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Preliminary assessment of whether to conduct a Part 4 inquiry into gas metering services

The Commission: Dr Mark Berry, Chair

Sue Begg

Dr Stephen Gale

Dr Jill Walker

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Executive Summary

Purpose of this report

X1 This report provides our reasons for not initiating an inquiry under Part 4 of the Commerce Act 1986 (Part 4 inquiry) into whether regulation should be imposed on the supply of gas metering services.[1]

Why we considered whether to conduct a Part 4 inquiry

X2 In April 2013, we concluded our assessment of Vector's clearance application to acquire Contact Energy’s natural gas metering business. This assessment identified a lack of competition in the North Island gas metering services market.[2] Consequently, we decided to conduct a preliminary assessment of whether to conduct a Part 4 inquiry in relation to these services.

X3 We have carried out a preliminary assessment of each part of the test for a Part 4 inquiry, as laid out in section 52G of the Act. This test considers whether:

X3.1 the goods or services are supplied in a market where there is little or no competition and little or no likelihood of a substantial increase in competition;

X3.2 there is scope for the exercise of substantial market power in relation to the goods or services, taking into account the effectiveness of existing regulation or arrangements (including ownership arrangements); and

X3.3 the benefits of regulating the goods or services in meeting the purpose of Part 4 materially exceed the costs of regulation.[3]

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1 All statutory references in this report are to the Commerce Act 1986 (the Act).

2 All references in this report to the “gas metering services market” are to the North Island market. There is no distribution of reticulated natural gas in the South Island, but there are small LPG reticulation schemes in Christchurch, Dunedin, Wanaka, Arrowtown, and Queenstown.

3 The purpose of Part 4 is set out in section 52A(1) of the Act. Section 52A(1) directs us to make decisions that promote the long-term benefit of consumers by promoting outcomes consistent with those in competitive markets.

We have decided not to conduct a Part 4 inquiry at this time

X4 We have decided not to conduct a Part 4 inquiry into gas metering services at this time. This is because:

X4.1 A Part 4 inquiry and any subsequent regulation can be a time-consuming and costly exercise. The Commission, Vector and Powerco (and possibly other parties) would all incur direct and indirect costs from both the Part 4 inquiry and any subsequent regulation. These costs can be substantial.

X4.2 The threshold for regulation under Part 4 is high. Part 4 is primarily intended to regulate markets with natural monopoly characteristics, and the benefits of regulation must materially exceed the costs.

X4.3 Our indicative cost-benefit analysis does not yield sufficiently material net benefits. Accordingly, the likelihood of us recommending regulation, following a Part 4 inquiry, is not sufficiently high when balancing the benefits against the cost of an inquiry and any subsequent regulation.

X4.4 The evidence before us suggests that the net benefits of regulation, from a consumer perspective, are likely to be positive, but relatively small. The estimated net benefits are in a range of 63 cents to 103 cents per customer per month.[4]

X4.5 Our analysis is based on a consumer welfare standard. We have not attempted to separately identify material effects on allocative, productive and dynamic efficiency, although these would need to be assessed in a Part 4 inquiry. We have placed less emphasis on the benefits (or costs) on a total welfare basis for the purposes of a preliminary assessment.[5]

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4 This assumes consumers ultimately pay for regulation.

5 The benefits calculated in the consumer welfare analysis result from the transfer of income from businesses to consumers. In the total welfare analysis, these transfers are treaded neutrally. Given that there is unlikely to be any gain to allocative efficiency from regulation and the imposition of regulation would still involve costs, under a total welfare approach the net benefits would be negative.

X4.6 It is also possible that a Part 4 inquiry may not lead to regulation. This means that the costs of a Part 4 inquiry could be incurred without any benefits being produced. Our indicative cost-benefit analysis assumes that full costs and benefits would occur. If we were to weight the costs and benefits according to the likelihood of regulation being implemented, following an inquiry, the resulting net benefits would be lower.

We remain concerned about the lack of competition and the scope for the exercise of market power

X5 We remain concerned about the lack of competition and the scope for suppliers to exercise substantial market power in the market for the supply of gas metering services.

X6 We have considered whether the introduction of smart gas meters may alleviate our concerns. We do not have sufficient evidence to form a conclusive view on the prospect of substantially enhanced competition or constraints on the scope of suppliers to exercise market power in the future. We recognise that investigating these matters would be important aspects if we were to conduct a Part 4 inquiry. We have also considered this as a factor which is likely to reduce the expected net benefits of undertaking a Part 4 inquiry into gas metering services.

