Public Competition Assessment

14 February 2013

APA Group - proposed acquisition of Hastings Diversified Utilities Fund

Introduction

1. On 19 July 2012, the Australian Competition and Consumer Commission (**ACCC**) announced its decision not to oppose the proposed acquisition of Hastings Diversified Utilities Fund (**HDF**) by APA Group (**APA**) (**proposed acquisition**), subject to an undertaking accepted by the ACCC on 19 July 2012 pursuant to section 87B of the *Competition and Consumer Act 2010* (Cth) (the **Act**). The ACCC decided that the proposed acquisition, in conjunction with the undertaking, would not be likely to have the effect of substantially lessening competition in any market in contravention of section 50 of the Act.

2. The ACCC made its decision on the basis of the information provided by the merger parties and information arising from its market inquiries. This Public Competition Assessment outlines the basis on which the ACCC has reached its decision on the proposed acquisition, subject to confidentiality considerations.

Public Competition Assessment

3. To provide an enhanced level of transparency in its decision making process, the ACCC issues a Public Competition Assessment for all transaction proposals where:

   - a transaction is opposed;
   - a transaction is subject to court enforceable undertakings;
   - the transaction parties seek such disclosure; or
   - a transaction is not opposed but raises important issues that the ACCC considers should be made public.

4. This Public Competition Assessment has been issued because APA's proposed acquisition of HDF is subject to a court enforceable undertaking.

5. By issuing Public Competition Assessments, the ACCC aims to provide the public with a better understanding of the ACCC's analysis of various markets and

the associated merger and competition issues. It also alerts the public to circumstances where the ACCC's assessment of the competition conditions in particular markets is changing, or likely to change.

6. Each Public Competition Assessment is specific to the particular transaction under review by the ACCC. While some transaction proposals may involve the same or related markets, it should not be assumed that the analysis and decision outlined in one Public Competition Assessment will be conclusive of the ACCC's view in respect of other transaction proposals, as each matter will be considered on its own merits.

7. Public Competition Assessments outline the ACCC's principal reasons for forming views on a proposed acquisition at the time the decision was made. As such, Public Competition Assessments may not definitively identify and explain all issues that the ACCC considers arise from a proposed acquisition. Further, the ACCC's decisions generally involve consideration of both non-confidential and confidential information provided by the merger parties and market participants. In order to maintain the confidentiality of particular information, Public Competition Assessments do not contain any confidential information or its sources.

The parties

<u>The acquirer: APA</u>

8. APA is one of Australia's major energy transmission companies. It owns a number of major gas transmission pipelines, including:

   a) the Victorian Transmission System (**VTS**);

   b) the Moomba to Sydney Pipeline (**MSP**);

   c) the Roma to Brisbane Pipeline (**RBP**);

   d) the Carpentaria Gas Pipeline (**CGP**); and

   e) a 50% interest in the SEA Gas Pipeline (**SEA Gas**).

9. APA also owns a number of distribution networks and has minority interests in the following companies:

   a) Envestra Limited;

   b) Ethane Pipeline Fund; and

   c) Energy Infrastructure Investments.

10. APA operates and maintains the assets of these companies.

<u>The target: HDF</u>

11. HDF owns 100% of Epic Energy Pty Ltd (**Epic**). Epic, through its subsidiaries, owns a number of Australian gas transmission pipelines, including:

   - the South West Queensland Pipeline (**SWQP**);

- the Queensland to South Australia/New South Wales Link (**QSN**);
- the Moomba to Adelaide Pipeline System (**MAPS**); and
- the Pilbara Energy Pipeline.

Other industry participants

Producers

12. Gas producers (**producers**) extract raw natural gas from petroleum reservoirs and coal seams. Producers then process the raw gas into pipeline quality natural gas for the domestic market or liquid natural gas (**LNG**) for export.

13. Gas producers in Australia include Santos, Esso, BHP Billiton, AGL Energy (**AGL**) and Origin Energy (**Origin**).

14. It is common for oil and gas producers to establish joint ventures due to the capital intensive nature and high risk profile of these projects. For instance:

    - the South Australia and the South-West Queensland Cooper Basin Joint Ventures – two joint ventures led by Santos in relation to the production in South Australia's and South-West Queensland Cooper Basin. The other participants, in both joint-ventures, are Beach Energy and Origin;
    - Longford gas production – a joint venture between Esso and BHP Billiton in relation to the production in the Gippsland Basin; and
    - Bass Gas – a joint venture between Origin and Australian Worldwide Exploration in relation to the production in the Bass Basin.

