ISSN no. 0144-2720
Project no. 11.04/13917
Public version

Determination

Vector Limited and Contact Energy Limited [2013] NZCC 9

The Commission:	Dr Mark Berry Dr Stephen Gale Elisabeth Welson
Summary of application:	An application from Vector Limited to acquire the assets and business of Contact Energy Limited's natural gas metering business
Determination:	Under s 66(3)(a) of the Commerce Act 1986, the Commission determines to give clearance to the proposed acquisition
Date of determination:	26 April 2013

Confidential material in this report has been removed. Its location in the document is denoted by [ ].

CONTENTS

Executive summary

E1. On 25 October 2012, the Commission received a notice under s 66(1) of the Commerce Act 1986 seeking clearance for Vector Limited (Vector) to acquire the assets and business of Contact Energy Limited's (Contact) natural gas metering business.

E2. On 26 April 2013, the Commission cleared Vector to acquire Contact's natural gas metering business.

E3. The proposed acquisition would result in the merger of the two largest providers of gas metering in the North Island gas metering market and would therefore remove any existing competition between Vector and Contact.

E4. However, based on the information and evidence provided by the parties and the Commission's own investigation and analysis, it appears that there is already limited competition between Vector and Contact and other market participants in the North Island gas metering market.

E5. Vector and Contact argued, and this was supported by the Commission's own investigation, that pricing in the market is conditioned by the threat of the wholesale replacement of meters, rather than by metering providers competing to install the relatively small number of new meters that are installed each year.

E6. The Commission considered whether the retention of Contact's metering business as an existing competitor (either owned by Contact or a third party) could materially increase the constraints on Vector—relative to the merger—but we have concluded that any constraint provided by Contact would be limited.

E7. The Commission considers that the proposed merger is unlikely to change the competitive dynamics in the market. In both the with and without scenarios, pricing in the market appears most likely to continue to be conditioned by the threat of the wholesale replacement of meters.

E8. Therefore, when the Commission compares the state of competition with the merger to the state of competition without the merger, the Commission concludes that there is likely to be no substantial difference in competition.

The proposal

1. A notice under s 66(1) of the Commerce Act 1986 (the Act) was registered on 25 October 2012. The Notice seeks clearance for Vector Limited (Vector or the Applicant) to acquire the assets and business of Contact Energy Limited's (Contact) natural gas metering business.[1]

Procedure

2. Section 66(3) of the Act requires the Commission to either clear or 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. Several extensions of time were agreed between the Commission and the Applicant. Ultimately, a decision on the application was required by 26 April 2013.

Statutory framework

3. Any person who proposes to acquire the assets or shares of a business, and considers that the acquisition may breach s 47 of the Act, can apply for clearance under s 66.

4. If the Commission is satisfied under s 66(3)(a) of the Act that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market, the Commission must give clearance for the proposed acquisition.

5. The Court of Appeal in *Port Nelson v Commerce Commission* held that for something to be "likely" it must be "above the mere possibility but not so high as more likely than not and is best expressed as a real and substantial risk that the stated consequence will happen". [2]

6. The High Court in *Woolworths & Ors v Commerce Commission* observed that "a substantial lessening of competition is one that is "real or of substance" as distinct from ephemeral or nominal. Accordingly a substantial lessening of competition occurs if it is likely that there will be a reduction in competition that is real or of substance". [3]

7. The burden of proof lies with the Applicant to satisfy the Commission on the balance of probabilities that the acquisition is not likely to substantially lessen competition.[4] If the Commission is presented with unclear or conflicting evidence, it must consider all the evidence and make a judgement call on whether or not it considers that there is a real chance of a substantial lessening of competition.[5]

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[1] The proposed acquisition only relates to metering for natural gas and so for the purposes of this report we will refer to natural gas simply as gas.

[2] *Port Nelson v Commerce Commission* (1996) 5 NZBLC 104, 150; (1996) 3 NZLR 562-563.

[3] *Woolworths & Ors v Commerce Commission* (2008) 8 NZBLC 102,128 (HC).

[4] *Commerce Commission v Southern Cross Medical Care Society* (2001) 10 TCLR 269 (CA) at [7] and *Commerce Commission v Woolworths Ltd* (2008) 8 NZBLC 102,336 (CA) at [97].

[5] *Brambles New Zealand Ltd v Commerce Commission* (2003) 10 TCLR 868 at [64].

8. If the Commission is not satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in a market, or it is 'in doubt' as to whether that is the case, it must decline the application under s 66(3)(b) of the Act.[6]

Analytical framework

9. The Commission's analytical framework for assessing whether an acquisition is likely to result in a substantial lessening of competition is described in our Mergers and Acquisitions Guidelines.[7] The specific manner in which we apply this framework depends on the facts in each case.

10. In any assessment, the determination of the relevant market or markets may be an important tool. To define markets, we identify the areas of overlap between the businesses of the acquirer and the target, and then consider what, if any, products and geographic regions, constitute relevant close substitutes from both a customer's and a supplier's point of view.

11. We use a forward-looking analysis to assess whether a substantial lessening of competition is likely. This exercise "requires a comparison of the likely state of competition if the acquisition proceeds (with the merger) against the likely state of competition if it does not (without the merger)".[8]

12. We make a pragmatic and commercial assessment of what is likely to occur in the future with and without the merger based on the information we obtain through our investigation and taking into account factors including market growth and technological changes.

13. The High Court in *Air New Zealand v Commerce Commission (No.6)*[9] accepted that an absence of market power would suggest there had been no substantial lessening of competition in a market but did not see this as a reason to forsake an analysis of the situation without the merger as well as with the merger. Justice Rodney Hansen stated that "a comparative judgment 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, that is, dominance has been attained".

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6 *Commerce Commission v Woolworths Ltd* (CA) above n 3 at [98].

