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COMMERCE COMMISSION

Decision No. 592

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

SOLID ENERGY NEW ZEALAND LIMITED

and

NEWVALE COAL CO LIMITED

The Commission:	David Caygill Peter JM Taylor Denese Bates QC
Summary of Application:	The acquisition by Solid Energy New Zealand Limited to acquire the entire share capital in Newvale Coal Co Limited.
Determination:	Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance to the proposed acquisition.
Date of Determination:	10 November 2006

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EXECUTIVE SUMMARY

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 21 September 2006. The Notice sought clearance for the acquisition by Solid Energy New Zealand Limited (Solid Energy, or the Applicant), or a wholly-owned subsidiary of Solid Energy, to acquire the entire share capital in Newvale Coal Co Limited (Newvale).

2. The Commission has considered the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the market for the production and wholesale supply of sub-bituminous and lignite coal in the southern half of the South Island (the southern NZ coal market).

3. In the factual scenario, Solid Energy would acquire Newvale. However, the existing coal reserves at Solid Energy's Ohai mine will be depleted by [ ]. All existing customers of Solid Energy will be required to switch to coal from another mine at that time. Accordingly, the Commission considers the relevant counterfactual to be Newvale continuing to supply the market under either its present ownership or an independent third party, with Solid Energy exiting the market in the short term.

4. In the southern NZ coal market, the combined entity would be the main supplier and the smaller competitors in the market would impose only a limited competitive constraint on the combined entity.

5. However, the Commission considers that the proposed acquisition would be unlikely to impede entry into the southern NZ coal market. The Commission considers that in the event that the combined entity contemplated raising prices or reducing quality the potential for entry would act to constrain it.

6. In particular, the Commission notes that the Straith mine, under either the present ownership of Eastern or any other third party, is a likely entrant into the market. Straith coal is of an appropriate quality for customers in the market and the present owner has the production facilities in place for large scale supply.

7. The Commission is therefore satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in any market.

THE PROPOSAL

1. A notice pursuant to s 66(1) of the Commerce Act 1986 (the Act) was registered on 21 September 2006. The Notice sought clearance for the acquisition by Solid Energy New Zealand Limited (Solid Energy, or the Applicant), or a wholly-owned subsidiary of Solid Energy, to acquire the entire share capital in Newvale Coal Co Limited (Newvale).

PROCEDURE

2. Section 66(3) of the Act requires the Commission either to clear or to decline to clear the acquisition referred to in a s 66(1) notice within 10 working days, unless the Commission and the person who gave notice agree to a longer period. An extension of time was agreed between the Commission and the Applicant. Accordingly, a decision on the Application was required by 10 November 2006.

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 determination notice. When that order expires, the provisions of the Official Information Act 1982 will apply.

4. The Commission's approach to analysing the proposed acquisition is based on principles set out in the Commission's Mergers and Acquisitions Guidelines.[1]

STATUTORY FRAMEWORK

5. Under s 66 of the Act, the Commission is required to consider whether the proposal is, or is likely to have the effect of substantially lessening competition in the market. If the Commission is satisfied that the proposal is not likely to substantially lessen competition then it is required to grant clearance to the application. Conversely if the Commission is not satisfied it must decline. 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 substantial lessening of competition test was considered in *Air New Zealand & Qantas v Commerce Commission*, where the Court held;

> We accept that an absence of market power would suggest there had been no substantial lessening of competition in a market but do not see this as a reason to forsake an analysis of the counterfactual as well as the factual. A comparative judgement is implied by the statutory test which now focuses on a possible change along the spectrum of market power rather than on whether or not a particular position on that spectrum, i.e. dominance has been attained. We consider, therefore, that a study of likely outcomes, with and without the proposed Alliance, provides a more rigorous framework for the comparative analysis required and is likely to lead to a more informed assessment of competitive conditions than would be permitted if the inquiry were limited to the existence or otherwise of market power in the factual.[3]

7. In determining whether there is a change along the spectrum which is significant the Commission must identify a real lessening of competition that is not minimal.[4] Competition must be lessened in a considerable and sustainable way. For the purposes of its analysis the Commission is of the view that a

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1 Commerce Commission, Mergers and Acquisitions Guidelines, January 2004.
2 Foodstuffs (Wellington) Cooperative Society Limited v Commerce Commission (1992) 4 TCLR 713-722.
3 Air New Zealand & Qantas Airways Ltd v Commerce Commission, unreported HC Auckland, CIV 2003 404 6590, Hansen J and K M Vautier, Para 42.
4 Fisher & Paykel Limited v Commerce Commission (1996) 2 NZLR 731, 758 and also Port Nelson Limited v Commerce Commission (1996) 3 NZLR 554.

lessening of competition and creation, enhancement or facilitation of the exercise of market power may be taken as being equivalent.

8. 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 ordinarily able to be sustained for a period of at least two years or such other time frame as may be appropriate in any given case.

9. Similarly, when the impact of market power is felt in terms of the non-price dimensions of competition such as reduced services, quality or innovation, for there to be a substantial lessening, or likely substantial lessening of competition, these also have to be both material and ordinarily sustainable for at least two years or such other time frame as may be appropriate.

ANALYTICAL FRAMEWORK

10. 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 access whether a lessening of competition is likely in the 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).

11. 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, in terms of:

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

KEY PARTIES

Solid Energy New Zealand Limited

12. Solid Energy is a state-owned enterprise that mines, processes and distributes coal to both domestic and international customers. Solid Energy's mines are located in the Waikato, the West Coast of the South Island and in Southland. In 2005, Solid Energy's mines produced approximately 4.5 million tonnes of coal.

