PUBLIC VERSION

ISSN NO. 0114-2720
J6822

COMMERCE COMMISSION

Decision No 540

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

VECTOR LIMITED

and

NGC HOLDINGS LIMITED

The Commission:	P R Rebstock D R Bates QC D F Curtin
Summary of Application:	Vector Limited or an interconnected body corporate has sought clearance to acquire, whether directly or indirectly, up to and including 100% of the shares in NGC Holdings Limited
Determination:	Pursuant to section 66(3) (a)/(b) of the Commerce Act 1986, the Commission determines to give clearance to the proposed acquisition.
Date of Determination:	10 December 2004

CONFIDENTIAL MATERIAL IN THIS REPORT IS CONTAINED IN SQUARE BRACKETS

TABLE OF CONTENTS

THE PROPOSAL

1. A Notice under s 66(1) of the Commerce Act 1986 (the Act) was registered on 11 August 2004. The notice was an application for clearance (the Application) for Vector Limited (Vector) to acquire up to and including 100% of the shares in NGC Holdings Limited (NGC).
2. Section 66(3) of the Act requires the Commission either to give clearance or to decline to give clearance in respect of a notice under s 66(1) within 10 working days, unless the Commission and the person who gave notice agree to a longer period. Two extensions of time were agreed between the Commission and Vector. Accordingly, a decision on the Application was required by 10 December 2004.
3. The Applicant sought confidentiality for specific aspects of the Application. A confidentiality order was made in respect of the information for up to 20 working days from the Commission's Notice of Determination. When that order expires, the provisions of the Official Information Act 1982 will apply.
4. The Commission's approach to analysing this proposed Acquisition is based on principles set out in the Commission's *Merger and Acquisition Guidelines*.[1]

STATUTORY FRAMEWORK

5. Under s 66 of the Act, the Commission may grant clearances for acquisitions where it is satisfied that the proposed acquisition would not have, or would not be likely to have, the effect of substantially lessening competition in a market. The standard of proof that the Commission must apply in making its determination is the civil standard of the balance of probabilities.[2]
6. The Commission considers that, to find a substantial lessening of competition, it is necessary to identify a real lessening of competition that is not minimal.[3] Competition must be lessened in a considerable and sustainable way. For the purposes of its analysis, the Commission is of the view that a lessening of competition and creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.
7. When the impact of market power is expected to be predominantly upon price, for the lessening, or likely lessening, of competition to be regarded as substantial, 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.
8. Similarly, when the impact of market power is felt in terms of the non-price dimensions of competition such as reduced service, quality or innovation, for there to be a substantial lessening, or likely substantial lessening, of competition, these also have to be both material and sustainable for at least two years.

ANALYTICAL FRAMEWORK

9. The Commission applies a consistent analytical framework to all its clearance decisions. The first step the Commission takes is to determine the relevant market or markets. As acquisitions considered under s 66 are prospective, the Commission uses a forward-looking type of analysis to assess whether a lessening of competition is likely in the

[1] Commerce Commission, *Mergers and Acquisition Guidelines*, January 2004.
[2] *Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission* (1992) 4 TCLR 713-722.
[3] See *Fisher & Paykel Limited v Commerce Commission* (1996) 2 NZLR 731, 758 and also *Port Nelson Limited v Commerce Commission* (1996) 3 NZLR 554.

defined market(s). Hence, an important subsequent step is to establish the appropriate hypothetical future with and without scenarios, defined as the situations expected:

- with the acquisition in question (the factual) ; and
- in the absence of the acquisition (the counterfactual).

10. The impact of the acquisition on competition is then viewed as the prospective difference in the extent of competition in the market between those two scenarios. The Commission analyses the extent of competition in each relevant market for both the factual and the counterfactual scenarios, in terms of:

- existing competition;
- potential competition; and
- other competition factors, such as the countervailing market power of buyers or suppliers.

THE PARTIES

Vector

11. Vector is owned by the Auckland Energy Consumer Trust (AECT). Vector owns and operates:

- electricity distribution networks in the greater Auckland and Wellington regions with [ ] electricity consumers connected to those networks;
- natural gas distribution networks in the greater Auckland region with about [ ] gas consumers connected to those networks;
- open-access fibre optic telecommunications networks in the central business districts of Auckland and Wellington;
- 70% of the shares of Stream Information Limited (Stream), which provides meters and metering services. The remaining 30% of the shares in Stream are owned by Energy Intellect Limited (Energy Intellect). NGC owns 25% of the shares of Energy Intellect; and
- electricity lines personnel training and tree trimming businesses.

NGC

12. NGC is a company incorporated in New Zealand and listed on the New Zealand Stock Exchange. The Australian Gas Light Company Limited (AGL), through AGL NZ Limited and AGL NZ Investments Pty Limited, owns 66.05% of the shares in NGC. New Zealand Central Securities Depository Limited hold 16.33% of the shares in NGC on behalf of a number of institutions. The public and institutions own the remaining 17.62% of the shares of NGC.[4]

13. The AGL group of companies is involved in most facets of the gas industry in Australia, including the ownership and operation of gas pipelines, and the distribution and marketing of gas to residential, commercial and industrial consumers.

14. NGC's wholly-owned subsidiaries undertake the following activities:

- the wholesale purchase of gas;
- the long distance, high pressure transmission of gas throughout the North Island;

---

[4] *NGC, 2003 Annual Report*, page 66.

- the treatment of high carbon dioxide gas produced from Kapuni and other gas fields;
- the low and medium pressure distribution of gas via pipeline networks in Northland, greater Auckland (small networks only), Waikato, Bay of Plenty, Rotorua, Taupo, Gisborne and Kapiti;
- the marketing and selling of gas throughout the North Island to consumers of more than 10 terrajoules (TJ) per annum of natural gas;
- the operation on behalf of Maui Development Limited (MDL) of the onshore Maui pipeline;
- the provision of consumers' electricity and natural gas meters and associated services, including installation, maintenance and collection and process of consumption data from its meters; and
- the distribution and sale of LPG.

15. NGC's partially owned subsidiaries and their activities are:
    - 60.25% of Liquigas Limited, a LPG distributor and wholesaler of LPG;
    - 25.1% of Wanganui Gas Limited (WGL), a gas distributor and electricity retailer in Wanganui and the Rangitikei area, and a gas retailer throughout the North Island;
    - 50% of the Kapuni Energy Joint Venture (KEJV), which undertakes electricity and steam generation at NGC's Kapuni gas treatment plant; and
    - 25% of Energy Intellect, which is a provider of electricity meters and metering services, including installation, maintenance and collection and processing of consumption data from energy meter information technology and solutions.

PREVIOUS DECISIONS

16. The Commission has previously considered a number of acquisitions pertinent to the present application. The relevant decisions are:
    - Decision 470, in which the Commission gave NGC and/or AGL clearance to acquire the gas pipeline assets of United Networks on 23 August 2002. That proposed acquisition, which did not proceed, is in many respects the reverse of the current proposal;
    - Decision 435, in which the Commission gave NGC clearance to acquire the gas distribution network of AGL located in the Hutt Valley, Tawa and Porirua areas on 8 June 2001; and
    - Decision 387, in which the Commission gave NGC clearance to acquire TransAlta New Zealand Limited on 17 March 2000.

THE INVESTIGATION

17. In the course of their investigation of the Acquisition, Commission staff have circulated the Application widely within the gas and electricity industries, and have discussed the Application with a number of parties, including:
    - NGC;
    - Vector;
    - Genesis Power Limited (Genesis);
    - Meridian Energy Limited (Meridian);
    - Mighty River Power (MRP);

- Todd Energy Limited (Todd);
- The Electricity Commission;
- Major Electricity Users Group (MEUG);
- Fonterra (Lactose NZ);
- Carter Holt Harvey Limited;
- Energy Intellect;
- Contact Energy Limited;
- Wanganui Gas Limited;
- Multigas Limited;
- The Lines Company Limited;
- PowerNet Limited;
- Delta Utilities Limited;
- Northpower Limited;
- Areva T & D New Zealand Limited
- Alpine Energy Limited;
- Powerco Limited;
- Trustpower Limited; and
- Counties Power Limited.