7 Commerce Commission, *Mergers and Acquisitions Guidelines*, January 2004. The Commission has recently published for consultation revised Mergers and Acquisitions Guidelines. Until the revised Guidelines are adopted by the Commission, the Commission will continue to have regard to the 2004 Guidelines. The broad analytical framework proposed in the revised Guidelines remains the same as that outlined in the 2004 Guidelines.

8 *Commerce Commission v Woolworths Ltd* (CA) above n 3 at [63]. This is also referred to as the factual and the counterfactual.

9 *Air New Zealand v Commerce Commission (No.6)* (2004) 11 TCLR 347 at [42].

The parties

Vector

14. Vector owns and operates infrastructure networks, including gas transmission pipelines and reticulated gas distribution networks.[10] Vector also provides electricity and gas metering as well as retailing gas through its subsidiary, OnGas.

15. Vector provides gas metering to gas retailers through its wholly owned subsidiaries Advanced Metering Assets Limited and Advanced Metering Services Limited.

16. At present, Vector provides gas metering in Auckland, Waikato, the Bay of Plenty, Gisborne and Wellington.

Contact

17. Contact is an energy company that operates power generators and retails electricity, natural gas and LPG.

18. Like Vector, Contact provides both electricity and gas metering. Unlike Vector, Contact is not a gas distributor.

19. At present, Contact provides gas metering in Auckland, Hawke’s Bay, Manawatu and Wellington.[11]

Other gas metering providers

20. In addition to Vector and Contact, three other parties currently supply gas metering. These three parties also operate gas distribution networks in the North Island.

    20.1 Powerco Limited (Powerco) provides gas metering in Taranaki, Manawatu, Hutt Valley, Porirua, Wellington City, Horowhenua and Hawke's Bay. Powerco is also the gas distribution network owner in these regions. It does not supply gas metering in areas where it is not the gas distribution network owner. As discussed further below, until mid 2012, Powerco’s gas metering was regulated under Part 4 of the Commerce Act.

    20.2 GasNet Limited (GasNet) provides gas metering in Wanganui, and to a much lesser extent in Hawke’s Bay and Manawatu. GasNet owns the gas distribution network in Wanganui.

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[10] Distribution networks transport gas from gate stations (transmission pipeline delivery points) and reticulate it to residential houses, offices, hospitals, factories, and other businesses. The distribution networks do not include LPG, which is delivered separately, and therefore the provision of LPG is excluded from the Commission’s assessment.

[11] Contact acquired the bulk of its existing gas meters when it acquired parts of the utilities company Enerco New Zealand Limited (Enerco) in 1998. Contact acquired most of Enerco’s gas retailing business; that business was supplying gas in Auckland, Hawke’s Bay, Manawatu and Wellington, and included gas meter assets. Enerco retained its large retail consumer supply contracts as well as its distribution network and other assets. Contact’s acquisition of Enerco’s gas retailing business was the subject of clearance from the Commission. See Contact Energy Limited and Enerco New Zealand Limited (Commerce Commission Decision 333, 10 December 1998).

20.3 Nova Energy (Nova), a division of the Todd Corporation, provides gas metering in Hawke's Bay, Wellington and more recently in Auckland. In most instances, Nova only provides meters in these areas where those meters are connected to Nova's by-pass networks in these regions.

Gas retailers

21. Some gas metering providers are also gas retailers, namely:

21.1 Vector, through its subsidiary OnGas;[12]

21.2 Contact;

21.3 GasNet, via Energy Direct NZ Limited;[13] and

21.4 Nova, whose retail divisions include Nova Gas and Bay of Plenty Energy.

22. While Contact and Nova supply gas metering, Contact and Nova also buy these services from other gas metering providers. For example, Contact buys gas metering from Vector on Vector's network.

23. Other gas retailers acquire gas metering from the various gas metering providers, namely:

23.1 Genesis Power Limited (Genesis) which provides gas through its retail divisions of Genesis Energy and Energy Online;

23.2 Mercury Energy Limited, a subsidiary of Mighty River Power Limited; and

23.3 Greymouth Petroleum Limited, through its retail division Greymouth Gas.

Background on gas metering in New Zealand

24. Gas meters are connected to reticulated gas distribution networks that are located throughout most of the North Island.[14] A gas meter is required to measure the amount of gas used by each gas consumer. Retailers use the information from the meter to bill their customers. Most industry parties consider that a gas meter is simply an extension of the gas distribution network.

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12 Although OnGas primarily supplies LPG, it does supply a number of large customers in the North Island with gas.

13 As of 26 April 2013.

14 There is no distribution of reticulated gas in the South Island. Historically, various local gas boards were responsible for the distribution of gas, the metering and the retail supply of gas to end consumers. Following deregulation in the 1990s, this structure changed and there were a number of horizontal and vertical acquisitions within the gas industry which led to the current industry structure. Further background on the New Zealand natural gas industry can be found at http://www.med.govt.nz/sectors-industries/energy/energy-modelling/publications/energy-data-file

25. A gas metering business involves the following:[15]

    25.1 installation, maintenance,[16] upgrade and replacement of gas meters;[17]

    25.2 ownership of gas meters;

    25.3 oversight of gas meter design so as to ensure compliance with New Zealand standards and gas retailer requirements;

    25.4 procurement and logistics;

    25.5 asset reconciliation, administration, assets management and stock management; and

    25.6 contracting with gas retailers for the supply of gas metering.

26. Typically, gas metering does not involve meter reading; gas retailers are responsible for meter reading.

27. To receive gas metering, a gas retailer enters into a gas metering services agreement (GMSA) with the provider of gas metering. The GMSA is terminable on short notice as a result of certain events.[18] It is relatively common for consumers to switch between gas retailers and this is facilitated by the GMSAs that each gas metering provider has with each of the gas retailers.