13. Solid Energy operates the Ohai mine located in Western Southland which produces approximately [ ] tonnes of sub-bituminous coal per year. Presently, Solid Energy does not produce any lignite.

Newvale Coal Co Limited

14. Newvale is a private owned mining company that operates the Newvale mine. The Newvale mine is located on the Waimumu lignite coal field in Eastern

Southland. Currently, the Newvale mine produces approximately [ ] tonnes of lignite per year.

OTHER RELEVANT PARTIES

Kai Point Coal Co Limited (Kai Point)

15. Kai Point is a privately owned and operated coal mine located in the Kaitangata coal field near Balclutha. Currently, Kai Point supplies approximately [ ] tonnes of sub-bituminous coal per year, primarily to customers in the Balclutha and Dunedin areas. Kai Point's subsidiary, A J Allen (1996) Limited (AJ Allen), also sells blended coal to customers.

Harliwich Carrying Co Limited (Harliwich)

16. Harliwich is a privately owned and operated coal mine located near Roxburgh in Central Otago. Currently, Harliwich supplies approximately [ ] tonnes of lignite per year, primarily to customers in the Central Otago area.

Sinclair Contracting Limited (Sinclair Contracting)

17. Sinclair Contracting owns and operates the Waituna coal mine located south-east of Invercargill. Currently, Sinclair Contracting supplies approximately [ ] tonnes of lignite a year.

Eastern Corporation Limited (Eastern)

18. Eastern is a coal and gas exploration company based in Queensland and listed on the Australian Stock Exchange. In June 2005, Eastern acquired the Cascade mine located in the Buller coal fields on the West Coast. Currently, the Cascade mine supplies approximately [ ] tonnes of bituminous coal per year, primarily used by domestic customers.

19. In September 2006, Eastern acquired the Straith mine from Straith Industries Limited.[5] The Straith mine is located in the Nightcaps region in Western Southland and contains sub-bituminous coal. In addition, Eastern recently purchased a distribution yard in Timaru.

Fonterra Co-operative Group Limited (Fonterra)

20. Fonterra is a dairy co-operative and operates several coal burning dairy plants in the lower South Island including the Edendale plant in Southland, the Clandeboye plant in South Canterbury and the Stirling plant in South Otago. Currently, Fonterra uses different coal suppliers for these three plants.

Crown Minerals Group (Crown Minerals)

21. Crown Minerals is a business group of the Ministry of Economic Development. Crown Minerals manages New Zealand's mineral estate as well as providing advice to the government on the relevant legislation such as the Crown Minerals Act 1991.

INDUSTRY BACKGROUND[6]

22. Coal is a combustible, sedimentary, organic rock that is composed primarily of carbon, hydrogen and oxygen. Coal is formed from vegetation that has been

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[5] Subsequently, Eastern changed the name of the mine to Takitimu.

[6] See *Decision 397: Solid Energy New Zealand Limited / Francis Mining Limited*, 4 August 2000 for additional industry background and the relevant references.

consolidated between other rock strata to form coal seams. It is altered by the combined effects of microbial action, pressure and heat over a considerable period of time.

23. The physical and chemical characteristics of coal are determined by the nature of the original plant debris and the degree of chemical alteration of the debris. It is the original plant material and any biochemical changes it goes through prior to burial that determine the coal type. The degree of geochemical alteration, or coalification, during burial determines the ranking of the coal.

24. The result of changes during coalification is a continuous but non-linear development of carbon with the increasing rank of the coal. Peat is very high in moisture and low in carbon content and is the lowest ranking coal. Peat is converted into lignite, a coal type with a low organic maturity. Over time the continuing effects of temperature and pressure produce additional changes in the lignite transforming it into a range of sub-bituminous coal. As the process continues, further changes occur until the coal becomes more mature and is classified as bituminous coal. Under the right conditions, the progressive increase in organic maturity continues to form anthracite.

25. The degree of coalification of coal as it matures from peat to anthracite determines the coal's physical and chemical characteristics. Lower ranked coals, such as lignite and sub-bituminous, are characterised by high moisture levels and a low carbon content and, as such, have a lower energy content. Higher ranked coals are generally harder and characterised by increasing carbon and energy contents and decreasing moisture contents. For example, lignite and sub-bituminous coals, typically, produce between 15 and 25 MJ/kg whilst bituminous produce in excess of 30 MJ/kg.[7]

26. The lower ranked coals are used in the lower South Island primarily, in the dairy and meat industries, for industrial process heating, and by hospitals for sterilisation, heating and laundering purposes. Higher ranked coals contain specialist properties and are typically used as a coking coal in the manufacture of steel. The highest ranking coals in New Zealand are, typically, exported.

27. Coal is mined using two methods: surface or 'open cast' mining and underground. The type of method used is determined by the geology of the coal deposit. Open cast mining recovers a higher proportion of the coal deposit than the underground mining methods. However, open cast mining is only economic when the coal seam is near the surface. The strata between the coal seams and the surface is called 'overburden', and the level of overburden impacts on the economics of mining. Currently, all coal mines operating in the lower South island are opencast.

28. Coal is New Zealand's most abundant fossil fuel with in-ground deposits estimated to be in excess of 15 billion tonnes, although not all of this coal is classified as economically recoverable. Lignite deposits in Southland account for the vast majority of these in-ground deposits. [8]

29. In 2005, New Zealand produced over five million tonnes of coal, with the bulk of this coal extracted from mines in the Waikato and the West Coast of the

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[7] For example, see JM Barry et al, *Coal Resources of New Zealand*, Ministry of Commerce, 1994.
[8] For example, see S Edbrooke, Mineral Commodity Report 18 – Coal, *New Zealand Mining*, 1999, vol 25, 12.

