

1 PRESENTATION BY VECTOR

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3 **CHAIR:** I'd now like to reconvene this session and welcome
4 Vector and I might just note before we start that it's my
5 intention to take a tea break, a late one at that, at 4
6 o'clock and then we will resume and we are likely to be
7 going until 6.30 this evening, which may mean that we'll
8 take an additional short break again later in the day. So
9 just to let people know what the current plan is.

10 I'd like to thank Vector for being patient with us as
11 we work through the earlier material and I'll do
12 everything I can do to ensure that we have adequate time
13 to hear Vector's submission as well.

14 I'd now like to ask you to introduce your team for the
15 record please and begin your submission when you're ready.

16 **MR MACKENZIE:** Thank you very much Chair, Commissioners and
17 staff, I'd like to introduce our team. John van Brink is
18 our Commercial and Pricing Manager, Bryan Crawford is our
19 Group General Manager Sales and Marketing. Myself, Simon
20 Mackenzie Group General Manager Networks, Peter Alsop is
21 our Regulatory Manager and Stuart Shepherd is our expert
22 advisor to our team from LECG.

23 Just to outline our submission, I'm going to give an
24 overview of Vector's submission, the team will then
25 discuss in more detail the specific parts of our
26 submission and we'll follow it up by a summary. As per
27 our normal style we'd obviously welcome an interactive
28 discussion as we move through.

29 Just to recap with regards to the Vector gas business.
30 The map we've shown here identifies where our gas business
31 is with respect to the Auckland region. Obviously our

1 volume consumption is 11 PJs. We have a system length of
2 4,700 kilometres, 11 gate stations, 144 regulating
3 stations and approximately 70,000 customers.

4 **MS BATES:** Could I just ask you, you may have heard me ask the
5 previous Wanganui Gas to give us a bit of information
6 about the breakdown by sector. That could be dealt with
7 in cross-submissions.

8 **MR MacKENZIE:** We can give an overview now if you like.

9 **MR VAN BRINK:** It's broadbrush stuff, obviously we'll tidy up
10 in the cross-submission, but in terms of volume,
11 approximately 60 percent of the volume sales is to the
12 industrial sector and 20 percent each to commercial and
13 residential.

14 In terms of connections it's 5 percent to commercials,
15 approximately 1 percent to industrial segment and 94
16 percent residential. In terms of revenue, again an
17 approximate split is 25 percent each to commercial and
18 industrial and 50 percent to residential market.

19 **MS BATES:** That's helpful thank you, and just follow it up
20 with the written stuff, thank you.

21 **MR MacKENZIE:** As mentioned the presentation overview is
22 firstly to give an overview of Vector's position, we'll
23 then follow it with going into more detail with regards to
24 how we arrive at our position; the first area being market
25 definition and competition analysis, assessment and
26 modeling issues and assumptions, and then lastly the legal
27 framework. I'd also like to note that the WACC and
28 benchmarking has been addressed by LECG and PEG in
29 separate sessions sponsored by Vector.

30 With regards to the overview of our position, firstly
31 the market definition competition analysis. Our view is

1 strongly that competition is not limited in the market
2 into which gas pipeline services are supplied. The gas
3 market is the appropriate mass market definition as
4 there's transport substitutability for gas, reticulated
5 networks and bottles and technical and economic
6 substitutability of different types of gas, particularly
7 LPG and natural gas.

8 As found by the Commission there is vigorous
9 competition in the bypass market, and other energy options
10 beside gas add further to competition to varying degrees
11 and in different circumstances depending on the area and
12 application.

13 This advert which was run just prior to our submission
14 underpins Vector's view of market definition as vigorous
15 competition with LPG is clearly the market reality and
16 John and Bryan will follow this up shortly.

17 With respect to the assessment and modeling issues,
18 correction of the interest tax shield significantly
19 reduces, if not eliminates, any net benefits to acquirers.
20 Vector is appreciative of the Commerce Commission's
21 approach to handling this issue and it's not discussed
22 today, a Section 70E response has been filed.

23 A range of other assessment and modeling assumptions
24 in need of amendment; these will be further discussed
25 shortly, which will reduce, in our view, any further
26 benefits.

27 A range of important regulatory matters in Draft
28 Report not carefully analysed, including lack of
29 consistency with precedent effects in other inquiries.
30 For example, the use of historical information and the
31 length of control period.

1 And lastly the significance of control, in our view,
2 warrants a much higher degree of confidence in findings.
3 Control should be invariant to choice of point estimates
4 within valid ranges.

5 Lastly the legal framework. The Minister has
6 specifically asked for advice on any other matter that the
7 Commerce Commission may think relevant to a decision on
8 whether control should be introduced. Draft
9 recommendations are based on the narrow s.52 test of
10 whether control may be imposed. The may result needs to
11 be considered alongside a range of other factors relevant
12 to whether control should be imposed, including net public
13 benefits, a de minimus test, the fact that, unless
14 updated, the ODV handbook is draft and outdated and the
15 Commission demonstrating that control would benefit end
16 consumers. Any control declaration should be six years,
17 not an unprecedented 11 as proposed by the Commission.

18 Finally just a general comment, we believe that
19 limited participation in an inquiry by acquirers is an
20 issue. There's, in our view, no specific performance
21 concerns raised by acquirers, there's no, for want of a
22 better word, weighty analysis for the Commission, rather
23 opportunistic support for the Commission's finding without
24 robust support.

25 An example for this would be in Contact Energy's
26 submission where their rationale was simply requiring
27 consistency with what occurs in electricity. In our view
28 this is woefully lacking in a robust analytical framework
29 to arrive at this decision.

30 On the surface this does not suggest regulation is
31 required. Consumers are not reliant on regulatory

1 procedures to resolve their issues. I'd like to now hand
2 over to Bryan Crawford and John van Brink to take you
3 through more details on our market definition and
4 assumptions.

5 **MR CRAWFORD:** Thanks Simon. To begin with firstly a summary
6 of Vector's position at a high level with respect to
7 competition and market definition and a couple of points
8 by the way of recap, and some themes that have been
9 mentioned obviously by many submitters.

10 We believe clearly that competition is not limited in
11 the supply of gas pipeline services. We would again point
12 out that gas is a discretionary fuel that competes with
13 other energy options, generally speaking to be second fuel
14 of choice behind electricity.

15 We note that the Commission has rejected in the past
16 the notion of an energy market but would point out that to
17 date a gas market has not been considered irrespective of
18 type.

19 A subpoint to that, we recognise that the Commission
20 have previously accepted the existence of vigorous
21 competition in bypass markets, or where bypass exists or
22 may exist. I'll be focusing for the most part here on the
23 mass market residential and commercial gas market and the
24 marketing activities and dynamics within that area. John
25 will follow me and move more into some issues in the
26 industrial and bypass market where we account manage
27 individual customers.