X7 Vector and Powerco submitted that the threat or imposition of regulation could hinder investment in smart gas meters. However, the lack of evidence to support this undermines this contention.

Alternative options for addressing any concerns

X8 This assessment is made against the existing legislative regime. However, where concerns about the exercise of market power are ongoing, legislative reform may be appropriate where this may achieve similar or better outcomes for the market more quickly or cost-effectively than regulation following a Part 4 inquiry.

X9 Gas pipeline services are already regulated under Part 4. A potential cost-effective way of enhancing the threat of regulation for gas metering services would be to amend the Act so that gas metering services are not an excluded service, and to provide for the scope of gas pipeline services to be readily extended to include gas metering services. This approach is consistent with the existing provisions for expanding the scope of regulated airport services.[6]

X10 Our remaining concerns about the scope Vector and Powerco have to raise their prices mean that we will continue to pay attention to the pricing of gas metering services in future, as we do with pricing in any infrastructure sector where competition concerns have been identified.

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[6] Section 56A(1)(d) of the Act which allows the Governor-General, by Order in Council made on the recommendation of the Minister to designate services as specified airport services.

Introduction

Purpose of this report

1. This report provides our reasons for not initiating an inquiry under Part 4 of the Commerce Act 1986 (Part 4 inquiry) into whether regulation should be imposed on the supply of gas metering services.[7]

Why we considered whether to conduct a Part 4 inquiry

2. On 25 October 2012, we received a clearance application under section 66 of the Act from Vector to acquire the gas metering assets and business of Contact Energy's natural gas metering business.

3. A clearance inquiry focuses on the change in the state of competition that will result or is likely to result from the proposed acquisition. Under section 66(3)(a) of the Act, we are required to give a clearance if we are satisfied that an acquisition will not, or would not be likely to substantially lessen competition in a market. Under section 66(3)(b) of the Act, we are required to decline to give a clearance if we are not satisfied that an acquisition will not, or would not be likely to substantially lessen competition in a market.

4. In a clearance decision, the existing level of competition generally acts as a baseline against which any change in the state of competition must be assessed, rather than as a determinative factor.[8] Accordingly, a clearance may be granted where an acquisition involves no increase in market power (and corresponding lessening of competition), even where competition is limited.

5. In considering the clearance application, we found that there was limited competition between Vector and Contact and other market participants in the North Island gas metering services market.[9] However, we granted Vector

[7] All statutory references in this report are to the Commerce Act 1986 (the Act).

[8] The existing state of competition is not the baseline in all cases, as we also consider the future with and without the acquisition, and the future without the acquisition may be more competitive than the existing state of competition.

[9] Commerce Commission, Vector Limited and Contact Energy Limited clearance decision, 26 April 2013, paragraphs E4 and E8.

a clearance on 26 April 2013 (the clearance decision) [10] because we found that there was likely to be no substantial difference between the future state of competition with and without the acquisition.

6. Consequently, because of our concerns about the lack of competition and the scope for suppliers to exercise substantial market power in the market, we said that we would consider undertaking an inquiry into gas metering services under Part 4 of the Act.

7. As noted in paragraph X3, a Part 4 inquiry involves separate assessments of:[11]

   7.1 the state of competition in the market;

   7.2 whether there is the scope for the exercise of substantial market power in relation to the goods or services; and

   7.3 whether the benefits of regulating the goods or services materially exceed the costs of regulation.

8. Having conducted a preliminary assessment, this report provides our reasons for deciding not to undertake a Part 4 inquiry due to the low level of the expected net benefits.

Structure of this report

9. The remainder of this report discusses the findings of our preliminary assessment of the three tests laid out in section 52G of the Act, being:

   9.1 **The competition test** - is there little or no competition, and little or no likelihood of a substantial increase in competition, in the gas metering services market?

   9.2 **The market power test** - is there scope for the exercise of substantial market power in the gas metering services market, taking into account

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[10] The determination clearing the acquisition, along with other information about the acquisition, including Vector's application, is available at http://www.comcom.govt.nz/business-competition/mergers-and-acquisitions/clearances/clearances-register/detail/774.

[11] In comparison, the test required for a clearance of an acquisition is a substantial lessening of competition test which compares the state of competition with and without the acquisition.

the effectiveness of existing regulation or arrangements (including ownership arrangements)?

