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## COMMERCE COMMISSION

### Decision No. 339

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

**ALLIANT INTERNATIONAL NEW ZEALAND LTD**

**and**

**CONTACT ENERGY LTD**

**The Commission:**

K M Brown  
E C A Harrison  
P R Rebstock  
E M Coutts

**Commission Staff:**

D R Ainsworth  
D Adam  
A J Brice

**Summary of the Application:**

Alliant International New Zealand Ltd (or an interconnected body corporate) has sought clearance to acquire up to 40% of the shares in Contact Energy Limited.

**Determination:**

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

**Date of Determination:**

12 February 1999

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

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## THE PROPOSED ACQUISITION

- 1 Pursuant to section 66(1) of the Commerce Act 1986 (the Act), Alliant International New Zealand Ltd (Alliant) gave notice to the Commission on 1 February 1999 (the application) seeking clearance for the proposed acquisition by it or an interconnected body corporate of Alliant of up to 40% of the shares in Contact Energy Limited (Contact).
- 2 The proposed acquisition follows the Government's decision in November 1998 to sell Contact through a concurrent 60% initial public offer and 40% cornerstone shareholding. The Government aims to finalise the sale of Contact by mid 1999.
- 3 ABN-AMRO Rothschild is managing the sale on behalf of the Crown. The sale process requires that, in order to bid for the cornerstone shareholding, companies with local operations in the New Zealand energy sector must obtain clearance or authorisation from the Commission for the acquisition of the cornerstone shareholding.

## THE PARTIES

### Alliant

- 4 Alliant is the wholly owned New Zealand subsidiary of IES International Inc a United States incorporated company. The ultimate parent Alliant Corporation is a large corporate based in Wisconsin, whose principal activities are the provision of electricity, natural gas, water and steam energy to more than one million consumers.
- 5 Alliant's New Zealand [ ]
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- 6 [ ]

### Contact

- 7 Contact is also an energy company whose principal New Zealand<sup>1</sup> business activities are in:
  - the generation and wholesaling of electricity on a national basis;
  - the retailing of electricity in various regions;
  - the wholesaling of gas in the North Island; and
  - the retailing of gas in various regions.

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<sup>1</sup> Contact also has investments in electricity generation in Australia. However, these are not relevant to the Commission's consideration of the application.

8 Contact was established by the Government to introduce competition in electricity generation, and was formed when Electricity Corporation of New Zealand Limited (ECNZ), was split into two competing entities. Contact became a state owned enterprise on 18 November 1995.

9 During 1998 Contact acquired the electricity retailing assets of 11 power companies and the natural gas retailing assets of Enerco New Zealand Ltd. Contact obtained Commission clearance for the Enerco acquisition.<sup>2</sup>

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<sup>2</sup> Decision No. 333, *Contact Energy Limited/ Enerco New Zealand Limited*, 10 December 1998.

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### Associated Persons

16 If the proposed acquisition proceeds, Alliant will own 40% of Contact. Given the intention of the Government to sell the remaining 60% by an initial public offering and ensure that there are many small shareholders amongst the public of New Zealand, no other large shareholder is on the horizon.

17 Section 47(2) and (3) of the Commerce Act provides:

- “(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 of 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.”

18 The Commission’s Business Acquisitions Guidelines<sup>3</sup> (*Business Acquisitions Guidelines*) state that:

“The Commission is of the view that a company which owns or controls 20 percent or more of the voting power in another has, prima facie, a substantial influence over that other company.”<sup>(p9)</sup>

19 Therefore, if the proposed acquisition proceeds the Commission concludes that Alliant and Contact will be associated persons in terms of the Commerce Act.

20 While the proposed acquisition will make Alliant and Contact associated persons in terms of the Commerce Act, on the basis of the information provided to the Commission, they will not become interconnected bodies corporate. Part II of the Commerce Act, the Restrictive Trade Practice provisions, will therefore continue to apply to agreements between the two entities.

21 The Commission notes that while the incentives for collusive behaviour may be strengthened by the proposed acquisition, collusive behaviour which results, or is deemed to result, in a substantial lessening of competition will remain subject to the Commerce Act.

### *Persons Associated with Alliant*

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<sup>3</sup> Commerce Commission, *Business Acquisition Guidelines*, 1996.