28 In terms of a gas market we also recognise that LPG is
29 not the subject of this inquiry, but we also note that it
30 can be considered within the process. Reticulated gas
31 supply, whether natural gas or LPG, is one way of

1 transporting gas to end consumers. Bottled gas is another
2 mode of transportation. Transport substitutability for
3 gas, as well as the technical and economic
4 substitutability of LPG and natural gas for consumers,
5 defines in our mind the gas market.

6 **MS BATES:** Can I just interrupt you there. I can't quite
7 understand your conclusion that competition isn't limited
8 in the supply of gas pipeline services for geographical
9 reasons really.

10 **MR CRAWFORD:** Sorry, could you expand on that?

11 **MS BATES:** There are some users who can't go to alternative
12 distributors I would have thought.

13 **MR ALSOP:** One of the key reasons for our position,
14 Commissioner Bates, is the ubiquitous availability of LPG
15 right across New Zealand, not just in the Auckland market
16 where Vector has its pipeline, but perhaps as the
17 presentation evolves...

18 **MS BATES:** Then I think that LPG is not suitable for use in
19 all of the market sectors, or its unlikely to be a fuel of
20 choice or substitutability in all of the market sectors.
21 I'll just alert you to that as a preliminary, you might
22 like to address that later on.

23 **MR ALSOP:** The inquiry is focused just on the pipeline
24 service, there is a supplementary question, in our view,
25 as to which market the pipeline service is delivered into.
26 It's quite a legitimate approach, in our view, that that
27 market definition may include other fuels.

28 **MS BATES:** Yes, but if you're looking at inter-fuel
29 competition which is what we're talking about, isn't it?

30 **MR ALSOP:** Yes.

31 **MS BATES:** Then I'd suggest that it's more likely to bite in

1 at, say, the level of residential than higher up because
2 the higher up you go, getting all the way to generation,
3 the cost and the time taken to have a viable alternative
4 could be very long indeed, so that the competition
5 probably wouldn't bite in nearly as quickly if it was
6 there. For some of the generators is there really a
7 choice?

8 **MR ALSOP:** We do canvass a differing degree of competition in
9 different, if you like, market segments further in the
10 presentation. One of the observations we will make is in
11 the bypass market, given the heightened significance of
12 energy for those large industrial users, its actually
13 commonplace for them to consider a broader range of energy
14 options than perhaps residential consumers, given the
15 higher significance of cost.

16 **MS BATES:** Perhaps we'll talk about it more, but you'll
17 appreciate I'm alerting you to the themes that we're
18 looking at.

19 **MR ALSOP:** Sure.

20 **MR CRAWFORD:** In terms of the activities that Vector undertake
21 in order to grow demand for gas, and again just for
22 reference we're talking here primarily about the mass
23 market, the residential market and the commercial market.
24 I think the Commission is aware that Vector, through the
25 use of a brand pure energy, promotes gas to end-users, to
26 potential customers, and that's portrayed in the left-hand
27 side of this slide as an activity which, if you like, in
28 marketing parlance tries to create a pull for demand from
29 consumers for gas connections through building awareness
30 of gas and encouraging consumers to consider it as an
31 option.

1 In that sense it seeks to grow gas, and I'm not being
2 specific here because at this point in the thought process
3 of a potential gas customer they don't necessarily
4 differentiate between LPG and reticulated gas.

5 So the activity is primarily aimed at raising
6 awareness of gas at a very early stage in the
7 consideration process and raising gas's share of what
8 other consumer energy options may exist.

9 The second leg of the strategy to grow demand for gas
10 occurs in Channel. That is effectively the push part of
11 the strategy where specifically, having created awareness
12 and levels of inquiry from consumers for gas, much can be
13 done to influence them towards either LPG or reticulated
14 natural gas.

15 Vector's Channel Partners who sell our connections and
16 package connections with appliances and other services are
17 non-exclusive to Vector. They provide LPG solutions in
18 all cases. In many cases they supply electricity
19 solutions and in some they supply connections to other
20 networks.

21 So our task at the Channel level is to build Channel
22 Partner preference and to ensure that sales people are
23 informing potential customers about the benefits of
24 natural gas and that we are therefore competing vigorously
25 for share within those stores.

26 So in that sense this is a two level strategy. I
27 think we mentioned a moment ago that the industrial market
28 is managed through account managers; like most industrial
29 markets, large accounts receive one-on-one sales focus
30 from individual account managers and aren't covered in the
31 slide we are covering here.

1 **MS BATES:** Can I just ask you at this point about -- we heard
2 some information from Wanganui about developers and the
3 concept of putting new reticulation in and I just --
4 Auckland is probably not like Wanganui in that it's
5 developing fast in many areas. So how much of your
6 business is chasing the developers to put in new
7 reticulation?

8 **MR CRAWFORD:** It's a significant area of focus. They are a
9 major decision point in whether gas finds its way to end-
10 users. Some developers have a positive predisposition
11 towards gas, they feel that it adds value to their
12 subdivision. It tends to be something that they see as
13 adding value above a certain level of lot price or home
14 price. In the lower end of the subdivision market
15 developers would see it just as an increased cost which
16 they couldn't flow on through the enterprise of the lots
17 or the homes.

18 So there is a battle to be waged there to make sure
19 that gas is reticulated to as many homes as possible. The
20 decision rests with the developer and so they are a
21 significant focus for us to ensure that we do everything
22 we can to encourage them to reticulate to gas.

23 **MS BATES:** What do you do to encourage them to reticulate to
24 gas?

25 **MR CRAWFORD:** We largely make sure we have the kind that they
26 need. Also the pull side of the strategy, architects, for
27 instance, are another counter-influence in this process
28 for example. So there are a range of influences in the
29 market that we are engaged with to make sure the message
30 is getting through about the advantages, the extent to
31 which gas going into homes enhances their attractiveness

1 from a purchaser's point of view.

2 **MS BATES:** Who actually pays for the pipes into the
3 development?

4 **MR CRAWFORD:** Into the homes?

5 **MS BATES:** No, into the development

6 **MR CRAWFORD:** Into the subdivision?

7 **MS BATES:** Yes.

8 **MR CRAWFORD:** That's negotiated with the developer in terms of
9 the cost to reticulate the subdivision.

10 **MS BATES:** Do you do it sometimes?

11 **MR CRAWFORD:** It would depend. I couldn't give you a for
12 instance. I think it's a matter of negotiation with
13 developers as to what share of costs is born by developers
14 and network operators.

15 **MS BATES:** One last question, is it a growth area in your
16 business?

17 **MR CRAWFORD:** Yes, it is. I think for a time gas was absent
18 in a vast number of growth areas of Auckland particularly.
19 If you look at West Harbour, for instance, in Auckland,
20 large tracts of housing there do not have gas networks in
21 them and you can see -- in fact we have a map later which
22 indicates presence of LPG in those areas.

23 So over time, and in the past electricity companies
24 did a pretty good job in the 70s and 80s of providing
25 incentives for subdivisions to not take gas with packaging
26 up hot water packages and those sorts of things. So you
27 do see pockets that were not reticulated some many years
28 ago and they remain pretty much untouched from a gas
29 perspective today.