9.3 **The cost-benefit test** - do the benefits of regulating gas metering services materially exceed the costs of regulation?

10. As we have found that the cost-benefit test is unlikely to be met if we were to conduct a Part 4 inquiry, we do not consider it necessary to reach firm conclusions on the competition and market power tests.

11. Attachment A explains the framework we used for our assessment in more detail.

12. Alongside this report, we have also published Covec's report on the benefits of regulating gas metering services under Part 4 of the Act.

Our process for undertaking this preliminary assessment

13. Our preliminary assessment was focused on the gas metering services supplied by Vector and Powerco. This was because:

13.1 Vector and Powerco together comprise 96% of the gas metering services market; and

13.2 given the preliminary nature of the assessment, gathering and analysing information about the other 4% of the market would have been unnecessarily complex and costly.

14. In carrying out our preliminary assessment, we:

14.1 obtained further information from Vector and Powerco about their gas metering businesses;

14.2 engaged Covec, an economic consulting firm, to undertake a high-level analysis of the benefits of regulating gas metering services;

14.3 estimated the costs of regulating gas metering services; and

14.4 obtained information from industry about the likelihood and timing of the introduction of smart meters.

15. We used Covec's estimates of benefits and our estimates of costs to identify the likely net benefits of regulating gas metering services, and the likelihood of meeting the Part 4 inquiry cost-benefit test.

16. In forming a view on the likelihood of the Part 4 inquiry competition and market power tests being met, we re-examined the findings of our clearance decision. This involved reconsidering the findings of the clearance decision in light of:

16.1 the competition and market power tests for Part 4 inquiries; and

16.2 new information that was not available at the time of the clearance decision's competition analysis.

Our decision

We have decided not to conduct a Part 4 inquiry

17. We have decided not to conduct a Part 4 inquiry into whether regulation should be imposed on gas metering services at this time. Although we consider that there is not currently a sufficient case for undertaking a Part 4 inquiry:

    17.1 we still have concerns about the lack of competition in the supply of gas metering services and the scope of Vector and Powerco to exercise substantial market power; and

    17.2 we will continue to pay attention to the pricing of gas metering services in future.

18. Where concerns about the exercise of market power continue, legislative reform may be appropriate, and in this case, may be the lowest cost option to address concerns. The supply of gas metering services could be brought into the current regulation of gas pipeline services.

The competition test

19. Under a Part 4 inquiry, section 52G(1)(a) would require us to assess whether:

    (a) the goods or services are supplied in a market where there is both—

        (i) little or no competition; and

        (ii) little or no likelihood of a substantial increase in competition…

20. In considering the competition test, we started from the substantive competition analysis on gas metering in the clearance decision. We then reconsidered the findings of the clearance competition analysis in light of:

    20.1 the statutory competition test for Part 4 inquiries; and

    20.2 new information that was not before us at the time of the clearance decision.

The competition analysis in the clearance decision

21. The competition analysis conducted for the clearance decision concluded that there was limited competition between Vector and Contact and other market participants in the North Island gas metering market.[12] However, as there was unlikely to be a significant difference between the state of competition with and without the acquisition, we granted a clearance.

22. In reaching that conclusion:[13]

> The Commission found limited existing competition between gas metering providers because… 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.

23. Castalia, on behalf of Vector, explained:[14]

> 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 that is less than half 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.

Findings reconsidered for the Part 4 inquiry competition test and new evidence

24. The competition test for a Part 4 inquiry is different to the competition test for a clearance assessment.

25. The competition test for a clearance requires a comparison of the likely state of competition with and without the acquisition. The competition test in a Part 4 inquiry is whether the goods or services are supplied in a market where there is little or no competition and little or no likelihood of a substantial increase in competition.

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12 Clearance decision, E4.

13 Ibid, para 80, citing Castalia submission to Commerce Commission of 28 January 2013.

14 Ibid, para 81.

26. We sought further information when re-examining our findings in the clearance decision. Vector provided information asserting that:

26.1 emerging developments in the smart metering market suggest that there is a likelihood of a substantial increase in competition in the future;[15] and

26.2 the Commission has yet to consider the substantial impact that the emergence of smart metering technology might have on competition, because:[16]

26.2.1 future market developments were not the primary focus of the clearance decision; and

26.2.2 significant developments in the gas metering market (relating to smart meters becoming more feasible) have occurred since the clearance decision.