28. Gas meter charges form part of a gas retailer's supply costs and are incorporated into the prices retailers charge final consumers/end-users. Importantly, gas consumers do not have a direct relationship with providers of gas metering services. Metering charges are a very small component of residential gas charges.[19]

29. The key procurement and contractual relationships in the gas metering supply chain are shown in the diagram below.[20]

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15 Vector clearance application, paragraph 15.

16 Gas metering providers typically procure field services such as installation and maintenance of meters from specialist service providers.

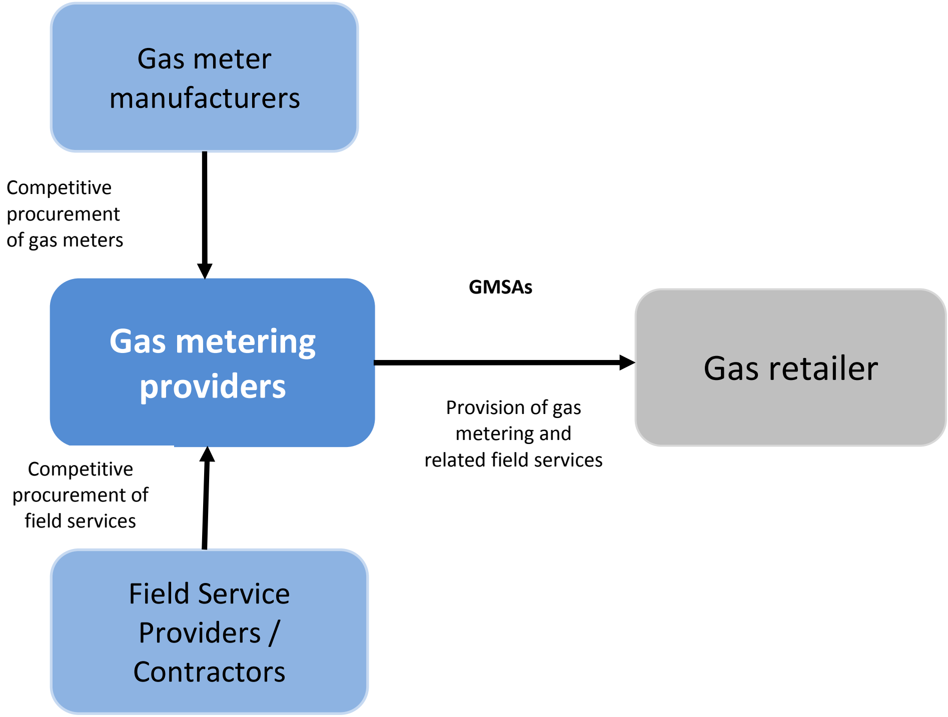
17 Industry standards define a gas meter, or a gas measurement system (GMS), as "a system for measuring the quantity of any gas or the energy content of any gas ... and includes any equipment that forms part of, or is ancillary to, any such system". For example, see clause 4, Order in Council: Commerce (Control of Natural Gas Services) Order 2005, gazetted 28 July 2005 and amended on 18 August 2005.

18 Vector submitted that while it enters into separate GMSAs with each of the gas retailers in relation to the provision of all services in the North Island, the GMSAs are essentially identical. Vector noted that through the GMSAs gas retailers have contractual rights to displace meters or terminate the GMSA in response to technology advancement or price increases.

19 For example, in respect of Contact, metering charges are on average about [ ] of its residential gas charges. See Contact submission, Data on displacement and financial returns from meters, 5 November 2012.

20 Based on diagram provided by Castalia Limited on behalf of Vector, 28 January 2013.

Diagram 1: Gas metering supply chain



30. The average life of a gas meter is approximately 20 years and once a meter is installed it is almost never replaced during this period, unless it is faulty. However, as noted above, it is relatively common for an end-user (ie, a residential customer or an industrial purchaser of gas) to switch between gas retailers. Nevertheless, when an end-user does switch, the gas retailer does not generally change meter provider.[21] We discuss this feature more, later on.

31. Most end-users have never contemplated owning or installing their own gas meters and it would appear to be commercially impractical for end-users to supply their own meters.[22] None of the existing gas metering providers or any of the gas retailers could provide an example of an end-user owning their own gas meters.

Regulatory history

32. The Commission has previously recommended that gas metering be regulated because it had concerns about the level of competition for these services. The Commission considered the supply of gas metering in its 2004 Gas Control Inquiry (Gas Inquiry).

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[21] If switching of gas metering providers did occur, then the providers may seek to impose termination fees or other pricing methods to ensure an adequate return. The Commission understands that termination fees are common in other jurisdictions.

[22] The compliance costs would include a meter owner needing to: meet the relevant industry safety standards; convince the gas retailer that their meter was accurate; and convince the network owner to allow them, or an approved contactor, access to work on their network. Those end-users who had considered potentially owning their own meter including [ ] confirmed the problems associated with self supply.

33. The Commission found in the Gas Inquiry that competition in the provision of gas distribution services operated by Vector and Powerco was "less than workable or effective" and recommended price control.[23] This recommendation subsequently led to a period of regulation for both Powerco and Vector, from 2005 to mid-2012.[24]

34. At the time of that decision, Vector did not provide gas metering. The gas meters connected to Vector's network were then owned by NGC Holdings Limited (NGC).

35. However, Powerco did own gas meters and the Commission defined Powerco's distribution services to include both network distribution services and gas metering services. As a result, the price charged by Powerco for its gas metering between 2005 and mid-2012 was regulated.

36. The Commission did not consider that NGC's assets, which included gas metering services, should be placed under control.[25] [26]

37. Subsequent to the Commission's control recommendation but before the necessary Control Order was authorised by the Crown,[27] Vector acquired NGC. As the Commission had not recommended control of the NGC assets, the NGC assets could not be made subject to the Commission's Control Order and so the NGC assets were excluded from regulation.[28]

38. Consequently, while Vector's gas distribution services were placed under price control, the NGC metering assets (which were then actually owned by Vector) were not. As a result, the price charged by Vector for gas metering has not been regulated.[29]

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[23] See Commerce Commission, Gas Control Inquiry, Final Report, 29 November 2004. The Gas Inquiry was into whether goods and services directly related to either a gas transmission system or a gas distribution system or both should be controlled. At the time, Contact did not supply either of these services and so it was outside of scope of the Gas Inquiry.