30 **CHAIR:** It might be useful if you provided us with aggregate
31 data on what capital contributions are made by who in the

1 case of Vector in terms of your experience. You've wanted
2 to come back to this issue about whether LPG and natural
3 gas is in the same market. You've put a reasonably strong
4 case forward that they may be and you've noted that from
5 the customer's point of view there's not often seen to be
6 a difference between them.

7 You would expect if there's that much constraint that
8 they actually fall in the same market, they're very strong
9 substitutes. If you contend that at the retail level, I
10 wonder if that is in fact the case. How does that sit
11 comfortably next to Vector's observation that in the past
12 its reduced distribution charges, but those reductions
13 weren't passed on to consumers, in fact I think you
14 indicated only 50 percent. I wonder how that can be.

15 What appears to be an argument that the retail market
16 is competitive and that there's a close substitute in that
17 market for natural gas, why is there no disciplining
18 device there to ensure your reductions in distribution
19 charges don't flow through to customers?

20 **MR VAN BRINK:** There are a number of issues, I think the most
21 obvious one being that the wholesale cost of gas has been
22 known to require increase as the market moves at the
23 supply side to a post Maui situation to meet new costs of
24 gas. I think that incentive has certainly driven
25 retailers to anticipate price movements, specifically with
26 contracted customers which is more on the industrial side
27 of the market, but also in the residential market.

28 Another factor is the fact that the cost of LPG has
29 increased as well. Last year, again through the decline
30 of the Maui field, saw an importation of some LPG during
31 the winter months. So the two have maintained a

1 relativity.

2 Thirdly, I think it's fair to say that the dominant
3 retailers in our network are also generators and they are
4 looking at a total portfolio of generation and retailing
5 to match, to balance their purchases; and we have seen
6 situations where the activity in the marketplace has
7 slowed down as retailers are looking towards obtaining gas
8 supply contracts for their generation business and
9 balancing their portfolios.

10 I think there has also been to an extent going back,
11 say, two or three years a continued move to disaggregate
12 the energy from the distribution prices following the
13 separation of companies such as Enerco into Orion and then
14 UnitedNetworks/Vector as distribution and Convec as
15 retailer and that's provided a rebalancing of prices over
16 the last year, certainly in say 2001 and 2002 which has
17 seen some changes in some areas that have probably been
18 quite significant.

19 **CHAIR:** I hear in those arguments, those arguments support
20 your contention here, but I'm not sure it supports the
21 contention later about even if there is market power in
22 distribution, if the control regime was put in place
23 there's no guarantee it would get through to end
24 customers. So we might want to come back to that at some
25 point because we see this sort of activity, the Commission
26 is very familiar with this and markets do save up price
27 changes. It doesn't necessarily mean market power at that
28 particular segment and in fact I think your arguments
29 actually suggest to us that there's something else going
30 on when you see a reduction not getting through. I
31 suspect you're going to come on to that subject later so

1 we can come back to it.

2 **MR CRAWFORD:** I think there was another point we wanted to
3 emphasise.

4 **MR ALSOP:** Just to close that off, the point that I was going
5 to make was the point you made, Chair, was that some price
6 reductions may be saved up for short periods of time.
7 While we'd like to think that the retail market can pass-
8 through cost reductions instantaneously, I think the
9 practical reality is there's large costs to retailers from
10 reprinting brochures and making customers aware of the
11 price charges, so there may be some rigidity or stickiness
12 in that price change.

13 The price reduction that we advised the Commission of,
14 the 50 percent that you're referring to, occurred, I think
15 John would confirm, but I think in the order of six weeks
16 to eight weeks ago, so it's not a long period of time, so
17 maybe it's a result of the --

18 **CHAIR:** My point there is, you might get downward price
19 stickiness, you might also have upward price stickiness
20 for the exact same reasons that you say, which is not
21 necessarily an indication that if control appeared to be
22 desirable that we'd have to be concerned about whether
23 they would be passed through the retail sector, that's the
24 point I'm trying to get at here.

25 It's hard to run both arguments at the same time, the
26 argument you're running here then the argument that you
27 run possibly at a later point in your presentation about
28 price reductions not getting through because of market
29 power at the retail level. So just happy with the
30 discussion as we've had it and if you want to come back to
31 it you're certainly welcome to.

1 **MR CRAWFORD:** This just expands slightly on the previous slide
2 in terms of the two levels of activity, or the two
3 components of activity which Vector engages in in order to
4 grow demand. I mentioned the Channel Partner Programme
5 which in the previous slide was on the right-hand side,
6 and the activities around that I think we have shared
7 previously with the Commission in terms of building
8 preference within stores with sales people given that they
9 are a significant influencer in the purchase decision.

10 As an aside we mystery shop these stores to ascertain
11 the extent to which sales people in store are steering
12 people either to LPG or to other energy types other than
13 our own in order that we understand what competitors are
14 doing, they run programmes similar to ours and we have
15 some examples coming up.

16 The brand and its promotion to consumers, as I said,
17 is effectively to put more people through the door of
18 those stores, to generate sales leads, to generate
19 inquiries of our Channel Partners and to direct consumers
20 to more detailed information via web or sales collateral.

21 The decision to get gas is a complex one with
22 significant investment even at the residential level and
23 it usually is associated with some really pretty
24 significant information search by consumers before they
25 make ultimate decisions.

26 If we move on to the next slide, we have some packs to
27 hand out to the Commission just with the latest tranche of
28 marketing material and collateral that we have in some
29 cases taken to market, in some cases you're seeing it
30 before the market has, so we've deemed it commercially
31 sensitive at this point.

1 You will note that the advertising doesn't mention
2 Vector as a company, that's for practical reasons, we
3 don't encourage people to call Vector to try and arrange a
4 gas connection, they go through Channel Partners to buy
5 connections and appliances and are facilitated through
6 that mechanism.

7 We make no specific reference to reticulated gas or
8 try in any way to differentiate it from LPG. As I said
9 earlier consumers are at the point where they start to
10 think about gas aren't themselves thinking along those
11 lines and for us to try and explain that in some of the
12 material would merely confuse them at a very early stage
13 or turn them off considering our product at a too early
14 stage, we just want to get them into stores and hopefully
15 convince them of the merits of our product at that point.
16 We have invested heavily over the years in our programme,
17 both at Channel level and at consumer level and we
18 continue to be committed to it.

19 This new campaign that we're sharing with you today
20 begins soon and it's a signal of our ongoing commitment to
21 try and see gas grow within New Zealand on a direct
22 reticulated basis.

23 With that if I could ask Anton to hand those out,
24 they're just for your reference. They contain effectively
25 the objectives for the campaign, the rationale behind it,
26 what we're doing and why effectively. We thought at this
27 point, and I hope you're not alarmed by what you see on
28 the screen, but at this point we thought we'd just take a
29 pause for 30 seconds and share with you some of our
30 advertising that will be going out to consumers very very
31 shortly. It isn't X rated, it's very family, so with that

1 I'll ask Peter to hit the button.

2 **CHAIR:** You mean they're going to be fighting over who gets to
3 take a shower first. **[advert showed to commission]**

4 **MR CRAWFORD:** I'm not sure if you could hear the sound track,
5 but you'll be seeing that on screen very soon. Returning
6 to the subject we touched on regarding the gas market in
7 LPG and I think in the next several slides we'll start to
8 unpack some of the thoughts we were exploring earlier.