MARKET DEFINITION

Introduction

18. 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.[5]

19. For competition purposes, a market is defined to include all those suppliers, and all those buyers, between whom there is close competition, and to exclude all other suppliers and buyers. The focus is upon those goods or services that are close substitutes in the eyes of buyers, and upon those suppliers who produce, or could easily switch to produce, those goods or services. Within that broad approach, the Commission defines relevant markets in a way that best assists the analysis of the competitive impact of the acquisition under consideration, bearing in mind the need for a commonsense, pragmatic approach to market definition.[6]

20. For the purpose of competition analysis, the internationally accepted approach is to assume the 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 would be able to impose at least a small yet significant and non-transitory increase in price, assuming all other terms of sale remain constant (the SSNIP test). The smallest space in which such market power may be exercised is defined in terms of the five

[5] Section 3(1) of the Commerce Act 1986.
[6] Australian Trade Practices Tribunal, *Re Queensland Co-operative Milling Association*, above note 10; *Telecom Corporation of NZ Ltd v Commerce Commission & Ors* (1991) 3 NZBLC 102,340 (reversed on other grounds).

dimensions of a market discussed below. The Commission generally considers a SSNIP to involve a five to ten percent increase in price that is sustained for a period of one year.

21. Markets are also defined in relation to functional level. Typically, the production, distribution, and sale of products proceeds through a series of vertical functional levels, so the functional levels affected by the application have to be determined as part of the market definition. For example, that between manufacturers and wholesalers might be called the "manufacturing market", while that between wholesalers and retailers is usually known as the "wholesaling market".

Relevant Trading Activities

22. The activities of NGC and Vector in gas and electricity markets are shown in Table 1.

Table 1: Activities of NGC and Vector

ACTIVITY	NGC	VECTOR
Electricity Markets		
Generation	Kapuni Energy Joint Venture	No
Wholesale	No	No
Transmission	No	No
Distribution	No	Yes
Retailing	Yes (via its involvement with Wanganui Gas)	No
Metering	Yes	Yes
Gas Markets		
Production and processing	Yes	No
Wholesale	Yes	No
Transmission	Yes	No
Distribution	Yes, to a small extent in greater Auckland, and in Northland, Waikato, Bay of Plenty, Rotorua, Taupo, Gisborne, Kapiti and Wanganui regions	Yes, in the greater Auckland region
Retailing	Yes	No
Metering	Yes	No
LPG distribution, wholesale, retail	Yes	No

23. It can be seen that the Acquisition would lead to:

- a aggregation of activities in electricity metering markets;
- a minor aggregation of activities in the greater Auckland gas distribution market; and
- an increase in the vertical integration of the activities of the merged entity by the addition of NGC's gas activities to the gas distribution activities of Vector in the greater Auckland region.

24. Vector has suggested the following markets are relevant to this Application:
    - the market for the distribution of gas in the greater Auckland area;
    - the national market for the leasing of electricity meters to electricity metering services providers; and
    - the national market for the supply of electricity metering services.

25. In the competition analysis section below, the Commission discusses the potential for a substantially lessening of competition to occur as a result of the increased degree of vertical integration in the gas sector that would follow the Acquisition. It also considers possible changes in the constraints on market power in the gas distribution networks of Vector and NGC. Therefore, the Commission considers that the following additional markets are also relevant to this Decision:
    - the wholesale gas market;
    - the long distance high pressure gas transmission market;
    - the market for retailing of gas to large industrial and commercial consumers connected to the gas distribution networks of NGC and Vector; and
    - the market for retailing of natural gas to small consumers connected to the gas distribution networks of NGC and Vector.

The Markets for the Distribution of Gas

26. In a series of Decisions pertaining to gas markets,[7] the Commission has previously stated its view that the distribution and sale of gas occur in separate markets. The Commission considers that this approach is appropriate to its consideration of the present Application.

27. Historically, gas distribution networks have been viewed as discrete natural monopolies. The sunk cost associated with existing pipelines and the scale economies derived from the operation of gas distribution networks means that the duplication of pipelines has generally not been economically viable. However, in greater Auckland and Lower Hutt, limited areas of competition for distribution to large customers have developed. Limited by-pass networks have been constructed and are operated by Nova Gas. Issues arising from the Acquisition relating to bypass competition are discussed below in the section on vertical integration issues.

28. In the greater Auckland area there are three areas of limited physical overlap of the gas distribution networks of NGC and Vector. These occur at Whangaparoa, Papakura and Drury. In these areas there exists the potential for inter-network competition between NGC and Vector.

29. In Whangaparoa the overlap occurs in respect of about 150 residential consumers. In Papakura and Drury, the overlap occurs for only about 400 metres of the pipelines of the individual companies.

30. Other than in the limited areas, there is no overlap or potential overlap of the gas distribution networks of NGC and Vector. The nearest the gas distribution networks of NGC and Vector approach each other are some minor distribution networks based on transmission gate stations in Southern Auckland and Northern Waikato, but these are separated by between five and 10 kilometres.

31. The Commission has considered whether the Acquisition would affect the constraints on the market power associated with gas distribution networks. Accordingly, the

[7] Decisions 387, 435 and 470.

Commission considers that the relevant markets for considering the gas distribution issues raised by the current proposal are the market for the distribution of gas in the greater Auckland area stretching from the Whangaparoa peninsula to the Bombay Hills, and the markets for the distribution of gas over NGC's networks in Northland, Waikato, Bay of Plenty, Rotorua, Taupo, Gisborne, Kapiti and Wanganui/Rangitikei.

Electricity Metering Markets

Electricity Meter Product Markets

32. Vector has submitted that the appropriate product markets in which to consider the horizontal aggregation in electricity metering are:[8]

    - the national market for the leasing[9] of electricity meters to suppliers of electricity metering services; and
    - the national market for the supply of electricity metering services to end consumers or electricity retailers. Metering services include the supply of the meter, the repair, and maintenance obligations and the supply of associated services required to provide consumption data.

33. Vector considers that electricity meters of every category, type, size, accuracy, and method of consumption data retrieval are in the same product market. After consulting widely with participants in the electricity industry regarding the metering market, the Commission does not consider this to be correct. The Commission has noted wide agreement across the industry that a degree of product differentiation exists with regards to meters types. In particular, electricity meters can be categorised as either 'Time of Use' (TOU) or 'non-Time of Use' meters (non-TOU).

34. Indeed, in its Application, Vector makes the distinction. It describes the differentiated characteristics of electricity meters as follows:[10]

    > TOU meters record electricity consumption in half-hourly units, which is stored electronically on a data logger together with the date and time of the half hour unit. These records can be retrieved by cell phone, landline or by manual reading. Non-TOU meters record usage cumulatively on a register on the front of the meter. There are several variations of non-TOU meters, but the characteristics are the same in that all are read manually, or downloaded on site to a portable reading unit on a periodic basis (bi-monthly) at the site the meter is installed.

35. The Electricity Governance Rules[11] (EGRs) define six different categories of electricity metering installations according to voltage and current. These range from Category 1 (typically used at residential and small commercial sites) to Category 6 (typically used at the sites of large industrial and commercial consumers). Meters in category 1 are usually non-TOU; meters in Category 2 can be TOU or non-TOU, but are more often non-TOU; meters in Categories 3 to 6 are required under the EGRs to be TOU.

36. Genesis Energy, Meridian Energy, and Contact Energy, have all argued that residential consumer, non-TOU, and large consumer TOU meters are quite distinctive products and are in different product markets.

---

[8] Vector Limited: Notice under s66 of the Commerce Act 1986, Para 11.34, pg. 34.
[9] "References to the 'leasing' of electricity meters includes the lease or licence of the meter and other arrangements for rights of access to or use of the meter" Para 11.2 p 28 Vector Limited: Notice under s66 of the Commerce Act 1986.
[10] Vector Limited: Notice under s66 of the Commerce Act 1986, para 13.2, p. 43.
[11] Vector Limited: Notice under s66 of the Commerce Act 1986, para 13.1, p 42.