[24] For further information on the related authorisation see Commerce Commission, Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, Decision Paper, 30 October 2008.

[25] The Commission's Gas Control Inquiry also considered whether to impose price control on GasNet. The Commission found that while there were some grounds for imposing control on GasNet, the Commission considered that regulation of GasNet by way of a Control Order was unlikely to be cost effective compared to alternative regulation approaches. Therefore, the Commission did not seek a Control Order on GasNet.

[26] Unlike Vector and Powerco, Nova primarily provides gas to retail customers on a bypass network. In the Gas Inquiry, the Commission concluded that on bypass networks there was workable or effective competition and so it did not seek price control on bypass networks.

[27] Only the Crown can implement price control and it can do this by way of an Order in Council under s 53 of the Commerce Act.

[28] Clause 4(2) of the Schedule to the Control Order provided that Vector is not to be treated as owning systems that are owned by NGC or its subsidiaries solely because the two companies are interconnected.

[29] As Contact was outside to scope of the Gas Inquiry, the price charged by Contact for gas metering has also not been regulated.

The prospect of advanced gas metering services

39. As with electricity meters, manufacturers are developing advanced gas meters. An advanced gas meter is a 'smart' meter that can be read remotely, can be used to give users more timely details of gas consumption and can potentially be used to remotely disconnect supply.

40. This compares to the traditional 'dumb' gas meters that gas metering providers currently supply. These traditional gas meters require on-site reading, connection and disconnection and do not provide regular and timely usage readings.

41. Many in the industry consider that advanced gas meters will become prevalent in the future.[30] Both Vector and Contact consider that advanced meters could bring cost savings to gas retailers and end users and this would drive their introduction.

42. Other parties were more circumspect about the prospect of advanced meters being introduced in the foreseeable future. Those parties noted that the potential benefits of advanced gas meters have yet to be quantified and may not actually outweigh the anticipated installation costs. In their view this was the main reason why advanced gas meters have not been introduced, *en masse*, to date.[31]

43. There is some evidence that gas retailers and meter owners have started to explore or trial the use of advanced gas meters.

    43.1 [ ].

    43.2 [ ].

    43.3 [ ].

    43.4 [ ].

30 For example, Vector stated in its application that there is an industry trend toward advanced gas meters. [ ].

31 Time of use meters are currently used by some larger industrial users who value being able to track their energy use in a timely fashion.

44. Nevertheless, we understand that it may be some time before advanced gas meters are rolled out to the entire market.

    44.1 [ ].

    44.2 [ ].

    44.3 [ ].[32]

45. The above evidence sets out the uncertainty in relation to when, and in what form, advanced gas meters will become widespread for residential gas users.

46. While the industry itself has confidence that advanced meters will become widespread at some point in time, there is not sufficient evidence before us to indicate that advanced gas meters would be introduced in the foreseeable future, and therefore be within the relevant timeframe for the Commission's analysis.

47. Accordingly, we have placed limited weight on the potential competitive implications for this merger of any introduction of advanced gas meters.

48. However, given the industry's views in relation to advanced gas meters, the Commission is cognisant that traditional gas meters are unlikely to be displaced in large volumes in the short-to-medium term because of the anticipated roll-out of advanced gas meters in the future. We have considered this point as part of our analysis below.

Relevant markets

49. Market definition helps identify and assess the close competitive constraints the merged firm would likely face.[33]

50. A market is defined in the Commerce Act as a market in New Zealand for goods or services as well as other goods or services that are substitutable for them as a matter of "fact and commercial common sense".[34]

51. The Commission defines markets in the way that best isolates the key competition issues that arise from the merger. There may not be a bright line that separates

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32 [ ].

33 *Commerce Commission v New Zealand Bus Limited* (2006) 11 TCLR 679 (HC), at [123].

34 Similarly, the courts have said that "[t]he boundaries of the market are defined by substitution between one product and another and between one source of supply and another, in response to changing prices". See *Commerce Commission v New Zealand Bus Limited* (HC), above n 29 at [123] citing *Re Queensland Co-operative Milling Association Ltd* (1976) ATPR 40-012 at 17,247.

those products that are within a market from those outside that market. In reality, a product may compete more closely (be a closer substitute) with some products, than with others.

52. What matters is that we consider all relevant competitive constraints, and the extent of those constraints. For that reason, we may also consider products which fall outside the market but which still impose some degree of competitive constraint on the merged firm.[35]

53. The Commission considers the relevant market in this case is that for the provision of gas metering on reticulated natural gas distribution networks in the North Island (the North Island gas metering market). The metering service is provided to gas retailers in respect of both residential and larger (industrial and commercial) end-users. The following paragraphs explain our reasoning.

Product dimension - gas metering

54. While gas metering providers' immediate customers are gas retailers, those retailers supply gas to two types of customers: residential customers (mass market) and large commercial and industrial customers (time of use).

55. Vector submitted that the relevant market includes supply to both sets of customers because:

    55.1 all gas metering service providers offer services to residential and commercial and industrial customers; and

    55.2 gas retailers provide gas to all these customer types.

56. We consider that there are a number of differences between residential and industrial meters and meter customers. For example, residential and industrial gas meters have differing technical requirements.[36]

57. However, on balance, we acknowledge that all customers have the same options across metering types and the same gas metering providers generally supply all product types.[37] Therefore in this instance, we consider all customer types in the one market.