9 At a high level the LPG industry, and we've
10 characterised it in our submission, has a large number of
11 retailers and the nature of the LPG industry, it is our
12 contention there are relatively low barriers to entry.
13 There is an industry diagram in the submission as I said.
14 I think it was mentioned earlier that it is by nature
15 ubiquitous and available on a nationwide basis. It does
16 have, and the next slide covers this, a wide variety of
17 residential and commercial uses.

18 I think one of the interesting points about the LPG
19 product is that it can be supplied through reticulated
20 networks or bottles, and perhaps to date the extent of
21 reticulated LPG networks in New Zealand hasn't been widely
22 publicised or understood or known, and we'll expand on
23 that point later. There is also ample evidence of
24 significant growth for the LPG product in New Zealand and
25 we will expand on that as well.

26 Just an aside, LPG is not, based on our anecdotal
27 evidence, associated with issues of depletion of Maui.
28 Perhaps because people may have understood that it's
29 easily transportable, that it's easily imported but for
30 some reason people tend to disconnect concerns about
31 depletions about depletion of Maui with concerns about

1 whether LPG will be available in the future. That's not
2 the case with reticulated gas unfortunately.

3 In terms of uses of LPG, the third point on the
4 previous slide, there are obviously a wide range of uses
5 across the residential, small commercial and large
6 commercial segments. I don't intend to read those ad
7 nauseum to you at this point, but I think the slide speaks
8 for itself in terms of the ability for the LPG to satisfy
9 demand in a range of areas.

10 As we move towards industrial markets specific
11 customer requirements may mean that it is another product
12 other than LPG that reticulated gas competes with. It may
13 be diesel, it may be coal, but those areas are generally
14 found in bypass market areas as well, so there is a
15 different dynamic as we move into that area and I think
16 that's in part what we were touching on earlier with the
17 question.

18 Just to come back to the point about reticulated LPG
19 networks, we have here some text from City Gas in Dunedin
20 which is a Todd Energy company, from their website in
21 which the first bold area talks about reticulated
22 specification gas. Just for clarity's sake, specification
23 gas is LPG, it's just a phrase that I think that company
24 used to describe LPG.

25 The interesting point about this and I'll pause and
26 perhaps let those of you who would like to read this, the
27 Dunedin network was originally a coal gas network that has
28 been established for many many years and today it is
29 reticulated with LPG, it's about 100 kilometres in length.
30 As I say, it's moved from coal gas through to today when
31 it effectively moves LPG gas around the greater Dunedin

1 area.

2 It raises an interesting idea that given the exclusion
3 of LPG from the inquiry the possibility that natural gas
4 networks, given technical substitutability, could in
5 theory be incentivised to utilise LPG in parts of the
6 networks or in whole in order to avoid regulation.

7 I also think it's interesting that within the GISG
8 process to integrate the gas industry into the Electricity
9 Complaint Commission, this issue was discussed in terms of
10 whether consumers in somewhere like Dunedin or
11 Christchurch who receive LPG through a reticulated network
12 could avail themselves of a complaints process in the same
13 way that consumers in Auckland could if they were
14 reticulated with natural gas.

15 Because it was pragmatically difficult to consider
16 including LPG in that process to integrate gas into the
17 Electricity Complaint Commission, the arbitrary decision
18 was made to exclude it at this point but it was recognised
19 in doing so that at some point it would be logical that
20 LPG would become part of a scheme such as that.

21 So I think the issue here is one of a boundary
22 potentially and we believe that the only difference
23 effectively between reticulated LPG networks and
24 reticulated natural gas networks is the chemical make-up
25 of the substance flowing through them.

26 So if we move to the next slide, we can see an
27 indication of where those reticulated networks exist. As
28 I said earlier I think it may have been something that in
29 the past we were aware of but perhaps not aware of in
30 terms of the nature and extent of this, and it's sitting
31 outside the process. We recognise the Commission's hands

1 are tied in that, but we just make some observations about
2 that fact.

3 The last point being that market definition, in our
4 view, must include LPG for that reason.

5 **CHAIR:** I want to pick this up again in the same vein as my
6 last question, and it seems to me that the arguments
7 you're putting to us would suggest possibly that the gas
8 distribution services, the demand for gas distribution
9 services might be a bit more elastic than what we might
10 have thought and I would expect that if what you're
11 telling us is the case.

12 But I have trouble reconciling that then with the
13 statement that you have in paragraph 6.81 of your
14 submission where you argue that a reasonable estimate of
15 price elasticity of demand for gas distribution services
16 is 0.15 or below. In other words that it is not only not
17 elastic but very inelastic.

18 I know that that argument has been made in a
19 particular point in your submission with another issue in
20 mind, but there seems to me to be an inherent
21 inconsistency in what you're submitting to us in these two
22 places. So I'd just invite your comment on that.

23 **MR SHEPHERD:** Perhaps I could comment in terms of that
24 calculation. It was derived from studies that the
25 submission referenced and also that the Commission
26 referenced and then was reduced due to including it
27 appropriately in the model. I'm just trying to remind
28 myself of what those reductions were from.

29 **CHAIR:** I guess my question to you is, is that statement in
30 6.81 where Vector comes to a particular view about what's
31 a reasonable estimate, leaving aside what the Commission

1 did and what others estimated, Vector came to that view.

2 In light of this discussion that we're now having
3 about LPG being so close a substitute for natural gas that
4 we would have one market, do you find that a consistent
5 proposition to put to us what's in 6.81 and the
6 proposition here in this discussion, and if so can you
7 explain to me how you make it consistent?

8 **MR SHEPHERD:** I think the best way for us to respond would be
9 to take it away and come back in the cross-submission and
10 track back how we got there and work through the
11 proposition you are putting to Vector.

12 **CHAIR:** I'm happy for you to come back on how you got there,
13 but I'm just asking in principle does that sort of, as an
14 expert in the field, does that sort of price elasticity of
15 demand suggest to you the sort of substitution that's
16 being argued here?

17 **DR SHEPHERD:** I understand the point that there's a potential
18 inconsistency there.

19 **MR CRAWFORD:** I mentioned that LPG had experienced significant
20 growth and this is a point made public by the LPG
21 Association itself and it's touched on in a couple of
22 subsequent slides, but it's demonstrated here there has
23 been significant growth and it's mentioned in the
24 submission in LPG, since its decline as an automatic
25 motive fuel, its ascendance as a source of heating and
26 other uses in other settings has been dramatic.

27 If we move to the next slide --

28 **CHAIR:** Can I ask you on that point when we talk about the
29 growth in LPG, if we looked at the growth of LPG in
30 residential markets, for instance, where there's
31 reticulation, what's the picture look like there compared

1 to --

2 **MR CRAWFORD:** We have a graphic in a couple of slides which
3 shows a map of Auckland which illustrates that, so we
4 could touch on that at that point.