Shippers

15. Parties that contract for the transmission of gas along a pipeline are referred to as **shippers**. Shippers include gas retailers, gas wholesalers and major users of gas such as electricity generators and industrial users.

16. Producers usually sell gas to shippers at the production point. The shipper then contracts with a transmission pipeline operator for the transmission of the gas. The ACCC understands that, in some instances, producers may themselves contract with the transmission pipeline operator to transport gas. This enables the producer to sell gas to customers at the point of delivery (rather than the point of injection). In these circumstances the producer is also the shipper.

17. Large gas users often negotiate directly with producers to purchase gas, and then negotiate with transmission pipeline operators for delivery of gas. Such users include Xstrata, Rio Tinto, Visy, AGL and Origin.

18. Major gas retailers, who purchase gas from producers, utilise the transmission system[1], and then on-sell gas to residential, commercial and industrial users

[1] Gas transmission systems transport natural gas from production fields to major demand centres. The pipelines typically have wide diameters and operate under high pressure to optimise shipping capacity.

through the distribution systems[2], include TRUenergy, Lumo Energy, Alinta Energy, AGL and Origin.

19. Vertically integrated parties such as AGL and Origin operate at multiple levels of the supply chain and are each a producer, shipper, retailer, wholesale customer and major user of gas.

Transmission pipeline operators

20. The gas transmission sector involves, among other things, the transportation of processed natural gas through high pressure pipelines from processing facilities to the entry point ('city gate') of the distribution system or to major manufacturing/power generation sites. Gas transmission pipelines typically have high operating pressure to optimise shipping capacity and act as storage vessels as well as modes of transportation.

21. APA, Epic (owned by HDF) and Jemena are the major pipeline operators in eastern Australia.

22. Jemena owns and manages the following eastern Australian gas infrastructure:
    - the Queensland Gas Pipeline (**QGP**);
    - the Eastern Gas Pipeline (**EGP**);
    - the VicHub facility;
    - the Colongra Gas Pipeline and storage facility; and
    - the Jemena Gas Network in New South Wales.