Geographic dimension – the North Island

58. Vector submitted that the relevant geographic market is for the supply of gas metering in the North Island market. Alternative approaches could be to consider the

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[35] *Brambles New Zealand Ltd v Commerce Commission* (2003) TCLR 868 (HC) at [34]-[39] and [157]-[159].

[36] Residential gas meters are generally standard installations, whereas for larger industrial consumers, meters can be considerably more sophisticated (including time of use data and remote reading for example) and more costly to install and operate. Moreover, in contrast to residential customers, industrial users are likely to expand or contract their gas requirements over time, to the point where a different type of gas meter may be appropriate.

[37] The one exception is Nova, which generally provides meters only for its own large gas retailing customers on its bypass network.

separate gas distribution networks or even each region as separate geographic metering markets. Nevertheless, all parties interviewed considered that however the market is defined, the same competition issues would need to be assessed, ie, the extent to which there is competition between Vector and Contact, and the extent to which entry or expansion would constrain Vector from increasing prices.

59. We agree with Vector, and consider that for the purpose of assessing this application it is sufficient to consider a North Island market for the provision of gas metering on a reticulated natural gas distribution network (the North Island gas metering market). Potential competitive constraints from either existing gas metering providers or potential entrants can be fully considered in the competition analysis.

60. Table 1 below illustrates where the various gas metering providers operate. In brief, distribution network owners provide gas metering only on their own networks. Contact is the exception, not owning a network, and providing metering on Vector's Auckland network and most of Powerco's networks.

Table 1: Gas metering providers in each region

Region	Distribution Network	Gas metering providers				
		Vector	Contact	Powerco	GasNet	Nova
Northland	*Vector*	✓				
Auckland	*Vector*	✓	✓			Minimal
Waikato	*Vector*	✓				
Bay of Plenty	*Vector*	✓				
Gisborne	*Vector*	✓				
Hawke's Bay	*Powerco*		✓	✓	Minimal	Minimal
Taranaki	*Vector*			✓		
Whanganui	*GasNet*				✓	
Manawatu	*Powerco*		✓	✓	Minimal	
Horowhenua	*Powerco*			✓		
Kapiti Coast	*Vector*	✓				
Wellington / Hutt Valley	*Powerco*	Minimal	✓	✓		

Source: Industry parties

Market share information

61. All parties advised that the market is relatively mature and that market shares are stable.[38] As discussed, the primary reason for this stability appears to be that once a gas meter is installed it is almost never removed.

62. Further, gas meters have a very simple function, which is to record the amount of gas used by the end-user. To this extent, there is limited opportunity for one gas metering service provider to differentiate its product offering from another provider's offering as they all supply gas meters that are almost identical.

63. Table 2 below shows the number of active gas meters that each gas metering provider has connected to the North Island gas distribution network, as published by the Gas Industry Company Limited (GIC), the gas industry's regulatory body, in March 2013.[39]

Table 2 Providers in the North Island gas metering market as at March 2013

Provider	Total	Market Share
Vector	76,193	29%
Contact	121,852	47%
Merged entity	*198,045*	*76%*
Powerco	51,504	20%
GasNet	9,997	4%
Nova	2,022	<1%
Other	7	<0.1%
Total	**261,575**	**100%**

Source: GIC data 'Active ICPs by meter owner' March 2013

64. Table 2 shows that the proposed acquisition would have a market share of 76% and the three-firm concentration ratio would increase from 96% to over 99%. This is outside the Commission's safe harbours.

38 While the installed base of each gas metering service provider is relatively stable, each provider still has to acquire a number of gas meters from manufacturers each year as the gas metering service provider installs meters for new gas customers and replaces existing meters as they expire.

39 The numbers of installed meters can vary month by month, as new meters are installed while other meters are deactivated. All parties consider that market shares in the industry are relatively stable and this is illustrated in the monthly data published by the GIC.

Likely scenarios with and without the merger

With the merger

65. If the proposed acquisition goes ahead:

 65.1 Vector would be the only provider of gas metering on its gas distribution network (absent entry or expansion); and

 65.2 Vector would also supply a large number of gas meters on Powerco's distribution network (by acquiring Contact's meters in Hawke's Bay, Manawatu and Wellington/Hutt Valley).

66. [ ].

Without the merger

67. Based on a range of evidence, much of which is commercially sensitive to the parties,[40] the Commission considers that there are two scenarios that have a real chance of occurring (ie, are likely) if the merger does not proceed, namely:

 67.1 Contact retains ownership of its gas metering services business (the Contact holds scenario); or

 67.2 Contact sells its gas metering services business to a party other than Vector (the sale to a third party scenario).

68. In our view the evidence demonstrates that, while there is a real chance that Contact would not sell its gas metering business, there is also a real chance that Contact and a third party would be able to conclude a sale on mutually acceptable terms.[41]

69. While we acknowledge that Contact had not reached an agreement with an alternative purchaser prior to its board approving the Vector transaction, the evidence suggests that Contact has a preference to sell its gas metering business if it can achieve a suitable sale agreement. Given this preference, we believe that there is a real chance that such an agreement would result.

70. Nevertheless, the evidence before the Commission indicates that the competition issues that would result from the proposed merger are largely the same, whether Contact would sell or retain its gas metering business without the merger.

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[40] This includes Contact's internal strategy documents assessing its gas metering business; discussions Contact had with third parties about potentially selling its gas metering business; Contact's internal calculations on the value of its gas metering business; advice to Contact from its external financial advisers; Contact's internal board papers and board minutes; communications between Contact and potential bidders; statements and letters provided to the Commission by Contact which set out Contact's view on the likely without the merger scenario; and discussions between the Commission and interested parties.

[41] Contact approached a number of parties as part of the potential sale of its gas metering business.

71. Accordingly, the Commission's assessment of the two likely scenarios is not determinative on our overall finding in respect of Vector's clearance application.