5 Can I just draw your attention to the second
6 paragraph, this is drawn from the LPG Association media
7 release of 30 April this year when they comment that the
8 Minister is quite right when he makes the point that there
9 is now an active energy market in New Zealand. They go on
10 to say that the residential and commercial market for LP
11 gas has grown by 50 percent in the last five years with
12 demand in the residential sector sky rocketing.

13 The graphic I mentioned that we'll show in a couple of
14 moment takes us up to 2001. One of the interesting points
15 is that the growth has been such that the registering
16 process, the paper trail that leads to being able to plot
17 LPG installations above 9 kg is so far behind as a
18 consequence of being avalanched by growth that the
19 scatterplot diagram we'll show you is incomplete, but we
20 do have come estimates that build on the 2001 figures.

21 If we move to the next slide, again the point I would
22 draw out of this is that there is significant growth. The
23 slide points to and underscores the low barriers to entry
24 for LPG companies and further reinforces the specific
25 advantages which LPG may enjoy over other energy types,
26 including reticulated natural gas, its ease of
27 transportation its versatility its cost-effectiveness and
28 plentiful supply.

29 Again this is a specific media release from Rockgas
30 in June of this year. It talks about its national
31 availability and that consumers are not faced with line

1 charges and offers the observation that incentivising
2 greater use of LP gas offers significant positive outcomes
3 for consumers in the country for very little additional
4 cost. I think they're referring to the lack of a
5 requirement to invest in significant amounts of network
6 and the capital required to fund that.

7 To further highlight at the Channel level what
8 competition looks like between natural gas and LPG, this
9 is an ad that ran in the Sunday Star Times on 27 June
10 this year, and we've drawn out the relevant parts of the
11 advertisement that point to the activities engaged in by
12 LPG companies with the same Channel Partners that Vector
13 engaged with. There's a subsidised offer for a free LPG
14 refill to encourage customers to choose LPG as a solution,
15 a free flue kit for the fire and such.

16 So it's ample evidence, we believe, of the competitive
17 battle we wage in Channel to get our share of the gas
18 market pie, if you will.

19 If we just flip forward to the next slide, I mentioned
20 that these Channel Partners are not exclusive, they do
21 sell LPG and other forms of, or solutions. It promotes
22 gas, the ad that we just saw promotes gas above other
23 energy options. It seeks consumers choosing gas on the
24 basis of a market driven initiative as distinct from
25 organic growth. Its explicitly agnostic to reticulation
26 and type of gas. It basically points out if you haven't
27 got a network don't worry you can still have gas.

28 The advert illustrates also the competing nature of
29 incentives and to some extent the incentive programme or
30 the effectiveness of our trade marketing activities have a
31 direct bearing on our share of sales out of Channel.

1 We believe it's further evidence -- there is further
2 evidence in the submission of the increasing nature of LPG
3 appliance sales. We've got some bar charts in the
4 submission which show the growth in appliance sales in the
5 gas market and the increasing share of appliances that are
6 LPG as opposed to natural gas.

7 With that I'll hand over to John van Brink to extend
8 this a little further.

9 **MR VAN BRINK:** This ties in with some of the earlier
10 discussions on the ubiquitous nature of LPG. If I explain
11 this map it was actually included to show that the LPG
12 installations, certainly in the residential and small
13 commercial markets are not limited to areas where the gas
14 network doesn't exist.

15 The part of the map that's outlined in the yellow
16 rectangle enlarged on the right-hand side is a fairly
17 approximate outline of the area where Vector's gas network
18 exists. Each of these black dots represents a certified
19 installation with cylinder over 9 or 10 kilograms,
20 generally they're the 45 kilogram twin set LPG packs. 45
21 kilogram packs are suitable for houses which have
22 extensive gas use, including water heating as well as
23 cooking and space heating.

24 What this map shows, as I said, is that the black dots
25 are representative right across Auckland where the gas
26 network exists and it shows that competition is fairly is
27 fairly healthy there. What it doesn't show is the number
28 of new installations, certified installations that have
29 been installed since 2001, as Bryan explained due to a
30 backlog of update of the LPG database.

31 We believe as of now, and I have to qualify it that

1 this is an estimate based on public statements about the
2 50 percent cumulative growth in LPG installations, that
3 currently there would be around about 11,000 dots on that
4 map in the region as of today, rather than the 2,500 that
5 are shown on that map.

6 **MR STEVENS:** Could you tell me what the colours mean on the
7 map again?

8 **MR VAN BRINK:** Certainly, the black dots represent the LPG
9 installations, the coloured grid lines, it's very hard to
10 see those grid lines, actually represents the gas network,
11 the different colours represent the different pressures of
12 the gas network, so low pressure and high pressure
13 distribution networks.

14 **MR STEVENS:** So red is high pressure is it, or pink?

15 **MR VAN BRINK:** I think there's green and a mauvey colour, the
16 mauvey colour are lower pressure networks.

17 **MR ALSOP:** The map is produced in full A4 size in the
18 submission.

19 **MR VAN BRINK:** The other thing that this map does not show are
20 the large number of 9 kilogram installations which,
21 excluding barbecues, also include some half a million odd
22 estimated portable heaters, LPG heaters, as well as gas
23 hobs in homes because those installations don't have to be
24 certified.

25 **MS BATES:** Doesn't tell us much about what's happening in the
26 breakdown vis-a-vis residential and commercial, does it?

27 **MR VAN BRINK:** That's correct, we don't have a residential
28 commercial split. These installations would be
29 predominantly residential. I am going into it later on,
30 but once you get into the commercial market, small
31 commercial installations do exist, predominantly in the

1 food distribution areas, cafes, restaurants, also in other
2 smaller commercial areas, small dry-cleaners. In the
3 larger commercial markets I think the installations tend
4 to be less ubiquitous.

5 **MS BATES:** Perhaps if you're going on to that I'll wait until
6 you do that.

7 **CHAIR:** In the areas where you have reticulated gas, not
8 everywhere else Vector happens to be with electricity, but
9 where you have reticulated gas what is the growth rate of
10 connections for natural gas compared with growth rate for
11 uptake of LPG in only those areas where -- do you have any
12 sense of that where you are directly competing with
13 reticulated gas?

14 **MR VAN BRINK:** Reticulated gas versus LPG; reticulated gas
15 connection growth is around about 3,800 per year. LPG
16 connections, as I said we don't have the latest
17 information with the growth, but we are talking about
18 similar numbers, we'd probably have to come back to you
19 with some figures on that.

20 **CHAIR:** Are those numbers just in those areas where you're
21 reticulated or is it across --

22 **MR VAN BRINK:** This is the Auckland area where our network is.

23 **CHAIR:** Just where your gas network is?