South Island.[9] Solid Energy is New Zealand's largest coal producer and accounts for over 80% of total production.[10] Table 1 indicates the total New Zealand coal production by rank and by location for 2005.

Table 1: New Zealand Coal Production by Rank and Location for 2005

Region	Bituminous	Sub-Bituminous	Lignite	Total (tonnes)
Waikato	-	2,119,909	-	**2,119,909**
West Coast	2,543,404	112,194	-	**2,655,598**
Canterbury	-	3,929	-	**3,929**
Otago	-	54,602	1,584	**56,186**
Southland	-	186,678	244,862	**431,540**
Total (tonnes)	**2,543,404**	**2,477,312**	**246,445**	**5,267,162**

Source: Crown Minerals.

30. The main coalfields in the lower South Island are located in the eastern and central regions of Southland. The Newvale mine, near Gore, primarily supplies industrial customers with lignite and is the only supplier of lignite of any significance. Solid Energy's Ohai is the main supplier of sub-bituminous coal in the Southland region.

PREVIOUS COMMISSION DECISIONS

31. The Commission has previously considered applications in respect of the coal industry, including:

- *Decision 397: Solid Energy New Zealand Limited / Francis Mining Limited*, 4 August 2000 (The Francis Decision); and
- *Decision 432: Solid Energy New Zealand Limited / Todd Coal Limited*, 28 June 2001 (The Todd Decision).

32. In both these Decisions, the Commission considered there was a degree of substitutability between the different types of coal; however, this substitutability was not sufficient to define a product market incorporating every type of coal. For example, in the Francis Decision the Commission considered the relevant market to include bituminous and sub-bituminous thermal coal and to exclude coking coal and lignite. In addition, the geographic markets were limited in scope as coal is, typically, not transported great distances.

33. The Commission granted clearance in both these decisions as it considered the combined entities would be constrained by the strength of existing competition and the ability of competitors to expand their production. The Todd Decision also noted the countervailing power of larger customers.

MARKET DEFINITION

34. The Act defines a market as:

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[9] Source: Crown Minerals, see www.crownminerals.govt.nz/coal/facts/index.html .
[10] Source: Solid Energy's Annual Report 2006.

> "… 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."[11]

35. 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 dimensions of the 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.

Product Market

36. 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.

37. 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.

38. Close substitute products on the supply-side are those between which suppliers can easily shift production, using largely unchanged production facilities and little or no additional investment in sunk costs, when they are given a profit incentive to do so by a small change to their relative prices.

39. Solid Energy produces sub-bituminous coal from its Ohai mine located in Western Southland while Newvale produces lignite from its mine near Gore. Both these coals are used principally to fuel industrial boilers and kilns in the Southland, Otago and South Canterbury regions,

40. The Applicant submitted that all forms of energy such as LPG, diesel and woodwaste compete with coal to some extent and that New Zealand is moving towards a single thermal energy market.

41. Nevertheless, the Applicant submitted that, while noting there are arguments for a wide market definition, the relevant market is that for the mining and distribution of lignite and sub-bituminous coal in the southern half of the South Island, which includes South Canterbury but excludes the greater Christchurch region.

<u>Differentiated/Undifferentiated Products</u>

42. Differentiated product markets are those in which the product offerings of suppliers vary to some degree and in which buyers make their purchase decisions on the basis of product characteristics as well as price. Suppliers' products are imperfect substitutes for one another and less close substitutes impose a lesser competitive constraint than others.

43. A "chain" of substitutes may be evident and, if there is no obvious break in the chain, there may be no obvious point where the boundary of the market can be drawn. If the competition analysis of an acquisition is sensitive to the market definition used, the Commission might not define the market precisely and

[11] s3(1A) of the Commerce Act 1986.

might instead focus on the competition analysis and the impact of the acquisition on prices.

44. As set out in the Commission's Mergers and Acquisitions Guidelines, “this approach recognises that in a differentiated product market, a structural analysis that takes into account market definition and market share may not be as helpful in judging market power as one that focuses on the degree of substitutability between products, and on the amount of competitive constraint that each imposes upon the others.”

45. Industry participants advised the Commission that coal is not a typical commodity product but rather coal has a number of different, yet important, characteristics. These characteristics affect the relative value of the coal and include:

- calorific value (which represents the energy value);
- sulphur content;
- ash levels;
- fine content, which represents the proportion of coal under a specified size; and
- moisture level.

46. Industry participants advised the Commission that these characteristics vary in importance depending on the requirements of the end customer, typically the specifications of the boiler or kiln. For example, the higher the calorific value the higher the cost of the coal but, typically, less is required. High ash levels may increase maintenance costs and a high sulphur content may increase omission levels.

47. Industry participants noted that the calorific value is arguably the most important factor as this represents the energy value the customer will receive from the coal; if the calorific value is too low, the boiler will not produce enough steam or the customer would be required to purchase more coal. However, a customer is unlikely to rely solely on the energy value because, if the calorific value is too high, burning the higher rank coal may cause damage to the boiler in the short term.

48. Boilers are tuned to burn coal with particular specifications. This ensures that the customer gets maximum efficiency from the fuel and also prolongs the lifetime of the boiler. As such, coal from various coal mines may not be perfect substitutes for each other.

49. However, the Commission understands that, in most instances, boilers can be modified to burn coal of a different quality (than the one currently used).[12] For example, some coal users have recently modified their boilers to take a different type of coal. Taylor’s Lime[13] is currently spending approximately [ ] to modify its [ ] kiln to take a new type of coal. The Commission previously noted that switching between coal types does not involve a high level of incremental cost.[14]

[12] The Commission notes that some boilers can be more readily modified than others.
[13] Taylor’s Lime is a subsidiary of Holcim (New Zealand) Limited
[14] See the Francis Decision.