27. Vector further submitted that smart meters are becoming commercially viable. In its view, wholesale displacement will likely soon be driven by retailers putting their gas metering requirements to competitive tender.[17]

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15 In particular, Vector's response to our information request noted that (covering letter, 22 October 2014, page 4): "In [Vector's] view, in New Zealand, wholesale displacement will likely soon be driven by retailers putting their gas metering requirements to competitive tender, as has occurred in the electricity smart metering space."

16 Ibid, page 3.

17 Vector, Letter proving comment on the Commission's draft report, 22 June 2015.

28. Competition Economists Group supported Vector's position that the introduction of smart meters would materially increase competition (provided Vector's characterisation of the likely future market developments was correct):[18]

> Even if incumbent providers did not previously face a binding competitive constraint on their pricing from the threat of displacement by retailers (which they arguably did do - see below), the emergence of new smart metering technology gives rise to this threat. In other words, even if one assumes that competition used to be limited, that is no longer the case - or, at the very least, there is the clear prospect of a material increase in competition in the future.
>
> Even if there were previously enduring barriers to entry created by incumbency, these will be ameliorated by smart metering technology. For example, even if entrants have faced higher costs than incumbents deploying legacy meters (such as from removing and returning existing meters) that will not be the case when deploying smart meters, since an incumbent and an entrant would both be making a new installation. Technological change will therefore strip incumbents of any substantial market power previously held.

29. We approached three major gas retailers, Powerco, and the Gas Industry Company (GIC) for their views on the likelihood of a smart meter rollout in the near future.

30. Two major retailers said that the business case for gas smart meters was improving but does not currently exist. Another major retailer said that there is not currently a business case for gas smart meters. GIC's view is that smart metering is evolving but is not expected to be disruptive for some time. Powerco also confirmed that none of the retailers had issued a request for tenders for gas smart meters.

[18] Competition Economists Group, *Economic Review of Draft Preliminary Assessment*, June 2015.

Conclusions on competition analysis

31. We consider that the fundamental characteristics of the gas metering services market described in our clearance decision remain the same. There is currently still little or no competition in the market for gas metering services.

32. The future state of competition is less clear, as based on the evidence obtained we are unable to reach a firm view on:

    32.1 the timing and likelihood of the roll out of smart meters; and

    32.2 whether or not the greater deployment of smart meters (if this occurred) would have a material effect on competition.

33. Given our findings on the cost-benefit test we do not consider it necessary to do further work on the competition test for purposes of this preliminary assessment.

34. If we were to proceed to a Part 4 inquiry, we would need to revisit the competition analysis in more detail to reach a definitive conclusion on the likelihood of a substantial increase in competition in the future.

The market power test

35. Under a Part 4 inquiry, section 52G(1)(b) would require us to consider whether:

    > (b) there is scope for the exercise of substantial market power in relation to the goods or services, taking into account the effectiveness of existing regulation or arrangements (including ownership arrangements)

36. For the purposes of the preliminary assessment, we looked at three issues when considering this test:

    36.1 Are there any existing regulations that may constrain Vector and Powerco from exercising substantial market power?

    36.2 Do the ownership structures of Vector and Powerco constrain them from exercising market power?

    36.3 What evidence is there about Vector and Powerco’s conduct?

Are there any existing regulations that constrain the ability of Vector and Powerco to exercise market power?

37. We consider that there are no existing regulations that may constrain Vector and Powerco's pricing of gas metering services.

38. Gas metering services are explicitly excluded from regulation under Part 4 of the Act.[19]

39. Technical aspects (such as safety, reconciliation and accuracy requirements) of gas metering services are regulated by legislation, regulations and rules. These are primarily administered by the GIC.[20] These regulations seem unlikely to constrain the ability to exercise market power.

Do the ownership structures of Vector and Powerco constrain their ability to exercise market power?

40. We consider that the ownership structures of Vector and Powerco do not constrain their market power.

41. The only notable consideration here is Vector's 75% trust ownership. However, only some gas metering customers are beneficiaries of the trust, and only because they are consumers of Vector's electricity distribution services. We consider that this would not constrain Vector from increasing its prices for gas metering services above competitive levels.

42. Powerco is privately held by QIC and AMP Capital.

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19 Section 55A(4), Commerce Act 1986.