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*Effect of These Conclusions*

27 In analysing this application the Commission has proceeded on the basis that [

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28 [ ] the proposed acquisition will make Alliant and Contact associated persons, in terms of the Act, on the basis of the information provided to the Commission they will not become interconnected bodies corporate. Part II, the Restrictive Trade Practice provisions of the Act, will therefore continue to apply to agreements, arrangements, or understandings between Contact, Alliant [ ]

## PROCEDURES

- 29 The application was registered by the Commission on 1 February 1999. Section 66(3) of the Commerce Act requires that the Commission, within 10 working days after the date of registration of the application, or such longer period agreed by the Commission and the applicant, gives, or declines to give, a clearance for the acquisition. The tenth working day after the registration of the application was 15 February 1999. However, Alliant requested that the Commission make its decision by 12 February 1999 to allow Alliant to meet its commitments under the Government's sale process.
- 30 On 11 February 1999 Alliant advised the Commission of the matters set out in paragraph 22 above. The Commission has taken these matters into account in its consideration of this application.
- 31 Alliant has sought confidentiality for certain information contained in its application for clearance and for additional information provided to the Commission. A confidentiality order was made in respect of the information contained in its application for clearance for a period of 20 working days from the Commission's determination of the application. When the confidentiality order expires, the provisions of the Official Information Act 1982 will apply to that information.
- 32 The Commission's Decision is based on an investigation conducted by staff and their subsequent advice to the Commission.

## STATEMENT OF GOVERNMENT POLICY

- 33 In applying the relevant provisions of the Commerce Act, the Commission is required to have regard to the economic policies of the Government, transmitted to the Commission in accordance with section 26 of the Commerce Act. Specifically, section 26(1) provides that:

"In the exercise of its powers under ... this Act, the Commission shall have regard to the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister."
- 34 The Minister for Enterprise and Commerce (the Minister) has transmitted in writing to the Commission, pursuant to section 26 of the Commerce Act, a statement, dated 21 December 1998, of the economic policy of the Government in relation to market power in the electricity sector. A copy of the Minister's statement together with the covering letter of 22 December 1998 is included in Appendix 1.
- 35 The Minister advised the Commission in the covering letter:

"... that the Government has agreed that the offer documentation for the sale of Contact Energy Limited should include a requirement that all parties with an interest in acquiring Contact obtain a Commerce Commission clearance or authorisation, in the context of the attached section 26 statement, before formally entering their bids".<sup>4</sup>
- 36 In respect of Government views on market power in electricity markets, the Government has concluded that a number of factors are important in considering market power issues in the electricity sector. These relate to:

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<sup>4</sup> The Commission was subsequently advised by the bid process managers (ABN-AMRO Rothschild) that a clearance or authorisation from the Commission would need to be obtained only by those parties having a presence in New Zealand.

- competition in the “physical spot market”;
- competition in the “contracts market”; and
- competition in retailing.

#### *Competition in the “Physical Spot Market”*

37 In respect of competition in the “physical spot market”,<sup>5</sup> the Government states:

“The effectiveness of competition in the physical spot market is determined in particular by:

- the number and physical characteristics of (generating) stations competing at the margin under various hydrological conditions;
- the portfolios of stations under common ownership and the ability and incentives this provides for manipulating the market;
- the extent to which electricity is not competitively dispatched through the wholesale market as a consequence of long term supply contracts and/or vertical integration of generation and retail businesses.”

38 Further, in optimally configuring the split of ECNZ to ensure effective competition, “... the Government considered that an assessment of market shares alone was unlikely to provide robust information on market power issues in the spot market”. It therefore “... found it necessary to undertake modelling to test the effect on competition of different combinations of stations”. Moreover, having “...determined that ECNZ should be split into three companies in order to achieve optimal outcomes, the Government would be concerned if any future aggregation of stations resulted in the ability to exercise market power in a material way”.

39 In a letter from the Minister of 18 January 1999, the Commission was advised “... that the Ministry of Commerce has commissioned a modelling study on market power in the electricity industry focusing on the sale of Contact Energy”. A copy of the Minister’s letter is included in Appendix 2.

#### *Competition in the “Contracts Market”*

40 In respect of competition in relation to long term contracts for electricity,<sup>6</sup> the Government states:

“Aggregation of vertically integrated generation and retail companies ... may affect the quality of price signals in the marketplace”.

#### *Competition in Retailing*

41 In respect of competition in retailing, the Government has raised a concern over “... the possibility that access to meters may be used by some retailers to frustrate competition”. This follows the Government’s requirement for ownership separation of line and energy businesses and the consequential recent acquisition of electricity retail businesses, which have generally included meter assets as part of the retail businesses. The Minister’s statement suggests that any future anti-competitive behaviour in relation to access to meters could be dealt with under the Commerce Act, but also warns that the Government will take action to address any significant problems that emerge.

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<sup>5</sup> That is, competition for dispatch between generating stations in the wholesale electricity market.

<sup>6</sup> The Minister’s statement notes that most of these hedge against spot market prices.