24 **MR MacKENZIE:** But I think we need to clarify, John will come
25 back with that about whether or not that backs out the
26 residential subdivisions and everything. That's something
27 we'll come back to with regards to -- to understand your
28 question was, where we have existing gas networks, because
29 I think the other issue is also in, for example,
30 subdivisions LPG also competes, so that's kind of like a
31 different issue to existing gas reticulating network;

1 what's the growth in that existing network with regards to
2 LPG penetration.

3 **CHAIR:** You can do it with and without the subdivision bit if
4 you think that's important. You probably never see a --
5 no-one would go from being connected to reticulated gas to
6 LPG would they, do they make that transition?

7 **MR VAN BRINK:** Yes, there are and I've got some examples a
8 little bit later on.

9 **CHAIR:** Okay.

10 **MR VAN BRINK:** Moving through I wanted to talk about this
11 whole aspect of switching between gas and LPG and also
12 other fuels. We talked to the Commission last October
13 about the switching costs in our submission at the last
14 conference and also corresponded with the Commission on
15 the matter since then.

16 We still contend that switching costs do not reflect
17 a situation where the customer is locked into one fuel
18 option. Once a decision has been made the marginal cost
19 of switching is a lot less, the cost of the pipeline is
20 sunk. We don't believe that the actual lock-in situation,
21 certainly where an option of the LPG is available, doesn't
22 exist.

23 Lock-in is not a competition concern in itself. The
24 infrequent switching and competition at the time of making
25 a decision is not inconsistent with workable competitive
26 markets in other jurisdictions. Examples being mobile
27 phone plans, other examples that compare to this would be
28 the fit-out of planes and buildings which are leased,
29 where decisions are made to lease a building and fit out
30 costs are incorporated after that.

31 Lock-in between LPG and natural gas and specifically

1 in the mass market is low. Based on the Commission's
2 acceptance of the bypass market shown in its Draft Report
3 it does show that the concern over contract lock-in is not
4 an issue. So I really want to focus now, moving on, from
5 the issue of switching to LPG.

6 For mass market applications that's small commercial
7 residential, switching to LPG in mid-cycle is viable and
8 it does occur. As I mentioned before once consumers have
9 invested in pipeline installations and have a connection
10 to their premises, those costs, once incurred, are sunk
11 and in terms of switching options don't become a relevant
12 switching consideration. The cost of fuel and operations,
13 any plant replacements take over as decision points.

14 The switching costs to LPG are low, up to \$550 odd of
15 cooking. I could relate to a personal experience of my.
16 I built a house and bought a gas hob two years ago, the
17 gas hob came with gas jets and LPG jets, and I simply
18 changed the jets to LPG and hooked up a cylinder and I had
19 a hob that was going at no cost.

20 **CHAIR:** Do you think that's the norm that hobs come with that
21 option?

22 **MR VAN BRINK:** I believe so, obviously I didn't research too
23 much, but I had a look at a number of brands when I made
24 the decision and certainly the ones from overseas come
25 with both sets of jets.

26 **MR CRAWFORD:** I think the question's normally asked in the
27 store, would you like LPG or gas and they'll switch them
28 in store for you often at no charge. Same appliance, just
29 change the little jet.

30 **CHAIR:** In your case it was set up for one and you had it set
31 up then for the opposite?

1 **MR VAN BRINK:** It was set up for reticulated gas, I decided at
2 that stage not to go ahead with a reticulated gas
3 connection and converted it to LPG and bought a cylinder
4 from The Warehouse.

5 **CHAIR:** And you disclosed this to the employer.

6 **MR MacKENZIE:** Only today.

7 **MS BATES:** I think Commissioner Rebstock, unless I anticipated
8 her wrongly, was asking about once you had the system, and
9 I appreciate it's a sunk cost and all of that, but once
10 you had the system in your house why would you change? I
11 think one of the earlier presenters told us that LPG was
12 actually a dearer fuel. I know you don't have the
13 transmission cost element, but why would you change?

14 **MR VAN BRINK:** The total cost does depend on usage. Again
15 later on I'll show an extract from a media release which
16 has a gas supplier trying to entice or encourage customers
17 to switch from reticulated gas to LPG, specifically where
18 they are low volume users with maybe just a bit of space
19 heating. The ongoing line costs may be more attractive
20 with higher usage such as with residential water heating
21 but not when you've got a very low amount of volume going
22 through your appliances.

23 **MS BATES:** Are you able to give us any data from your company
24 about switching from reticulated to LPG, in your own
25 company have you got data about that?

26 **MR VAN BRINK:** I couldn't answer you at this stage, I'm not
27 sure.

28 **MS BATES:** Could you see if you have got some information
29 about it? I accept that it's theoretically possible, I
30 accept that there may be some advertising. I have
31 difficulty in accepting that it would be incredibly

1 successful.

2 **MR MacKENZIE:** I think the other thing that we'd like to note
3 too, that from the market perspective the low cost of
4 being able to switch to LPG forms a natural constraint on
5 our behaviour as well.

6 **CHAIR:** Sorry I didn't get that, I just didn't hear you.

7 **MR MacKENZIE:** With regards to the low cost to be able to
8 switch to LPG actually is a natural constraint in the
9 market too.

10 **MS BATES:** If your gas price has got to -- if the whole price
11 got too high then there would be an incentive to switch to
12 LPG, I can understand that argument. I just have
13 difficulty in accepting you've got there yet, that much of
14 this is actually happening. I think I'd probably like a
15 bit more help on that.

16 **MR VAN BRINK:** There is a lot of marketing information
17 available encouraging customers to switch and we believe
18 that I suppose, well, I certainly think that wouldn't
19 exist to the same extent if it wasn't practical in being
20 done.

21 **MS BATES:** But you'd probably be in a position to look at
22 what's happening in your own company, I think that would
23 be interesting.

24 **CHAIR:** If you don't mind me interrupting I think it might be
25 an appropriate time to take a short break and we'll ask
26 that we reconvene at a quarter past 4 please.

27 **Adjournment from 4.00 pm to 4.15 pm**

28 **CHAIR:** I'd like to reconvene this session now and I'll invite
29 Vector to continue with their presentation. I believe
30 we're on page 15.

31 **MR VAN BRINK:** Page 14, just the last two bullets. I just

1 wanted to make the point that many websites do provide
2 information on switching to LPG and they promote the fact
3 that appliances can be readily converted as we were
4 discussing before the break. Some suppliers actually
5 provide an option where a customer temporarily uses LPG
6 whilst waiting to be connected to reticulated gas.

7 This next slide is typical of the marketing material
8 that's available and it shows there is technical
9 assistance available to switch at a low cost. I think the
10 headings speak for themselves, what's involved in
11 conversion from natural gas to LPG, it's got a few simple
12 steps there.

13 **CHAIR:** Who's advertisement is this, just out of curiosity?

14 **MR VAN BRINK:** This is Home Gas. The next one is another one
15 that provides information on how to obtain temporary
16 connection to LPG. There's a couple of scenarios where
17 you may want to have this facility, one is obviously if
18 you've installed gas appliances and you want some gas
19 before the reticulated gas network is extended to your
20 house. Another situation may be where an electric water
21 cylinder may have failed and rather than replacing with
22 another electric water cylinder you could decide to go to
23 reticulated gas or LPG and get an installation pack. This
24 is Simply Gas, another Auckland LPG gas provider.