Competition assessment

72. As noted earlier, the Commission's analysis compares the state of competition with and without the merger.

73. As a starting point, we have assessed the current state of competition in the North Island gas metering market. To begin with, we asked what choices do the gas retailers have for gas metering?

    73.1 If the retailer considers that one of its metering providers is overcharging, the retailer could get another provider (or a new entrant) to swap out all the meters serving that retailer.

    73.2 When the retailer wins a gas customer from another retailer, the winning retailer could seek a better metering price by engaging a different metering provider to displace the meter.

    73.3 When a retailer recruits a new gas customer—a new installation—the retailer could seek competing prices from metering providers.

74. The price of gas metering appears at present to be set by the first of these mechanisms, ie, the price is at the gas metering provider's perception of the limit above which the retailers would be better off to sponsor the 'wholesale displacement' of the meters for their customers. Such wholesale displacement involves substantial switching costs so the limit price is significantly higher than a new installation cost.[42] [43]

75. The second mechanism does not happen because the associated price to the retailer would need to be even higher than the wholesale displacement limit price. This is because metering providers would need to price to recover the meter and switching costs over the shorter time of the retailer/customer relationship, not the full life of the meter.

76. The third mechanism has not been observed because Contact has chosen not to compete with Vector on Vector's network, or Powerco on Powerco's network. Powerco and Vector have apparently chosen not to seek to expand their metering businesses onto each other's network, at least partly because of a lack of scale in contracting for field services.

77. The consequence has been that all gas metering prices appear to be at the limit price set by the gas metering providers' perception of the threat of wholesale

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42 For a meter to be displaced, the old existing meter has to be removed and returned to the original meter provider, and the new meter needs to be installed in its place. The displacement process also requires coordination between meter owners, the retailer and the end-user.

43 Castalia's submission on behalf of Vector indicates that gross margins are [ ] after deducting depreciation but not allowing for indirect costs.

displacement—sponsored by retailers. In the absence of any competition for new installations, new connections are priced at the same limit price.

78. The following sections explain this reasoning in more detail.

Limit pricing of installed meters

79. This section sets out the evidence on the limit pricing of existing meters.

80. The Commission found limited existing competition between gas metering providers because, as explained below, once a gas meter is installed it is almost never removed. In effect, gas metering providers operate like parallel monopolists in respect to their installed meters.

81. Castalia Limited (Castalia), on behalf of Vector, explained:

> We believe that the key feature of any potential competition between gas meter owners is the fact that once a meter is installed, it effectively acquires an element of natural monopoly at that particular ICP and can be priced up to replacement cost.
>
> …
> In order to out compete an incumbent asset owner on price, a competitor would therefore have to be able to access capital at a cost [ ] of the incumbent's cost of capital. Since this is unlikely, we would not expect to see effective competition for the right to replace an existing meter prior to retirement.[44]

82. Vector submitted that it is this displacement cost that limits its existing pricing (and that this would remain the case, post-acquisition).

> The likely entrants (gas retailers) are large and sophisticated companies. Importantly, gas retailers already have existing relationships with the relevant contractors and service providers through other parts of their business. To the extent any benefit can be derived from scale, retailers could leverage their whole of business propositions. The retailers also have large customer bases that themselves underwrite a scale play, which could be underwritten either directly or by involving an intermediary.[45]

83. Contact advised that, post-acquisition, there would be nothing constraining any of the main gas retailers from self-supplying their own gas meters, as Contact has done for the past 14 years, or by sponsoring a third party to provide the necessary gas meters on the retailer's behalf.[46]

84. It seems more likely that a retailer would "sponsor" a third party (an existing metering provider or a new entrant) to provide the necessary gas meters on the retailer's behalf. The evidence before the Commission indicates that, in general, retailers have been exiting gas metering services markets.[47] Retailers have advised us

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44 Castalia submission to Commerce Commission 28 January 2013.

45 Vector response to Commerce Commission's Letter of issues, 2 December 2012.

46 For example, Contact advised that the most important skill in the provision of gas metering was being a good contract manager and this is one of the reasons its gas metering business only had [ ] staff.

47 This view is supported by statements from Contact and Genesis (who no longer supply electricity meters).

that they have other commercial opportunities with higher returns (such as generation) in which to invest their limited capital.[48]

85. Nevertheless, gas meters are an essential requirement for end-users and their respective gas retailers; one that both end-users and gas retailers cannot do without. Therefore, it is not a question of if a meter will be provided, but rather who will provide the meter and at what price.

86. We conclude that the price of gas metering is effectively at the metering providers' perception of the limit above which retailers would be better off to sponsor the wholesale displacement of the meters for their customers.

87. In other words, when an existing gas metering service provider is considering the pricing for its gas metering, the constraint on pricing is not from a retailer considering switching to an alternative metering provider for an individual meter. Rather, the constraint on the gas metering service provider is the threat of a gas retailer deciding that it would be more cost effective for the retailer to self-supply its own meters or the retailer may ask a different gas metering service provider to replace all of its customer's meters.

88. In effect, the threat of wholesale displacement sets the price that gas metering providers can charge in the North Island gas metering market. This is not the consequence of any competitive or anti-competitive process between the participants in the market. Rather it is the limit set by the price at which a gas metering provider perceives it would make sense for a retailer to displace existing gas meters.

No competition for metering during customer 'churn'

89. The Commission could not find any examples of an installed meter being displaced before the end of its economic lifecycle. As with the limit price, for a meter to be displaced, the old existing meter has to be removed and returned to the original meter provider, and the new meter needs to be installed in its place. Further, this requires coordination between meter owners, the retailer and the end-user.

90. If a gas retailer wanted an installed meter removed and a new meter installed every time an end-user switched retailers, this would increase the costs associated with supplying the 'switching' end-user.

91. In turn, the gas metering provider would likely look to recover the increase in costs in supplying the 'switching' end-user through higher meter charges to the gas retailer for that particular end-user. Alternatively, the metering provider could impose on the retailer some form of early 'termination' fee in relation to the 'switched' meter. Termination fees are common in other jurisdictions.