Demand-Side Substitutability

37. The greater the extent to which one good or service is substitutable for another, on either the demand-side or supply-side, the greater the likelihood that they are bought and supplied in the same market. The degree of demand-side substitutability is influenced by the extent of product differentiation.

38. 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.

39. The Commission has considered the demand-side substitutability of meters and considers that TOU meters are not substitutable for the simple aggregating non-TOU meter used to measure residential and other small electricity consumptions. The reasons for this view are as follows:

- a non-TOU meter is not technically suitable as an alternative for a TOU meter as the devices do not permit large industrial and commercial consumers to purchase electricity on a time interval basis;
- moreover, non-TOU meters are designed to measure electricity consumed at low voltages (230 volts) by small consumers. TOU meters are designed to measure electricity at high voltages (either 400 or 11,000 volts) by large consumers;
- non-TOU meters do not currently (nor, according to Meridian Energy, will do so within the next five years, to any substantial degree) permit remote data retrieval by telephone. This is an important requirement of TOU meters, which service consumers with a multiplicity of sites and a multiplicity of meters on each site (reading the consumption for individual cost centres, for example); and
- prices of TOU meters are much higher than those of non-TOU meters. A TOU meter is not currently economically substitutable for a residential consumer. Category 5 and 6 TOU meters cost about $15,000 installed. Category 3 TOU meters cost about $1,200, with an installation cost of about $400. Non-TOU meters cost $100 plus an installation cost of about $100.[12]

40. As a result, non-TOU meters are mostly used by residential and small commercial consumers, and TOU meters mostly by large industrial and commercial consumers, whose levels of consumption and methods of purchase of electricity require the use of the latter meters.

41. Most parties spoken to by the Commission said they considered that the provision of a TOU meter, its installation, maintenance and data collection and processing were all part of the one market. In some cases, NGC, Stream and Energy Intellect provide all of those services for their TOU meter customers in a bundle. In other cases (Trustpower, for example), electricity retailers may carry out data collection and processing.

Conclusion on Product Markets

42. The Commission considers that the relevant product market is that for the provision of TOU electricity meters, including associated metering services. Metering services includes the installation and maintenance of such meters and electricity consumption data retrieval and processing.

---

[12] These estimated prices were confirmed by electricity retailers.

Geographic Markets

43. The Commission defines the geographic dimension of a market to include all of the relevant, spatially dispersed sources of supply to which buyers would turn should the prices of local sources of supply be raised.

44. Vector has submitted that the appropriate geographical market in which to consider the horizontal aggregation in the metering market is national.

45. The Commission notes that NGC, Stream and Energy Intellect supply TOU meters to consumers and retailers throughout New Zealand. The provision of TOU metering is directly related to electricity retailing to large consumers, which is carried out on a national basis.

Conclusion on Geographic Metering Markets

46. Those providing TOU meters and metering services tend to operate on a national basis and it is appropriate to adopt a national market for the consideration of the proposed Acquisition.

Conclusion on Electricity Metering Market Definition

47. The Commission concludes that the relevant market is a national market for the provision of time of use electricity meters, including associated metering services. Metering services includes the installation and maintenance of such meters and electricity consumption data retrieval and processing.

48. This market will be referred to either as "the relevant metering market" or the "TOU meter market".

The Gas Transmission Market

49. Gas transmission is undertaken by NGC in high pressure gas pipelines from the gas production fields in Taranaki: south to Wellington; north to Auckland and Whangarei and on branch pipelines to Hawkes Bay, Bay of Plenty and Gisborne, and Morrinsville.

50. Maui Developments Ltd transmits gas in the Maui gas pipeline from the Oaonui production station to Huntly. This latter pipeline is operated by NGC on behalf of the Maui Joint Venture. While, up to the present, the Maui pipeline has been used exclusively to transport Maui gas, with the end of the life of that field in sight, a general pipeline access regime is being negotiated.

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

Gas Retailing

52. The Commission has concluded in the past that:[13]

- gas retailing to small consumers falls within localised geographic markets, each corresponding to the geographic boundaries of the relevant distribution network; but that
- it is appropriate to define a discrete gas retail market for larger industrial and commercial consumers. This market is North Island in scope.

53. The Commission has seen no evidence that would justify a different approach.

[13] See Decision 470 for example.

54. NGC retails gas only to large commercial/industrial consumers. Vector does not currently retail gas, but given its large residential electricity customer base, may have an incentive to retail gas to those consumers in the future.

Summary of Relevant Markets

55. The Commission considers that the markets relevant to its consideration of the application are:

- the TOU meter market;
- the markets for the distribution of gas in the greater Auckland area stretching from the Whangaparoa peninsula to the Bombay Hills, and for the distribution of gas over NGC's networks in Northland, Waikato, Bay of Plenty, Rotorua, Taupo, Gisborne, Kapiti and Wanganui/Rangitikei;
- the market for the transmission of gas in the North Island; and
- the markets for the retailing of gas to small consumers within localised geographic markets, each corresponding to the geographic boundaries of a distribution network, and for the retailing of gas to larger industrial and commercial consumers, which is North Island in scope.

COMPETITION ANALYSIS

Substantially Lessening Competition

56. 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.

57. Section 2(1A) provides that substantial means "real or of substance". Substantial means something more than insubstantial or nominal. It is a question of degree.[14] 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.[15]

58. Section 3(2) provides that references to the lessening of competition include references to the hindering or preventing of competition.[16]

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

- the nature and extent of the contemplated lessening; and
- whether the contemplated lessening is substantial.[17]

---

[14] *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).

[15] *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.

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

[17] 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.

60. In interpreting the phrase "substantially lessening competition", the Commission takes into account the explanatory memorandum to the Commerce Amendment Bill (No 2). The memorandum noted that:

> Two of the three 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).

The Counterfactual

61. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a "with" and "without" comparison rather than a "before" and "after" comparison. The comparison is between two hypothetical future situations, one with the acquisition (the factual) and one without (the counterfactual).[18] The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

62. 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.

63. The Commission considers that, while it does appear that AGL wishes to dispose of its shares in NGC, absent Vector's proposed acquisition of the shares, there is no certainty as to the acquirer(s) (if any). In these circumstances the Commission considers that the appropriate counterfactual is the status quo.

Competitive Impacts of the Acquisition

64. The competitive impacts within electricity metering markets and gas distribution markets from any loss of actual or potential competition are considered below. After that the Commission considers whether the greater level of vertical integration of the activities of the merged entity within the relevant markets give rise to any competition concerns.

COMPETITIVE IMPACTS IN METERING MARKETS

Introduction

65. Vector has a 70% interest in Stream. Stream owns about [ ] electricity meters that measure the electricity consumption of large commercial and industrial consumers throughout New Zealand. In the great majority of cases, Stream leases meters to consumers, rather than to electricity retailers. Stream supplies metering services, as defined above, as part of its metering package. Stream's meters are exclusively TOU/remotely read devices. It does not supply non-TOU meters.

66. Vector has no direct role in the provision of metering services. Rather, retailers using Vector's network negotiate metering arrangements direct with the supplier of these services (such as Stream, Energy Intellect or NGC).

67. NGC owns and leases approximately [ ] of the simple non-TOU meters at residential and small commercial sites, and about [ ] TOU meters at large commercial and industrial sites, throughout New Zealand. NGC leases the majority of its electricity meters to electricity retailers. NGC provides similar electricity metering services to those provided by Stream, these include the collection and processing of electricity

[18] Commerce Commission, *Decision 410: Ruapehu Alpine Lifts/Turoa Ski Resorts Ltd (in receivership),* 14 November 2000, paragraph 240, p 44.

consumption data. NGC provides varying levels of metering services to each of sites at which it owns TOU meters. NGC provides meters nationally and in contrast to stream, NGC enters into meter supply agreements with electricity retailers rather than consumers. NGC charges separately for that service.

68. The Commission has not previously considered an acquisition involving the aggregation of businesses involved in electricity metering.

Existing Competition in the Metering Market

69. Existing competition occurs between those businesses in the market that already supply the product, and those that could readily do so by adjusting their product-mix (near competitors). Supply-side substitution by near competitors arises either from redeployment of existing capacity or from expansion involving minimal investment. Both cases involving a delay of no more than one year.

