



COMMERCE COMMISSION

Decision No. 443

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

SHELL OVERSEAS HOLDINGS LIMITED

and

THE OWNER OF THE TAWN FIELDS

The Commission: MJ Belgrave
PR Rebstock
D Bates QC

Summary of Application: The acquisition by Shell Overseas Holdings Limited of up to 100% of the assets and interests associated with the TAWN Deep.

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

Date of Determination: 26 October 2001

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THE PROPOSAL

1. On 24 August 2001 Shell Overseas Holdings Limited (SOH) registered a notice with the Commission seeking clearance under s66 (1) of the Commerce Act 1986 to acquire all the assets and interests associated with the TAWN Deep in the following manner:
 - ?? SOH will divest all of its direct and indirect legal and equitable interests and rights in the TAWN fields (including, but not limited to, any interests in the TAWN PMLs and the TAWN pipeline) to a third party purchaser in strict accordance with the terms of the Divestment Undertaking entered into as part of decision No 411;
 - ?? SOH will enter into a put option deed in favour of the purchaser (“Put Option”), whereby the purchaser would have, in the event that the purchaser decided to dispose of the TAWN Deep, an option to put the TAWN Deep to SOH no earlier than one week after completion of the sale of TAWN to the purchaser;
 - ?? If the purchaser decided to exercise its rights under the Put Option, SOH would be entitled to acquire up to 100% of the TAWN Deep in accordance with the terms of the Put Option, but would not be required to do so.
2. On 17 November 2000 the Commission gave a clearance pursuant to section 66(3) of the Commerce Act 1986 (Act) in respect of the business acquisition by SOH or its interconnected body corporate to acquire, directly or indirectly:
 - ?? 100% of the shares associated with Fletcher Challenge Energy (FCE); and
 - ?? 100% of the shares in FCE’s holding company, Energy International Holdings Limited (formerly Zurich Holdings (No.7) Limited) (FCE Acquisition).
3. As part of that clearance SOH had undertaken, pursuant to section 69A of the Act, to divest all the legal and equitable interests in certain assets to be acquired by SOH pursuant to the FCE Acquisition (Divestment Undertaking) within [] after the date of settlement of the FCE Acquisition (or such longer period as the Commission may agree).
4. In particular, the Divestment Undertaking includes an undertaking to divest the TAWN fields, in the following terms:

“all of FCE’s direct and indirect equity interests in Tariki, Ahuroa, Waihapa and Ngaere fields (including, but not limited to, any interests in the petroleum mining licences associated with these fields) and, for the avoidance of doubt, such divestment shall include the pipeline which runs from the TAWN fields to Contact’s New Plymouth power station.”
5. The FCE Acquisition settled on 23 March 2001. Shell is currently engaged in a process that will result in the sale of the TAWN fields to a third party or third parties in accordance with the Divestment Undertaking, although the specific purchaser has not yet been determined.

THE PROCEDURES

6. 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. An extension of time was sought by the Commission and agreed to by the applicant. Accordingly, a decision on the application was required by 26 October 2001.
7. In its application, SOH sought confidentiality for specific aspects of the application. A confidentiality order was made in respect of the information for a period of 20 working days from the Commission's determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply.
8. The Commission's determination is based on an investigation conducted by staff.
9. The Commission's approach is based on principles set out in the Commission's *Practice Note 4*.¹

THE PARTIES

SOH

10. SOH is a holding company for overseas investments of the Royal Dutch/Shell group of Companies (Shell Group). New Zealand subsidiaries of Shell Group include Shell New Zealand Holdings Company Limited, Shell New Zealand Limited and Shell (Petroleum Mining) Company Limited (Shell NZ).
11. The Shell Group is engaged in the following internationally:
 - ?? *Exploration and Production (or "E&P")*: searching for oil and gas fields by means of seismic surveys and exploration wells, developing economically viable fields by drilling wells and building the infrastructure of pipelines and treatment facilities necessary for delivering hydrocarbons to market;
 - ?? *Oil Products*: refining and processing crude oil and other feedstocks into transportation fuels, lubricants, heating and fuel oils, LPG and bitumen, and distributing and marketing these products to customers;
 - ?? *Chemicals*: processing hydrocarbon feedstocks into base chemical products, petrochemical building blocks and polyolefins, and marketing them globally;
 - ?? *Downstream Gas and Power*: marketing and trading natural gas, wholesaling and retailing of natural gas and electricity to industrial and domestic customers, developing and operating independent electric power plants;

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.

?? *Renewables*: manufacturing and marketing solar energy systems, implementing rural electrification projects in developing countries, sustainably growing and marketing wood, converting wood fuel into marketable energy, developing wind energy projects.

12. The primary activities of Shell NZ include:

?? The exploration for, and production of, oil and gas, including holding significant shareholdings in the Maui and Kapuni fields; and

?? The operation of *Shell* brand petrol stations.

Other Exploration Companies

13. Several companies are currently carrying out exploration in New Zealand. The following companies are among those regarded by industry participants as capable of effectively carrying out exploration.

Preussag Energie GmbH (Preussag)

14. Based in Germany, Preussag has 534 million euro turnover, and spends 50 to 100 million euro a year on exploration. It is looking to establish a new core area in New Zealand, has 33.3% share in Pohokura field, and is described by industry participants as an aggressive explorer.

Swift Energy New Zealand Ltd (Swift)

15. Swift is a subsidiary of US based Swift Energy Company, which engages in exploring and operating oil and gas properties. It has a 90% interest in the Rimu field and Kauri fields in Taranaki where gas and oil have been found, and is continuing to drill wells in those fields.