50. In addition, the Commission understands that there is a reasonable degree of correlation between the prices of the different types of coal, when adjusted for their energy levels. This would suggest that they each have an influence on the price of the other.

51. However, several industry participants noted that any switching between coals, such as sub-bituminous coal and lignite, would be infrequent and would usually occur when a coal user was upgrading an existing boiler. In these instances, customers may consider other energy forms, such as LPG, diesel or woodwaste, as potential substitutes, particularly when a boiler is coming to the end of its economic life.

52. The Commission notes that Solid Energy only produces sub-bituminous coal and Newvale only produces lignite. While acknowledging that there are arguments in favour of both a narrow and broad product market, the Commission considers that for the purposes of the present application, the relevant competition effects are best identified by including sub-bituminous coal and lignite in the same product market.

53. The Commission concludes that for the purpose of assessing the competition implications of the proposed acquisition, the appropriate product market includes both sub-bituminous coal and lignite.

Functional Market

54. The production, distribution and sale of a product typically occurs through a series of functional levels – for example, the manufacturing/import level, the wholesale/distribution level and the retail level. It is often useful to identify the relevant functional level in describing a market, as a proposed business acquisition may affect one horizontal level, but not others. Generally, the Commission will seek to identify separate relevant markets at each functional level affected by an acquisition and assess the impact of the acquisition on each.

55. Both the Applicant and Newvale produce and supply coal from their respective coal mines. Accordingly, the Commission considers that the relevant functional level is that for the production and wholesale supply.

Geographic Markets

56. 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.

57. Both Solid Energy's Ohai mine and the Newvale mine supply coal almost exclusively to customers in the southern half of the South Island. For example, approximately [ ] of Newvale's customers are located in Southland. Industry participants advised the Commission that due to the large quantities of coal required by customers, transportation costs make up a high component of the end price. As such, it is uneconomic to transport low ranked coal large distances, particularly lignite.

58. The Applicant and Newvale advised the Commission that only a minimal amount of their respective coal is transported outside the Otago and Southland regions. In addition, the Commission understands that there is very little West Coast coal used in either Otago or Southland.

59. Solid Energy's Ohai mine's largest customer is Fonterra's Clandeboye plant in Temuka. Fonterra advised the Commission that

[ ]. In this respect, the Commission considers it appropriate to include the Clandeboye plant as a customer within the relevant geographic boundaries and to exclude coal supply from the West Coast.

60. Accordingly, the Commission considers that, for the purposes of the present application, the appropriate geographic market is the southern half of the South Island.

Conclusions on Market Definition

61. The Commission concludes that the relevant market is the production and wholesale supply of sub-bituminous and lignite coal in the southern half of the South Island (the southern NZ coal market).

COUNTERFACTUAL AND FACTUAL

62. In reaching a conclusion about whether an acquisition is likely to lead to a substantial lessening of competition, the Commission makes a comparative judgement considering the likely outcomes between two hypothetical situations, one with the acquisition (the factual) and one without (counterfactual).[15] The difference in competition between these two scenarios is then able to be attributed to the impact of the acquisition.

Factual

63. In the factual scenario, the combined entity would be the main coal supplier in southern New Zealand with Kai Point also supplying the market. A number of other mines would also be operating; however, other than the combined entity and Kai Point, these operators are not presently supplying more than 10,000 tonnes per annum, respectively.

64. Solid Energy advised the Commission that the Ohai mine will close between [ ] due to a lack of economically recoverable coal reserves. Solid Energy submitted that it has conducted extensive drilling and feasibility studies on the mine and has failed to identify additional economic reserves. In this respect, the Applicant advised the Commission that the proposed acquisition would allow it to remain a competitor in the market.

Counterfactual

65. Newvale advised the Commission that the existing owners have no long term aspirations to continue in the mining industry. In this respect, Newvale has approached potential purchasers including [ ] and Solid Energy.

66. Solid Energy advised the Commission that the Ohai mine will not be supplying coal after [ ] Currently, the mine has an economic reserve of approximately [ ] tonnes of sub-bituminous coal and, based on existing demand, this reserve would be depleted by [ ].

67. The Commission considers the relevant counterfactual to be Newvale continuing to supply the market under either its present ownership or an independent third party, with Solid Energy exiting the market in the short term.

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[15] Air New Zealand & Qantas Airways Ltd v Commerce Commission (No.6), unreported HC Auckland, CIV 2003 404 6590, Hansen J and KM Vautier, Para 42.

COMPETITION ANALYSIS

Existing Competition

68. 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).

69. 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.

70. A business acquisition is considered unlikely to substantially lessen competition in a market where, after the proposed acquisition, either of the following situations exist:

    - 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 persons or associated persons) has less than in order of 40% share; or
    - 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%.

71. 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.

72. Industry participants advised the Commission that it is relatively common to measure market share in this industry by the quantity of coal extracted from each mine. Typically, this is measured in tonnes per annum. Alternatively, another form of measurement is to calculate the total energy value of the supplier, calculated by multiplying the annual quantity by the calorific value of the coal.

The Southern NZ Coal Market

73. The major producers of coal in the southern New Zealand coal market are Solid Energy, Newvale and Kai Point. A number of smaller competitors such as Harliwich and Sinclair Contracting also supply the market.