25 This next slide is an excerpt from the Daily News in
26 Taranaki in 2000 when Todd was providing a Fresh Start
27 brand offering electricity as well as gas energy services.
28 The comment there on the second paragraph, apart from
29 installing the two, 45 kilogram gas bottles and adjusting
30 the home's gas burners, there were no problems in a home
31 running on LPG. Ultimately it's about choice. We are

1 offering customers a competitive choice if they want it.

2 This statement was targeted at existing gas customers
3 in the Taranaki area. It talks about freeing customers
4 from a fixed gas pipelines charge and offering a choice of
5 gas type reticulated or LPG as part of an electricity gas
6 package by this company.

7 We mentioned the bypass market. I think we agreed
8 that there is vigorous competition in the vicinity of the
9 Nova Gas pipeline, specifically from the other pipeline
10 distribution services but also from other fuels in terms
11 of substitution.

12 We've made a comment in our submission regarding the
13 definition of the term and I quote "in the vicinity of",
14 we believe "in the vicinity of" must be defined to include
15 areas where bypass would be possible, not just where
16 pipelines exist.

17 We make that statement on the basis of the fact that
18 it reflects the fact that distribution pipelines can quite
19 easily be connected to the transmission line in a cost-
20 effective manner where there is a higher energy density,
21 where clusters can be connected to another pipeline, or as
22 part of a retailer's commercial strategy.

23 **MS BATES:** Could I just ask you then if you agree with
24 paragraph 10.8 of the Draft Report which says:

25 "bypass opportunities tend to be limited to where
26 there is a concentration of medium to large consumers who
27 are close to an off-take point on the transmission
28 pipeline where an existing bypass network can expand its
29 scope, or where there is an alternative source of gas".

30 Do you agree with that?

31 **MR VAN BRINK:** That's correct.

1 **MS BATES:** So you would agree, then, they tend to be limited
2 these opportunities?

3 **MR VAN BRINK:** I think they're probably more predominant than
4 they seem, primarily because the transmission pipeline,
5 certainly in the Vector network, traverses right through
6 the middle of our network past the industrial and
7 commercial heartland, Penrose, Mount Wellington right
8 through to South Auckland where there is quite a large
9 predominance of large industry using gas.

10 So while the relative number of connections may be
11 relatively small compared to a total 70,000 connections,
12 in terms of revenue and volume this is quite an important
13 area and with the gas pipeline traversing past those
14 industrial areas it is relatively easy to connect a number
15 of customers as we have seen.

16 **CHAIR:** You told us today the capacity was used on the
17 pipeline in Auckland.

18 **MR VAN BRINK:** On the existing pipeline. We have no
19 information on that, but we are aware that it's quite
20 feasible to build a new pipeline in areas like Westfield
21 by the transmission gate station to connect a number of
22 customers that have been contracted on a cluster basis.

23 **CHAIR:** What strategies do you use when you think there's a
24 bypass opportunity?

25 **MR VAN BRINK:** Firstly probably in answer to that I just want
26 to mention that we should be careful to note that bypass,
27 where it has occurred, is not necessarily a result of the
28 incumbent's pricing or our pricing being inefficiently
29 high. There are a number of reasons why bypass may occur
30 and each one would probably attract a different response.

31 The sort of examples of where bypass could occur is if

1 an entrant is delivering a different specification gas, a
2 product that has different standards such as the Nova
3 landfill gas supply, as has been in Wellington. In those
4 cases it may well be the energy price is significantly
5 less because it is a different specification and has
6 limited uses or applications.

7 It may be because the entrant has some cost advantage
8 due to economies of scope or improved technology, or due
9 to vertical integration, where a retailer can actually
10 package a product and capture a margin through a delivered
11 product rather than just an energy component or a line
12 component.

13 **MS BATES:** Didn't Nova tell us that it only delivered non-
14 specification gas?

15 **MR VAN BRINK:** That's not what I understand. Nova have a
16 connection to the NGC transmission line in Auckland and
17 deliver the same gas as we do. Certainly not in Auckland.

18 **CHAIR:** Nova Gas gave us an example in which the original
19 distribution price at 1 January 2004 was \$4.60 and it was
20 prior to when they began building their East Tamaki bypass
21 pipeline and they indicated to us that, they told us what
22 their price was -- and I can't recall what it was -- but
23 they told us that Vector recently offered a distribution
24 price of 97 cents, and that the total reduction in the
25 incumbent's price from pre-entry to post entry was \$3.63
26 cents or 79 percent. Your proposition is that that \$4.60
27 may have been an efficient price, pre-bypass?

28 **MR VAN BRINK:** No, I think one of the other areas where bypass
29 can occur, and that certainly was the case when the
30 pipeline was built in 1999 in Auckland, the Nova Gas
31 pipeline, is where there is significant amount of

1 averaging across a network in the line charge. Certainly
2 when Vector, through its predecessor UnitedNetworks,
3 purchased the gas network it had only been separated into
4 a distribution and energy business, and a number of those
5 customers in the competitive zone, being larger commercial
6 and industrial customers, had prices that were contracted
7 for up to five years, those prices were bundled.

8 What we've seen as these contracts have come up for
9 renewal, is that there is a change in relativity between
10 distribution and energy prices which reflects still that
11 move from the averaging component going back to 1999. Our
12 prices have been slowly deaveraged over time. I think we
13 mentioned in our October submissions that we had in
14 January 2003 introduced zonal pricing, the first stage of
15 a pricing mechanism that more closely reflected the energy
16 density and price.

17 **CHAIR:** This reduction to 97 cents was simply you separating
18 out the distribution price and you separately charged for
19 delivered gas that was previously bundled into this \$4.60
20 price, is that what you're saying?

21 **MR VAN BRINK:** That was certainly apart it. The other part of
22 us was the need for us to respond competitively in
23 ensuring that when the customer looks at our delivered
24 price, which is gas plus distribution, that they were
25 facing a price change in terms of the energy component as
26 well with the Maui gas price increasing last year through
27 the year.

28 So there's a combination of effects; one is the
29 unbundling component, but also the other side we have to
30 be mindful of what the customer actually saw.

31 **CHAIR:** So how do you fund a reduction in the distribution

1 price if originally the distribution price was an
2 efficient price in order to meet the competition?

3 **MR VAN BRINK:** Well when we reduce price it's purely a
4 competitive response and we do, as a result, in a number
5 of cases actually reduce our margins and don't recover
6 those.

7 **CHAIR:** You reduce your margins and you don't recover them
8 anywhere else. The proposition was put to us that in
9 effect you're cross-subsidising, prices stay high and
10 perhaps above efficient levels where you have market
11 power, and where you're challenged you bring them down.

12 Do you bring them down to an efficient price or you
13 just bring it down to whatever you have to do to meet the
14 market?

