission of gas in the North Island;
- the regional gas distribution markets in Greater Auckland, Hawkes Bay, Palmerston North/ Manawatu, Wellington, Northland, Waikato, Bay of Plenty, Taupo, Gisborne, Kapiti, and Wanganui/Rangitikei;
- the market for the retailing of gas to residential consumers in Greater Auckland, Hawkes Bay, Palmerston North/Manawatu and Wellington; and
- the market for the retailing of gas to industrial and commercial consumers in the North Island.

DETERMINATION ON NOTICE OF CLEARANCE

Accordingly, pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the acquisition by Natural Gas Corporation Holdings Limited and/or any of its wholly owned subsidiaries, and/or its parent Australian Gas Light Company of the gas pipeline assets of UnitedNetworks Limited.

Dated this 23rd day of August 2002

MJ Belgrave
Chair