74. Table 2 shows the total volumes of coal supplied in the southern New Zealand region in the 2005/2006 year.

Table 2: Estimated Total Volumes of Coal Supplied in the Southern New Zealand region for the 2005/2006 Year

Supplier	Calorific Value	Quantity (tonnes pa)	Percentage of Total	Energy value (million MJ)	Percentage of Total
Solid Energy	25.1 MJ/kg	[ ]	[ ]	[ ]	[ ]
Newvale	15.3 MJ/kg	[ ]	[ ]	[ ]	[ ]
Combined entity	-	*[ ]*	*[ ]*	*[ ]*	*[ ]*
Kai Point	19.6 MJ/kg	[ ]	[ ]	[ ]	[ ]
All other suppliers	Various	[ ]	[ ]	[ ]	[ ]
Total	**-**	**[ ]**	**100%**	**[ ]**	**100%**

Source: Industry participants, Commission estimates

75. Table 2 indicates that, post acquisition, the combined entity would supply [ ] of the total volume in the southern New Zealand region, Kai Point would be supplying approximately [ ]% and all other suppliers would be supplying approximately [ ]%.

76. However, the Commission notes that a significant volume of coal supplied to the market is contracted. Where those contracts are for significantly long periods of time, the subject volumes of coal may not be contestable. The Commission is of the view that including non-contestable volumes in the market may not reflect the true size of the market. For that reason, the Commission has assessed the contestability of the coal volumes supplied in the southern New Zealand region.

Contestable versus Non-contestable Volumes

77. The following table indicates the volume of coal sold by the participants in the market to their respective customers in the southern New Zealand region, together with the length of any contracts and their expiry dates.

Table 3: Volume of Coal Sold by Suppliers of Coal in the Southern New Zealand Region in the 2005/2006 Year, including Contract Details.

Supplier	Customer	Quantity (tonnes pa)	Term	Expiry (if applicable)
Solid Energy	Fonterra (Clandeboye)	[ ]	[ ]	[ ]
	Meridian Energy Limited	[ ]	[ ]	[ ]
	McKay Group Limited	[ ]	[ ]	[ ]
	Southern Transport Company Limited	[ ]	[ ]	[ ]
	Taylor's Lime	[ ]	[ ]	[ ]
	All other customers	[ ]	-	-
	Sub-total (Solid Energy)	***[ ]***		
Newvale	Fonterra (Edendale)	[ ]	[ ]	[ ]
	Alliance Group Limited	[ ]	[ ]	[ ]
	Clifton Wool Scour Limited	[ ]	[ ]	[ ]
	SDHB	[ ]	[ ]	[ ]
	Prime Range Meats Limited	[ ]	[ ]	[ ]
	All other customers	[ ]	[ ]	[ ]
	Sub-total (Newvale)	***[ ]***		
Combined entity		***[ ]***		
Kai Point	All customers	[ ]	[ ]	[ ]
All other suppliers	[ ]	[ ]	[ ]	[ ]
Total all suppliers		**[ ]**		

Source: Solid Energy, Newvale, industry participants

78. Table 3 shows that there is one significant long term contract in the southern New Zealand coal market. This is between Newvale and Fonterra. In addition, there are a number of other coal supply contracts ranging in term from [ ] years and these contracts are due to expire between [ ].

79. Fonterra is the main customer of Solid Energy in the southern New Zealand region. Currently, Solid Energy supplies Fonterra's Clandeboye plant with all its coal requirements. The existing contract is due to expire in [ ].

80. Fonterra advised the Commission that it is currently assessing its options for future supply to the Clandeboye plant and has issued an RFP to potential suppliers.[16]

81. Fonterra advised that, at this stage, the [ ] most realistic responses to the RFP were from [ ].

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[16] [ ]

[ ]

82. [ ]. The Commission considers that the volume covered by this contract is presently contestable.

83. Table 3 indicates that Solid Energy also had contractual relationships with [ ] advised the Commission that it is actively seeking a new supplier because Solid Energy has not been able to guarantee [ ] sufficient long term supply due to the imminent closure of the Ohai mine. The Commission considers that the volume covered by this contract is also presently contestable.

84. [ ]. To this extent, the Commission will include this volume in the contestable market.

85. Aside from the Fonterra contract, the Commission notes that a significant proportion of Solid Energy's customers are not committed to long term contracts. Solid Energy advised the Commission that one of the reasons for this is it has to be certain of its ability to supply these customers in the future, given the likely closure of the Ohai mine.

86. The Commission considers that, because of the likely closure of the Ohai mine, all existing customers of the mine will be required to switch to another source of coal. In this respect, all the existing volumes of Solid Energy in the southern New Zealand region are likely to be contestable.

87. Newvale has [ ] contracts in place with its customers. These include a [ ] contract with Alliance Group Limited and a [ ] contract with the Southland District Health Board (SDHB). These contracts will both be contestable within the [ ].

88. Newvale also has a long term contract with Fonterra, for coal supply to Fontera's Edendale plant. Currently, Newvale is contracted to supply Fonterra [ ]

89. The Commission notes that the effect of this contract is to make the supply to the Fonterra's Edendale plant non-contestable for other competitors in this market until [ ]. For example, absent a forfeit of contract, no existing (or potential) competitor could tender for this contract. Consequently, the Commission is of the view that the non-contestable volume of coal supplied to Fonterra's Edendale plant should not be considered to be contestable in the relevant market.

