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COMMERCE COMMISSION

Decision No. 362

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

THE AUSTRALIAN GAS LIGHT COMPANY

and

NATURAL GAS CORPORATION HOLDINGS LIMITED

The Commission:

K M Brown
E C A Harrison
P R Rebstock

Summary of the Application:

The Australian Gas Light Company (or an interconnected body corporate) has sought clearance to acquire up to and including 100% shareholding in Natural Gas Corporation Holdings Limited.

Determination:

Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission gives clearance for the proposed acquisition.

Date of Determination:

10 June 1999

CONFIDENTIAL MATERIAL IN THIS DECISION IS CONTAINED IN SQUARE BRACKETS []

CONTENTS

CONTENTS	2
THE PROPOSED ACQUISITION.....	3
PROCEDURES	3
THE PARTIES.....	3
NATURAL GAS CORPORATION HOLDINGS.....	3
AUSTRALIAN GAS LIGHT COMPANY.....	4
AGL AND NGCH AS ASSOCIATED PERSONS.....	4
MARKET DEFINITION	6
IDENTIFYING RELEVANT MARKETS.....	6
SEPARATE ELECTRICITY AND GAS PRODUCT MARKETS	7
IDENTIFYING THE RELEVANT GAS DISTRIBUTION MARKETS	8
IDENTIFYING THE RELEVANT ELECTRICITY RETAIL MARKET	9
COMPETITION ANALYSIS	9
GAS DISTRIBUTION MARKETS.....	9
NATIONAL ELECTRICITY RETAIL MARKET	10
CONCLUSION	11
DETERMINATION ON NOTICE OF CLEARANCE	11

THE PROPOSED ACQUISITION

- 1 The Australian Gas Light Company (AGL), or an interconnected body corporate, has applied in terms of section 66 of the Commerce Act for clearance to acquire up to and including 100% shareholding in Natural Gas Corporation Holdings Limited (NGCH).

PROCEDURES

- 2 The notice was registered on 26 May 1999.
- 3 Section 66(3) of the Commerce Act requires the Commission to clear, or to decline to clear, a notice given to it under section 66(1) within 10 working days, unless the Commission and the person who gave the notice agree to a longer period of time. The tenth working day after the registration of the application was 10 June 1999.
- 4 The applicant sought confidentiality for the fact of the application, and a confidentiality order was made in respect of the fact of the application for a period of 20 working days from the Commission's determination of the notice. When the confidentiality order expires, the provisions of the Official Information Act will apply.
- 5 The Commission's determination is based on an investigation conducted by its staff and their subsequent advice given to the Commission.

THE PARTIES

Natural Gas Corporation Holdings

- 6 NGCH is a listed company. NGCH is owned:
 - 33.3% by Fletcher Challenge Utilities Investments Limited, a member of the Fletcher Challenge Group of companies;
 - 33.3% by members of the Australian Gas Light (AGL) group of companies (29.79% by AGL NZ Limited and 3.55% by AGL NZ Investments Pty Limited); and
 - 33.3% by the public.
- 7 NGCH's operating subsidiary Natural Gas Corporation of New Zealand Limited (NGC) undertakes the business of the acquisition, transmission and marketing of natural gas throughout the North Island. NGC operates at the distribution and retail level directly in Northland, Waikato, Bay of Plenty, Taupo, Gisborne, Taranaki and Kapiti. NGCH has a 25.1% interest in the Wanganui gas distributor and retailer, Wanganui Gas Limited. NGCH also owns 50% of the Kapuni Energy joint venture, which undertakes electricity and steam generation at the Kapuni gas treatment plant site. NGCH owns 100% of Energy Waikato Limited, which retails electricity in the Waikato region.

Australian Gas Light Company

- 8 The AGL group of companies is involved in most facets of the gas industry in Australia, including the ownership and operation of gas pipelines and the distribution and marketing of natural gas to domestic, commercial and industrial consumers. In New Zealand, AGL has a management contract (the Management Agreement) with NGCH to manage the distribution and retail businesses of NGC. AGL recently purchased TransAlta New Zealand Limited's gas distribution network. AGL also has a 8.8% shareholding in Trustpower Limited, an electricity retailer, with options to purchase up to an additional 9.2%.