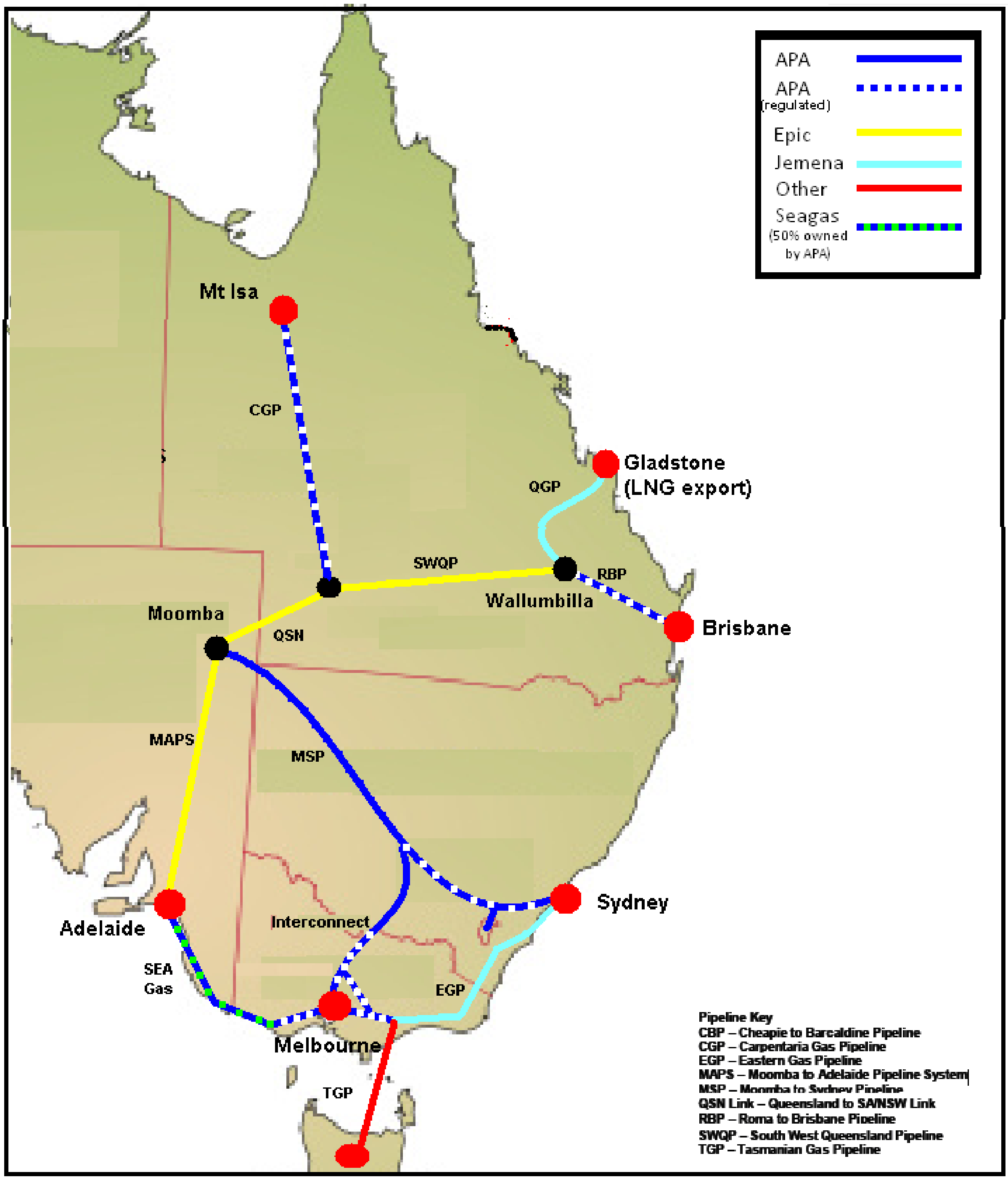
23. Jemena also has a 50% ownership interest in the ActewAGL gas distribution business.

24. Jemena Asset Management (a Jemena entity) also manages the Central Ranges Pipeline on behalf of APA, and the South Gippsland Natural Gas Pipeline and Multinet Gas on behalf of the DUET Group.

25. The following map illustrates the major transmission pipelines (including ownership and regulatory status), and demand centres in eastern Australia.

[2] Gas distribution systems take gas from transmission pipelines and reticulate it into residential homes, offices, hospitals and businesses. Their main customers are energy retailers, which aggregate loads for sale to customer.

Figure 1 – Eastern Australian gas transmission pipelines



The proposed transaction

26. On 14 December 2011, APA announced a takeover offer for all remaining HDF shares. At the time of this announcement APA owned 21.11% of the shares in HDF.

27. APA's bid for 100% of HDF was conditional on obtaining informal clearance from the ACCC.

28. On 15 May 2012, HDF received a non-binding and conditional takeover proposal from Pipeline Partners Australia Pty Limited (**PPA**) which became binding on 10 July 2012. On 17 August 2012 APA increased its takeover offer for HDF and on 20 August 2012, PPA announced that it did not intend to exercise its right to match the consideration offered by APA.

Review timeline

29. The following table outlines the timeline of key events in this matter.

Date	Event
14 December 2011	ACCC commenced review under the Merger Review Process Guidelines.
13 January 2012	Closing date for submissions from interested parties.
6 February 2012	ACCC requested further information from the merger parties. ACCC timeline suspended and former proposed decision date for announcement of ACCC's findings of 16 February 2012 delayed.
16 March 2012	ACCC timeline recommenced.
29 March 2012	Former proposed decision date of 29 March 2012 for announcement of ACCC's findings delayed.
30 March 2012	ACCC published a Statement of Issues outlining preliminary competition concerns.
13 April 2012	Closing date for submissions relating to Statement of Issues.
16 April 2012	Timeline extended at the request of APA to allow it to make further submissions. ACCC timeline suspended. Former proposed decision date for announcement of ACCC's findings of 26 April 2012 delayed.
11 May 2012	APA requested the ACCC to consider and consult upon an in-principle proposal to divest MAPS and commit to behavioural obligations to allow connection to the SWQP. The ACCC commenced market inquiries on the new proposal as described by APA in order to determine whether a section 87B undertaking based on this proposal would be capable of addressing its competition concerns. ACCC timeline recommenced.
24 May 2012	Closing date for submissions relating to APA's proposal.
12 June 2012	Previous tentative decision date of 21 June 2012 delayed to allow the ACCC to assess the information provided during market inquiries and engage with APA on any relevant issues arising from market inquiries.
19 July 2012	ACCC announced it would not oppose the proposed acquisition, subject to the section 87B undertaking accepted by the ACCC.