## Consideration to be Given to Statements of Government Economic Policies

42 The implications of a section 26 statement have previously been considered by the Commission and the High Court.<sup>7</sup> The Commission has noted that:

“... having regard to the general policy discretion in the Act to promote competition sec 26 may be used to advise the Commission of Government policy or policies or to be more specific in relation thereto. It is not to influence or determine the decisions which the Commission must make. Thus, fully preserving the discretions given to the Commission in the Act, the Commission is required only ‘to have regard to’ such statements in reaching its decisions.”<sup>8</sup>

43 The High Court (Wylie J) held that the issue of a section 26 statement:<sup>9</sup>

“... is the exercise of a statutory right specifically conferred on {the Minister} by the Legislature for the very purpose of influencing the outcome of applications under the Act. That is not to say that the Commission ... is bound to apply the policy so transmitted to it. The statutory injunction of section 26 is no greater than that the Commission ‘shall have regard to’ the Government’s policy.”

44 Further:

“As with any other evidence it is for the tribunal to assess the weight to be given to each item of evidence and in the case of a statement of this kind, which in our view is simply an evidentiary statement of Government policy - it is certainly not a direction – it remains for the tribunal to assess the weight to be given to it as an expression of official perception of, in this case, public benefit.”

...

“The tribunal may not ignore the statement. It must be given genuine attention and thought, and such weight as the tribunal considers appropriate. But having done that, the tribunal is entitled to conclude it is not of sufficient significance either alone or together with other matters to outweigh other contrary considerations which it must take into account in accordance with its statutory function: ... In the end, however weighty the statement may be as an expression of considered Government policy, it does not have any legislative effect to vary the nature of the duties which the tribunal must carry out.”<sup>10</sup>

45 The Commission has given the section 26 statement of the economic policy of the Government, in relation to market power in the electricity sector, careful consideration. In reaching its decision as to whether an acquisition or strengthening of dominance would not result, or would not be likely to result, from the proposed acquisition,<sup>11</sup> the Commission has had regard to the section 26 statement. Issues raised by the section 26 statement are dealt with in the body of the Decision where considered by the Commission to be necessary.

## THE INVESTIGATION

46 Commission staff contacted the following parties during the investigation of the proposed acquisition:

- ABN-AMRO Rothchilds;
- ECNZ;

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<sup>7</sup> *Re New Zealand Kiwifruit Exporters Associations (Inc) – New Zealand Kiwifruit Coolstorers Association (Inc)* (1989) 2 NZBLC (Com).

<sup>8</sup> *Ibid.* 104,494.

<sup>9</sup> *New Zealand Co-operative Dairy Company Ltd & Anor v Commerce Commission* (1991) 3 NZBLC 99-219, 102,067.

<sup>10</sup> *Ibid.* 102,067-068.

<sup>11</sup> As specified by section 66 of the Commerce Act.

- Contact; and
- the Major Electricity Users' Group.

47 In addition, Alliant provided further information and comment to the Commission.

48 The Commission has also had regard to information gathered in its consideration of the clearance application by TransAlta Corporation of Canada to acquire a 40% shareholding in Contact.

## MARKET DEFINITION

49 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”.

50 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.

51 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”.<sup>(p14)</sup>

52 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”.<sup>(p15)</sup>

53 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”.<sup>(p15)</sup>

## Identifying Relevant Markets

54 To identify the markets relevant to the application, it is necessary to consider the business activities undertaken by the merging firms and to assess whether, post-acquisition, dominance would, or would be likely to, result or be strengthened.

55 The principal business activities of Alliant [ ]

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56 The principal business activities of Contact are:

- the generation and wholesaling of electricity on a national basis;
- the retailing of electricity in various regions;
- the wholesaling of gas in the North Island; and
- the retailing of gas in various regions.

57 [ ]

58 Alliant has no involvement in, nor is it associated with, any companies involved in any natural gas markets. According it is not necessary to consider further these markets in this decision.

59 The Commission, therefore, considers that the starting point for market analysis in the context of the application are those involving the activities of electricity generation, wholesaling, and retailing. [ ]

## Defining Relevant Electricity Markets

### *The National Electricity Generation and Wholesaling Market*

60 In past decisions the Commission and the Court have concluded that there is a national electricity generation and wholesaling market. The Commission has most recently defined such a market in Decision 317,<sup>12</sup> and prior to that such a definition had been upheld by the High Court and Court of Appeal in the context of a power company merger decision in *Power New Zealand Ltd v Mercury Energy Ltd* (1996) 1 NZLR 686.

61 The national electricity generation and wholesaling market is the market in which the generators (sellers) and buyers of wholesale electricity interact to determine the prices and quantities traded. The buyers are electricity retailers (some of whom are vertically integrated with particular generators) and large industrial users (or their agents) of electricity which buy at wholesale. This market comprises three interrelated forms of transactions: bilateral contracts, spot trading and reserves trading. Each is now dealt with in turn.

62 Bilateral contracts occur between generators and individual retailers or large users outside the spot market. Apart from the special contract involving Comalco,<sup>13</sup> some of the contracts may have arisen from the Memorandum of Understanding between the Government and ECNZ which obliges ECNZ to offer some of its capacity for this purpose. Such contracts may be attractive to both parties through the protection

<sup>12</sup> Decision 317, *Mercury Energy Limited and Power New Zealand Limited*, 25 February 1998.