AGL AND NGCH AS ASSOCIATED PERSONS

- 9 Sections 47(2) and (3) of the Act provide:

“(2) For the purposes of this section and section 48 of this Act, where 2 or more persons are interconnected or associated and together are in a dominant position in a market, each them is deemed to be in a dominant position in that market.

(3) For the purposes of this section and section 48 of this Act, a person is associated with another person if that person is able, whether directly or indirectly, to exert a substantial degree of influence over the activities of the other.”

- 10 AGL has a 33.3% shareholding in NGCH. It has the right to appoint two directors of the six which form NGCH's Board of Directors. A Shareholders' Agreement exists between FCL, which also has the right to appoint two directors of NGCH, and AGL. A Management Agreement exists between AGL and NGCH in terms of which AGL manages NGC's Sales and Distribution Division
- 11 It is the Commission's view that a company which owns or controls 20% or more of the voting power in another has, prima facie, a substantial influence over that other company¹.
- 12 It is noted that the Act is concerned with the potential of a company to exert a substantial influence over another. Whether, up to the present, the company has chosen to exercise that potential is irrelevant for the purposes of determining whether it is associated with another company.
- 13 AGL is a substantial Australian company with assets of over \$3 billion. Its Managing Director and Group General Manager Finance are members of NGCH's Board of Directors. In 1998 NGCH accounted for about A\$21 million² of AGL's profit of A\$200 million. The Commission considers that AGL's investment and interest in the activities of NGCH is not of a minor nature and AGL is not a passive investor in NGCH but will seek to influence the activities and direction of the company in a way which enhances the value of both NGCH and AGL, as is evidenced by the current proposal.

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¹ Commerce Commission Business Acquisition Guidelines 1996, page 9.

² Before tax and borrowing costs.

- 14 Moreover, FCL and AGL have entered into an agreement (the Shareholders' Agreement) which amongst other matters:
- prevents either party to the Shareholders' Agreement from disposing of its shareholding in NGCH except to the other party in accordance with a pre-emptive rights procedure or with the other party's agreement;
 - ensures consultation between AGL and NGCH on all material matters affecting NGCH's interests;
 - ensures that each of FCL and AGL have two directors on the board of NGCH and ensure that FCL and AGL together control the majority of directors of those companies which are subsidiaries of NGCH and ensure that the nominated persons of each are appointed as directors; and
 - ensures any member of the NGCH group shall not enter into arrangements with subsidiaries of either FCL or AGL without agreement;
 - ensures the Chief Executive Officer of any member of the NGCH group is not removed from office or appointed without agreement;
 - ensures the natural gas transmission system is not sold without agreement; and
 - ensures FCL and AGL will use NGCH as the exclusive entity through which either will expand its natural gas purchase, transmission, distribution and sale of natural gas in New Zealand.
- 15 The Shareholders' Agreement terminates once either party's shareholding in NGCH falls below 5%.
- 16 The Shareholder's Agreement appears to reflect a strategy to ensure that the combined voting strength and representation on the Board of Directors of FCL and AGL does not fall below the levels required for the two together, to have majority control of NGCH. If FCL and AGL act together to have majority control of NGCH, then it is the Commission's view that individually they have the ability to exert a substantial influence over the company.
- 17 The shares in NGCH other than those held by FCL and AGL are publicly and diffusely held and therefore there are no other interests to balance or compete with the FCL/AGL block on the NGCH board.
- 18 The Management Agreement reflects AGL's particular expertise in the marketing, distribution and sale of natural gas to consumers gained through almost 130 years of experience in the Australian gas industry. This expertise gives added weight to the influence which AGL is able to exert on NGCH.
- 19 It is the Commission's conclusion that AGL is able to exert a substantial degree of influence over the activities of NGCH and is therefore, in terms of section 47, associated with NGCH.

MARKET DEFINITION

20 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”.

21 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.

The Commission’s *Business Acquisitions Guidelines* 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”.^(p14)

22 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”.^(p15)

The *Business Acquisitions Guidelines* draw a clear distinction between the processes of defining a relevant market and of 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”.^(p15)

Identifying Relevant Markets

23 AGL (as a person associated with NGCH) is involved in the processing of natural gas, co-generation of electricity and steam, the sale and distribution of LPG, the long distance transmission of natural gas at high pressures through pipelines, the wholesaling of natural gas and the local distribution and retailing of natural gas and the retailing of electricity in the Waikato region. AGL in its own right is a distributor of gas and has an interest in Trustpower which is a generator and retailer of electricity.