90. To this extent, Table 4 shows the contestable volumes of coal in the southern New Zealand coal market.

Table 4: Contestable Volumes in the Southern NZ Coal Market

Existing Supplier	Existing Customers	Quantity (tonnes pa)
Solid Energy	Fonterra (Clandeboye)	[ ]
	Meridian Energy Limited	[ ]
	All other Solid Energy customers	[ ]
Newvale	Alliance Group Limited	[ ]
	Clifton Wool Scour Limited	[ ]
	All other Newvale customers	[ ]
Combined entity		*[ ]*
Kai Point	No customers under long term contracts	[ ]
All other suppliers	No customers under long term contracts	[ ]
Total contestable volume		**[ ]**

Source: Commission estimates

91. Table 4 indicates that the volume of coal that is contestable in the market is approximately [ ]. Post acquisition, the combined entity would be supplying [ ] tonnes of that volume. This represents approximately [ ] of the contestable market. Kai Point would have a [ ] share of the market and the three-firm concentration ratio would be approximately [ ]. This is outside the Commission's safe harbours.

92. However, as previously stated, Solid Energy advised the Commission that the Ohai mine will close between [ ] due to a lack of economically recoverable coal reserves. Further, Solid Energy stated that the remaining coal resource at the mine is largely committed to existing customers, particularly the supply to Fonterra's Clandeboye plant. In this respect, the Commission considers that Solid Energy will be unable to continue its current level of production from the Ohai mine.

93. Solid Energy further submitted that post-acquisition, competition between existing coal suppliers would constrain the combined entity, noting that:

- the supply of sub-bituminous coal and lignite in the region is the most competitive in New Zealand; and
- suppliers have sufficient production capacity to supply large quantities of coal.

94. Industry participants advised the Commission that there is not a high degree of day-to-day competition between the respective coal suppliers. However, all existing customers stated that when a significant purchase decision arises, such as when a contract is due to expire or a new boiler is to be purchased, competition between the relevant suppliers increases.

95. For example, boilers or kilns are generally tuned to burn coal with particular specifications and any change to these specifications can change the performance of the boiler. In this respect, customers do not switch between

suppliers on a routine basis. However, as noted in the market definition section, industry participants advised the Commission that boilers and kilns can be modified to burn different coals, if an incentive is given.

96. For example, Alliance Group Limited advised the Commission that it switched from Solid Energy to Newvale coal when it installed a new boiler in its Lorneville Plant, as did the SDHB when it also installed a new boiler.

97. Industry participants informed the Commission that, to a large extent, the level of competition between coal suppliers is determined by the requirements of customers, namely:

- the price of the coal relative to its energy value;
- the specifications and quality of the coal; and
- the proximity of the mine to the customer.

98. The price of coal relative to its energy value is one of the main considerations for customers. For example, customers of Newvale consider Newvale's lignite to be the cheapest energy source, particularly when compared to Solid Energy's higher priced (yet higher energy value) sub-bituminous coal.

99. Several industry participants considered that the specifications of coal are an important consideration for them, such as the ash content and the number of contaminants (eg rocks) in each coal load. In particular, several coal users did not consider Kai Point to be a feasible alternative provider because of the high sulphur content of the Kai Point coal. For example, [ ] advised the Commission that it could not burn Kai Point coal [ ] because the resulting emission would likely breach its existing resource consents.

100. Industry participants also noted that different coals can be blended together to meet the specific needs of the customer. For example, Kai Point coal can be blended with another supplier's coal to reduce the sulphur level. Typically, retailers or coal merchants perform the blending and industry participants advised that the process is not complicated. For example, [ ] blends Newvale lignite and Solid Energy Ohai coal itself. However, industry participants advised the Commission that it is relatively uncommon for larger users to use a blend because of their ability to adjust their particular boilers for each type of coal.

101. Industry participants advised the Commission that the proximity of the mine to the customer is also an important competitive dynamic. For example, the transportation component can make up as much as 40% of the total cost to a purchaser. In this respect, Fonterra advised the close proximity of the Newvale mine to its Edendale plant is one of its major reasons for selecting this supplier. Further, PPCS Limited purchases coal for its Finegand plant from the nearby Kai Point mine and the low transportation component (in comparison to another supplier) offsets its concerns over the sulphur content of the Kai Point coal.

102. The Commission notes that, in the factual scenario, the combined entity would be the largest supplier in the market. The other competitors are significantly smaller, the mines are located further away from the main customers (in relation to the combined entity) and, for some customers, the type of coal is unlikely to be a realistic substitute. In this respect, the Commission considers that at current levels of production, existing competitors would provide a limited constraint on the combined entity.

Barriers to Expansion

103. The Applicant submitted that all current suppliers of lignite and sub-bituminous coal have the potential to increase production in response to higher prices or to meet additional demand within the market. The Applicant stated that opencast mining requires relatively limited capital investment for production expansion. Currently, all existing mines in the southern half of the South Island are open cast mines.

104. However, all industry participants interviewed advised the Commission that demand for coal in the market is relatively static. Demand for coal from domestic customers is low, so commercial customers such as hospitals, factories and freezing works are highly sought after. The Commission has estimated in Table 4 above that there are presently [ ] tonnes of contestable coal supply business in the market.

105. All existing mining operators advised the Commission that once a mine is operational the cost of increasing production by a small percentage is minimal. For example, Kai Point could increase its capacity by [ ] using its existing production facilities. However, as previously stated some parties would be reluctant to switch to Kai Point coal because of the coal's higher sulphur content and the need to blend it, in many instances, with the coal of other suppliers.

106. Harliwich advised the Commission that it could increase production from [ ] tonnes pa without difficulty, if there was sufficient demand. The Commission considers that if Harliwich expanded to its maximum capacity, competition for the supply of [ ] tonnes, or [ ] of the market, it would provide some constraint on the combined entity but only to a limited degree.

107. Accordingly, the Commission considers that existing competitors' ability to expand would only provide a limited constraint on the combined entity.

