NOVA GAS LTD

2 July 2004

Public Version

Gas Pipelines Inquiry
Commerce Commission
P O Box 2351
Wellington

Submission in Response to the Gas Control Draft Report (21 May 2004)

Executive Summary

1. Nova Gas Limited ("**Nova**") is a relatively new entrant for gas distribution.

2. Nova's bypass pipelines extend for only 110 kilometres. Over 70% of Nova's customers' gas is distributed via third party distribution pipelines.

3. Nova supplies gas mainly to large commercial and industrial customers. For the most part, Nova supplies gas to its customers on a bundled energy and distribution basis.

4. The entry of Nova has had a significant impact on the price for distribution services within the areas of Nova's operations, namely Auckland, Wellington and the Hawkes Bay. Some examples of this price competition are set out in paragraphs 28 - 32 below.

5. Nova's presence provides a competitive stimulus. Nova faces strong competition to win and retain its customers.

6. Competition is not "limited or likely to be lessened" in any of the markets in which Nova operates. Accordingly, there is no case for control so far as Nova's bypass pipelines are concerned.

7. Confidentiality is claimed in respect of all information contained within square brackets in this submission on the basis that it is cost/price information and/or is otherwise commercially sensitive.

Background to Nova's Operations

8. Nova is a supplier of reticulated natural gas, primarily to commercial and industrial customers. It commenced operations in 1995 and is a relatively new entrant to the gas distribution and retail markets.

   With a few limited exceptions, Nova's customers are commercial and industrial businesses with annual demand of greater than 1TJ. The majority of Nova's customers are situated in Auckland, Wellington and the Hawkes Bay. Nova's share of the national gas distribution market by volume conveyed is approximately [ ].

9. Nova usually quotes customers a bundled price for delivered gas. In Nova's experience customers prefer to receive a single price for all of their gas services.

10. Nova currently sources its gas from the Kapuni gas field. It is supplied partly by Shell (Petroleum Mining Company) Limited and partly by Todd Petroleum Mining Company Limited ("**TPM**")). In the past Nova has also sourced gas from its landfill gas extraction projects and is currently developing similar projects for use in the near future.

11. At paragraph 15.14 of the Draft Report the Commission noted that there was some suggestion at the conference that Nova acquires its gas from TPM at less than market prices. This is incorrect. Despite being a subsidiary of TPM (though not wholly owned), Nova acquires its Kapuni gas at market prices and does not receive any discount from its parent company.

12. There was also a suggestion that Nova is able to offer customers lower gas prices because it shares the cost of network rollout with other infrastructure companies (such as telecommunications companies). Again, this statement is incorrect. It is true that Nova has installed ducts for Saturn TV in its gas pipeline trenches in parts of Wellington. While this slightly reduced costs for both parties, Nova's cost saving was minor and had little impact on the overall economics of the project. The decision to build the bypass was made on economic grounds on a standalone basis long before the opportunity to share trenches with Saturn eventuated. It did not amount to a significant factor in Nova's ability to offer lower prices.

13. Nova also operates gas extraction systems at landfills and has distributed treated landfill gas to customers as a substitute for natural gas. It is currently developing a landfill gas project at the Happy Valley landfill south of Wellington. The Nova networks have been built with the ability to supply customers with a mix of treated landfill gas and natural gas. The Nova customer network has a different contractual gas specification to that in the New Zealand pipeline network.

14. Nova distributes its gas to its customers using both third party transmission and distribution networks and its own bypass distribution networks. Nova has entered into various arrangements with transmission and distribution network owners to transmit gas along their networks.

15. Gas purchased by Nova from the Kapuni gas field is treated at NGC's Kapuni gas treatment plant before being transmitted along NGCT's transmission pipelines. It exits the transmission pipeline at a gate station and is then distributed to Nova's customers either through NGCD, Powerco or Vector's distribution networks or through Nova's bypass pipelines. Gas generated from Nova's landfill projects is distributed to customers via dedicated bypass pipelines. It is not distributed over third party networks.