- 24 As the Commission considers AGL and NGCH to be already associated, any increase in AGL's shareholding in NGCH would not result in any increase in market share for competition analysis purposes, in the business activities undertaken by NGCH. Aggregation could occur only in the markets relating to the business activities which AGL undertakes independently of NGCH.
- 25 NGCH is a 50% joint venture partner with Todd Energy, in a joint venture owning a twenty megawatt steam and electricity co-generation plant at Kapuni. The Commission does not consider potential aggregation in the generation market as a result of the combination of AGL's interest in Trustpower's generators and NGC's partially owned co-generation plant to be material in respect of the competition issues arising from the proposed acquisition.
- 26 Accordingly the markets which the Commission considers require further consideration are
- the distribution of gas in the areas geographically defined by the networks owned by AGL and NGCH; and
 - electricity retailing.

Separate Electricity and Gas Product Markets

- 27 The Commission has previously adopted discrete electricity and gas product markets when assessing business acquisitions in the energy sector. The Commission stated in Decision 270:³

"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". (para. 129)

- 28 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 (PowerNZ/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)

- 29 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)

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³ Decision 270, *Natural Gas Corporation of New Zealand Limited and Enerco New Zealand Limited*, 22 November 1993.

- 30 In Decision 333⁴, the Commission considered it appropriate to adopt discrete product markets for electricity and gas. Although the Commission recognised that inter-fuel competition provides some constraint, 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.
- 31 Accordingly, while the Commission recognises that inter-fuel competition provides some constraint, 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.

Identifying the Relevant Gas Distribution Markets

- 32 In the past five years, the Commission has determined a number of significant applications involving the gas sector, most recently Decision 333.⁵ 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.
- 33 Gas distribution networks have historically been viewed as natural monopolies. The sunk cost associated with existing gas pipelines and the scale economies derived from the operation of gas distribution networks means that the duplication of pipelines was generally not economically viable. The Commission discussed in Decision 345⁶ the competition provided by Nova Gas Limited for distribution services to large customers, particularly in the area where AGL has since purchased the gas distribution network previously owned by TransAlta New Zealand Limited. In that Decision, however, the Commission concluded that gas distribution services for small commercial and domestic consumers are not likely to be contestable.
- 34 For the purpose of analysing the competition effects of the proposed acquisition, the Commission concludes that the relevant gas markets affected by this proposal are distribution markets geographically defined by:
- NGC’s local distribution networks in Northland, Waikato, Bay of Plenty, Taupo, Gisborne, Taranaki and Kapiti.
 - AGL’s local distribution networks in the Hutt Valley, Porirua basin, Newlands and Paekakariki Hill Road regions

⁴ Decision 333, *Contact Energy Limited and Enerco New Zealand Limited*, 10 December 1998.

⁵ See Decision 333 for a discussion of the Commission’s recent determinations in relation to gas markets.

⁶ Decision 345, *UnitedNetworks Limited and TransAlta New Zealand Limited*, 11 March 1999.

Identifying the Relevant Electricity Retail Market

- 35 In Decision 333, the Commission considered the changes which have occurred, and are continuing to occur, in respect of electricity markets, and their implications for market definitions. In that Decision, the Commission was satisfied that there was clear evidence of electricity suppliers being able to switch supplies between different categories of consumers, including small consumers, depending on market opportunities. Suppliers did not appear constrained to supplying limited geographical areas or to supplying to consumers on particular networks only. The majority of small consumers had, and the remainder would have in the near future, a choice of suppliers. The situation of small consumers increasingly matched that of larger consumers. Therefore the Commission concluded in Decision 333 that it was no longer appropriate to define discrete markets for the supply of delivered electricity to small consumers and to medium and large consumers. This view was based on the new dynamics in the marketplace. The Commission concluded in Decision 333 that the relevant market to consider that application was a national retail electricity market.
- 36 Accordingly, in assessing this application, the Commission adopts the same market definition as in Decision 333 and has concluded that the relevant market in respect of electricity retailing is the national electricity retail market.