Indo-Pacific Energy Ltd (Indo-Pacific)

16. Through its subsidiaries, Indo-Pacific controls interests in 19 exploration and production concessions in Australia, Papua New Guinea and New Zealand, including interests in four PEPs (see paragraph 24) in Taranaki, four on the East Coast on the North Island, and one in the South Island. It has discovered hydrocarbons in the Goldie field in Taranaki.

Westech Energy New Zealand (Westech)

17. A subsidiary of a US based company, Westech has 100% interest in three Taranaki PEPs, and varying interests in five PEPs on the East Coast of the North Island. It has drilled several wells and discovered some gas and is continuing to drill exploration wells with [

]

Bligh Oil and Minerals N.L (Bligh).

18. Bligh has two subsidiaries in New Zealand. Bligh Oil & Minerals NZ owns 3.24% of the TAWN joint venture and is owned 50/50 by Todd Energy and Bligh Oil & Minerals NL. All Bligh's other activities in NZ are carried out through Marabella Enterprises Ltd which owns Bligh's interests in the Rimu block joint venture with Swift. Bligh is involved in the joint venture with Shell to drill the Makino well in Taranaki early next month.

Todd Energy Limited (Todd)

19. Through its subsidiary, Todd Petroleum Mining Company Co Ltd, Todd owns interests in two PEPs and two PMLs (see paragraph 27) in Taranaki, and two PEPs off the coast of Northland. It is a joint venture partner with Shell in the Kapuni field and in the Maui field.

Other Exploration Companies

20. Other exploration companies of a reasonable size with interests in PEPs, particularly in Taranaki, include Origin Energy Resources NZ Ltd (Origin), Pacific Tiger Energy (NZ) Ltd, AWE NZ Pty Ltd, and OMV Petroleum Pty Ltd.

INDUSTRY BACKGROUND

21. All of New Zealand's gas and oil production so far has been from the Taranaki Basin, the country's most explored and commercially successful hydrocarbon area. However, the basin is only moderately explored compared with basins world-wide, and there is considerable scope for further commercial discoveries as demonstrated by recent exploration successes. The rest of New Zealand is severely under-explored, and most sedimentary basins have the potential for commercial hydrocarbon discoveries.

Permitting and Licencing System

22. To undertake exploration or development in New Zealand a company must obtain a petroleum permit or farm-in to an existing permit or licence area. All naturally-occurring petroleum is the property of the Crown. Crown Minerals allocates permits to undertake petroleum exploration or development. Petroleum permits are granted under the Crown Minerals Act 1991, and in accordance with the Minerals Programme for Petroleum and the Crown Minerals (Petroleum) Regulations 1999.

Prospecting Permits

23. Entities interested in exploring for petroleum may apply for a petroleum prospecting permit ("PPP"). PPPs can be applied for at any time over any un-permitted area. PPPs are issued for general geophysical investigations of large areas, usually for a period not exceeding 2 years. Currently, there is only one PPP on issue in New Zealand, which is

held by TGS/NOPEC Geophysical Company. If there is sufficient data in respect of a land area, a PPP will not be issued and the applicant is obliged to apply for a Petroleum Exploration Permit (“PEP”).

Exploration Permits

24. PEPs are issued for more detailed and intensive work. PEPs are issued by two methods, the Acceptable Frontier Offer (AFO), and the Blocks Offer. The AFO system allows explorers to submit bids at any time over virtually any unpermitted area of their choice. This type of permit requires an applicant to carry out a programme of work aimed at drilling an exploration well within the first two to three years of a permit. The applicant must have the technical ability and financial capacity to complete the work programme and drill a well. A Blocks Offer is advertised over specified blocks of areas and competitive staged work programme bids are called for. The successful applicant is usually the bidder proposing the best work programme for the permit area. For any oil and gas produced the Government collects a royalty of either a 5% ad valorem royalty or a 20% accounting profits royalty, depending on which is the higher.

25. PEPs allow in-depth exploration (including geological, geochemical and geophysical surveying, drilling, bulk sampling and mine feasibility studies) and are granted for undertaking work to identify petroleum deposits and evaluate the feasibility of mining any discoveries made. PEPs are issued for an initial period of 5 years, which can be extended for a further 5 year period if justified (however 50% of the initial area must be surrendered at the time of granting any extension). In addition, PEPs are often relinquished in their entirety before their terms expire. Accordingly, PEPs have a relatively high turn-over rate. Section 30(3) of the CMA deems the holder of a PEP to have the rights of a holder of a PPP.

Mining Permits

26. Potential reservoirs are developed by obtaining a petroleum mining permit (“PMPs”). Usually, the grant of a PMP results from successful exploration under a PEP. PMPs allow the extraction and production of petroleum, which are more relevant to production market activities. However, section 30(3) of the CMA deems the holder of a PMP to have all of the rights of a holder of a PEP, in addition to the right to mine the relevant minerals. Indeed, it is common for holders of PMPs to continue to explore the area to which the mining permit relates (especially if technology advances during the life of the field). Accordingly, participants in the exploration market include holders of PMPs.

Licences

27. This three-tier permit system was preceded by a two-tier licensing system administered under the Petroleum Act 1937. Certain petroleum prospecting licences (“PPLs”) and petroleum mining licences (“PMLs”) are still operative (including the TAWN PMLs). There is currently only one PPL and nine PMLs on issue.