70. An examination of concentration in a market can provide a useful indication of the competitive constraints that market participants may place upon each other, providing there is not significant product differentiation. Moreover, the increase in seller concentration caused by a reduction in the number of competitors in a market by an acquisition is an indicator of the extent to which competition in the market may be lessened.

71. An aggregation that would result in a low concentration level is unlikely to be associated with a substantial lessening of competition in a market. On this basis, indicative safe harbours may be specified.

72. 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 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%.

73. Vector submitted that, under its proposed metering market definition, the increase in the aggregated market shares of NGC and Vector (through Stream) would be less than [ ]% of the total market, which Vector said is de minimis and of no account in competition terms.

74. However, as stated above, the Commission considers that the appropriate product market is the market for TOU meters. Contact Energy and NGC have informed the Commission that there are approximately 12,000 TOU meters in service at present. In this product market the post-Acquisition market share of Vector/NGC would be about 82%, which prima facie raises competition concerns as the figure is well outside the Commission's safe harbours.

75. The Commission recognises that concentration is only one of a number of factors to be considered in the assessment of competition in a market. In order to understand the impact of the acquisition on competition, and having identified the level of concentration in a market, the Commission considers the behaviour of the businesses in the market. Specifically, the Commission seeks to understand the dynamics of the competition that would exist between the remaining firms in the market, compared to what would exist in the absence of the merger.

76. Current competitors in the TOU meter market supply different ranges of the individual components within the relevant market, as is shown in Table 2 below.

Table 2: Participants in the National Market for the Provision of TOU metering and metering services

Company	Meter Providers	Lease Meters	Meter Installation	Meter Maintenance	Consumption data retrieval	Data Processing services
NGC	✓		✓	✓	✓	✓
Stream	✓		✓	✓	✓	✓
Energy Direct Limited	✓		✓	✓	✓	✓
Various lines companies*	✓		✓	✓		
Contact Energy		✓				✓
Trustpower		✓			✓	✓
Meridian	✓	✓				
Mighty River Power		✓			✓	✓
Energy Market Services (EMS)					✓	✓
Todd Energy		✓			✓	✓
Delta Utilities					✓	
Energy Intellect Limited			✓	✓	✓	✓

*Examples of lines companies that own TOU meters and lease to third parties: Counties Power, Powerco, Alpine Energy, North Power, Orion, Transpower, West Power.

77. In addition to the current competitors indicated in Table 2 there are other meter providers that are not currently participating in the market for the provision of TOU meters, but who have historical leasing arrangements with either retailers or end consumers. For example, Areva, a meter test house, leases TOU meters to Vector, Genesis & Meridian and Contact Energy.

78. In addition, there are a number of large consumers throughout New Zealand who own the electricity meter at their sites.

Conclusion on Existing Competition

79. The Commission concludes that currently there are number of competitors and near competitors in the relevant market, and that situation is likely to continue post-Acquisition. However, the Commission considers that the merged entity would be the significant provider of TOU meters and metering services post-Acquisition (with 82% of the market), and that existing competition would not be sufficient to constrain the merged entity.

Potential Competition in the Metering Market

Introduction

80. An acquisition is unlikely to result in a substantial lessening of competition in a market if the businesses in that market continue to be subject to real constraints from the threat of market entry.

81. The Commission's focus is on whether businesses would be able to enter the market and thereafter expand should they be given an inducement to do so, and the extent of any barriers they might encounter should they try.

82. In this case, if Vector attempted to exercise market power post-Acquisition leading to a significant rise in prices, electricity retailers such as Contact Energy, Genesis Energy, Meridian Energy and Mighty River Power or other industry participants would have an incentive to enter the market or expand the range and level of their existing metering activities. Most retailers currently contract with other providers to supply TOU meters and metering services. However, in the near past they have all used an in-house metering service, and could easily revert to that situation should Vector attempt post-Acquisition to raise prices or reduce service. For example, Meridian Energy leases about [ ] TOU meters, which under a price rise circumstance would give it sufficient scale to operate its own metering business.

83. Providers, other than electricity retailers, who have the potential to enter and expand in the relevant market are:

- the meter test houses such as Areva;
- current market participants, Energy Intellect and Energy Direct;
- the electricity lines companies such as Counties Power; and
- large electricity consumers who own TOU meters and provide their metering services.

Barriers to Entry in the Metering Market

84. The likely effectiveness of the threat of new entry in preventing a substantial lessening of competition in a market following an acquisition is determined by the nature and effect of the aggregate barriers to entry into that market. The Commission is of the view that a barrier to entry is best defined as anything that amounts to a cost or disadvantage that a business has to face to enter a market that an established incumbent does not face.

85. The Commission considers that barriers to entry in the relevant market are low.

86. Hardware meter technology is widely available. TOU meters can be easily acquired. As well as the New Zealand TOU meter manufacturer, Energy Intellect, there are a number of international companies that supply TOU meters to the New Zealand market through local agents including:

- ABB;
- Siemens;
- Actaris; and
- Ampy E-mail.

87. Software technology for consumption data retrieval and analysis is widely available. Energy Intellect, Intermoco Solutions, Ampy E-mail Metering and Siemens all have suitable software available off the shelf. In addition, electricity data retrieval and processing is now carried out internationally. Energy Intellect, for example, provides such services in Victoria, Australia and in other countries from its base in New Zealand.

88. Retailers may purchase and install their own meters to service their individual customers. TOU meters are only utilised in respect of large electricity consumers that provide retailers with sufficient margin to allow such an investment. Large retailers already have in-house capability for the provision of metering services, such as data retrieval and consumption data processing and reporting to end-consumers.

89. NGC currently employs about 30 electrical contractors to install and maintain its meters, so access to suitable skills by other potential meter providers does not appear to be an issue.

90. Access to meter certifiers is readily available, examples being Areva T & D New Zealand, Electrix, VirCom Energy Management Services Limited, who are all active in providing this service.

<u>The “LET” Test</u>

91. In order for market entry to be a sufficient constraint, entry of new participants in response to a price increase or other manifestation of market power must be Likely, sufficient in Extent and Timely (the LET test).

92. The mere possibility of entry is, in the Commission’s view, an insufficient constraint on the exercise of market power, and would not 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 business would 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.

93. It is apparent that electricity retailers currently consider it more economical not to own their own TOU meters, but instead to use specialist meter providers such as Stream and NGC. For example, Trustpower told the Commission that it currently considers it more efficient for NGC to manage the compliance, installation and maintenance of its meters. However, Trustpower added that it could potentially revert to carrying out the function itself. The Commission considers that Trustpower could buy the meters from one of the manufacturers named above, and arrange for the maintenance and installation by either its own staff or by contractors.

94. Genesis Energy, Contact Energy, Mighty River Power, and Meridian Energy all made statements to similar effect.

95. The Commission considers that if entry is to alleviate competition concerns, it must be feasible within two years. Contact Energy informed the Commission that it would take about 12 months for it to completely switch between TOU meter providers for all its large customers. The Commission considers that if retailers were unhappy with the price or quality of service offered by the merged entity they could expand the degree and level of metering activities within a short timeframe.

96. NGC informed the Commission that TOU meter contracts between itself and retailers are either for a one year duration or are back-to-back with the relevant consumer electricity supply contract (up to two years in length). There does not appear to be a contractual barrier to entry within the Commission’s two year time frame.

97. The above discussion concludes that entry would be both likely and of sufficient extent if Vector were to raise prices or reduce service post-Acquisition.

Conclusion on Potential Competition in the Metering Market

98. The Commission considers that the LET test is satisfied. Were Vector to price TOU meters unreasonably, retailers and others would have the ability to enter or expand the range and level of their activities in the relevant market within a short timeframe.

99. Hence, the Commission concludes that the potential for new entrants and for current competitors to expand their range and level of activities will act as a constraint on the exercise of market power by an otherwise dominant firm.

Countervailing Power

100. The potential for a business to wield market power may be constrained by countervailing power in the hands of its customers, or when considering buyer market power (oligopsony or monopsony), its suppliers. In some circumstances, this constraint may be

sufficient to eliminate concerns that an acquisition would be likely to lead to a substantial lessening of competition.