20 Gas metering is primarily regulated by the Gas Act 1992 and the Gas (Safety and Measurement) Regulations 2010. Gas measurement obligations on meter owners and retailers are also set out in the Gas (Downstream Reconciliation) Rules 2008, and measurement standards are covered by a variety of formal Standards overseen by Standards New Zealand. In addition, the Retail Contracts Oversight Scheme 2010 principles administered by the Gas Industry Company require that retailers' supply arrangements with small consumers clearly describe the requirements for metering, including the frequency of meter reading and the obligation to ensure metering is conducted in accordance with relevant industry standards and codes of practice. See "The New Zealand Gas Story", 2nd Ed., Gas Industry Company (2014), pages 149–150, available at http://gasindustry.co.nz/dmsdocument/4127.

What evidence is there about Vector and Powerco's conduct?

43. Powerco has informed us that:[21]

> Powerco's pricing strategy over the last two years has been to increasing [sic] metering charges to align with other metering providers in the New Zealand market (noting that Vector's metering business was not regulated under its Gas Authorisation).

44. This suggests that, for Powerco, the pricing of its metering services is not directly linked to the cost of providing them.

45. In our clearance decision, we found that:[22]

> Contact's prices for gas metering services are
> [
>]

46. [ ]

47. In the clearance decision, we found that pricing is set at the cost of wholesale displacement:[23]

> … the price is [set] 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.
>
> …
>
> all gas metering prices appear to be at the limit price set by the gas metering providers' perception of the threat of wholesale displacement—sponsored by retailers. In the absence of any competition for new installations, new connections are priced at the same limit price.

48. This suggests that suppliers of gas metering services have the ability to take advantage of their market power by pricing well-above the cost of providing the metering services.

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[21] Powerco's response to our information request (31 October 2014), page 11.

[22] Clearance decision, para 66.

[23] Ibid, paras 74 and 77.

Conclusions on market power

49. We consider that there is continued scope for the exercise of substantial market power by Vector and Powerco.

50. The future position is less clear as, based on the available evidence, we are unable to reach a firm view on the likely constraints on the scope for Vector and Powerco to exercise market power in the future.

51. Given our findings on the cost-benefit test we do not consider it necessary to do further work on the market power test for purposes of this preliminary assessment.

52. If we were to proceed to a Part 4 inquiry we would need to conduct the market power analysis in more detail to reach a definitive conclusion on the likelihood of constraints on the scope for Vector and Powerco to exercise market power in the future.

The cost-benefit test

53. This test balances the potential benefits against the costs of regulation.

54. A preliminary assessment of the costs and benefits of imposing regulation allows for a sense of scale as to the likelihood that benefits of regulation will materially exceed costs. Our analysis includes:

    54.1 an estimate of the benefits based on simplifying assumptions;

    54.2 an estimate of the direct costs incurred by the Commission and ‘potentially’ regulated suppliers from a Part 4 inquiry and any subsequent regulation; and

    54.3 some sensitivity and scenario analysis.

55. From this analysis an element of judgement is then applied as to the likelihood that benefits will materially exceed costs.

The net benefits are not sufficiently material

56. Our indicative cost-benefit analysis does not yield sufficiently material net benefits. Accordingly, the likelihood of us recommending regulation, following a Part 4 inquiry, is not sufficiently high when balancing the benefits against the cost of an inquiry and any subsequent regulation.

57. Factors leading to this conclusion are:

57.1 A Part 4 inquiry and any subsequent regulation can be a time-consuming and costly exercise. The Commission, Vector and Powerco (and possibly other parties) would all incur direct and indirect costs from both the Part 4 inquiry and any subsequent regulation. These costs can be substantial.

57.2 The threshold for regulation under Part 4 is high, and the benefits of regulation must materially exceed the costs. Evidence before us suggests that the net benefits are not sufficiently material to support a Part 4 inquiry.

57.3 From a consumer bill perspective, the net benefit from regulation is positive, but relatively small. The estimated net benefit is in a range of 63 cents to 103 cents per customer per month.

57.4 Our analysis is based on a consumer welfare standard. We have not attempted to separately identify material effects on allocative, productive and dynamic efficiency, although these would need to be assessed in a Part 4 inquiry. We have placed less emphasis on the benefits (or costs) on a total welfare basis for the purposes of a preliminary assessment.[24]

57.5 As indicated in the competition test section above, the future state of competition is unclear and the outcome is uncertain at this stage. If and when smart meters are rolled out, competitive constraints in the market may be greater in the future.

57.6 It is possible that a Part 4 inquiry may not lead to regulation. This means that the costs of a Part 4 inquiry could be incurred without any benefits being produced. Our indicative cost-benefit analysis assumes that full costs and benefits would occur. If we were to weight the costs and benefits according to the likelihood of regulation being implemented, following an inquiry, the resulting net benefits would be lower.