Farm-Ins

28. It is common for entities interested in exploration to farm-in to an existing permit or licence area. There may be some procedural requirements under any applicable joint venture agreement and the approval of Crown Minerals will be required.
29. Farm-in agreements allocate risks and share costs associated with exploration and enable an explorer to acquire the relevant technological expertise required to enhance the exploration, or future production, of gas or oil in a particular area.

The Tawn Deep

30. Prior to 1994 FCE (and its predecessor, Petrocorp Exploration) undertook some exploration activity (culminating in a drill stem test in 1985) beneath the reservoirs containing the 2P gas reserves for the TAWN fields, as currently “booked” with the Ministry of Economic Development, and from which reservoirs all current TAWN gas and LPG production is derived. The TAWN Deep area of exploration can be stratigraphically described as every formation underlying the Base Tikorangi Limestone in petroleum mining licences 38140 (Waihapa) and 38141 (Ngaere), and every formation underlying the Base Tariki Sandstone in petroleum mining licences 38138 (Tariki) and 38139 (Ahuroa).
31. SOH, through its subsidiaries Energy Exploration NZ Limited and Southern Petroleum (New Zealand) Exploration Limited, is the beneficial holder (together with Bligh) of PMLs 38138 (Tariki), 38139 (Ahuroa), 38140 (Waihapa) and 38141 (Ngaere) (“TAWN PMLs”) for the TAWN fields. The TAWN PMLs (as with other mining licences and permits on issue) cover the strata from the earth’s surface to the centre of the earth, which are a much more extensive strata than the strata in respect of which the reservoirs containing the 2P reserves are situated and from which all gas and/or LPG production from known reserves is produced.

MARKET DEFINITION

32. 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.

33. For the purpose of competition analysis, a relevant market is the smallest space within which a hypothetical, profit-maximising, sole supplier of a good or service, not constrained by the threat of entry, could impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the ‘*ssnip* test’). For the purpose of determining relevant markets, the Commission will generally consider a *ssnip* to involve a five percent increase in price for a period of one year.
34. It is substitutability at competitive market prices which is relevant in defining markets. Where the Commission considers that prices in a given market are significantly different

from competitive levels, it may be necessary for it to assess the effect of a *ssnip* imposed upon competitive price levels, rather than upon actual prices, in order to detect relevant substitutes.

35. The Commission will seek to define relevant markets in terms of four characteristics or dimensions:
- ?? the goods or services supplied and purchased (the product dimension);
 - ?? the level in the production or distribution chain (the functional level);
 - ?? the geographic area from which the goods or services are obtained, or within which the goods or services are supplied (the geographic extent); and
 - ?? the temporal dimension of the market, if relevant (the timeframe).
36. 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.
37. 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.
38. The applicant submitted that the market that will be affected by the proposed acquisition is the petroleum exploration market in New Zealand.

Product Dimension

39. The delineation of relevant markets as a basis for assessing the competitive effects of a business acquisition begins with an examination of the goods or services offered by each of the parties to the acquisition. Both demand-side and supply-side factors are generally considered in defining market boundaries. Broadly speaking, a market includes products that are close substitutes in buyers' eyes on the demand-side, and suppliers who produce, or are able easily to substitute to produce, those products on the supply-side.
40. The Commission takes the view that the appropriate time period for assessing substitution possibilities is the longer term, but within the foreseeable future.² The Commission considers this to be a period of one year, which is the period customarily used internationally in applying the 'ssnip' test (see above) to determine market boundaries. The Commission will take into account recent, and likely future, changes in products, relative prices and production technology in the process of market definition.

² In *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [] 2 NZLR 351 Smellie J and the Court of Appeal on appeal approvingly quoted an earlier decision of the Commerce Commission in *Edmonds Food Ind Ltd v W F Tucker & Co Ltd* (Decision 21, June 1984) where the Commission had ruled: "A market has been defined as a field of actual or potential transactions between buyers and sellers amongst whom there can be strong substitution, at least in the long run, if given a sufficient price incentive". See also *News Limited v Australian Rugby Football League Limited & Ors* (1996) ATPR at 41,687, where Burchett J stated: "Long term prospects that can be more or less clearly foreseen are, to that extent, a present reality, from the point of view of identifying the constraints upon commercial action. This fact emphasises the importance of the principle . . . that substitution possibilities in the longer run may be very significant for market delineation." Also *Re Tooth & Co Ltd v Tooheys Ltd* (1979) 39 FLR 1 emphasises longer run substitution possibilities.

Demand-side and Supply-side substitution

41. Close substitute products on the demand-side are those between which at least a significant proportion of buyers would switch when given an incentive to do so by a small change in their relative prices.
42. Initially, markets are defined for each product supplied by two or more of the parties to an acquisition. Unequivocal substitutes are combined. For each initial market so defined, the Commission will examine whether the imposition of a ssnip would be likely to be profitable for the hypothetical monopolist. If it were, then all of the relevant substitutes must be incorporated in the market. If not, then the next most likely substitute good or service will be added to the initial market definition and the test repeated. This process continues until a combination of products is found which defines the product dimension of a relevant market, namely, the smallest combination of goods or services for which a ssnip would be profitable.
43. On the demand-side, the technical viability of one good or service as a substitute for another must be assessed. However, even where another product may technically be suitable as an alternative for the product in question, its price may be so much higher that it may be a poor substitute in an economic sense, at least for the great majority of buyers. In judging economic substitutability between products, the Commission will have regard to relative prices, quality and performance when assessing whether they are, in fact, close substitutes in the eyes of buyers.
44. Close substitute products on the supply-side are those between which suppliers can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs, when they are given a profit incentive to do so by a small change in their relative prices.
45. The Commission considers that while different energy forms provide some competition to each other, it is not sufficient to include them in the same market.
46. The TAWN Deep is at a depth where temperatures are such that the formation of gas, rather than oil, is likely. The initial exploratory Waihapa 1 well resulted in the discovery of gas and no oil. Furthermore, the Commission does not consider, in any event, that the proposed acquisition would result in any change in the present competitive situation in the oil production market. This is because the supply and price of oil is determined by international market conditions, and not by market conditions relevant to production within New Zealand.
47. The Commission therefore concludes that for the purpose of assessing the competition implication of the proposed acquisition, the appropriate product market is gas.