101. Vector and NGC argue that the large electricity retailers or large electricity consumers, as users of TOU meters, have countervailing power. This appears to be correct. If price or terms of access to existing meters were unreasonable, large electricity retailers and large consumers would have the resources and expertise to install new meters. This would place the previous meter supplier at risk of having to face the expense of removing the existing meters. [ ].

Conclusion on Countervailing Power

102. The Commission considers that the electricity retailers and large consumers are also likely to constrain the merged entity, and that the constraint currently provided by these parties is unlikely to be reduced significantly as a result of the Acquisition.

Conclusion on Metering Markets

103. The Commission considers that:

- Vector will not be constrained post-acquisition by existing competition in the relevant metering market;
- Vector would be constrained by potential competition post-acquisition. This would take the form of the ability to enter and/or expand of existing market participants, most importantly the large electricity retailers, meter test houses, existing TOU meter providers, electricity lines companies and large consumers; and
- Vector would be constrained by the countervailing power of the large electricity retailers and consumers, with the associated potential for its existing meters to become stranded assets.

104. The Commission is satisfied that the constraints that would remain, following the Acquisition, would be such that there would be unlikely to be a substantial lessening of competition as a result of the Acquisition. The Commission has placed emphasis on the low barriers to entry into the relevant metering market enabling near competitors easily to expand their product mix, together with the countervailing power of large electricity retailers, to constrain the merged entity from exercising market power.

COMPETITIVE IMPACTS IN THE GREATER AUCKLAND GAS DISTRIBUTION MARKET

105. The Commission has previously considered that gas distribution networks are discrete natural monopolies in the geographic regions of the individual networks, apart from the limited competitive constraints that inter-network competition[19] or bypass (or potential bypass) of a network originating at a gas transmission pipeline, may provide. Constraints from bypass arises, in principle from the actions of any potential gas distribution pipeline investor, and are unrelated to either Vector's or NGC's ownership of any individual gas distribution network. While Vector and NGC are potential bypassers of the other's network, other than at Whangaparoa, such bypass has not occurred in the past. Moreover NGC and Vector have advised that the duplication of gas pipelines at that location was "largely historic and a ludicrous and expensive exercise which is unlikely to continue in the future." Therefore, the Commission considers that constraints from potential bypass are unaffected by the Acquisition.

---

[19] Inter-network competition in this particular case is considered below.

106. While the vast majority of gas consumers in the greater Auckland region may only access the gas pipelines owned by Vector, a small number of consumers in Whangaparoa, Papakura and Drury theoretically have access to the gas distribution pipelines of both Vector and NGC, and may potentially be the beneficiaries of inter-network competition.

107. In Decision 470, the Commission examined the potential for competition between NGC's and (what is now) Vector's gas pipeline networks in the Whangaparoa, Papakura and Drury areas. It concluded that while there was some limited competition between the two gas distribution companies in all of the three areas, the reduction in competition as a result of the proposed merger was insufficient to meet the substantial lessening of competition test in s 47 of the Act.[20]

108. The Commission's reasons for this conclusion[21] were:

- the relatively small numbers of customers in the areas where duplication of gas distribution pipelines occurred in terms of gas flows, number of consumers and areas of overlaps;
- the high cost of connection to the alternative network combined with the delivered gas price benefits, rendering the proposal uneconomic to the relevant small consumers;
- the absence of any actual switching between the two distribution networks; and
- the fact that distribution prices in the areas of overlap were similar to those across the wider Auckland region.

109. The Commission has not found any new factors in respect of the Acquisition that would alter the conclusions on inter-network competition reached in Decision 470.

110. It follows that the Commission can be satisfied that Vector's proposed acquisition of NGC would not have the effect of lessening any competition between Vector's and NGC's gas distribution networks.

COMPETITIVE IMPACTS IN OTHER GAS DISTRIBUTION MARKETS - IMPLICATIONS OF THE FINDINGS OF THE GAS CONTROL INQUIRY

The Gas Control Inquiry

111. On 29 November 2004, the Commission released its Final Report on its Gas Control Inquiry.[22] This Inquiry was undertaken in response to a request by the Minister of Energy for the Commission to report as to whether gas pipeline services should be controlled under Part V of the Commerce Act. The Inquiry considered (among other things) whether competition was limited in the relevant markets and whether control was necessary or desirable in the interests of acquirers of pipeline services.

112. In the course of the Inquiry, the Commission undertook a 'building blocks' assessment of the individual gas pipeline service providers, including Vector and NGC. This required an assessment of each of: the efficient level of capital; rate of return of capital (depreciation); rate of return on capital (WACC); and efficient level of non capital costs.

113. In respect of the gas services supplied by the parties to the Acquisition, the Commission concluded:

- Vector, in the Commission's base case over the period 2000-2008, earned excess returns (that is, returns in excess of the mid-point of WACC determined by the Commission) with an annuity value of $9.361 million. Its average return was

[20] When compared to a similar counterfactual to that adopted in the present case.
[21] Readers are invited to refer to Decision 470 for more details of the inter-network competition.
[22] Commerce Commission, *Gas Control Inquiry Final Report,* 29 November 2004.

approximately 13.5% over the analysis period. If control was imposed, on the Commission's analysis, Vector's distribution prices could be reduced by as much as 18.5%; and

- NGC Distribution, in the Commission's base case over the period 1997-2008, earned excess returns with an annuity value of $3.069 million. Its average return was approximately 10.5% over the analysis period. If control was imposed, on the Commission's analysis, NGC's distribution prices could be reduced by as much as 5.6%.

114. After taking account of the different findings for Vector and NGC, and having regard to a number of additional matters including the net efficiency cost to the economy of reducing excess returns, the size of the benefits to acquirers and the impact of the recommendation not to control, the Commission recommended to the Minister of Energy that Vector should be controlled under Part V of the Act, and that NGC should not be controlled under Part V.

Issues Raised by the Conclusions Reached in the Gas Inquiry

115. During the course of its consideration of the current application, the Commission wrote to both Vector and NGC noting the different findings and conclusions the Commission had reached in its Inquiry, in particular the conclusion that Vector is earning significantly greater returns than its cost of capital when compared with NGC. It sought responses to the following questions:

- What are the factors which apparently constrain NGC but which do not appear to constrain Vector?;
- If the acquisition proceeds, will Vector apply its existing pricing policies to NGC's distribution and transmission networks?;
- If the Commission considers that Vector's acquisition of NGC Holdings would, in itself, lead to price increases on NGC's networks, can the Commission take the potentioal behaviour into account, and is it reasonable for the Commission to infer that Vector's acquisition of NGC Holdings would result in a substantial lessening of competition in the relevant markets, in terms of ss 47 and 66 of the Commerce Act?; and
- Is it reasonable for the Commission to take into account that, if the number of substantial gas distribution network owners is reduced from three to two (i.e. if only Powerco and Vector remain), the potential competitive constraint arising from the ability to benchmark similar businesses could be lessened.

116. Vector's comments in response included the following:

- Vector's prices are similar, or in many cases lower than NGC's;
- if gas distribution businesses are monopolies, the only market constraints Vector and NGC face are determined by their demand curves for their services, and not by competitive interactions. Demand can vary by region, but this demand would not be affected by the acquisition;
- levels of return are affected by market conditions in particular areas and by levels of efficiency;
- since acquiring its gas network, Vector has changed its commercial pricing to be more reflective of costs and market conditions. It would expect to take a similar approach to pricing NGC's distribution services. It is possible that NGC is adopting a similar approach at present in which case no change would be required;

- it is not the Commission's role to speculate about what future pricing policies Vector might apply. Price rises arising from a substantial lessening of competition is a different matter;
- it is not reasonable or logical for the Commission to infer, from an expectation it may have that prices may rise post-acquisition (as a result of the application of a different set of pricing policies), that the acquisition would result in a substantial lessening of competition;
- benchmarking may be seen as a regulatory constraint, but is not a competitive constraint; and
- the implication of the Commission's Inquiry Report was that the preservation of a number of companies in order to maintain local data for benchmarking purposes appears to have little value.