<sup>13</sup> ECNZ supplies Comalco New Zealand Ltd's aluminium smelter at Bluff under contract for approximately 4,500 GWh pa.

provided against the price volatility involved with spot trading. The two sorts of trading are clearly related, in that fixed prices in bilateral contracts will reflect participants' expectations about spot prices over the period of the contract. For example, if the prices in bilateral contracts become too 'high', electricity buyers will tend to buy more electricity on the spot market, and vice versa.

- 63 Spot trading of wholesale electricity began with the commencement of operation of the New Zealand Electricity Market (NZEM) in October 1996. This market operates as a pooling arrangement, under which generators and buyers make price/volume offers and bids for electricity supplied and demanded respectively for discrete half-hourly periods on a day ahead basis (although bids can be revised up to two hours prior). This offer process establishes a dispatch order for generation plant running from lowest bid to highest bid, and individual plants are generally dispatched in that order until demand in the relevant period is met. The spot price in that period is determined by the price bid by the last power station to be dispatched, called the "marginal station". When ECNZ produced 95% of the electricity generated the order was determined by each station's marginal cost; now it is determined by the owner's bids, which may deviate from marginal cost.
- 64 Hydro Energy, in a report by The Law and Economics Consulting Group (LECG)<sup>14</sup>, note that about 70% of the electricity generated is exchanged through the NZEM, a figure which has declined from 90-95% in early 1998. The balance is traded through a second, smaller, clearing house (RMB<sup>15</sup>), through bilateral contracts, and through vertical integration.
- 65 In practice, the wholesale and dispatch activities are more complex. A number of examples of relevance to this determination are now cited. Firstly, it would appear that individual power stations do not bid their entire capacity at a single price. Rather, a range of prices for different tranches of capacity may be bid, with that for the first tranche often being bid at zero to ensure operation of the plant. The actual price received for that output will be the market price, which is determined by the bid of the marginal station.
- 66 Secondly, the aggregate supply and demand patterns for each half-hour uncovered by the bidding process have to be reconciled with possible physical constraints arising from the structure of the transmission system. The most significant of these is the central North Island constraint, which carries power north to feed the major Auckland load centre. Such lines have a finite capacity which cannot be exceeded, and that capacity falls during the period of high summer temperatures. Moreover, when demand is high, voltages can fall when power is transmitted over long lines, which may have to be rectified by the 'forced' (constrained on) operation of power stations close to the load centre.
- 67 A third example of the complexity in the operation of the generation and wholesaling market is that wholesale electricity is not priced on a national basis, but at approximately 180 grid exit points or 'nodes' throughout the country. The price at each node is calculated by starting with the optimal generation configuration for the half-hour period,

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<sup>14</sup> Submitted to the Commission in relation to Decision No. 340, *TransAlta Corporation of Canada and Contact Energy Limited*, 12 February 1999

<sup>15</sup> RMB Energy Group NZ Limited.

and then separately for each node computing the increase in total cost of supplying a hypothetical additional MW of demand at that node. The cost will reflect the reconfiguration of generation and reserve capacity for the system as a whole needed to minimise the cost of supply to the country as a whole. Viewed in this way, the concept of the 'marginal station' becomes more diffuse. The marginal station may vary, depending upon the node at which the extra demand occurs.

- 68 Trading in reserves is made necessary by the need to maintain a capability within the electricity supply system to meet inevitable but random plant failures or demand spikes. This capability is provided in two ways: by generators who operate plant which is either synchronised to the network but is not producing electricity (spinning reserves), or which is operating below maximum or efficient output; and by electricity consumers who are willing to shed load with no notice (interruptible load). In the current integrated system where generators can supply both electricity and (for a price) reserves, and where users can consume electricity and provide (at a price, by way of a discount on the retail price for electricity) interruptible load, the two areas of trading are closely interrelated. For example, generation capacity held back for reserves cannot be used to generate electricity, thereby reducing supply and potentially raising the spot price.
- 69 The NZEM accepts bids from generators on reserves for each half-hourly period, and a supply curve is built up. This is equated with the demand for reserves, based on the biggest contingency in the system. This could be the failure of the HVDC link, or the emergency shutdown of a power station. Available reserves have to be large enough to cope with such an event in order to prevent the potential collapse of part of, or even the entire, supply system.
- 70 As indicated, the trading in bilateral contracts, spot electricity and reserves is not conducted independently, such that they could be considered to fall into separate markets. Rather, given the very close interdependencies between them, with prices in one being influenced closely by trading activity in the others, the Commission considers that the relevant market comprises all three. This market may be called the electricity generation and wholesaling market.
- 71 The market is considered to be a national one. Although wholesale prices vary between nodes, the generation and transmission network connections between them ensures that none individually can be considered to constitute a separate market. Similarly, North Island prices are typically higher than South Island prices by 3-10%, reflecting the energy losses in transmitting electricity from south to north. However, this does not indicate separate markets in each of the Islands.
- 72 In terms of the temporal dimension of this market, pricing behaviour has to be viewed 'in the round' over a lengthy period, rather than on the basis of half-hourly pricing. In competition policy cases the objective of defining a market is as a first step in analysing the potential for dominance to be acquired or strengthened. Competition has to be considered over the long-run, during which time the potential for entry can be incorporated. The long-run period can vary widely between industries depending upon their particular characteristics. Because of the significant investments and resource consents needed for new generating capacity, the electricity industry is characterised by lengthy time delays before new entry can occur. Moreover, about one-third of generation capacity is provided by hydro stations with significant water storage reserves, which fill up in the spring and are typically held over to the following winter.