Geographic Extent

48. The Commission will seek to define the geographical extent of a market to include all of the relevant, spatially dispersed, sources of supply to which buyers can turn should the prices of local sources of supply be raised. For each good or service combination, the overlapping geographic areas in which the parties operate are identified. These form initial markets to which a ssnip is applied. Additional geographic regions are added until

the smallest area is determined within which the hypothetical monopolist could profitably impose a ssnip.

49. Generally, the higher the value of the product to be purchased, in absolute terms or relative to total buyer expenditure as appropriate, the more likely are buyers to travel and shop around for the best buy, and the wider the geographic extent of the market is likely to be.
50. Where transport costs are high relative to the final value of a product, a narrower geographic market is more likely to be appropriate. Where product perishability and other similar practical considerations limit the distance that a product may be transported, this may limit the geographic extent of the market. The timeliness of delivery from alternative geographic sources is similarly relevant.
51. Although buyers and sellers of a particular good or service may interact in markets that are apparently local or regional in extent, those markets may themselves overlap and interrelate so as to form a market covering a larger geographical area. In these situations, the larger market is likely to be the appropriate one for analysing the competitive effects of a business acquisition.
52. The applicant submitted that the petroleum exploration market is a national market. There are three recognised petroleum provinces in New Zealand: Western, Southern and Eastern. The Western province contains the Northland, Taranaki, and less definitive West Coast and Wanganui basins. The Southern province contains the Great South Basin, Canterbury Basin, and Western Southland basins. The Eastern province contains significant oil and gas reefs along the North Island and in Marlborough/Hawkes Bay. Traditionally, petroleum exploration was centred in the Taranaki basin. However, activities by Westech and Indo-Pacific in the East Coast Basin, and the recent success of Swift has led to an increase in exploration across New Zealand.
53. All of these areas, including Taranaki, are considered “under-explored”. Although product transmission costs at the production level may increase outside Taranaki, such costs are not necessarily prohibitive to either the exploration of petroleum or the subsequent development and production of petroleum in other areas of New Zealand. Furthermore, several companies are involved in exploration in at least two of the three provinces.
54. From the supply perspective, exploration companies could relatively easily shift their focus (and therefore exploration equipment) from one geographic area to another.
55. The Commission concludes that the geographic market is a national one.

Functional Level

56. The production, distribution and sale of a product typically occur through a series of functional levels – for example, the manufacturing/import level, the wholesale/distribution level and the retail level. It is often useful to identify the relevant functional level in describing a market, as a proposed business acquisition may affect one

horizontal level, but not others.³ Alternatively, some acquisitions, such as those involving businesses at different vertical levels, may raise issues related to vertical integration. Generally, the Commission will seek to identify separate relevant markets at each functional level affected by an acquisition and assess the impact of the acquisition on each.

57. In past Commission decisions related to the gas sector (the two Shell/FCE decisions, for instance), the Commission has focussed on the gas production market which was seen as the principal area where there was potential for market power to be accumulated from the business acquisition. Although both parties in the Shell/FCE cases were also engaged in gas exploration, the Commission considered that, in the circumstances at that time, there was very limited potential for the merged entity to obtain excessive market power from its exploration activity given the number of other firms engaged in gas exploration and the relatively low entry barriers. The Commission considered exploration in the context of entry conditions to the gas production market.
58. In this case, however, the Commission believes that it is appropriate to focus its principal attention on gas exploration. Clearance is sought in respect of the assets and interests associated with the TAWN Deep. These assets and interests do not in themselves provide the ability to produce gas, but rather provide the owner with the ability to undertake exploration in the TAWN Deep area.
59. It is recognised that the assets are of value only because they provide some potential for future gas production. However, there is no certainty that the TAWN Deep will prove to be a commercially viable source of gas, or if it does, how large the gas reserves may be, or even how successful other firms may be with their exploration activities in the meantime.
60. The Commission has spoken to a range of geologists and firms with an interest in gas exploration and production. There appears to be a general view that, because of the exploratory work that has already been undertaken in respect of the TAWN Deep, and the advancement of technology that may be helpful in development of fields of this depth and nature, the chances of finding gas reserves which can be commercially extracted is likely to be greater than is usually the case. [] However even these relatively favourable odds are lower than those which would be necessary for the Commission to attribute a likely impact from the TAWN Deep exploration on the current or future gas production market.
61. Furthermore, other participants stated that the TAWN Deep was a very risky exploration target and all stated that not enough is known about it to assess the chances of success. They pointed out that before it would be possible to assess whether the TAWN Deep could produce commercially viable gas, it would be necessary to drill a well into the

³ *Telecom Corporation of New Zealand Ltd v Commerce Commission* (1991) 4 TCLR 473, 502 The High Court (Greig J, Shaw WJ, Prof M Brunt) noted: "If we ask what functional divisions are appropriate in any market definition exercise, the answer, ..., must be whatever will best expose the play of market forces, actual and potential, upon buyers and sellers. Wherever successive stages of production and distribution can be co-ordinated by market transactions, there is no difficulty: there will be a series of markets linking actual and potential buyers and sellers at each stage. And again, where pronounced efficiencies of vertical integration dictate that successive stages of production and distribution must be co-ordinated by internal managerial processes, there can be no market."