Market inquiries

30. The ACCC conducted market inquiries with a range of industry participants, including producers, shippers, energy retailers, gas transmission pipeline owners and relevant industry and consumer associations. Submissions were sought in relation to the substantive competition issues, the in-principle proposals put forward by APA to remedy the ACCC’s competition concerns and the proposed undertaking.

Statement of Issues

31. The ACCC published its Statement of Issues on 30 March 2012 identifying a number of competition issues. The key issue of concern was that the aggregation of ownership of transmission pipelines in eastern Australia would give APA an increased incentive and/or ability to:

- increase charges on the MSP and the MAPS, by removing constraints currently imposed by separate ownership of these competing pipelines;
- adopt an 'injection and withdrawal pricing model' which would remove the incentive to provide customised service solutions that currently exist as a result of separate ownership of different pipelines in the network;
- raise the price of ancillary services, by removing the competitive tension that currently exists as a result of the MSP being owned by one party and the MAPS and QSN/SWQP being owned by another party; and
- increase the already significant barriers to entry.

In-Principle Proposal and the Proposed Undertaking

32. On 26 April 2012, APA provided the ACCC with an in-principle proposal for a section 87B undertaking by which APA proposed to:

- divest the MAPS following the proposed acquisition (**divestment proposal**); and
- provide a negotiation/arbitration regime for parties seeking to connect a pipeline from the Gunnedah Basin to the SWQP (**behavioural proposal**),

(collectively the **in-principle proposal**).

33. As a result of market inquiries in relation to the in-principle proposal, the ACCC decided the behavioural proposal was not necessary to address the competition concerns arising from the proposed acquisition.

34. APA subsequently formalised the key terms of the divestment proposal in the form of a section 87B undertaking (the **proposed Undertaking**). On 2 July 2012, the ACCC commenced market consultation in relation to the proposed Undertaking.

Post Statement of Issues competition concerns

35. Based on the market inquiries conducted after the publication of the Statement of Issues, the ACCC identified the following additional competition issues that might arise notwithstanding the divestment proposal:

- whether single ownership of the MSP and the QSN/SWQP would reduce the bargaining power of shippers and provide APA with the ability to significantly and sustainably increase prices on those pipelines; and
- whether the proposed acquisition would remove the threat of bypass to the QSN/SWQP (represented by the potential for a new pipeline to be built connecting Wallumbilla with the MSP).

With/without test

36. In assessing a proposed acquisition pursuant to section 50 of the Act, the ACCC considers the likely effect of the acquisition by comparing the likely future competitive environment post-acquisition if the transaction proceeds (the “with” position) to the likely future competitive environment if the acquisition does not proceed (the “without” position) to determine whether the proposed acquisition is likely to have the effect of substantially lessening competition in any relevant market.

37. In the absence of the proposed acquisition, the ACCC considered it is likely that the status quo would prevail, that is, either HDF continues as the owner of the HDF assets or PPA’s alternative bid suceeds. In either case a single owner would continue to operate the HDF assets as a standalone gas transmission operator.

Market definition

38. The ACCC considered that the following two markets were most relevant to the assessment of the competitive impact of the proposed acquisition:
    - the integrated market for the transmission of gas via one or more pipelines from eastern Australian points of production to eastern Australian points of demand; and
    - the integrated market for the supply of ancillary services via one or more pipelines from eastern Australian points of production to eastern Australian points of demand.

39. The effect of the transaction on any upstream and downstream markets was also highly relevant in the ACCC’s consideration of this matter.

40. Within these markets, areas of close competition between the merger parties were identified. These were the transport of gas to particular demand centres and the transport of gas from particular points of supply.