117. NGC's comments in response included the following:

- the Commission should not rely on its assessment of future pricing behaviours of NGC. NGC Management cannot predict that;
- as the Inquiry shows, there is a complex matrix of factors relevant to the companies' market behaviours;
- constraints faced by gas distributors may vary to some extent geographically, but are substantively the same; and
- the Commission's assessment should focus on any changes to constraints that could amount to a substantial lessening of competition. No significant changes to existing levels of constraint in the market would result from the acquisition.

118. The principal issues raised by Vector and NGC are discussed under relevant headings below.

Pricing and Pricing Constraints

119. The current distribution prices of Vector and NGC are broadly similar. The Ministry of Economic Development's Schedule of Natural Gas Prices up to 15 August 2004, shows the average distribution component in the delivered gas price to domestic consumers is 4.34 c/kWh on Vector's Auckland gas distribution network, and is 4.27 c/kWh on NGC's various gas distribution networks. Since that time NGC has increased its charges and they are now slightly higher than Vector's current charges.

120. Vector has rebalanced its tariffs for industrial and commercial customers since it acquired the Auckland network in late 2002, principally to meet actual or potential bypass competition. However in that time it has not increased prices overall.

121. As noted in the Gas Inquiry Report, the Commission has concerns about the extent of the excess returns in Vector's prices (and, to a lesser extent, in NGC's prices). The excess returns are indicative of a significant amount of market power. Distribution prices are reflective not so much of the cost of supply (which would be the usual situation in a competitive market) but rather of general demand conditions and broad energy-sector factors. These factors include the ability of some gas users to switch to other energy forms at certain price levels, the threat of bypass competition and countervailing power in the hands of some gas users. Together they place an upper ceiling on gas distribution prices, though this ceiling appears to be above efficient prices. As distribution prices are reasonably similar in all geographic regions, the amount of excess returns being earned varies with the costs of supply in individual region. Vector's greater returns appear to reflect its lower costs (possibly because of the greater population concentration in Auckland) compared with those faced by NGC in the region it services.

122. As current prices are constrained by the ceiling provided by inter-fuel competition and other broad energy sector factors, and as the height of this ceiling will not be affected by the acquisition, the Commission considers that the acquisition, in itself, is not likely to lead to higher prices.

Constraints from Benchmarking

123. The Commission considers that benchmarking can have an important constraining factor on firms where reasonable comparisons between a number of similar firms can be made. In this case, however, comparisons between the four gas distributors (Vector, NGC, Powerco and Wanganui) are difficult to make. There are important differences between them including; scale, type and density of customers they serve and the terrain of the regions.

124. As the Commission noted in its Gas Control Inquiry, it can be difficult to draw definitive quantitative conclusions from benchmarking analysis in the gas sector. One important reason is the small number of firms, each with distinctive characteristics, in New Zealand. A reduction in the number of firms by one as a result of the Acquisition would make some difference, but the Commission considers that such a reduction would not, in the current circumstances, be sufficient to have a significant impact on the effectiveness of benchmarking to constrain market power.

Limitations on Constraints Which Might be Considered

125. In its assessment of the market the Commission takes into account all matters which might impact on market power and the ability of firms to exercise that market power when it assesses business acquisitions in terms of s 66 of the Act. If an acquisition results in a firm increasing its market power (that is, the ability to charge more and give less) the Commission would take that into account in reaching its determination.

126. Regulatory constraints form part of the competitive landscape, and must be taken into account when carrying out competition analysis. For example, in Telecom Corporation of New Zealand Ltd v Commerce Commission[23] (AMPS - A) the Court of Appeal considered that regulatory constraints, including current regulation and the threat of further regulation, were "part of the environment constraining Telecom in practical terms from engaging in discriminatory conduct"[24].

127. The Commission has therefore had regard to the impact of regulatory intervention but in this case the Commission does not consider that the Acquisition would lead to a material lessening of the regulatory threat, nor a significant change in the constraint on market power arising from regulatory threat.

Consideration of Behaviour

128. The Courts have endorsed the view that behaviour of firms in a market is relevant to the competition analysis. In AMPS - A the Court of Appeal noted the need to give weight to both structure and behaviour when examining a market environment, and confirmed that the weighting must vary according to the particular facts. Richardson J stated "…structures only function through people and at the end of the day it is how participants in the market behave that counts".[25] The Court of Appeal endorsed the approach of the Commission of the European Community in Re Continental Can Co Ltd[26] and said "the approach reflects the concern for how firms behave and eschews a total preoccupation

[23] [ ] 3 NZLR 429.
[24] Ibid at 446.
[25] Ibid at 444.
[26] (1972) CMLR D11.

with structure". And in Tru Tone Ltd v Festival Records Retail Marketing Ltd. the Court of Appeal stated: "…behaviour in the market, reflects the reality that constraints on the operation of firms are a key indicator of market power".[27]

129. Having regard to market circumstances and the past behaviour of Vector and NGC, the Commission finds, on the balance of probabilities, no indication that a change of ownership in this instance would necessarily lead to a behavioural change which would be disadvantageous to users of the gas networks.

COMPETITIVE IMPACTS OF VERTICAL INTEGRATION

Introduction

130. Vertical acquisitions are those that involve businesses operating at different functional market levels in the production of a particular good or service. Where a vertical acquisition also has horizontal implications, the Commission considers each aspect of the acquisition in its own right.

131. The Commission is of the view that, in general, the vertical aspects of acquisitions are unlikely to result in a substantial lessening of competition in a market unless market power exists at one or more of the affected functional levels. Where such a situation is found to exist, the Commission considers whether the acquisition would strengthen that horizontal position, or have vertical effects in upstream or downstream markets, and whether that change would substantially lessen competition at one or other of the horizontal levels.

132. Vertical integration has the potential to raise a number of competition concerns, including:

- facilitation of co-ordination effects – the efforts of a group of manufacturers to collude may be undermined by the competition between the downstream retailers. This might be prevented if each retailer were to be acquired by a manufacturer. However, this potential effect does not appear to fit within the facts of this case. In regard to gas transmission, it seems unlikely that Maui Developments Ltd (a limited competitor to NGC in the transmission market, the owner of the Maui pipeline), will enter gas retail markets. In regard to gas distribution Vector has no competitors with which to co-ordinate;
- foreclosure of entry into the vertical levels affected – a commodity processor that vertically integrates with upstream suppliers of the commodity may be able to foreclose others from the processing market. Likewise, a manufacturer that gains control of a downstream distribution level of the market may be able to foreclose others from the manufacturing market;
- increased entry barriers – foreclosure may raise barriers to entry by requiring an entrant at one functional level of the market to enter simultaneously at the other, foreclosed level; and
- access concerns – a vertically integrated business that owns an essential facility to which others need access in order to compete at a downstream level has the ability to discriminate in favour of its own affiliated activities in the downstream market. Those affiliated activities could also benefit from information gained about competitors through them requiring access at the upstream level.

133. Vertical integration may also promote efficiencies in circumstances where it leads to the replacement of market transactions with less costly transactions within the business.[28]

[27] *Tru Tone Ltd v Festival Records Retail Marketing Ltd* [ ] 2 NZLR 352.

For example, a firm with very particular supply requirements, or where a critical input is involved, may find it less costly to coordinate supplies of the desired quality through an integrated upstream supplier. Vertical integration may also reduce the transactions costs associated with having to bargain when suppliers are few, and possess market power. Own-supply of part of a firm's requirements for an input may inform the firm about efficient supplier costs. Vertical integration may also overcome supply problems when the supplier may be reluctant to commit to a sunk investment, for fear of opportunistic behaviour by the buyer once the commitment has been made. The transaction costs for the customer may also be reduced, as it may be able to negotiate and enforce a contract with only one party, rather than with two.

134. The issue is whether the addition of Vector's greater Auckland gas distribution network to the gas distribution networks of NGC would lead to such an additional degree of vertical integration that a substantial lessening of competition, relative to the counterfactual, would result.