Deep, find gas, carry out production and flow testing, and go through an appraisal process which could consist of drilling several further wells because of the complexity of the reservoir.

62. In the past the Commission, in its assessment of gas production markets, has taken into account all reserves which the field operators consider are proven and probable (known as “2P” reserves). These are reserves that the operator considers have greater than a 50% probability of being technically and economically producible. While it is generally recognised that the TAWN Deep contains some gas, none of the parties spoken to by the Commission considered, on the basis of the present level of knowledge that it is close to falling within the 2P category. They all considered that the TAWN Deep is an exploration target only.
63. In these circumstances, and given that gas production assets do not form part of the application, the Commission considers that no purpose is served by considering the gas production market in the context of the current application. The Commission therefore concludes that, for the purpose of analysing the competition affects of the current application, the appropriate functional market is the gas exploration market.

Conclusion on Market Definition

64. The Commission concludes that the relevant market is the national market for gas exploration (the exploration market).

COMPETITION ANALYSIS

Substantially Lessening Competition

65. 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.

66. 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.⁴ 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.⁵
67. Section 3(2) provides that references to the lessening of competition include references to the hindering or preventing of competition.⁶
68. 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:

⁴ *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).

⁵ *Dandy Power Equipment Ltd v Mercury Marina Pty Ltd* (1982) ATPR 40-315, 43-888; *South Yorkshire Transport Ltd v Monopolies & Mergers Commission* [] 1 All ER 289.

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

- ?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.⁷

69. 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).”

70. 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.
71. 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

72. 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

⁷ See *Dandy*, supra n 5, pp 43–887 to 43–888 and adopted in New Zealand: *ARA v Mutual Rental Cars* [] 2 NZLR 647; *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [] 2 NZLR 352; *Fisher & Paykel Ltd v Commerce Commission* [] 2 NZLR 731; *Commerce Commission v Carter Holt Harvey*, unreported, High Court, Auckland, CL 27/95, 18/4/00.

evident in the market, in which case the appropriate counterfactual may be based on an extrapolation of that trend.

73. If Shell was not to acquire the TAWN Deep, it might be explored by the owner of the TAWN fields either alone or together with another company. The rights to the Deep might also be sold to another company. It is not possible at this stage to state with any certainty which, if any of these two possibilities might occur. Indeed, the Deep may remain unexplored.
74. SOH stated in the application that it is far from certain that a new owner would progress exploration of the TAWN Deep without SOH's involvement. This was not the view of all companies with an interest in the exploration market. The Commission assumes that the owner of the field in the counterfactual scenario would have similar incentives to develop (or not develop) the TAWN Deep as SOH.
75. The present state of competition in a market can be referred to in order to illuminate the future state of the market where there is a range of possible scenarios should an acquisition not occur⁸. The Commission considers that the status quo is the most appropriate approximation of the counterfactual given the uncertainty of what changes, if any, there will be in the market if the proposed acquisition does not proceed. The Commission therefore proposes to use the status quo, that is the ownership of the TAWN Deep by the company that purchases the TAWN fields, as the counterfactual.

Competition Analysis Principles

76. The Act prohibits business acquisitions that would be likely to have the effect of substantially lessening competition in a market. The Commission makes this assessment against a counterfactual of what it considers would be likely to happen in the absence of the acquisition. In the present case the counterfactual is considered to be the status quo. A substantial lessening of competition is taken to be equivalent to a substantial increase in market power. A business acquisition can lead to an increase in market power by providing scope either for the combined entity to exercise such power unilaterally, or for the firms remaining in the market to co-ordinate their behaviour so as to exercise such power.
77. In broad terms, a substantial lessening of competition cannot arise from a business acquisition where there are sufficient competitive constraints upon the combined entity. The balance of this Decision considers and evaluates the constraints that might apply in the defined markets under the following headings:
- ?? existing competition; and
 - ?? potential competition from entry.

⁸ *Stirling Harbour Services Pty Ltd v Bunbury Port Authority* (2000) ATPR 41 at paras 113 & 114.

ANALYSIS OF EXISTING COMPETITION

Introduction

78. One consequence of a merger between competitors is that the number of firms competing in a market is reduced or, put another way, concentration is increased. This raises the possibility that competition in the market may be substantially lessened through the exercise of unilateral or coordinated market power. These are the subject of the analysis in this section.

Scope for Unilateral Market Power

Introduction

79. An examination of concentration in a market post-acquisition can provide a useful guide to the constraints that market participants may place upon each other, including the combined entity. Both structural and behavioural factors have to be considered. However, concentration is only one of a number of factors to be considered in the assessment of competition in a market. Those other factors are considered in later sections, as noted above.

80. Market shares can be measured in terms of revenues, volumes of goods sold, production capacities or inputs (such as labour or capital) used. All measures may yield similar results in some cases. Where they do not, the Commission may, for the purposes of its assessment, adopt the measure that yields the highest level of market share for the combined entity. The Commission considers that this will lead to an appropriately conservative assessment of concentration, and that the factors that lead to the other different market share results are more appropriately considered elsewhere during the assessment of the acquisition.⁹

81. In determining market shares, the Commission will take into account the existing participants (including 'near entrants'), inter-firm relationships, and the level of imports. This is followed by a specification of the Commission's 'safe harbours', an estimation of market shares, and an evaluation of existing competition in the market. Each of these aspects is now considered in turn.