16. During recent years Nova has installed approximately 110km of bypass distribution pipelines, allowing it to distribute gas without relying on access to third party distribution networks and compete in the gas distribution market. However, over 70% of the gas supplied by Nova is still distributed via third party distribution pipelines.

17. The table below lists the points of interconnection between Nova's bypass networks and third party networks and describes the transmission charges paid by Nova. Nova generally pays NGCT's posted prices for transmission. However, in some cases Nova pays an increased price to cover the cost of additional capital equipment installed to facilitate Nova's bypass. Other than the connection with the Vector distribution network at Walmsley Road in Mangere, all of Nova's bypass pipelines connect with NGCT's transmission network.

Network	**Interconnection Point**
Wellington/Porirua/ Petone transmission network	Tawa B gate station. This gate station was constructed by Nova in 1998 and was subsequently sold back to NGC. Nova pays the same transmission charges as users of the Tawa A and Belmont gate stations (the interconnection point for the Powerco networks) plus an additional monthly rental charge for NGC assets installed.
Hastings transmission network	The interconnection point is at the NGC Hastings gate station. The pricing and terms for transmission services are the standard NGC terms, the same as for users of the Powerco network in Napier and Hastings.
Hawera Transmission Network	The interconnection point is at the NGC Hawera gate station. The pricing and terms for transmission services are the standard NGC terms, the same as for users of the Powerco network in Hawera.
Papakura (Hunua) Transmission Network	The interconnection point is at the NGC Hunua gate station. The pricing and terms for transmission services are the standard NGC terms, the same as for users of the Vector network in Hunua.
Wiri transmission network	The interconnection point is at the Flat Bush gate station. This gate station was constructed by Nova in 1999 and was subsequently sold back to NGC. Nova pays the same transmission charges as users of the Westfield and Papakura gate stations (the main interconnection points for the Vector network) plus an additional monthly rental charge for NGC assets installed.

East Tamaki transmission network	The interconnection point is the Flat Bush gate station as above.
Mangere distribution network	The interconnection point is on the Vector network at Walmsley Road. This interconnection agreement was negotiated in 2000 when the network was owned by Orion. The agreement allowed Nova to construct a line extension to the Mangere wastewater treatment plant. The line was subsequently extended to connect two additional gas loads but the limited capacity allowed under the interconnection agreement means that further extensions are unlikely.

Legal Framework

18. The Commission is required to advise the Minister on, amongst other things, whether gas pipeline services may be controlled in terms of section 52 of the Commerce Act 1986 ("the Act"). There are two limbs to section 52. The first issue, under section 52(a), is whether the services in question are, or will be, supplied or acquired in a market in which competition is limited or is likely to be lessened. The second issue, under section 52(b), is whether control is necessary or desirable having regard to the interests of the various persons identified in this provision.

19. The Commission can only advise, and the Minister can only recommend, control if competition in relation to the services in question is limited or likely to be lessened: sections 56(1) and 53(3). If competition is not limited or likely to be lessened within the meaning of section 52(a), then it is unnecessary to consider the provisions of section 52(b) in relation to such services. There is, simply stated, no case for control.

20. The central issue in relation to section 52(a) is the meaning of the competition threshold, being whether competition is limited or likely to be lessened in the relevant market.

21. The "limited" competition threshold involves a current inquiry. For competition to be limited, there needs to be more than a nominal or de minimis restriction or impairment of competition in the relevant market. Clearly, if workable or effective competition exists, then competition cannot be "limited".

22. The "likely to be lessened" competition threshold involves a forward-looking inquiry. Is a change of circumstances likely which will have the effect of resulting in limited competition in the market? This threshold will potentially only be of relevance to markets that are likely to move from workable or effective competition to limited competition.

23. Nova faces, and will continue to face, workable or effective competition in all relevant markets for the reasons set out below.

Dynamics of Bypass Competition

24. Nova agrees with the Commission's conclusion (at paragraph 3.67 of the Draft Report) that there is strong competition in the bypass market and that it does not meet the requirement in section 52 of the Act for the imposition of control.