Additionally, some users, such as those providing interruptible load, have an ability to switch demand between half-hourly periods. The Commission therefore considers it appropriate to define the temporal dimension of the market as being at least one year.

- 73 Accordingly, in assessing the application, the Commission adopts the same market definition as in Decision 333 and has concluded that the relevant market in respect of electricity generation and wholesaling is the national electricity generation and wholesaling market.

#### *National Electricity Retail Market*

- 74 The national retail electricity market is the market formed between retail suppliers on the one hand and end-users on the other. Until recently the Commission considered that there were two such retailing markets: one for larger and medium-sized customers (ie. industrial and larger commercial) with half-hourly meters, which was regarded as contestable (users were not restricted to buying from the incumbent lines operator cum retailer); and one for small customers (ie. small commercial and households), with non-time-of-use meters, which was regarded as non-contestable. The former was thus a nation-wide market, while the latter was restricted to the area covered by the distribution network of the incumbent retailer.

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

“... there is clear evidence of electricity suppliers being able to switch supplies between different categories of consumers, including small consumers, depending on market opportunities. Suppliers do not appear constrained to supplying limited geographical areas or to supplying to consumers on particular networks only. Small consumers now have, or will have in the near future, a choice of suppliers. This situation increasingly matches that of larger consumers. Therefore the Commission concludes that it is no longer appropriate to define discrete markets for the supply of delivered electricity to small consumers and to medium and large consumers. This view is based on the new dynamics in the marketplace arising from:

- the lowered barriers to new entry due to the separation by legislation of electricity lines businesses and supply businesses;
- the emergence of significant new players in the marketplace who have signalled their intention to compete against incumbent retailers; and, most significantly,
- the Government’s stated commitment to ensuring that small electricity consumers benefit from competition, and its expectation that deemed profiling be introduced (either by the industry participants or, if necessary, by itself) in the near future.<sup>16</sup>

- 76 Accordingly, in assessing the 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.

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<sup>16</sup> Decision No. 333, para 40

## Relevant Markets - Summary

77 The Commission has concluded that the following are the relevant markets for considering the application:

- the national electricity generation and wholesaling market; and
- the national electricity retail market.

## COMPETITION ANALYSIS

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

79 Competition in a market is a broad concept. It is defined in section 3(1) of the Commerce Act as meaning “workable or effective competition”. In referring to this definition the Court of Appeal said:<sup>17</sup>

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

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

“For the purposes of sections 47 and 48 of this Act, a person has ... a dominant position in a market if that person as a supplier ... of goods and services, is or are in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in that market and for the purposes of determining whether a person is ... in a position to exercise a dominant influence over the production, acquisition, supply, or price of goods or services in a market regard shall be had to-

- (a) The share of the market, the technical knowledge, the access to materials or capital of that person or those persons;
- (b) The extent to which that person is ... constrained by the conduct of competitors or potential competitors in that market;
- (c) The extent to which that person is ... constrained by the conduct of suppliers or acquirers of goods or services in that market.”

### *The Dominance Test*

81 Section 47(1) of the Commerce Act prohibits certain business acquisitions:

“No person shall acquire assets of a business or shares if, as a result of the acquisition, -

- (a) That person or another person would be, or would be likely to be, in a dominant position in a market; or
- (b) That person’s or another person’s dominant position in a market would be, or would be likely to be, strengthened.”

82 The test for dominance has been considered by the High Court. McGechan J stated:<sup>18</sup>

“The test for ‘dominance’ is not a matter of prevailing economic theory, to be identified outside the statute.”

...

“Dominance includes a qualitative assessment of market power. It involves more than ‘high’ market power; more than mere ability to behave ‘largely’ independently of competitors; and

<sup>17</sup> *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554, 564-565

<sup>18</sup> *Commerce Commission v Port Nelson Ltd* (1995) 5 NZBLC 103,762 103,787 (HC)

more than power to effect ‘appreciable’ changes in terms of trading. It involves a *high degree of market control*.”