Existing Participants

82. There are currently 60 PEPs held by 49 firms, currently undertaking exploration activities in New Zealand. The more significant companies are described in paragraphs 14 to 20.

⁹ For example, where market share measured in terms of capacity produces a significantly lower share of the market in the hands of participants than a measure in terms of sales volumes, the constraint on a combined entity from that unemployed capacity might be taken into account when identifying near entrants or the constraint from new market entry. In some cases, the model of market power being used may influence the choice as to which market share measure is used.

Inter-firm Relationships

83. Companies that are part of the same corporate grouping, or that have similar strong relationships, cannot be relied upon to provide an effective competitive constraint to one another. Other less formal relationships between companies may also give rise to limitations on the extent of rivalry between them. Relationships between persons in the relevant market and other businesses may also affect rivalry in a market.
84. A number of exploration companies are involved in joint venture arrangements in respect of specific areas of exploration, which enable explorers to pool resources or increase competitive prospects.
85. The applicant submitted that the nature of the exploration market does not lend itself to co-ordination between industry participants that independently, or jointly, undertake exploration in respect of specific areas/fields. The following characteristics of the exploration market support the argument that co-ordination is unlikely to occur in the gas exploration market:
- ?? New Zealand is considered “under-explored”. An abundance of exploration opportunities means there is considerable scope for independent exploration by both existing and new competitors;
 - ?? the exploration market does not have substantial barriers to entry. New entry and expansion can therefore occur relatively quickly (see paragraphs 106 to 116 below);
 - ?? there are a number of firms undertaking exploration over a wide geographic area, including a number of smaller explorers (eg: Westech, Origin and Bligh).
86. It would appear, from information supplied by industry participants, that the relationships between exploration companies do not significantly affect competition within the gas exploration market.

Safe Harbours

87. Once the relevant market has been defined, the participants have been identified, and their market shares estimated, the Commission’s ‘safe harbours’ can be applied. Under these safe harbours, a business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:
- ?? where the three-firm concentration ratio (with individual firms’ market shares including any interconnected or associated persons) in the relevant market is below 70%, the combined entity (including any interconnected or associated persons) has less than in the order of a 40% share; or
 - ?? where the three-firm concentration ratio (with individual firms’ market shares including any interconnected or associated persons) in the relevant market is above 70%, the market share of the combined entity is less than in the order of 20%.
88. As noted below, market shares by themselves are insufficient to establish whether competition in a market has been lessened. Other relevant issues are discussed in later sections.

Market Shares

89. Table 1 sets out the land area covered by PEPs in which each exploration company has an interest. It should be noted that companies frequently hold only a certain percentage interest in a PEP, e.g. PEP 38719 is held 90% by Swift, 5% by Marabella and 5% by Antrim Oil & Gas. The land area covered by each PEP is therefore allocated in accordance with the percentage interest held by each company.

Table 1
Exploration Land Area in New Zealand Held by Exploration Companies

Exploration Company	Total Land Area km2	% of Total Land Area Subject to PEPs
TGS/NOPEC Geophysical	59,336.90	26.63
Conoco (UK) Ltd	27,691.75	12.43
Anschutz NZ Corporation	17,856.72	8.02
Inpex Northland Ltd	16,286.68	7.31
Thomasson International Ventures	11,833.68	5.31
Westech	8453.25	3.82
EEX NZ Ltd	8833.74	3.97
Stewart Petroleum Co Ltd	7184.91	3.23
Indo-Pacific	6691.74	3.00
Todd	5776.04	2.59
Bounty Oil & Gas NL	5103.56	2.29
Hardman Resources NL	5103.66	2.29
Tyers Petroleum Pty Ltd	4551.69	2.04
Orion Exploration Ltd	4303.16	1.93
AMG Oil (NZ) Ltd	3913.16	1.76
GEL Exploration Inc	3840.43	1.72
Origin	3743.57	1.68
SOH	2728.37	1.22
Resource Development Technology	2196.39	.99
WM Petroleum Ltd	2086.81	.94
Pacific Tiger	2062.68	.93
Tyers Investments Pty Ltd	2004.33	.90
Pancontinental Oil & Gas NL	1670.49	.75
Albatross Energy NL	1166.53	.52
Kenham Holdings Ltd	1095.98	.49
AWE NZ Pty Ltd	1076.82	.48
Greymouth Energy Ltd & Greymouth Petroleum Ltd	2118.55	.93
Swift	597.74	.27
OMV	400.84	.18
Marabella	274.14	.12
Preussag	131.48	.06
Others	2781.97	1.25
Total	222,782.22	100.00

90. As explained above, exploration rights are also contained in PMLs and PMPs. SOH's total interests amount to 1.7% of total area subject to exploration. This includes the assets to be divested. The area covered by the TAWN PMLs is .06% of the total area subject to exploration and the proposed acquisition only relates to the TAWN Deep and does not include the TAWN field current 2P reserves.
91. However, land area holdings are not an accurate measure of the likely success of the exploration of those areas and, therefore, of the true worth of any land area and the associated PEPs. The fact that a PEP covers a large land area does not indicate that it is likely to be more successful than a smaller PEP and indeed the reverse is more likely. The high grade permits are those in Taranaki which are for very small areas. The larger PEPs are in areas such as the Southern Basin, which have no production and are regarded as frontier areas. For instance, the PEPs held by the first five companies are in areas other than Taranaki. It is therefore not accurate to assess the competition in the exploration market by means of land area holdings alone. However, there are no other single measures that can be used to measure concentration, and Table 1 does at least signal the breadth of competition in the exploration market.
92. Because of the difficulty in directly measuring market shares and concentration, the other competition factors noted above have been considered in order to establish whether competition in the exploration market will be lessened by the proposed acquisition.