41. The ACCC notes that its approach to market definition is purposive, recognising that market definition is a tool to identify and define the boundaries of competitive overlap between the merger parties. Therefore other market definitions may be relevant to future possible transactions, including markets more limited in geographic scope.

<u>Product dimension</u>

42. Both APA and Epic are involved in gas transmission and the supply of ancillary services.

43. Gas transmission services include:
    - *Forward haul* which involves the transportation of gas from a point of production to a point of demand via one or more pipelines;
    - *Back haul* involves the contractual right to the transportation of gas in a direction opposite to the aggregate physical flow of gas molecules in a pipeline.

44. In addition to the above mentioned services, transmission pipeline operators offer ancillary services to assist shippers in managing the short-term differences between the available supplies of gas and the demand for gas by their customers. The services offered to shippers that provide them with some degree of flexibility to manage the variability in the demand for gas by end-users include:

- *Imbalance services*: an imbalance will occur when the volume of gas injected by the pipeline operator differs from the volume of gas withdrawn by the shipper. Gas Transportation Agreements (**GTAs**) may allow an imbalance up to a specified threshold before imposing imbalance charges.
- *Storage*: this service allows a shipper to inject more gas into a pipeline than it takes out on a *particular* day, up to a specified threshold (imbalance allowance) without incurring imbalance charges. The additional gas supplied into the pipeline (positive imbalance) may be withdrawn by the shipper at a later point in time.
- *Storage and loan*: this service allows a shipper to inject less gas than it takes out on any given day (negative imbalance) up to a specified level without incurring imbalance charges. The additional gas taken by the shipper (the 'loan') must be repaid within the time specified in the contract.

45. The ACCC formed the view that ancillary services are a separate product market from gas transmission, because ancillary services are used differently from transmission services and ancillary services on one pipeline are often used in combination with gas transmission services on a different pipeline.

Geographic dimension

46. The eastern Australian gas transmission pipeline system became fully connected in 2009 with the completion of the QSN. This created an integrated pipeline network between the three main supply regions (Victoria, the Cooper Basin and eastern Queensland) and each of the major demand centres (Adelaide, Melbourne, Sydney, Brisbane and Canberra).

47. The dynamics surrounding gas transmission pricing and pricing incentives in eastern Australia are consistent with the existence of an integrated market for the transmission of gas via one or more pipelines from eastern Australian points of production to eastern Australian points of demand.

48. Shippers consider both direct and indirect routes to manage their portfolio risk at the least cost. Additionally, shippers may utilise gas swaps[3] to overcome the physical limitations imposed by pipeline direction, pipeline capacity and the location of supply and demand. Shippers may also rely on their potential use of gas swaps as a competitive threat in negotiation with transmission pipeline operators.

49. The ACCC formed the view that the existence of multiple routes from a given supply centre to a given demand centre in combination with the use of gas swaps means that competition between gas transmission pipelines should be

[3] Gas swaps are a mechanism that gas producers and shippers can use in order to bypass or minimise the use of gas transmission pipelines (while still obtaining gas at the desired location). Gas swaps can be conducted internally within a shipper's or gas producer's own portfolio or externally through negotiation between at least two shippers and/or at least two gas producers.

analysed in an eastern Australian market for gas transmission and ancillary services.[4]

50. Importantly, the ACCC also considered it relevant to examine the possible effects of the proposed acquisition on particular routes within this market, which by serving the same demand centre or by providing transport services from the same point of supply, are considered particularly close substitutes. These routes can appropriately be considered as distinct narrower markets within the broader eastern Australian market.

Competition analysis

51. The ACCC considered that, in the absence of the Undertaking, the proposed acquisition would have the effect, or be likely to have the effect, of substantially lessening competition in the relevant markets, as identified above.

52. The ACCC's primary concern was that the proposed acquisition would result in APA owning the majority of the gas transmission pipelines in eastern Australia, including:

- all of the pipelines servicing the Cooper Basin; and
- all of the pipelines servicing Adelaide.

53. The aggregation of ownership of these pipelines would give APA an increased incentive and/or capacity to raise transmission charges and the price of ancillary services.