25. Over the past decade Nova has used its bypass networks to compete with incumbent gas distribution network owners – Powerco in Wellington, Hawera and Hastings and Vector in South Auckland. As noted above, Nova has installed approximately 110 kilometres of bypass pipelines and competes with the incumbents for supply to mainly large commercial and industrial customers situated close to the interconnection points listed in paragraph 17 above.

26. The cost of installing bypass pipelines is dependent on many factors, including the underground conditions (soil type, presence of rock etc) and above ground conditions (traffic flows and road conditions). Average costs are significantly higher than suggested at paragraph 3.59 of the Draft Report and typically range from [ ] to [ ] per metre of pipeline. A substantial proportion of the cost of a bypass is the installation of a new gate station at the connection point or connection to existing NGCT interconnection infrastructure. This may cost upwards of $500,000. Other substantial costs include:

- customer connections and meters;
- easements over private land;
- railways crossings; and
- bridge crossings.

27. By constructing bypass pipelines Nova has been able to offer its retail customers savings of up to 50% in the price of their delivered gas. Most of the cost savings in the bundled price can be attributed to a decrease in distribution charges. Typically, to establish a bypass market Nova offers customers a reduction of [ ] in its bundled gas price. Of this, the distribution charge component of the price is reduced by [ ]. In Nova's experience, competitive pressure from incumbent distributors over time further reduces distribution charges to approximately 50% of the price prior to Nova's entry to the market. As ACIL noted in its *Review of the New Zealand Gas Sector: A Report to the Ministry of Economic Development* (October 2001) "bypass or threat of it has resulted in lower prices for some customers"[1].

28. The competitive response from incumbent network companies in the areas where Nova has built or threatened to build bypass networks has been fierce and is evidenced by the significant reduction in distribution prices since Nova's entry. In some cases distribution prices for large commercial and industrial sites in bypass markets have reduced by up to 90%. When Nova offers customers decreased distribution prices the incumbents are forced to drop their prices to compete. The table below gives some examples of effect of competition in the bypass market on distribution prices.