135. In this instance the issue is the transmission, distribution and retailing of gas. At two of those functional levels – the transmission and the distribution markets – the combined entity would have a significant amount of market power. At the retail level NGC has [ ] large customers in the Auckland region, while Vector is not engaged in this market at present.

136. In its Decision 470 the Commission considered similar vertical integration issues arising as a result of NGC's Acquisition of what is now the greater Auckland gas distribution network of Vector, and other gas distribution networks in Hawkes Bay, Wellington and the Manawatu (now owned by Powerco). On the face of it, the Acquisition involves a lesser increase of vertical integration to that considered in Decision 470. The Commission granted clearance to NGC in that case.

The Ability of Vector to Foreclose Competition Post-Acquisition

Industry Concerns

137. During the Commission's investigation of the Application, several concerns about the Acquisition were raised by industry participants in this regard:

- in the electricity sector there is a competitively neutral power transmitter, and the Electricity Industry Reform Act prevents lines companies from selling electricity. If the Acquisition proceeds, there would be further integration between the monopoly and contestable elements of gas supply;
- although there was supposedly open access to both NGC's and Vector's gas transmission and distribution networks, there were many "special deals" offered by the two companies. Given Vector's potential to enter into gas retailing post-Acquisition, various gas retailers wished to ensure they continue to receive those deals on an equal footing with any gas retail arm of Vector;
- Vector has an incentive to increase the utilisation of its Auckland gas distribution networks, and that it may seek to do this by subsidising Auckland gas prices from transmission. Similarly there was a concern, given that Vector/NGC's gas distribution networks are in the northern half of the North Island, that Vector would seek to bias gas transmission prices in that direction. This would deter competition in the North Island market for retailing of gas to large consumers;

[28] Fletcher Metals Ltd and Fletcher Trust and Investment Co Ltd v Commerce Commission (1986) 6 NZAR 33; News Ltd/Independent Newspapers Ltd (1986) 6 NZAR 47; Dunlop NZ Ltd/Goodyear NZ Ltd (1987) 1 NZBLC (Com) 104,190; and Carter Holt Harvey Ltd/Elders Resources NZFP Ltd (1990) 2 NZBLC (Com) 104,549.

- there was the potential for the internal transfer of confidential competitive information within Vector concerning other parties' applications for connections to transmission pipelines to allow Vector's distribution network to be bypassed;
- Vector could bundle gas transmission, distribution and metering into one package, and this would create barriers to entry or expansion in gas retailing;
- Vector would have the ability to lever its post-Acquisition market power in the treatment of Kapuni gas into the Auckland gas distribution and retailing markets, creating barriers to gas producer/retailers who required gas treatment at Kapuni; and
- Vector is the only gas distributor that requires its gas distribution charges to be paid in advance by retailers. This is a barrier to entry. Concerns exist that this policy could be extended to NGC's gas distribution networks post-Acquisition.

Vector's Response to These Specific Concerns

138. In response Vector submitted that:

- the fact that the Government has decided to implement different regulatory structures for the gas and electricity sectors is not an issue that should be analysed during a clearance application. This transaction cannot be used to undo market structures that already exist;
- there is nothing wrong with customer-specific solutions that recognise competition for large end-consumers from other fuels (coal, electricity or diesel) or by-pass competition. Further, NGC is signatory to the Gas Pipeline Code under which NGC agrees to provide non-discriminatory access. Vector has contractually committed to treat all retailers even-handedly (clause 1.16 of its Agreement for Use of Networks). In addition, the Government Policy Statement on Gas Governance (October 2004) (the GPS) requires a gas industry body to submit arrangements for a gas transmission open access regime by 31 March 2005. Finally, the GPS requires development of consistent standards and protocols across gas distribution pipelines by 31 December 2005. The regulatory environment for gas, following the GPS, is discussed in more detail below;
- Vector, subsidising distribution prices in its greater Auckland gas distribution network from transmission, is unlikely to be an optimising strategy because a transmission pipeline owner has limited ability to influence final delivered gas prices. Transmission and distribution price falls in electricity have not necessarily led to falls in prices to consumers because electricity retailers have taken the reduced prices as extra margin. In any event this would be the kind of behaviour the gas industry regulatory environment seeks to restrain. The Information Disclosure Regulations mean that transmission pricing will be transparent;
- the issue in respect of internal transfers of confidential competitive information exists in the counterfactual. NGC has 'Chinese wall' arrangements in place and Vector would plan on continuing those post-Acquisition;
- the gas industry regulatory environment will control any bundling issues. Again the issue exists in the counterfactual;
- other sources of gas and other processing plants provide competitive constraint on the Kapuni gas treatment plant (including gas that doesn't need processing). This was another example where the factual was no different to the status quo counterfactual. In addition the proposed regulatory environment makes direct reference to regulation for reasonable terms and conditions for access to gas processing; and

- payment in advance is a method of managing credit risk. Vector's ownership of NGC would not change the options available to NGC or Vector in the counterfactual. While NGC is already contractually committed to the way it charges for gas distribution, when those contracts expire it would have the ability to switch to payment in advance if it chose to do so.

Gas Governance and Regulatory Regime

139. The GPS specifies a range of outcomes with short-term deadlines, including reasonable terms and conditions for access to gas processing facilities, gas transmission and distribution pipelines. The outcomes need to be achieved either through industry-led solutions or, if those cannot be achieved, through regulation. The regime is now in existence. Vector has provided the Commission with a diagrammatic representation of the current gas governance and regulatory regime, which is attached as Appendix 1.

140. Vector has noted that the governance regime provided for in the Gas Amendment Act 2004 includes three alternative paths to satisfy the outcomes required by the GPS:

- the Gas Industry Company (GIC - industry body with a regulation-recommending role) may devise industry solutions to meet the outcomes. [ ];
- the GIC, if unable to agree on industry solutions, may directly recommend regulations to the Minister to achieve the GPS outcomes; and
- if the GIC fails to recommend regulations or contractually-bound industry solutions, the Minister has stated he will pass regulations to "bolt on" gas governance onto the Electricity Commission, which will then become the Energy Commission.

141. Vector has submitted that while its Application does not rely only on the constraints of the regulatory environment, it is nevertheless important that the Commission recognises the regulatory environment (for both electricity and gas) in both its factual and counterfactual. Both the electricity and gas regimes are law, with a wide range of regulation-making powers across all functional levels of both industries. Those regimes, and their regulatory threats, are 'here and now', not hypothetical possibilities in the future. Vector submits that the regulatory regime should be considered by the Commission as a relevant constraint on its future conduct.

142. Vector notes the recent statement of the Honourable Pete Hodgson to the Gas Industry Reform Conference:

> I would like to stress however, that it is my preference for co-regulation to be a success, and I would only reach for backstop regulation if the industry process fails. In electricity it did fail and the result is the Electricity Commission. Please don't make me do it twice.

143. In addition, Vector has submitted that:

- the gas industry will be regulated across all functional levels of the industry, whether that be by the GIC, or the Energy Commission;
- the GIC has statutory backing and only needs broad representation of the industry in order be approved by the Minister – this is important, as a minority number of dissenters cannot veto the adoption of the industry-regulator option. Further, and importantly, any dissenters are then bound by the outcomes of the GIC;
- given the statutory requirement that the GIC have an independent Chair, as well as a majority of independent board members, the industry itself cannot dictate the outcomes of the GIC;

- the new regime (section 43ZN Gas Amendment Act 2004) includes a focus on ensuring competitive outcomes, and specifically requires that the objectives of the GIC in recommending gas governance regulations include, amongst others, the following objectives:
  - the facilitation and promotion of ongoing supply of gas to meet New Zealand's energy needs by providing access to essential infrastructure and competitive market arrangements;
  - barriers to competition in the gas industry are minimised; and
  - delivered gas costs and prices are subject to sustained downward pressure.
- The constitution of the GIC must include objectives that are consistent with these objectives (see section 43ZL). These objectives are also stated as specific outcomes that the Energy Commission (if established) must seek to achieve (refer section 43ZZK);
- the GIC is required to report regularly to the Minister on the performance and present state of the New Zealand gas industry and the performance and achievement of the GIC's objectives (refer section 43ZL). As a result, the Minister (in addition to his own advice from officials) will be well informed on an ongoing basis, minimising any delay in the implementation of the Energy Commission regime (should that be required); and
- while the Gas Amendment Act 2004, which invokes the new regulatory regime, is a very important part of achieving the outcomes in the GPS, the Commerce Act and the existing information disclosure regime also supports their achievement.