54. The ACCC also considered whether, notwithstanding the proposal to divest the MAPS, the proposed acquisition would:

- provide APA with the ability to significantly and sustainably increase prices on the MSP and QSN/SWQP by reducing the bargaining power of shippers; and
- remove the threat of bypass to the QSN/SWQP (for example, by the potential for a new pipeline to be built connecting Wallumbilla and the MSP).

Aggregation of ownership of gas transmission pipelines in eastern Australia

55. The ACCC considered that the proposed acquisition would have the effect, or be likely to have the effect, of substantially lessening competition, as by aggregating the ownership of gas transmission pipelines in eastern Australia, APA would be likely to have an increased incentive and/or ability to:

- increase charges on the MSP, MAPS and/or SEA Gas, because it would remove the constraints currently imposed by separate ownership of these competing pipelines at Moomba (the MSP and the MAPS) and at the Adelaide demand centre (the MAPS and the SEA Gas); and

[4] The Australian Competition Tribunal (**Tribunal**) in previous decisions has recognised that the gas transmission market in eastern Australia is becoming more integrated, with its geographic scope broadening over time. See, for instance, the Tribunal decision regarding the AGL Cooper Basin supply arrangements [(1997) ATPR 41-593 at 44211] and the Duke EGP decision [(2001), ATPR 41-821 paragraph 77)].

- raise the price of ancillary services, because it would remove the competitive tension that currently exists as a result of the separate ownership of the MSP by one party and the MAPS and the QSN/ SWQP by another party.

56. As discussed further at paragraph 71 below, the ACCC ultimately formed the view that these competition issues would likely be addressed by the proposed Undertaking.

Reducing bargaining power of shippers on the MSP and the QSN/SWQP

57. The ACCC also considered the extent to which the MSP currently constrains prices charged to shippers for transport on the QSN/SWQP and vice versa. This competition concern was not specifically addressed by the proposed Undertaking.

58. The ACCC noted that, while these pipelines do not directly serve the same demand centres, they are vertically related pipelines and potentially complementary, as some routes may require the transportation of gas along the full length of MSP-QSN/SWQP.

59. Where there are two separate owners of these pipelines there is uncertainty on the part of each of APA and HDF about the tariff charged by the other pipeline owner (for example: (i) along the route that may be currently used, without a change of the flow direction, to transport gas from the Surat/Bowen Basin to service demand in Sydney and surrounding regions, via the QSN/SWQP and MSP; or (ii) along the route that may be used to transport gas from the Gippsland Basin to Wallumbilla, via the VTS, MSP and the QSN/SWQP, in a scenario where there is a reversal of flow, with gas flowing from south to north).

60. This uncertainty constrains the two pipeline-owners, because in the event the combined tariff of transporting gas along the full length of the complementary pipelines (QSN/SWQP-MSP) is set too high, both APA and HDF risk ending up in a situation where no transportation agreement is reached with the shipper.

61. Therefore, each pipeline owner has an incentive to charge shippers a tariff that is low enough to still allow the contract to proceed, and it has to calculate this tariff without knowing the level of the tariff charged by the other pipeline owner.

62. If APA is able to increase transportation tariffs this may lead to lower ex-field prices being paid for gas (because the acquirers of the gas would have to factor in the need to pay higher transport tariffs to APA) which may in turn reduce future gas exploration and/or investment in gas fields.

63. Following the market concerns described above, the ACCC considered:

    - whether the current uncertainty on the part of each of APA and HDF as to the tariff charged by the other pipeline owner provides a constraint, in that APA and HDF risk a situation where no transportation agreement can be agreed with the shipper if the total cost of transporting gas along the MSP and QSN/SWQP is too high (in which case neither pipeline owner will receive any transmission revenue); and
    - if this is the case, whether the proposed acquisition would remove this uncertainty, thereby putting APA in a superior position to charge higher

tariffs with less risk that doing so would result in a failure to agree a transportation agreement.

64. The ACCC formed the view that, on balance, it was unlikely that the common ownership of the MSP and QSN/SWQP would result in a substantial lessening of competition. If, in the future, gas flows from the south to north in eastern Australia, with or without the proposed acquisition, the owners of the MSP and QSN/SWQP would likely be constrained in their conduct by shippers' ability to:

- use swaps;
- source gas from a different basin;
- use the EGP; and/or
- use the MAPS.