COMPETITION ANALYSIS

Gas Distribution Markets

- 37 The relevant gas markets affected by this proposal are distribution markets geographically defined by:
- NGC's local distribution networks in Northland, Waikato, Bay of Plenty, Taupo, Gisborne, Taranaki and Kapiti.
 - AGL's local distribution networks in the Hutt Valley, Porirua basin, Newlands and Paekakariki Hill Road regions.
- 38 In Decision 302⁷, 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 by-passing 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

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⁷ Decision 302, *Powerco Limited and Egmont Electricity Limited*, 21 July 1997.

- competition from other fuels.
- 39 In Decision 345, the Commission discussed the changes which have occurred in the gas sector in the period since Decision 302. The Commission noted that these changes were likely to strengthen the extent to which market power in gas distribution networks is constrained. The constraints which were discussed in Decision 302, however, are still faced by gas distributors.
- 40 The Commission has considered whether the proposed acquisition would lessen any constraint from potential cross border competition between NGC's network in the Kapiti region and AGL's network in the Paekakariki Hill Road region. The Commission concludes that, given the ten kilometre distance between the two networks and the minimal number and size of customers at the extremities, cross border competition is not a relevant issue in this matter. The proposed acquisition would not affect the ability of competitors to by-pass AGL's distribution network by connecting directly to the transmission pipeline.
- 41 The Commission considers that none of the constraints facing AGL and NGC as gas distributors will be lessened as a result of the acquisition proceeding. The proposed acquisition is a bare transfer of NGC's position in the various local distribution markets where NGC is the incumbent gas distributor. In the local distribution market where AGL is the incumbent gas distributor, the Commission concludes that it is satisfied that the proposed acquisition will not result in the strengthening of a dominant position.

National Electricity Retail Market

- 42 For the reasons outlined in Decision 333, the Commission is now of the view that electricity retailers are no longer constrained to supplying small consumers connected to their particular networks only. Accordingly, it has been considered appropriate to define a national electricity retail market.
- 43 The Commission considers that the electricity industry reforms have substantially removed the constraints on competitive activity, and on new entry to the national electricity retail market. Having regard to current and potential competitive activity in this market to consumers of all sizes, the Commission has previously concluded that no firm is currently dominant.
- 44 NGCH owns Energy Waikato Limited which retails electricity in the Waikato region and has a market share of about 3% of retail electricity sales. [
-]
- 45 AGL currently has an 8.8% shareholding in Trustpower Limited which has a market share of around 10% of retail electricity sales. AGL has a right of first refusal to purchase up to 14.975 million convertible notes in respect of Trustpower Limited. There is a put option whereby AGL can be compelled to acquire 3.39 million shares in Trustpower Limited from the Tauranga Electricity Consumer Trust, exercisable until 17 September 1999.

- 46 The Commission does not consider that AGL and Trustpower are at present associated. The Commission has noted the options which could result in AGL increasing its shareholding in Trustpower to a level of 18%. This level would not be likely to give AGL a position of substantial influence over Trustpower, taking into account the fact that there are several other significant shareholders in Trustpower. In particular, Infratil, which has a 26% shareholding in Trustpower, has advised of its intention to maintain its involvement in Trustpower. Other shareholders include the Rotorua Electricity Charitable Trust (17.7%) and the Tauranga Electricity Consumer Trust (24.9%). The Commission notes that it would be able to consider any issues arising from AGL's acquisition of an increased shareholding in Trustpower at the time when such options are exercised.
- 47 As the Commission does not consider that AGL currently has the ability to substantially influence Trustpower, no aggregation of market shares will occur in the electricity retail market as a result of the proposed acquisition.

CONCLUSION

- 48 The Commission has considered the impact of the proposed acquisition in two relevant markets:
- The local distribution markets for gas geographically defined by the networks owned by NGCH and AGL; and
 - The national electricity retailing market.
- 49 Having regard to the factors set out in section 3(9) of the Commerce Act and all the other relevant factors, the Commission concludes that the proposal would not result, and would not be likely to result, in AGL or any other person acquiring or strengthening a dominant position in a 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 The Australian Gas Light Company, or any interconnected body corporate, of up to and including 100% shareholding in Natural Gas Corporation Holdings Limited.

Dated this th day of June 1999

The Commission