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48 [ ].

92. Under these circumstances, the effective price of metering would be higher than the limit price, so it is not surprising that such switching is not observed.

No competition for new meter installations

93. The Commission did not find evidence of existing competition for new gas meter installations. A lack of competition for new meters would explain why the charge for a new installation is the same as the charge for an installed meter. That is, a price up to, or near to, the metering supplier's perception of the limit price.

94. Contact does not compete for other gas retailers' new installations and it has never done so. Contact only installs new meters if it is the new customer's retailer. The result of this is that Contact does not currently compete directly with either Vector or Powerco to supply new gas metering services to other retailers.

95. Also, Powerco does not compete directly with Vector or Contact for end-users. Powerco only installs new installations on its own distribution network when it is requested to by a gas retailer. Powerco advised that the limited number of new installations each year does not provide it with sufficient scale to expand outside its existing regions, which is one of the reasons why it has never installed new meters on Vector's distribution network.

96. In any event, the number of new installs each year in the market is relatively small, [ ] compared to the number of installed meters.

97. Other industry parties advised as follows:

    97.1 GasNet stated that its primary focus is supplying gas metering on its own network. It expanded its business in the past, hence its (minimal) presence in the Hawke's Bay and the Manawatu, but supplying 'off net' would increase GasNet's service and transaction costs and so it would only be rational if GasNet could obtain sufficient scale. GasNet considered [ ].

    97.2 Nova advised that it would not increase its presence in residential gas metering as it did not regard the provision of gas metering services as its core business, [ ]. The small number of residential users for which it currently 'self supplies' metering were acquired through an acquisition. For large customers, if that customer is not to be on Nova's bypass network, Nova approaches the relevant network owner for metering.

    97.3 Powerco also advised that gas meters are an extension of the gas distribution network itself and there are efficiencies from providing both the distribution network and gas metering services together. These efficiencies reduce its incentive to supply 'off net'. Powerco also stated that given the limited number of new installations each year these installations would be unlikely to provide sufficient scale to induce it to expand outside its existing regions.

> While Powerco already has scale in that it has an existing gas metering business with back office functions, and purchasing power in relation to meters and existing service contracts, Powerco stated [
>
>].[49]

98. Both GasNet and Powerco highlighted that expansion onto other networks may provoke entry onto its network. There is therefore a potential strategic disincentive to expand off-network. Furthermore, metering providers say that there is a risk in seeking to compete off net, that the owner of the network - and rival metering provider - may have an ability to limit the outsider's access to the network and frustrate any expansion plans.[50]

Impact of pricing for new installation on installed meters

99. While the Commission did not find any evidence of competition to date for new installations, the Commission asked NERA Economic Consulting Limited (NERA) to provide its opinion on whether the pricing for new installations impacts on the pricing of the installed bases of both Vector and Contact. [51]

100. NERA explained that when deciding on the price to charge for a new meter a gas metering provider faces a trade-off between pricing low to win new installs and the reduction in revenue that it will suffer on its already installed base if it lowers prices generally to win the new meter.

101. It follows, as NERA explained, that the lower the proportion of new installs to existing meters, the lower the incentive gas metering service providers will have to price aggressively to win new meters.

102. The Commission accepts that competition for marginal customers (ie, new gas end-users) may influence providers' pricing. However, the question for the Commission is how strong this influence is.

103. As noted above, the proportion of new installs compared to each the party's installed base is relatively low, [ ]. This suggests that there may not be a strong incentive to reduce prices significantly for new installs.

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49 [

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50 See statements from interviews with [
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51 This assessment applies equally to the constraint on Powerco from new installations although, as noted above, Powerco metering price has until recently been a regulated price.

104. A lack of a strong incentive to reduce prices for new installs is consistent with Vector and Contact each pricing at their perception of the limit price for both existing meters and new installations.

104.1 First, Vector will have competing incentives as lowering its price on new installs will lower its prices for its whole portfolio.[52]

104.2 Secondly, NERA's analysis shows Vector may be pricing at, or close to, the bypass cost.[53] This suggests – as Castalia notes – there is very little room for competition between existing meter owners.[54] [55]

105. The Commission found little evidence to support the proposition that Vector currently provides a material constraint on Contact's prices (or vice versa). This is because there does not appear to be competition to install new meters; one would expect Contact (or Vector) to be pricing at or near its perception of the bypass cost for existing meters.

106. Overall, the Commission found that any incremental constraint provided by Vector and Contact on each other would arise only if the cost to switch out an installed Contact (Vector) meter and replace it with a Vector (Contact) meter is lower than the cost to switch to a gas metering provider other than Vector. That is, the bypass cost is lower when Vector or Contact is in the market. The Commission has not seen any evidence to date that suggests this is the case.

Conclusion on the current state of competition

107. The current state of competition in the North Island gas metering market appears to be limited.

108. Each provider's installed base is relatively stable and there is little incentive for existing gas metering service providers to expand outside their incumbent footprints.

109. Instead of pricing being determined by direct head-to-head competition, pricing in the market is constrained by the threat of a mass displacement of meters which means that providers effectively operate as parallel monopolies, in respect of their installed base of meters. The small number of new gas meter installations each year does not appear to have an impact on pricing in the market.

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52 This implies that the lower the proportion of new installs to existing meters, the lower the incentive the provider will have to price aggressively to win new meters. The proportion of new installs to the installed base is relatively low.

53 [ ].

54 Moreover, since Vector would not know precisely what the bypass cost for the retailer is, and given the asymmetry of the risk of pricing below or above the bypass cost, one would expect Vector to price at some margin below the bypass cost to ensure bypass does not happen.

55 While it may be argued that Vector has not conducted this type of bypass analysis, the fact that it has not performed the calculation says nothing about whether it is pricing on this basis. [ ].