<u>Removing the threat of bypass to the QSN/SWQP</u>

65. Without the proposed acquisition, the MSP could provide an alternative for shippers to bypass the QSN/SWQP. As this option will be removed with the common ownership of the MSP and the QSN/SWQP, the ACCC also considered whether any market power held by the owner of the QSN/SWQP is constrained by the threat of bypass by a newly constructed pipeline. For example, a new pipeline connecting Wallumbilla with the MSP was identified by some market participants as the least costly bypass option. Some market participants considered that the possibility that such a pipeline may be built by APA constrained the current owner of the QSN/SWQP.

66. The ACCC formed the view that there are a number of possible bypass options to the QSN/SWQP, including:

- a new pipeline that, in whole or in part, duplicates the QSN/SWQP for gas produced at the Cooper Basin and destined for Queensland domestic demand or LNG requirements; and/or
- a new pipeline connecting Wallumbilla and the Newcastle distribution network for gas produced in the Surat/Bowen Basins and destined for Sydney, Canberra and/or Melbourne.

67. The ACCC considered that the proposed acquisition would not remove the only credible threat of bypass to the QSN/SWQP.

Undertaking

68. On 19 July 2012, the ACCC accepted a court enforceable undertaking given by APA pursuant to section 87B of the Act (the **Undertaking**), to address the competition concerns identified by the ACCC.

69. The Undertaking requires APA to divest the MAPS (**Divestiture Business**) to a purchaser approved by the ACCC.

70. The Undertaking also requires APA to hold its interest in the Divestiture Business separate from its other assets and businesses in the period after APA gains control of HDF but prior to the divestiture. Independent management, ring fencing and other provisions apply to the Divestiture Business during this period.

71. The Undertaking addressed the competition issues resulting from the aggregation of gas transmission pipelines in eastern Australia which would otherwise arise in the absence of the Undertaking (see paragraph 55 above) by:

- preserving the status quo of two independent pipeline operators servicing Moomba and ensuring that the Adelaide demand centre will continue to be served by two independently owned pipelines (SEA Gas and the MAPS);
- preserving the *status quo* of shippers having two independent pipeline operators from which to seek storage, with shippers being able to choose between the MSP and the MAPS and between the MAPS and the SWQP; and
- ensuring that APA, post-acquisition, will continue to be constrained in its ability and incentive to impose prices or terms which disadvantage shippers servicing the Sydney and Adelaide demand centres and/or the Moomba and Wallumbilla hubs.

72. The Undertaking addressed the ACCC's competition concerns by :

- the creation of a viable, effective, stand-alone independent and long term competitor in the markets for the supply of gas transmission and ancillary services via one or more pipelines in eastern Australia;
- ensuring that the purchaser of the Divestiture Business (to be approved by the ACCC) has the necessary assets, rights and agreements to ensure that effective competition is maintained post-acquisition;
- maintaining the economic viability, marketability, competitiveness and goodwill of the Divestiture Businesses prior to divestiture including ensuring effective ring fencing measures are implemented to protect the confidential information of the Divestiture Business;
- requiring APA to hold its interest in the Divestiture Business separate from its other assets and businesses pending divestiture of the Divestiture Business; and
- providing for the effective oversight of APA's compliance with the Undertaking.

Conclusion

73. On 19 July 2012, the ACCC accepted the court enforceable Undertaking given by APA, pursuant to section 87B of the Act, to address the competition concerns that would otherwise arise as a result of the proposed acquisition in the markets for the supply of gas transmission and ancillary services via one or more pipelines in eastern Australia.

74. Based on market feedback and its assessment of the viability of the MAPS as a viable, effective, stand-alone independent and long term competitor in the relevant markets, the ACCC formed the view that the purchaser of the Divestiture Business would be likely to provide an ongoing and effective competitive constraint in the relevant markets.

75. The Undertaking is available on the Section 87B Undertakings Register on the ACCC website at www.accc.gov.au/content/index.phtml/itemId/1066611.

Conclusion

76. On the basis of the above, including taking into account the Undertaking, the ACCC formed the view that the proposed acquisition would not be likely to result in a substantial lessening of competition in any market in contravention of section 50 of the Act.