- 83 Both McGechan J and the Court of Appeal, which approved this test,<sup>19</sup> stated that a lower standard than “a high degree of market control” was unacceptable.<sup>20</sup> The Commission has acknowledged this test:<sup>21</sup>

“A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor or customer reaction.”

- 84 The Commission’s *Business Acquisitions Guidelines* state:

“A person is in a dominant position in a market when it is in a position to exercise a high degree of market control. A person in a dominant position will be able to set prices or conditions without significant constraint by competitor {or} customer reaction.”

...

“A person in a dominant position will be able to initiate and maintain an appreciable increase in price or reduction in supply, quality or degree of innovation, without suffering an adverse impact on profitability in the short term or long term. The Commission notes that it is not necessary to believe that a person will act in such a manner to establish that it is in a dominant position, it is sufficient for it to have that ability.” (p21)

- 85 The role of the Commission in respect of an application for clearance of a business acquisition is prescribed by the Commerce Act. Where the Commission is satisfied that the proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of a dominant position in a market, the Commission must give a clearance. Where the Commission is not satisfied, clearance is declined.

- 86 The Commission applies the dominance test in the following competition analysis.

### **The National Electricity Generation and Wholesaling Market**

- 87 An examination of concentration in a market often provides a useful first indication of whether a merged firm may or may not be constrained by others participating in the market, and thus the extent to which it may be able to exercise market power.

- 88 The *Business Acquisitions Guidelines* specify certain “safe harbours” which can be used to assess the likely impact of a merger in terms of s 47 of the Act -

“In the Commission’s view, a dominant position in a market is generally unlikely to be created or strengthened where, after the proposed acquisition, either of the following situations exist:

the merged entity (including any interconnected or associated persons) has less than in the order of a 40% share of the relevant market;

the merged entity (including any interconnected or associated persons) has less than in the order of a 60% share of the relevant market and faces competition from at least one other market participant having no less than in the order of a 15% market share.” (p 17)

- 89 These safe harbours recognise that both absolute levels of market share and the distribution of market shares between the merged firm and its rivals is relevant in considering the extent to which the rivals are able to provide a constraint over the merged firm. The Commission went on to state that:

<sup>19</sup> *Commerce Commission v Port Nelson Ltd* (1996) 5 NZBLC 104,142 104,161 (CA)

<sup>20</sup> *Commerce Commission v Port Nelson Ltd* (1995) 5 NZBLC 103,762 103,787 (HC)  
and *Commerce Commission v Port Nelson Ltd* (1996) 5 NZBLC 104,142 104,161 (CA)

<sup>21</sup> *Business Acquisition Guidelines*, Section 7

“Except in unusual circumstances, the Commission will not seek to intervene in business acquisitions which, given appropriate delineation of the relevant market and measurement of shares, fall within these safe harbours.”

- 90 Although, in general, the higher the market share held by the merged firm, the greater the probability that dominance will be acquired or strengthened (as proscribed by s 47 of the Act), market share alone is not sufficient to establish a dominant position in a market. Other factors intrinsic to the market structure, such as the extent of rivalry within the market and constraints provided through market entry, also typically need to be considered and assessed.

### *Market Concentration*

- 91 Table 1 shows approximate market share data by generator based on generation capacity and output, and assuming the future split of ECNZ into Hydro Energy Ltd (Hydro Energy), Waikato SOE Ltd (Waikato SOE) and Genesis Power Ltd (Genesis Power). It shows the approximate shares that those generators would have held based on known plant capacities, and actual generation volumes for the years ended March 1997 and March 1998.

Table 1: Electricity Generation Market Share Data

<b>Generator</b>	<b>Capacity MW<sup>22</sup></b>	<b>%</b>	<b>Output YE March 1997<sup>25</sup> GWh</b>	<b>%</b>	<b>Output YE March 1998<sup>25</sup> GWh</b>	<b>%</b>
Contact	2,034	25	7,257	21	9,329	27
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Total</b>	<b>8,098</b>	<b>100</b>	<b>34,295</b>	<b>100</b>	<b>35,010</b>	<b>100</b>

- 92 One important qualification to these estimates involves the inclusion of the long-term Comalco contract with Hydro Energy, which amounts to about 4,500 GWh per annum. It could be argued that this contract is special because it is a physical contract for a very large quantity of electricity of a very long duration with special transmission arrangements with Transpower. This contract will not be open to competition from any other generator, and therefore falls outside the defined market. If it were to be excluded from Table 1, [ ]. The effect on the market share data of excluding Comalco’s contract with Hydro Energy for approximately 4,500 GWh per annum is shown in Table 2.

Table 2: Electricity Generation Market Share Data excluding Comalco’s Contract

<sup>22</sup> Data collected directly from generators by the Commission.