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[24] Under a total welfare standard, the net benefits of regulation are likely to be negative, given that there are unlikely to be any gains in allocative efficiency and transfers of surplus to consumers would not be counted.

58. It is ultimately the Minister's decision whether services should be regulated having considered our recommendation.[25] We (and the Minister) would need to consider a wider range of factors, including both consumer and total welfare considerations, under a Part 4 inquiry before a firm could be regulated.

59. The following paragraphs provide the results, and more detailed discussion, of our indicative cost-benefit analysis.

Results of our indicative cost-benefit analysis

60. We conducted a simplified, indicative, cost-benefit analysis, to assess the net benefits of regulating gas metering services.

61. Our cost-benefit analysis considered two main scenarios. One scenario assumes no or little switching to smart meters, and the other scenario assumes incremental smart meter rollout for gas metering services.

62. Our indicative cost-benefit analysis found there are likely benefits to consumers of imposing regulation. However, these benefits are relatively small and in the range of 63 cents to 103 cents per month, per customer. The 63 cents was derived from our estimated $15 million net benefits over 10 years, and the 103 cents was derived from our estimated $25 million net benefits over 10 years.[26]

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[25] See section 52M(1).

[26] Our net benefit of $15 million over 10 years in this preliminary assessment is lower compared to other preliminary Part 4 inquiries previously conducted by the Commission. For example, in our preliminary assessment of Eastland Ports, we estimated a net benefit of $65 million, and found the $65 million is sufficiently material to justify a Part 4 inquiry. See, Commerce Commission, *Letter to Matt Todd of Eastland Group-Preliminary assessment of Eastland Port*, 20 June 2014, Table 1, and page 9, is available at http://www.comcom.govt.nz/regulated-industries/part-4-inquiries/previous-inquiries-and-preliminary-assessments/eastland-port-preliminary-assessment/.

63. Our estimates are shown in Table 1.1, broken down by the different scenarios considered in our analysis.

Table 1.1 Benefits, costs and discounted net benefits of regulating gas metering services (consumer welfare standard)

	Benefit per customers (cents, per month)	Benefits of regulation ($2016 million, 2016-25)	Costs of regulation ($2016 million, 2016-25)	Net benefit ($2016 million, 2016-25)
No smart meter roll out	103	40	15	25
Incremental smart meter rollout	63	30	15	15

Source: Commission's analysis

64. As illustrated in Table 1.1 our cost-benefit analysis considers:

64.1 The direct costs of undertaking a Part 4 inquiry and subsequent regulation.

64.2 Benefits of regulation under a scenario that assumes no or little switching to smart meters.

64.3 Benefits of regulation under a scenario that assumes incremental smart meter rollout for gas metering services. This scenario assumes that firms will incrementally change their meter stock to smart meters over the course of the next 10 years.

64.4 Net benefits for each scenario, being the difference between benefits and costs for each scenario.

64.5 Benefit per customer per month, which is the net present value (NPV) over 10 years converted to a benefit per customer per month.[27]

65. The remainder of this section explains each of the considerations above.

[27] Total NPV net benefit figures were annualised and divided by the number of customers to get a per customer benefit for regulation on an annual basis. This was then converted to a monthly figure and compared with an average annual gas bill. We used a discount rate of 7%.

Indicative costs for regulating gas metering services

66. Our cost-benefit analysis includes estimated direct costs, but excludes indirect and opportunity costs. Table 1.1 above shows that we have estimated the costs of regulation over 10 years to be $15 million for all scenarios.[28]

67. We have estimated the direct costs to be similar to those we have previously incurred when undertaking regulation. These costs include estimates of the costs that would be incurred by the Commission, Powerco, Vector and other firms that may be involved were gas metering services to be regulated and consist of:

    67.1 Setup costs, including both the Commission's costs and external costs. The Commission's costs include all costs associated with a Part 4 inquiry, such as consideration of the tests under section 52G, specification of regulated services, determination of input methodologies, assessing the costs and benefits of different forms of regulation, and all costs for a new determination under section 52P. External costs include costs borne by 'potentially' regulated suppliers.

    67.2 Ongoing costs of regulating gas metering services. Our assumptions include the Commission's costs, annual costs of information disclosure and summary analysis, compliance costs and reset costs. Our cost assumptions also include costs borne by 'potentially' regulated suppliers in relation to ongoing costs of regulation.