State of Existing Competition

93. All industry participants spoken to advise that the exploration market is competitive and that this competition is unlikely to be affected by the proposed acquisition. There has been a marked increase in recent exploration activity undertaken in the last five years. 60 PEPs are currently held by 40 companies. 24 new wells are planned or have been drilled already in 2001 with a number scheduled for 2002. Industry participants advise that most of those planned will be drilled.
94. Swift, Preussag, Westech, Indo-Pacific and Todd were identified as companies that have already been involved in successful exploration. Preussag, Westech, Bligh and Swift have been identified as aggressive explorers. Each of these companies is capable of attracting farming-in by other companies if they are successful in finding gas or oil. Origin was identified as a company that already has an interest in New Zealand and will be carrying out further exploration.

Conclusion – Unilateral Market Power

95. SOH will not gain unilateral market power by obtaining exploration rights to the TAWN Deep.

Scope for the Exercise of Coordinated Market Power

Introduction

96. A business acquisition may lead to a change in market circumstances such that coordination between the remaining firms either is made more likely, or the effectiveness of pre-acquisition coordination is enhanced. Firms that would otherwise compete may attempt to coordinate their behaviour in order to exercise market power by restricting

their joint output and raising price. In extreme cases, where all firms in the market are involved and coordination is particularly effective, they may be able to behave like a collective monopolist. Where not all firms are involved, and market share in the hands of the collaborators is reduced, coordinated market power becomes more difficult to exercise because of competition from the independent firms in the market.

97. When assessing the scope for coordination in the market during the consideration of a business acquisition, the Commission will evaluate the likely post-acquisition structural and behavioural characteristics of the relevant market or markets to test whether the potential for coordination would be materially enhanced by the acquisition. The intention is to assess the likelihood of certain types of behaviour occurring, and whether these would be likely to lead to a substantial lessening of competition.
98. “Collusion” involves firms in a market individually coming to a mutually profitable expectation or agreement over coordination. Both explicit and tacit forms of such behaviour between firms are included.
99. The structural and behavioural factors that are usually considered to be conducive to collusion are set out in the left-hand column Table 4. The significance of these is explained more fully in the Commission’s *Practice Note 4*. The right-hand column of the table then assesses the extent to which those factors are present, or are likely to be enhanced post-merger, in the exploration market. A high proportion of ‘yes’ responses would suggest that the market was particularly favourable to ‘collusion’; a high proportion of ‘no’ responses the reverse.

TABLE 4
Testing the Potential for ‘Collusion’ in the Exploration Market

Factors conducive to collusion	Presence of factors in the market
High seller concentration	No
Undifferentiated product/service	Yes
New entry slow	No
Lack of fringe competitors	No – There are several smaller fringe competitors
Price inelastic demand curve	No
Industry’s poor competition record	No – no problems apparent
Presence of excess capacity	No
Presence of industry associations/fora	Yes – Some industry bodies

100. The assessment of the relevant conditions suggests that the market has few characteristics that are likely to be conducive to collusion. Although, as discussed above, it is common for exploration companies to enter into joint ventures with each other to share risk and costs, there is no evidence that any of the companies have co-ordinated

their behaviour in order to exercise market power. This situation is not likely to be altered by the proposed acquisition.

Conclusion – Co-ordinated Market Power

101. It appears unlikely that the proposed acquisition would materially enhance the likelihood of co-ordinated market power in the gas exploration market.

Conclusion – Existing Competition

102. The Commission considers that existing competition will alleviate any concerns of unilateral power being exercised by the merged entity.
103. Furthermore, the Commission considers that the scope for the exercise of co-ordinated market power would not be enhanced by the acquisition.

CONSTRAINTS FROM MARKET ENTRY

Introduction

104. A business acquisition is unlikely to result in a substantial lessening of competition in a market if behaviour in that market continues to be subject to real constraints from the threat of market entry.
105. Where barriers to entry are clearly low, it will not be necessary for the Commission to identify specific firms that might enter the market. In other cases, the Commission will seek to identify likely new entrants into the market.
106. The Commission will consider the history of past market entry as an indicator of the likelihood of future entry. The Commission is also mindful that entry often occurs on a relatively small scale, at least initially, and as such may not pose much of a competitive constraint on incumbents within the relevant time frame.

Barriers to Entry

107. The likely effectiveness of the threat of new entry in constraining the conduct of market participants, following a business acquisition that might otherwise lead to a substantial lessening of competition in a market, is determined by the nature and height of barriers to entry into that market.
108. The Commission considers that, for the purpose of considering this issue, a barrier to entry is best defined as an additional or significantly increased cost or other disadvantage that a new entrant must bear as a condition of entry. In evaluating the barriers to entry into a market, the Commission will generally consider the broader ‘entry conditions’ that apply, and then go on to evaluate which of those constitute entry barriers.
109. It is the overall obstacle to entry posed by the aggregation of the various barriers that is relevant in determining whether entry is relatively easy or not, and therefore whether or not potential entry would prevent a substantial lessening of competition.