Conclusions on Existing Competition

108. In the factual scenario, the combined entity would be the major supplier of coal to the market. The Commission considers that the remaining competitors in the market would provide limited competitive constraint on the combined entity, given their limited ability to expand.

Potential Competition

109. 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. 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 impediments they might encounter should they try.

110. The Applicant submitted that the potential for new entry would act to constrain the combined entity in the factual scenario. In particular, the Applicant noted the recent acquisition of the Straith mine by Eastern.

111. In September 2006, Eastern acquired the Straith mine from Straith Industries Limited. This mine is located in the same region as Solid Energy's Ohai mine and contains sub-bituminous coal. Straith Industries Limited stated that it had not been marketing the coal from the mine, preferring to concentrate on its other

business interests.
[ ]

Barriers to Entry

112. 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 market conditions that impede entry.

113. Industry participants advised the Commission that the requirements for entering the southern NZ coal market include:

- access to customers;
- sufficient coal reserves;
- reputation;
- access to transport; and
- the relevant permits and licences;

Access to customers

114. All industry participants advised that demand for coal in the market is relatively static. As such, access to customers is a key criterion for any potential coal supplier.

115. However, as previously stated, the Commission considers that in the factual scenario there would be at least [ ] tonnes of contestable business in the market. In addition, the Commission notes that existing customers of Solid Energy will also be required to switch to an alternate source of coal due to the likely closure of the Ohai mine [ ]. The Commission notes that Ohai coal makes up around [ ] of the market.

Coal reserves

116. The Commission notes that Eastern has stated that the Straith mine has a resource of 2.85 million tonnes of sub-bituminous coal and all necessary consents and infrastructure are in place to produce in excess of 100,000 tonnes pa.[17] Straith Industries Limited also advised the Commission that the mine could easily expand production and it previously had plans to extract approximately [ ] from the mine.

117. The Commission considers that, unlike Solid Energy's Ohai mine, the Straith mine has sufficient economically recoverable reserves that a potential supplier could extract to become a viable competitor in the market.

Reputation

118. Existing purchasers of coal advised the Commission that reputation and the ability to guarantee supply are important considerations when selecting a coal supplier. In this respect, customers stated that they would be cautious about selecting an unproven supplier. The reasons for this include:

- reliability – any disruption to coal supply has a negative effect on a customer's output; and

[17] ASX announcement, 5 September 2006, see www.asx.com.au .

- storage – customers often do not have the storage space for large amounts of coal so they rely on regular (often daily) deliveries;

119. The Commission understands that large coal users may be reluctant to switch to a new producer if they have doubts about that producer's on-going ability to supply. A new producer would typically need a contract in order for it to be viable, but the customer needs to see viability demonstrated before it will sign a contract. For example, [ ] advised the Commission that it would be cautious about selecting an unproven supplier because of the need to guarantee supply to the [ ], which is classed as an 'essential' service.

120. The Commission notes that all existing customers of Solid Energy will be required, in time, to switch from Ohai coal to coal from another mine. Therefore, no existing customer of Solid Energy has long term security of supply, [ ]. For example,
[
].

121. Therefore, the Commission considers that Solid Energy's existing customers, in both the factual and counterfactual scenarios will have to switch coal source by [ ]. In this respect, the Commission considers that these customers will be more open to considering an alternative supplier.

122. Industry participants noted that, all things being equal, a customer is more likely to switch to coal with an equivalent energy rating / quality than coal with a lower energy rating, in order to avoid having to adapt its boiler. The Commission notes that the Straith coal has the closest energy rating to that currently supplied from the Ohai mine.

123. [
]

124. In this respect, Fonterra considered Eastern to be a realistic competitive threat to Solid Energy. [ ]

125. The Commission considers that if the combined entity contemplated raising prices or restricting supply, customers would have a strong incentive to assist a new entrant if they considered the potential entrant had a reasonable financial standing, credibility and an appropriate coal resource.

126. In addition, the Commission considers that, even if Eastern does not proceed to develop the Straith mine, it is likely that another entity could. The Straith mine has significant quantities of sub-bituminous coal while the only other significant source of this type of coal in the market, Ohai, will be depleted by [ ]. Further, the Commission notes that Eastern has indicated that it could readily expand output from the mine.

127. Therefore, the Commission considers that customers would have the ability to switch to supply from the Straith mine, under the existing ownership of Eastern or any other subsequent owner, should the combined entity attempt to exercise any market power which might otherwise exist in the factual scenario. Any potential entrant would need to demonstrate that it can supply coal reliably; however, the Commission does not consider this would impede entry in this market.

Access to Transport

128. Industry participants advised the Commission that the cost of transporting coal is one of the main concerns in this industry. However, industry participants noted that the physical transportation of coal is typically contracted out to third party transport companies.[18] In this respect, no industry participant considered that it was difficult for a supplier to transport coal; the main concern is the price they are charged.

129. However, Eastern submitted that Solid Energy has access to substantial amounts of rail capacity – far in excess of what is currently needed to supply existing customers. Eastern submitted that Toll NZ Limited is unlikely to add additional capacity without a significant commitment from a potential coal supplier such as itself.[19] As such, a potential entrant would have to approach Solid Energy to acquire its rail capacity, or use road transport.

130. The Commission understands that the only major rail link used for the transportation of coal in the relevant market is that currently used to supply Fonterra's Clandeboye plant. Currently, Solid Energy has an agreement with Toll NZ Limited for rail supply. Solid Energy submitted that [ ] In this respect, the Commission considers that if Fonterra decided to switch to another coal supplier, for instance to supply from the Straith mine, it would have the opportunity to continue the existing agreement with Toll in regards to supply to Clandeboye.