110. To date, it appears that providers price up to their perception of the limit price, the price at which it would make sense for someone to wholesale-displace a large number of meters.

Competition without the merger

111. Although the Commission considers that there is currently no material competition between Vector and Contact, the Commission applies a forward looking test. The question, therefore, is whether Vector and Contact would continue to provide no material competitive constraint on each other if this merger did not proceed?

112. The Commission considers that the answer is 'yes', regardless of which of the two likely without-the-merger scenarios actually eventuates.[56]

113. The Commission acknowledges that competition from a new owner of the Contact business could be different from how Contact has acted in the past, particularly if a new owner faced different incentives to those of Contact.

114. The key issue is whether it would be likely for any new owner of Contact's business to act in a materially different way to what Contact would do if it retained the business.

115. The difference between the Contact 'holds' scenario and the sale to a third party scenario is that it is likely that a third party owner would not be integrated into retailing. This may induce a new owner to compete for new installs in a way that Contact currently does not.[57]

116. However, the Commission also has a concern about the strength of any competition for new installations on the market. The Commission is of the view that competition for marginal customers is not a primary driver of prices in the market. The Commission is of the view that the minimal number of new installations means that competition for these customers is not sufficient to materially impact on pricing for metering across the entire market.

117. Rather, the perceived limit price through the threat of wholesale displacement sets the price that gas metering providers charge in the market.

Limit pricing likely to continue if the proposed acquisition does not go ahead

118. The Commission cannot dismiss the possibility that, without the merger, Contact or a new owner could compete in a different way from how Contact and Powerco have competed with Vector in the past. For example, any metering provider could potentially start offering some kind of incentive to a gas retailer to encourage that gas retailer to select it as the preferred metering provider for new gas connections for that particular gas retailer.

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56 As noted above, this is because the Commission considers there would no material difference in the competitive constraint imposed by Contact's gas metering business if that business was owned by a third party rather than Contact.

57 [ ].

119. In this scenario, a gas metering provider would then be offering, in effect, a price that was less than the limit price. However, as the proportion of new installs is relatively small, any pricing impact as a result of new installations is unlikely to be substantial.

120. On the basis of the evidence available, the Commission considers that it is likely that gas retailers would only enter the market, through self supply or sponsorship, if pricing exceeded the limit price.

Conclusion on competition without the merger

121. Without the proposed merger, the Commission is of the view that the current limited competition would continue, regardless of whether Contact's gas metering business was owned by Contact or by a third party.

122. There appears to be little incentive for gas metering providers to charge a price other than what they perceive the limit price to be, given that the main constraint on pricing in the market would be the threat of a mass displacement of meters.

Competition with the merger

123. If the proposed acquisition goes ahead:

123.1 Vector would be the only provider of gas meter services on its gas distribution network (absent entry or expansion); and

123.2 Vector would also supply a large number of gas meters on Powerco's distribution network (by acquiring Contact's meters in Hawke's Bay, Manawatu and Wellington/Hutt Valley).

124. The proposed merger would remove the largest provider of gas metering in the North Island gas metering market. However, the removal of Contact as an independent competitor is unlikely to have a significant price effect because, as outlined above, the Commission is of the view that competitors in the market are already pricing up to, or near to, what they perceive as the limit price.

125. Post acquisition, Powerco would be the next largest gas meter provider after Vector. However, the Commission has seen little evidence to suggest that the proposed acquisition would cause Powerco to significantly expand its existing operations.

126. Powerco, to date, has shown little incentive to expand outside its incumbent footprint.[

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127. The Commission accepts that entry via a large contract, essentially resulting in the wholesale displacement of meters, would most likely be of sufficient extent to

constrain Vector from increasing prices, and that such entry could occur in a sufficiently timely fashion.[58]

128. The Commission considers that incremental new entry is unlikely to occur, if the proposed acquisition went ahead. All industry participants advised that the number of meters installed each year was limited and would not be sufficient to incentivise incremental entry and/or expansion.[59] The primary reason for this is the lack of scale.

129. Accordingly, with the merger, pricing in the market would likely be ultimately conditioned by the possibility of potential entry via the wholesale displacement of gas meters, which is the same dynamic that would likely exist without the merger.

Conclusion

130. The Commission has considered the probable nature and extent of competition that would exist, post-merger, in the North Island gas metering market.

131. Based on the information and evidence provided by the parties, it appears that if the proposed acquisition went ahead, the primary constraint on Vector (and other market participants) would be the limit price, as perceived by metering providers, that is, the price above which wholesale replacement of installed meters would be induced.

132. However, it appears that this is also the main constraint without the merger. As indicated, the question for the Commission is whether the retention of the Contact metering business as an existing competitor (either owned by Contact or a third party) would materially increase the constraints on Vector.

133. For the reasons explained, the Commission considers that any constraint provided by Contact would be limited.

134. The Commission considers that the proposed merger is unlikely to change the competitive dynamics in the market. In both the with and without scenarios, pricing in the market appears most likely to continue to be conditioned by the threat of the wholesale replacement of meters.

135. Therefore, when the Commission compares the state of competition with the merger to the state of competition without the merger, the Commission concludes that there is likely to be no substantial difference in competition.

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58 As explained above, the uncertainty in relation to advanced gas meters means that the Commission cannot be satisfied that entry with advanced gas meters would occur in a sufficiently timely manner so as to constrain Vector in the scenario with the merger.

59 [ ].

136. Accordingly, the Commission is satisfied that the proposed acquisition will not have, or would not be likely to have, the effect of substantially lessening competition in the North Island gas metering market.

Determination on notice of clearance

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

138. Under s 66(3)(a) of the Commerce Act 1986, the Commission gives clearance to Vector Limited to acquire the assets and business of Contact Energy Limited's natural gas metering business.

Dated this 26th day of April 2013

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Dr Mark Berry
Chairman