Generator	Capacity MW	%	Output YE March 1997 GWh	%	Output YE March 1998 GWh	%
Contact	2,034	25	7,257	24	9,329	31
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]	[ ]	[ ]	[ ]
<b>Total</b>	<b>8,098</b>	<b>100</b>	<b>29,795</b>	<b>100</b>	<b>30,510</b>	<b>100</b>

- 93 The market share figures in both tables indicate that, even using the most conservative post acquisition scenario, that is, excluding the Comalco contract, the proposed acquisition is within the Commission’s first “safe harbour” of 40%.<sup>23</sup>
- 94 The market share figures, in themselves, do not suggest that the proposed acquisition would result, or would be likely to result, in the acquisition or strengthening of a dominant position.

*Barriers to Entry*

- 95 Even where a firm has a large market share, its ability to exercise market power might be constrained if entry barriers are low, allowing new firms to enter should prices rise much above the competitive level. A number of factors need to be considered in relation to new entry in electricity generation. The consensus appears to be that substantial new entry is most likely to be in the form of gas-fired combined cycle plants, which can be built on a relatively small scale, relatively quickly and involving less capital-intensive technology than most other types of plants. The technology is widely available and the capital outlay involved is within the ability of many large firms or joint ventures to finance. Entry is thus relatively easy from a technical perspective, although the need to obtain resource consents is likely to delay the process.
- 96 However, such plants are unlikely to be built without the assurance of long-term gas supply and electricity off-take contracts, about which there is currently some doubt. Presently, gas prices appear to be too high to make entry attractive, given the recent level of electricity prices. The latter probably reflect the current substantial excess generating capacity, amounting to at least 5,000-6,000 GWh, or around 15% of the current output of about 35,000 GWh pa. In recent years there has been a significant amount of new generating capacity built, although this has not necessarily been profitable.
- 97 It seems unlikely that major new investments in generation will occur for several years at current and anticipated prices and demand levels. Prices are likely to be constrained to some extent by surplus capacity, albeit of relatively high cost marginal thermal stations.

<sup>23</sup> *Business Acquisition Guidelines*, p17

- 98 The extent to which the threat of entry would be likely to constrain the merged entity can be assessed using the ‘LETS’ test,<sup>24</sup> which considers the likelihood, extent, timeliness and sustainability of entry. Entry is likely once prices rise to equal the long-run marginal cost of new investment in generation. It is generally accepted that prices are currently below that level, at least partly because of existing substantial excess capacity. Nonetheless, if an existing participant were to succeed in exerting market power leading to a significant rise in prices, a new entrant would have an incentive to enter, given access to gas, and users would have an incentive to enter into long-term contracts with it to gain a lower priced source of supply. Entry is likely to be on a significant scale, given the “lumpy” nature of generation plant. Such entry is also likely to be timely in the context of the electricity sector, which is characterised by long-term investments to increase capacity in line with the secular growth in demand, and sustainable, given the “sunk” nature of such investments.
- 99 Hence, the Commission concludes that the potential for new entry will act as a constraint on the exercise of market power by an otherwise dominant firm.

#### *Conclusion on National Electricity Generation and Wholesaling Market*

- 100 Having regard to all the relevant factors and, in particular, the markets shares post-acquisition in relation to the Commission’s “safe harbour” guidelines and the relative ease of market entry, the Commission concludes that the proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of a dominant position in the national electricity generation and wholesaling market.

#### **The National Electricity Retail Market**

- 101 The recent reforms in the electricity sector, led by the introduction of the Electricity Industry Reform Act 1998 (the EIR Act), have a major impact on the analysis of actual or potential competition for electricity retailing to small consumers. These reforms include the development of the wholesale market, the separation of electricity lines and supply (retail and generation) businesses, and the planned introduction of deemed profiling.<sup>25</sup> One result has been a significant change in the ownership of incumbent electricity retailer franchises.
- 102 In the past the Commission has considered that electricity retailing to small consumers took place in a number of discrete geographic markets corresponding with each local distribution network. 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.
- 103 Both TrustPower and Contact have been active acquirers of incumbent electricity retailer franchises and are both now major participants in the national electricity retail market. [ ] as shown in Table 3:

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<sup>24</sup> *Business Acquisition Guidelines*, p19

<sup>25</sup> For a full discussion see Decision 333.

[

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104 Contact has also been active in its attempts to gain additional customers in areas, such as Auckland and Wellington, where it is not the incumbent electricity retailer. However, volumes of switching customers have been low with Contact gaining approximately [ ] customers. ECNZ (through First Electric), has been more successful, gaining approximately 15,000 consumers in the Auckland, Wellington, Bay of Plenty and Christchurch regions.

#### *Current Competition in the National Electricity Retail Market*

105 Prior to the announcement of the electricity reforms, power companies were only competing for medium-sized customers outside a company's traditional supply area. The reforms have enhanced actual and potential competition for these customers.