131. The Commission considers that, in the factual scenario, the existing relationship between Solid Energy and Toll NZ Limited would not foreclose a potential competitor from negotiating commercial terms with Toll NZ Limited.

132. Further, industry participants advised the Commission that road transportation is, arguably, a more efficient method of transporting coal when customers are reasonably close to the coal mine. For example, [ ]

133. Accordingly, the Commission does not consider access to transport would impede entry in this market.

Permits and licences

134. In the Todd Decision, the Commission concluded that entry conditions and barriers to the market were high with the principal barriers being high start-up and development costs, obtaining necessary licences, permits and resource consents, and the risks in developing a mine. The Commission notes that these conditions were in respect to underground mining. The present case relates to open cast mining.

135. The Commission notes that obtaining the relevant permits and resource consents can be difficult and time consuming for many mining operations. However, the

[18] The Commission notes that Newvale is an exception, as it is one of the few suppliers with a large fleet of its own trucks.

[19] Industry participants advised the Commission that the main bottle neck in respect of access to rail transport is on the alpine rail link between the West Coast and Christchurch. The coal from these regions falls outside the boundaries of the relevant market.

Ministry of Economic Development advised the Commission that, in respect of open cast lignite mining in Southland, this may not be a substantial barrier because the lignite reserves are plentiful and, in the main, close to the surface.

136. In addition, Eastern stated that barriers to entering into coal mining in New Zealand are low. It said that "the geology is well known, there being extensive in-ground coal resources, the industry has a high degree of professionalism and the government provides experienced, efficient regulation that encourages exploration and development".[20]

137. Further, Straith Industries Limited advised the Commission that little effort was required to transfer the licences for the Straith mine to Eastern. The Commission understands that Eastern now holds all the permits required to operate the Straith mine as well as additional permits for the surrounding areas.

138. Accordingly, the Commission does not consider that the regulatory requirements would impede entry via the Straith mine in this market.

Strategic incentives of the combined entity

139. Eastern advised the Commission that the proposed acquisition would allow the combined entity to act strategically and thereby alter the commercial incentives for Eastern to compete in this market.

140. For example, Eastern claimed that [ ]. The Commission considers however that due to the likely closure of the Ohai mine any such threat by Solid Energy is likely to be hollow.

141. The Commission notes that most supply contracts are for exclusive supply. Typically, coal users do not want the inconvenience of having multiple sources of supply. However, no customer advised the Commission that it felt inhibited about changing suppliers if it became in its best interests to do so. As such, the Commission considers that it is rational for customers, in both the factual and counterfactual scenarios, to seek reasonably long term contracts to limit supply and price risk.

142. In addition, as stated previously, other than the Fonterra contract with Newvale, there are no long term contracts in place. In this respect, an existing or potential supplier would likely have an opportunity to compete for these contracts when they are next tendered. Existing customers such as [ ] advised the Commission that in the factual scenario, they considered that there would be alternative options for them to be able to test the market.

143. [ ]

144. The Commission considers that the combined entity would have an incentive to respond to the threat of a new entrant into the market. However, the Commission does not consider that the combined entity would have the ability,

[20] Eastern, Annual Report 2006.

in the factual scenario, to respond to the threat of potential entry in a manner that would limit the ability of a potential competitor to enter the market.

Conclusion on Potential Competition

145. The Commission considers that the barriers to entry in the southern NZ coal market would be unlikely to impede entry. The Commission considers that in the event that the combined entity contemplated raising prices or reducing quality the potential for entry would act to constrain it.

146. In particular, the Commission notes that the Straith mine, under either the present ownership of Eastern or any another third party, is a likely entrant into the market. Straith coal is of an appropriate quality for customers in the market and the present owner has the production facilities in place for large scale supply.

147. In addition, the Commission considers that the threat of entry would be increased by the requirement of all the existing customers of the Ohai mine to switch to an alternate coal supply in the short term.

OVERALL CONCLUSION

148. The Commission has considered the probable nature and extent of competition that would exist, subsequent to the proposed acquisition, in the market for the production and wholesale supply of sub-bituminous and lignite coal in the southern half of the South Island (the southern NZ coal market).

149. In the factual scenario, Solid Energy would acquire Newvale. However, the existing coal reserves at Solid Energy's Ohai mine will be depleted by [ ]. In this respect, all existing customers of Solid Energy will be required to switch to coal from another mine at that time. Accordingly, the Commission considers the relevant counterfactual to be Newvale continuing to supply the market under either its present ownership or an independent third party, with Solid Energy exiting the market in the short term.

150. In the southern NZ coal market, the combined entity would be the main supplier and the smaller competitors in the market would impose only a limited competitive constraint on the combined entity.

151. However, the Commission considers that the proposed acquisition would be unlikely to impede entry into the southern NZ coal market. The Commission considers that in the event that the combined entity contemplated raising prices or reducing quality the potential for entry would act to constrain it.

152. In particular, the Commission notes that the Straith mine, under either the present ownership of Eastern or any other third party, is a likely entrant into the market. Straith coal is of an appropriate quality for customers in the market and the present owner has the production facilities in place for large scale supply.

153. Therefore, the Commission considers that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening of competition in any market.

DETERMINATION ON NOTICE OF CLEARANCE

154. Pursuant to section 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance for the proposed acquisition by Solid Energy New Zealand Limited, or a wholly-owned subsidiary of Solid Energy New Zealand Limited, to acquire the entire share capital in Newvale Coal Co Limited.

Dated this 10th day of November 2006

David Caygill
Deputy Chair
Commerce Commission