Analysis

144. NGC is a monopoly transmitter of gas to Auckland. Vector is a monopoly distributor of gas in Auckland, apart from the limited areas served by Nova's bypass network.

145. Absent constraining factors, gas distributors and transmitters have the ability to foreclose potential retail competitors from entering or competing viably in the retail market. For these potential competitors the networks are essential facilities. Foreclosure could, theoretically, take the form of outright denial of access to these networks, discrimination by the network owner in favour of its own retail business, or the use of information supplied by the retail competitor to the network business for the advantage of the network owner's retail business.

146. It may be that vertical integration achieves efficiencies in the retail market for Vector. A price reduction by Vector which reflects those efficiencies would not fall into the market foreclosure category.

Incentives to Foreclose

147. The incentive for Vector to foreclose competition in the gas retail market would arise if this led to, or enhanced, market power, and hence profitability, in the retail market. If it was not able to achieve significant market power in the retail market, the incentive to foreclose would be lessened and the anti-competitive harm from foreclosure would be limited.

Constraints on Foreclosure

148. Potential constraints on the combined entity from engaging in anti-competitive foreclosure post-Acquisition include:

- limited ability to achieve market power: at present NGC has [ ] customers on Vector's network. These are all over-10 TJ users, and represent [ ] of all over-10 TJ users connected to the network. Wanganui Gas has [ ] customers. Others include Contact [ ], Nova Gas [ ], E-Gas [ ] and Genesis [ ]. NGC and Vector do not currently retail to small customers;
- contractual protection of other retailers. all existing retailers (and possibly some other potential retailers) have entered into use of network agreements with Vector[29]. These agreements commit Vector to treat all retailers even-handedly. For the life of these contracts, they provide protection from Vector denying these retailers access, or changing access terms in a way that would put them at a disadvantage to the joint entity. In a similar manner retailers are also protected by NGC's open access regimes for its transmission and distribution networks;
- the provisions of the Commerce Act: a dramatic change in access terms would be very transparent, and would put the joint entity at serious risk of Commerce Act action against it;
- the gas governance arrangements: the changes to the gas sector regulatory regime are in place. Any dramatic action to foreclose competition on Vector/NGC's network would appear to be strategically unsound at this time; and
- constraint from other energy forms: while the Commission has never considered that other energy forms are sufficiently substitutable to place them within the same market as gas, they do provide some constraint on gas utilities. Any anti-competitive behaviour by the joint entity that resulted in higher gas prices would risk substitution occurring, and the amount of gas carried through the Vector/NGC's network reducing.

Evidence from Other Vertically Integrated Gas Supply Situations

149. If the Acquisition takes places, the vertically-integrated structure of the industry in Auckland would match those regions where NGC currently owns networks. The Commission's investigations at the time of Decision 435 indicated that competition on vertically-integrated networks was not materially different than that on non-vertically-integrated networks. Gas retailers reported that it was no more difficult to compete for retail customers on vertically-integrated NGC's distribution networks, than it was on what are now Vector's and Powerco's distribution networks. The Commission has found no evidence in the investigation of this Acquisition that the situation today has changed from that prevailing at the time of Decision 435.

150. Moreover, at the time of Decision 435, access to gas pipelines by gas retailers was achieved under what was termed "light handed regulation". That regime included a voluntary industry access code, information disclosure and the provisions of the Commerce Act. At the time of the Commission's consideration of this Acquisition, matters have changed. A comprehensive and more heavy handed regulatory scheme has been enacted in the Gas Amendment Act 2004 (see Apppendix 1) whose purpose is to provide for the governance of the gas industry. In the Commission's view, this new regime has lessened concerns that Vector's increase in vertical integration would result in a substantial lessening of competition.

Impact on Bypass Competition

151. Within the area covered by Vector's gas distribution network are bypass networks owned by Nova Gas. Nova Gas is both a bypass network owner and a gas retailer. In Auckland

[29] Of between three and five years duration.

it retails to commercial and industrial customers utilizing its own network and also Vector's network. Nova Gas does not make its own networks available to other retailers of gas.

152. In the Gas Control Inquiry Final Report, the Commission found that competition in the gas distribution markets within the vicinity of bypass networks is vigorous. However this covers a relatively small part of Auckland and applies only to the distribution to industrial and commercial gas users. Nova estimated that in Auckland approximately [ ] PJ per annum of gas or [ ]% of the total Auckland volume of [ ] PJ per annum is supplied to customers within [ ] of its network.

153. Nova Gas does not bypass NGC's distribution networks.

154. In a submission to the Commission, Nova Gas has submitted that the Acquisition would result in a substantial lessening of competition in the bypass market. It stated that this would arise from, amongst other things, continued and broadened discriminatory behaviour by Vector as a result of the increase in vertical integration in the sector following the Acquisition.

155. The Commission is currently considering a complaint by Nova Gas that it is being discriminated against by Vector and that this is in breach of the Commerce Act. The Commission has not reached a conclusion on this complaint, but it notes that the behaviour complained of has allegedly taken place without the Acquisition. The Commission is not persuaded that the Acquisition would change market circumstances in a way that would make such behaviour more likely.

156. The Commission considers that competition in the vicinity of bypass pipelines is likely to remain vigorous, post-Acquisition.

Conclusion on Vertical Integration

157. Having considered all these arguments, and consistent with its views in Decision 470, the Commission considers that the slightly greater level of vertical integration arising from the Acquisition would not result in a substantial lessening of competition in any market relative to the counterfactual.

OVERALL CONCLUSION

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

- the TOU meter market;
- the markets for the distribution of gas in the greater Auckland area stretching from the Whangaparoa peninsula to the Bombay Hills, and for the distribution of gas over NGC's networks in Northland, Waikato, Bay of Plenty, Rotorua, Taupo, Gisborne, Kapiti and Wanganui/Rangitikei;
- the market for the transmission of gas in the North Island; and
- the markets for the retailing of gas to small consumers within localised geographic markets, each corresponding to the geographic boundaries of a distribution network, and for the retailing of gas to larger industrial and commercial consumers, which is North Island in scope.

DETERMINATION ON NOTICE OF CLEARANCE

159. Pursuant to section 66(3) (a) of the Commerce Act 1986, the Commission determines to give clearance to Vector Limited, or an interconnected body corporate, to acquire, whether directly or indirectly, up to and including 100% of the shares in NGC Holdings Limited.

Dated this 10th day of December 2004

P R Rebstock

Chair

Commerce Commission

APPENDIX 1

Representation of gas industry governance and regulatory regime

Government Policy Statement on Gas Governance (Oct 2004)
(Range of outcomes across gas industry, including tight deadlines for open access)

Commerce Act

Part 2
(constraint across all business activity; ComCom and private actions possible)

Part 4 & 5
(pipelines inquiry and more focused threat thereafter – Commission or Government can initiate)

Info disclosure
(existing/can be changed)

Gas Amendment Act 2004
(New sector-specific regulatory regime enshrined in law)

Minister of Energy
(Maker of regulations – required to act on Regulator's recommendations)

Industry-specific regulator
(Required to achieve outcomes in GPS (some with deadlines); wide range of regulation-making powers to draw on)

Gas Industry Company (GIC)

-So-called "co-regulatory" model
- Independent Chair required (appointed (Bolger))
- Majority of independent Board members required (appointed)
- Imminent presentation to Minister for approval (GIC constituted)
- Dissenters can't veto establishment or ongoing decisions
- If not approved or not successful, Energy Commission established
-Recommendations must meet competition & efficiency objectives

or

Energy Commission

- Easy bolt on to existing Electricity Commission
- Threat very clear from electricity ("don't make me do it twice" (Minister))
- Gas industry, including Vector/NGC, well attuned to costs of Electricity Commission regime and breadth of powers
- Industry keen to avoid this