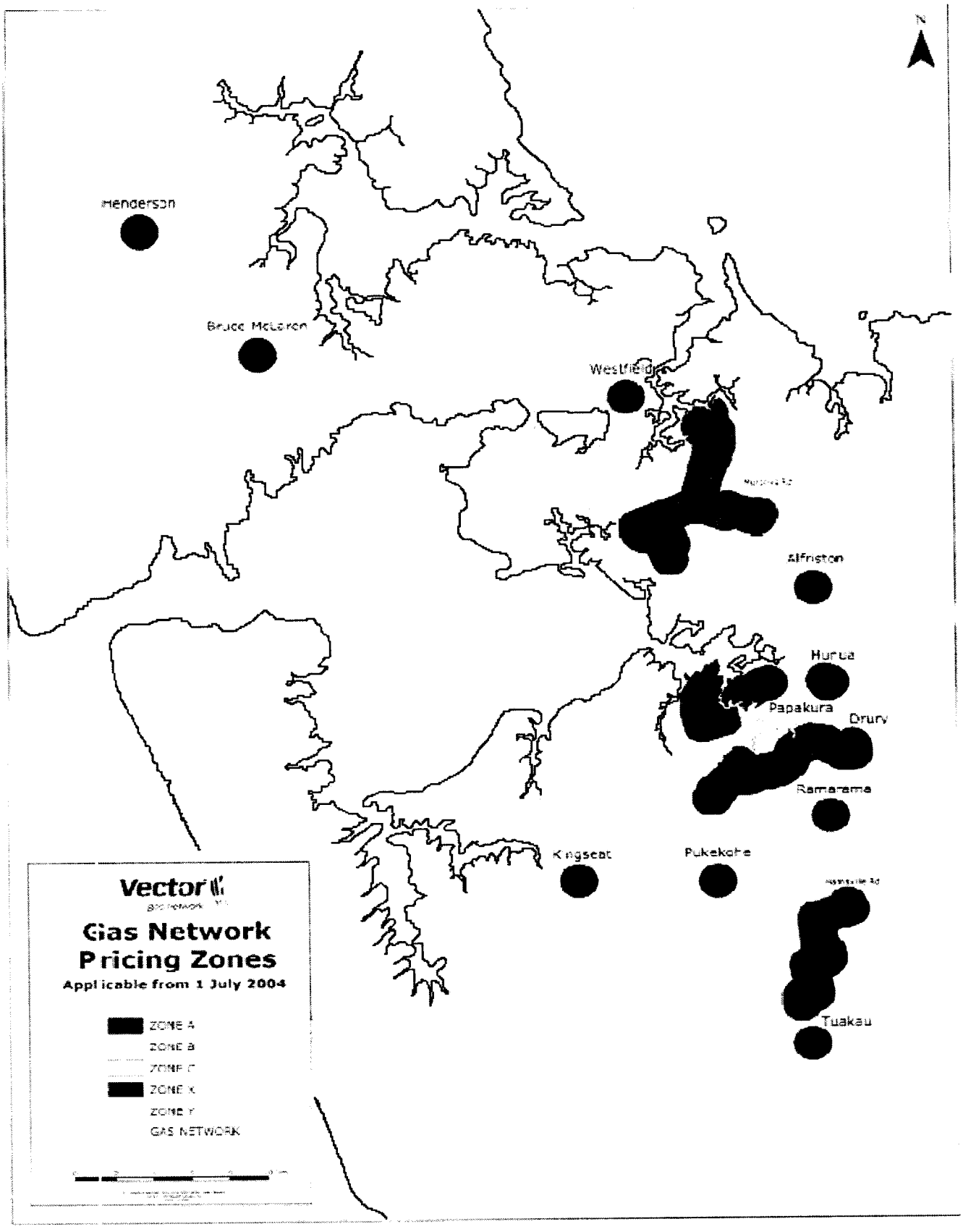
[1] At page XV.

Customer	**Distribution price in 1998 prior to Nova's entry**	**Distribution price offered by incumbent in 2003/2004 after Nova's entry**	**Percentage decrease in price**
[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]
[ ]	[ ]	[ ]	[ ]

29. These examples can be contrasted with distribution prices for smaller commercial and residential customers. Nova does not typically supply small commercial or residential customers unless they are located within approximately 100 metres of an existing bypass pipeline. The vast majority have no choice of gas distributor and gain no benefit from the competition generated by bypass. Distribution prices for these customers have continued to rise and there is now a substantial difference between the per GJ distribution price for large gas users in bypass markets and smaller customers. This was not the case before Nova entered the distribution market.

30. The incumbents have also responded to Nova's entry to the market by changing their pricing strategies. Vector has introduced a system of zonal pricing for customers in South Auckland and prices distribution services depending on the customer's distance from Nova's bypass pipeline (illustrated in the map below). Vector has decreased its prices for customers close to Nova's bypass networks and increased the prices for customers located in areas where there is not a risk of bypass.

31. Customers in zone X (less than 1 kilometre from Nova's pipeline) are offered the lowest prices, followed by customers in zone Y (between 1 and 3 kilometres from Nova's pipeline). Prices are highest in zone C where there is little or no threat of bypass.


N
Henderson
Bruce McLaren
Westfield
Alfriston
Hunua
Papakura
Drury
Ramarama
Kingseat
Pukekohe
Tuakau
Vector
Gas Network
Pricing Zones
Applicable from 1 July 2004
ZONE A
ZONE B
ZONE C
ZONE X
ZONE Y
GAS NETWORK

32. The following table shows the movement in price for customers in each zone. Distribution charges for large customers in zone C has in fact increased by 16% while charges for similar customers in zone X have decreased by 41%. Distribution prices in zone C are now 96% higher than the charges for a similar sized customer in zone X. This illustrates the increased competition in both actual and potential bypass markets. It also illustrates the ability of incumbents to engage in discretionary pricing conduct where there is no apparent threat of bypass.