110. For entry to act as an antidote to a substantial lessening of competition stemming from a business acquisition, it must constrain the behaviour of the combined entity and others in the market.
111. In order to enter the exploration market, a company must obtain a PEP under the CMA. However, the Commission recognised in Decisions 270 and 408 that the need to obtain a permit is not a major barrier to new entry. The New Zealand permit regime is considered one of the most attractive in the world. The Honourable Paul Swain has stated at page 2 of the Crown Minerals Publication “Explore New Zealand: Petroleum”:
- “The New Zealand Government is keen to attract explorers and developers to New Zealand. Accordingly our overriding objective has been to provide an industry climate that is amongst the best in the world for investment in petroleum exploration and development. The Government has put in place a highly competitive regime, a very open and innovative allocation system and a business environment designed to attract foreign investment. Most of New Zealand’s basins have very good potential for the discovery of petroleum but are best classified as “under-explored”. Even in Taranaki Basin, the most commercially successful hydrocarbon province, exploration continues to turn up surprises in terms of new plays, many of which have already become productive. Recent increased exploration has led to commercial discoveries onshore and offshore Taranaki Basin and onshore East Coast. I am sure many more pleasant surprises are awaiting explorers as more of the secrets of the country’s large frontier acreage are uncovered.”*
112. Industry participants advised that the costs of setting up an exploration operation on promising sites, although considerable, are not regarded as a major barrier to new entry. The requirement for technical knowledge and expertise is also not a barrier to entry as several existing competitors and other overseas companies have the necessary knowledge and technical expertise.
113. Two of the parties spoken to were of the view that New Zealand has become less attractive for exploration because overseas companies see SOH as having a dominant position in the gas production market. However, existing competitors of SOH did not agree with this view. SOH claimed that its substantial international marketing of the assets it is required to divest in accordance with Decision 411 has in fact informed many international companies of the desirability of New Zealand as an exploration target.
114. In Decision 258 the Commission stated that there are no major entry barriers associated with the exploration of gas. The information gathered by the information relevant to the current application confirms this conclusion.

The “LET” Test

115. In order for the threat of market entry to be such a constraint on the exercise of market power as to alleviate concerns that a business acquisition could lead to a substantial lessening of competition, entry of new participants in response to the exercise of market power must be likely, sufficient in extent and timely (the *let* test). If they are to act as a constraint on market participants following a business acquisition that might otherwise lead to a substantial lessening of competition in a market, entry must be relatively easy, or to put it another way, barriers to entry must be relatively low.

Likelihood of Entry

116. The mere possibility of entry is, in the Commission's view, an insufficient constraint on the exercise of market power to alleviate concerns about a substantial lessening of competition. In order to be a constraint on market participants, entry must be likely in commercial terms. An economically rational firm will be unlikely to enter a market unless it has a reasonable prospect of achieving a satisfactory return on its investment, including allowance for any risks involved.
117. Crown Minerals will be issuing a blocks offer for unpermitted areas in Taranaki and elsewhere in New Zealand within the next few months. This provides an opportunity for companies to commence exploration in New Zealand and for existing competitors to expand their exploration. Furthermore, any overseas exploration company can farm-in to an existing PEP. Preussag, for example, advised that [] These opportunities for entry and expansion, together with the low barriers to entry discussed above, the attractiveness of New Zealand to exploration companies, and the existence of many companies with the financial standing and technology to enable them to carry out exploration in New Zealand, result in the conclusion that entry or expansion by existing competitors is likely in the near future.

Extent of Entry

118. If entry is to constrain market participants, then the threat of entry must be at a level that is likely to cause market participants to react in a significant manner. The Commission will not consider entry that might occur only at relatively low volumes, or in localised areas, to represent a sufficient constraint to alleviate concerns about market power.
119. As stated above, there are many overseas companies that are capable of carrying out exploration in New Zealand and have a similar chance of success to SOH and other market participants. The acquisition by SOH of the TAWN Deep exploration rights does not materially alter that position.

Timeliness of Entry

120. If it is effectively to constrain the exercise of market power to the extent necessary to alleviate concerns about a substantial lessening of competition, entry must be likely to occur before customers in the relevant market are detrimentally affected to a significant extent. Entry that constrains must be feasible within a reasonably short timeframe from the point at which market power is first exercised.
121. As stated in paragraph 19, Crown Minerals is about to issue a block offer. Accordingly new entry or expansion by existing competitors is likely to be within a very short timeframe.

Conclusion on the LET Test

122. The Commission concludes that the various components of the LET test are satisfied.

Conclusion on Barriers to Entry

123. The Commission concludes that the barriers to entry are not likely to deter expansion or new entry in the exploration market. Potential competition is likely to provide constraint on the exercise of market power by SOH if the proposed acquisition proceeds.

OVERALL CONCLUSION

124. The Commission has considered the probable nature and extent of competition that would exist in the exploration market but for the acquisition. The Commission considers that the appropriate benchmark is the status quo, in which the market is characterised by effective competition from existing participants.
125. The Commission has considered the nature and extent of the contemplated lessening in terms of the competitive constraints that would exist following the merger from:
- ?? existing competition; and
 - ?? potential competition from entry.
126. The Commission is satisfied that the proposed acquisition would not have, nor would be likely to have, the effect of substantially lessening competition in the national market for gas exploration.

DETERMINATION ON NOTICE OF CLEARANCE

127. Accordingly, pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by Shell Overseas Holdings Limited of up to 100% of the assets and interests associated with the TAWN Deep.

Dated this 26th Day of October 2001

Paula Rebstock
Deputy Chair