Indicative benefits for regulating gas metering services

68. Table 1.1 shows the benefits of regulating gas metering services to be $40 million over 10 years in the scenario assuming no smart meter rollout. Benefits are $30 million over 10 years in the scenario assuming incremental smart meter rollout. These benefits were estimated on a consumer welfare basis.[29]

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[28] We have considered whether the Commission's costs were relevant to a consumer welfare test. For the purposes of a preliminary assessment of whether to undertake a Part 4 Inquiry, we are satisfied these costs are relevant to the overall question we are considering because they would ultimately be borne by consumers either through higher prices and/or higher taxes.

[29] Covec indicated that there is likely to be little benefit from regulation on a total welfare basis, and we agree.

69. We commissioned Covec to forecast the benefits of regulating gas metering services under price-quality regulation.[30] In summary, Covec assessed the potential benefits as the differential between the estimated return on asset value and WACC for each scenario reflected in Table 1.1 above.[31]

70. These estimated benefits were used in our indicative cost-benefit analysis to estimate the net benefit, taking into account the cost of regulation.

On balance, net benefits are not sufficiently material

71. Table 1.1 above shows that the net benefit to customers, from a consumer bill perspective is positive but not sufficiently material in this instance:

    71.1 For the scenario based on the incremental rollout of smart meters, the net benefit is 63 cents per customer per month. This benefit per customer per month was derived from the estimated total net benefit of $15 million over 10 years;[32] and

    71.2 For the scenario assuming no smart meter rollout, the net benefit is 103 cents per customer per month. This benefit per customer per month was derived from the estimated total net benefit of $25 million over 10 years.[33]

72. The reason for the benefits being lower in the smart meter scenario compared to the scenario with no smart meter rollout is because the smart meter rollout requires investment which reduces profit levels and the rate of return during the 10 year period.[34]

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[30] Covec, "Updated preliminary Assessment of merits of Part 4 inquiry into gas metering", Prepared for the NZ Commerce Commission, 29 January 2016 (Covec's report).

[31] Results of the estimated benefits for Powerco and Vector are presented in Covec's report at Figure 7 and Figure 11.

[32] If $15 million in benefits over 10 years was delivered to customers, this would result in an $8 reduction in an average annual gas bill or 63 cents per customer per month.

[33] A $25 million net benefit would result in a $12 reduction in an average annual gas bill or 103 cents per customer per month.

[34] The return on book value improves in later years once the investment program is complete. For the purposes of this preliminary assessment, we have assumed prices would not increase following such investment in smart meters. This is a conservative approach to estimating the benefits of regulation.

73. Our indicative cost-benefit analysis is most sensitive to assumptions around smart meter rollout. We think that a 10 year rollout is a reasonable assumption on which to base our analysis. This assumption was informed by views from industry stakeholders.[35]

74. We conducted sensitivity analysis to consider the effect of our assumption on the time-horizon for the incremental rollout of smart meters. If we assumed a shorter time-horizon for the rollout of smart meters, the resulting net benefits are still positive, but reduced to some extent.

75. The benefits calculated in the consumer welfare analysis result from the transfer of income from businesses to consumers. In the total welfare analysis, these transfers are treated neutrally. Given that there is unlikely to be any gain to allocative efficiency from regulation and the imposition of regulation would still involve costs, under a total welfare approach the net benefits would likely be negative.

A Part 4 inquiry may be required in future

76. While the net benefits are not sufficiently material at this stage to undertake a Part 4 inquiry, this may change in future. Our remaining concerns about the scope Vector and Powerco have to raise their prices mean that we will continue to pay attention to the pricing of gas metering services in future, as we do with pricing in any infrastructure sector where competition concerns have been identified.

77. Powerco suggested that signalling a later review would chill investment in the same way that actually undertaking a Part 4 inquiry would.[36] However, Powerco submitted no evidence to support this contention. We do not think that regulation of gas metering services need harm or disrupt investment in the deployment of smart meters.

78. The net benefits assessment is made against the backdrop of the existing legislative regime. We have also considered alternative options that might

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[35] The $22 million over 10 years is based on the assumption that Powerco and Vector will incrementally roll out smart meters over the next 10 years.

[36] See, for example, Powerco's response to our information request (31 October 2014), para 7(a).

achieve similar or better outcomes for the market more quickly or cost-effectively if our concerns about the exercise of market power continue.