	Pricing before introduction of zone pricing (Dec '02)			Current pricing			Change
	$/day	$/kWh	$pa	$/day	$/kWh	$pa	%
Residential	0.2351	0.0238	$ 276	0.2398	0.0261	$ 296	7%
Gp 1 Zone C	0.2147	0.028	$ 834	0.2897	0.0286	$ 877	5%
Gp 2 Zone C	0.09301	0.0226	$ 3,085	1.1376	0.0231	$ 3,527	14%
Gp 3 Zone C	6.7555	0.015	$ 26,466	6.936	0.0168	$ 29,476	11%
Gp 4 Zone C	19.418	0.0133	$ 80,244	21.342	0.0155	$ 93,048	16%
Gp 1 Zone B	0.2147	0.028	$ 834	0.2897	0.0286	$ 877	5%
Gp 2 Zone B	0.09301	0.0226	$ 3,085	1.1376	0.0231	$ 3,527	14%
Gp 3 Zone B	6.7555	0.015	$ 26,466	6.00	0.0145	$ 25,390	-4%
Gp 4 Zone B	19.418	0.0133	$ 80,244	18.00	0.0135	$ 80,827	1%
Gp 1 Zone A	0.2147	0.028	$ 834	0.2897	0.0286	$ 877	5%
Gp 2 Zone A	0.09301	0.0226	$ 3,085	1.1376	0.0231	$ 3,527	14%
Gp 3 Zone A	6.7555	0.015	$ 26,466	5.00	0.013	$ 22,625	-15%
Gp 4 Zone A	19.418	0.0133	$ 80,244	15.00	0.011	$ 65,981	-18%
Gp 1 Zone Y	0.2147	0.028	$ 834	0.2897	0.0286	$ 877	5%
Gp 2 Zone Y	0.09301	0.0226	$ 3,085	1.10	0.014	$ 2,292	-26%
Gp 3 Zone Y	6.7555	0.015	$ 26,466	4.00	0.012	$ 20,660	-22%
Gp 4 Zone Y	19.418	0.0133	$ 80,244	12.00	0.01	$ 59,385	-26%
Gp 1 Zone X	0.2147	0.028	$ 834	0.2897	0.0286	$ 877	5%
Gp 2 Zone X	0.09301	0.0226	$ 3,085	0.90	0.012	$ 1,949	-37%
Gp 3 Zone X	6.7555	0.015	$ 26,466	3.00	0.01	$ 17,095	-35%
Gp 4 Zone X	19.418	0.0133	$ 80,244	9.00	0.008	$ 47,289	-41%

33. Vector's price discrimination strategy (in particular in zone C) may be relevant to the Commission's consideration of the appropriate form of control to be recommended to the Minister.

34. Competition in bypass markets is also evidenced by the competitive tension when gas supply contracts come up for renewal. Customers with a choice of suppliers often request quotes from both suppliers before entering into a supply contract.

35. The impact of competition from Nova has resulted in various responses from incumbents. Nova's competitors in the distribution market have developed strategies that effectively prevent Nova competing for supply to new customers. Examples include:

- Requiring Nova to align the term of its gas supply contract with customers with the term of its distribution contracts with the rival network owner;

- Offering lower distribution prices to competing retailers and directly to Nova's customers than they offer to Nova;

- Controlling the price at which Nova may on-sell the competitor's distribution services to the customer; and

- Refusing to provide Nova with prices for distribution services unless Nova complies with the competitor's pricing request processes.

These actions restrict Nova's ability to compete in both the retail and distribution markets.

36. Nova agrees with the Commission's assessment of competition in bypass markets in the Draft Report. Nova faces workable and effective competition in the markets in which it provides gas distribution services. This is evidenced by the reduction in distribution charges paid by customers in bypass markets and the competitive response in areas where there is bypass or the potential for bypass. Customers in bypass markets have a choice of suppliers and contracts for supply are vigorously contested by Nova and its competitors. Competition in bypass markets is not limited or likely to be lessened and therefore there are no grounds for control.