106 There are some regions where actual competition at present is limited or non-existent for small consumers. Smaller regions around New Zealand have not seen the arrival of competing electricity retailers and no retailer has announced firm plans to supply small consumers in these regions. However, First Electric, for instance, has indicated that it is likely to extend its retail activities to these areas during the current year.

107 The emerging major participants have been investing in significant organisational restructuring to re-focus their businesses on the new market, and to adjust for their acquisitions of additional electricity retailing businesses. The evolution of corporate branding, investment in call-centres, significant hiring of retail marketing expertise, and more timely resolution (in most cases) of line access agreements all signify that national retailing of electricity will occur on a timely basis.

#### *Potential New Entry*

108 In the past it has been considered that the constraints on new entry to electricity retailing markets arose primarily from lack of competition in the wholesale market, difficulty in negotiating a satisfactory use-of-system agreement with a distributor who was the incumbent retailer, and the cost of time-of-use meters. These constraints were particularly significant for new retailers seeking to compete in the domestic segment of the market.

109 It is considered that these constraints on entry have been, or soon will be, substantially removed by the recent industry reforms. In particular, deemed profiling will remove the

need for time-of-use meters, while the distributor will no longer have an incentive to deter new entry.<sup>26</sup>

110 A number of those who have been successful in purchasing existing retail businesses to date (eg: TransAlta, Contact, ECNZ, and TrustPower Ltd) have substantial generation assets. They have indicated that they are seeking to reduce their forward risk as generators by acquiring retail customers, thereby securing predictable demand.

111 The Commission believes that potential new entry will not be limited to electricity generators, although in the short term, they may be prepared to pay higher prices for existing retail businesses than non-generators. It has been widely reported that some in the industry believe that it is necessary to have at least 400,000 customers to operate a fully efficient national retail operation. Even if this is so, the Commission believes that there is still considerable scope for ‘niche’ retailers to enter the market to concentrate on particular classes of customers.

112 It has also been suggested that retailers could obtain economies of scope and other commercial advantages by being able to offer natural gas along with electricity. Contact, for instance, acquired Enerco’s gas customer base in order to give it a significant entry point to retail electricity competition on a North Island-wide basis. The Natural Gas Corporation (NGC) has also entered the national electricity retail market with its acquisition of the electricity retail business of WEL Energy Ltd.

#### *Conclusion on Current State of Competition in the National Electricity Retail Market*

113 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 concludes that no firm is currently dominant in the national electricity retail market.

#### *Impact of the Proposed Acquisition on Competition in Electricity Retailing*

114 [

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115 The market share figures in table 3 indicate that the entity resulting from the proposed acquisition is well within the Commission’s first “safe harbour” of 40%.<sup>27</sup> [ ]. There are a number of other very significant market participants, both larger and smaller.

116 Traditionally, individual acquirers (consumers) have had virtually no ability to constrain their electricity supplier. With the arrival of competition in the national electricity retail market, and particularly with the advent of deemed profiling,<sup>28</sup> individual consumers will have choice. While it appears that, currently, consumers are reluctant to switch suppliers (ie: ‘sticky’), this may be due to their concern over entrusting supply of such a critical product as electricity to new, ‘unknown’, companies. As the public awareness

<sup>26</sup> See Decision 333 for a full discussion.

<sup>27</sup> *Business Acquisition Guidelines*, p17

<sup>28</sup> See Decision 333 for a full discussion.

and confidence in suppliers increases, and competition arrives at the consumers 'door-step', they are likely to be less reluctant to exercise their ability to switch suppliers.

### *Conclusion on National Electricity Retail Market*

117 Having regard to all the relevant factors and, in particular, the markets shares post-acquisition in relation to the Commission's "safe harbour" guidelines and the relative ease of market entry, it is concluded that the proposed acquisition would not result, or would not be likely to result, in an acquisition or strengthening of a dominant position in the national electricity retail market.

## **CONCLUSION**

118 The Commission has considered the impact of the proposal in two relevant markets:

- the national electricity generation and wholesaling market; and
- the national electricity retail market.

119 Having regard to the factors set out in section 3(9) of the Commerce Act and all the other relevant factors, the Commission is satisfied that the proposed acquisition would not result, or would not be likely to result, in Alliant or any other person acquiring or strengthening a dominant position in a market.

## **DETERMINATION ON NOTICE OF CLEARANCE**

Accordingly, pursuant to section 66(3) of the Commerce Act 1986, the Commission gives clearance for the acquisition by Alliant International New Zealand Limited, or any interconnected body corporate, of a 40% shareholding in Contact Energy Limited.

Dated this 12<sup>th</sup> day of February 1999

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The Commission

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**APPENDIX 1: SECTION 26 STATEMENT**

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## **APPENDIX 2: MINISTER'S LETTER**