79. As gas pipeline services are already regulated under Part 4, a potential cost-effective way of enhancing the threat of regulation would be to amend the Act so that the scope of regulated gas pipeline services can be readily extended to gas metering services. This approach is consistent with the existing provisions for expanding the scope of regulated airport services.[37]

[37] Section 56A(1)(d) which allows the Governor-General, by Order in Council made on the recommendation of the Minister to designate services as specified airport services.

Attachment A Regulatory framework

The framework for conducting a Part 4 inquiry

A1 A Part 4 inquiry can be triggered by the Minister of Commerce or on our own initiative.[38]

A2 The purpose of a Part 4 inquiry is for us to assess whether or not regulation under Part 4 should be imposed in relation to specified goods or services, and to then make a recommendation to the Minister who will make the final decision.

A3 Section 52I of the Act sets out the framework of a Part 4 inquiry, namely it provides that when conducting an inquiry into particular goods or services, we must consider:

A3.1 whether the tests in section 52G are satisfied in relation to the goods or services; and

A3.2 if those tests are satisfied, whether the goods or services should be regulated.

A4 Section 52G sets out the initial tests that needs to be met before goods or services may be regulated, it provides:

52G When goods or services may be regulated

(1) Goods or services may be regulated under this Part only if-

(a) The goods or services are supplied in a market where there is both-

(i) little or no competition; and

(ii) little or no likelihood of a substantial increase in competition; and

(b) there is scope for the exercise of substantial market power in relation to the goods or services, taking into account the effectiveness of existing regulation or arrangements (including ownership arrangements); and

(c) the benefits of regulating the goods or services in meeting the purpose of this Part materially exceed the costs of regulation.

A5 Sections 52I(2)(b) and 52I(3) further provide:

(2) As part of an inquiry into particular goods or services, the Commission-

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[38] Section 52H(1) of the Act.

(b) must, when carrying out the analysis required by section 52G(1)(c), undertake a qualitative analysis of all material long-term efficiency and distributional considerations.

(3) As part of that qualitative analysis, the Commission must, as far as practicable,-

(a) quantify material effects on allocative, productive, and dynamic efficiency; and

(b) quantify material distributional and welfare consequences on suppliers and consumers; and

(c) assess the direct and indirect costs and risks of any type of regulation considered, including administrative and compliance costs, transaction costs, and spill-over effects.

A6 Section 52I (5) also makes it clear that we have a wide discretion regarding the matters we can have regard to:

(5) During an inquiry, the Commission may have regard to any other matters it considers necessary or desirable for the purpose of the inquiry.

Our approach to this preliminary assessment

A7 The purpose of a preliminary assessment is for us to reach a view on whether the likelihood of recommending regulation under Part 4 is sufficiently high to justify the cost associated with a Part 4 inquiry.

A8 While a preliminary assessment is our own non-statutory process, we have taken guidance from the statutory tests for an inquiry. Our preliminary assessment therefore involves consideration of whether each of the three tests under section 52G that we would need to consider as part of a Part 4 inquiry would be likely to be met in the case under consideration.

A9 The purpose of the preliminary assessment is not to definitively answer any of the relevant Part 4 inquiry questions, but rather to determine whether the evidence justifies initiating a Part 4 inquiry.

A10 A preliminary assessment of the costs and benefits of imposing regulation includes:

A10.1 an estimate of the benefits based on simplified assumptions;

A10.2 an estimate of costs based on our costs for similar work; and

A10.3 some sensitivity analysis.

A11 Unlike under a Part 4 inquiry, we have not attempted to separately identify material effects on allocative, productive and dynamic efficiency. We have focused on consumer welfare impacts from exercising substantial market power for the purposes of this preliminary assessment.

A12 We recognise that a Part 4 inquiry may come to a different finding to a preliminary assessment. Accordingly, we do not seek to draw any firm conclusions in relation to the tests in section 52G, but rather assess the prospect that those tests would be satisfied if a Part 4 inquiry was conducted.

A13 We have previously provided public guidance on the framework for when and how we will conduct an inquiry under Part 4 of the Commerce Act.[39] The guidance also notes that:[40]

> ...We also need to consider whether an alternative option is open to the Commission (or another body) that might achieve similar or better outcomes for that market more quickly or more cost-effectively.

[39] Commerce Commission fact sheet “The Commerce Act: Regulation of goods and services” (June 2011), available at http://www.comcom.govt.nz/dmsdocument/7022.

[40] Ibid.