15 **MR VAN BRINK:** We do actually have an underlying modeling
16 process that ensures you actually understand the cost of
17 supplying to an area or to a customer group. In terms of
18 the difference in price, at the extremities of our network
19 which is a greater distance away from the gate stations
20 the customer base is largely residential and our prices
21 there are very much limited by such competition as LPG and
22 other fuel substitution.

23 **MR SHEPHERD:** As you're probably aware there is a significant
24 component of common costs in the full cost structure of
25 the delivery system and I'm sure you're also aware there's
26 no, from an economic perspective, particularly correct way
27 of allocating those common costs when setting prices, and
28 so when faced with competitive threats, as Vector has
29 been, part of what they've done in their pricing process,
30 as I understand it, is they've recovered at least some of
31 the common costs in a different manner giving rise to

1 lower prices than had been the case in those competitive
2 areas.

3 **CHAIR:** We were also given from Nova a reprint of, I think it
4 was a Vector zonal pricing map for that area and they
5 indicated to us that Vector's prices vary according to how
6 far a customer is from the bypass pipeline which is not
7 surprising, that prices in zone X where you're less than 1
8 kilometre from Nova's pipeline and zone Y between 1 and 3
9 kilometres from Nova's pipeline have decreased; and you're
10 suggesting to us that they would do that and re-allocate
11 common costs.

12 They went on to say that prices in zone C, where
13 there's little or no threat of bypass, have increased. Is
14 this increase due to a reallocation of common costs that
15 cover the bypass competition response that you had, would
16 that be a fair --

17 **MR VAN BRINK:** Vector made, as I said, a first step in the
18 implementation of zonal pricing in January 2003 which was
19 a rebalance and it did look at the amount of pipelines
20 used to supply customer segments, certain areas and
21 geographies. The latest change on 1 July which related to
22 zones X and Y did not have a corresponding price increase
23 anywhere. It was a move as part of our second stage of
24 implementing zonal pricing.

25 **CHAIR:** If you look at stage 1 and stage 2 of introducing
26 zonal pricing, is it incorrect the statement that prices
27 in zone C were increased?

28 **MR VAN BRINK:** In 2003 there was a rebalance which had an
29 increase in zone C, which is --

30 **CHAIR:** How much was that increase?

31 **MR VAN BRINK:** I honestly can't recall off the top of my head,

1 I'd have to come back to you with those figures.
2 Certainly on the 1st of July when the second stage was put
3 into place there was no increase at all.

4 **CHAIR:** Sure, but this was a two stage of a one -- if I
5 understand you right, you had a two stage process in a
6 rebalancing in response to this zonal pricing change, is
7 that right?

8 **MR VAN BRINK:** I think we always recognise that the first
9 stage in January 2003 was going to be the first step of a
10 long-term move to rebalance, and the timing really
11 depended on the market conditions. This second stage was
12 a move in that direction, but it also recognised the
13 extension of Nova's pipeline in East Tamaki.

14 **CHAIR:** Sure. It's kind of interesting to hear about price
15 decreases where you face direct competition through
16 bypass, but despite all this competition from LPG and the
17 need to keep the reticulated gas competitive, that you
18 nevertheless were able to put through a price increase in
19 that part of the market.

20 So I think we need to know what that price increase
21 was in zone C and I'd like to know how that compared to
22 the price falls in zone X and Y, even if it was at stage 2
23 rather than stage 1, and it might be also interesting to
24 know what the volumes were that were in play in those
25 areas.

26 But I might suggest to you that if LPG was as much a
27 constraint on your behaviour as bypass you wouldn't have
28 been able to increase prices in one area while you were
29 decreasing them elsewhere.

30 **MR VAN BRINK:** I'm not too sure about that, Commissioner,
31 because I do believe that the competitiveness of gas to

1 LPG is of major concern in residential areas and you'll
2 find we'll get the information through to you, but you'll
3 find the increase was quite small in zone C.

4 Also I think the implications of customers looking at
5 options of either LPG or reticulated gas should be focused
6 on the delivered price of gas and in light of the fairly
7 steep increases in the energy price of gas over the last
8 18 months which have been significant, whereas, as I said,
9 our distribution price in July this year, our total
10 revenue has taken a significant reduction which hasn't
11 been recovered.

12 **CHAIR:** What's happened to the delivered price of LPG; has it
13 experienced the same volatility as natural gas?

14 **MR VAN BRINK:** It's much stabler, it's linked to an
15 international Saudi price benchmark, so there is some
16 volatility in relation to things like the foreign exchange
17 movements and hedging that the companies would have.
18 Other than that I'd expect there would be some sort of
19 linkage to the competitiveness to LPG compared to
20 delivered gas through a reticulated pipeline.

21 **MS BATES:** On zonal pricing map we got given, you'll give us
22 information of the size of your increase, but the area
23 covered by the increase seems very much greater than the
24 combined area of zones A and B.

25 **MR VAN BRINK:** First I must again emphasise that that
26 rebalance took place about 18 months ago early in 2003.
27 It would have taken place earlier if it hadn't been
28 deferred by the sale process when UnitedNetworks was sold
29 to Vector.

30 The move was very much a recognition of the level of
31 averaging in published prices across the whole gas network

1 and we understood that the implication of that averaging
2 was very clean in showing that bypass pipelines could be
3 built to provide customers with a lower priced product.

4 So I think the actual price changes was a move to
5 deaverage pricing more than anything else.

6 **CHAIR:** Deaverage on what basis? What was the driving the
7 deaveraging?

8 **MR VAN BRINK:** In terms of the geographic spread of our
9 network and distance from the gate stations, energy
10 densities in industrial versus residential areas, the
11 costs to actually reticulate to those areas and the amount
12 of assets involved.

13 **CHAIR:** So you did that reallocation on the basis of what you
14 thought was a more reasonable estimate of the cost you
15 faced in delivering the gas there, it wasn't driven by,
16 this picture seems to strongly suggest, bypass threat?

17 **MR VAN BRINK:** No, the original price adjustment in January
18 2003 was very much, as I said, the first step which had
19 been deferred in rebalancing based on the averaging
20 implications that were inherent in our network and trying
21 to get a more cost reflective pricing, that's correct.

22 **CHAIR:** I think it's an interesting thing to look at because
23 it's hard for us to judge where your access points
24 actually are, but I think it would be useful if you have a
25 look at it and if there's any further comment you want to
26 make it would be useful.

27 I think it would also be useful for us to see the work
28 that went in to determining the new cost allocation,
29 because I think it's always an interesting question when
30 you see increased price discrimination whether it's an
31 efficient response or it reflects the existence of market

1 power in some parts of market. So I think we'd be
2 interested in actually seeing when you did that first
3 stage what was the analysis that supported it.

4 **MR VAN BRINK:** I understand, we have a published methodology
5 and we could make it available.

6 Just another, perhaps another point I'd like to
7 clarify, perhaps to move on in terms of your original
8 question about the reduction, one specific example that
9 was mentioned, one thing that you should be aware of is
10 that in our pricing options that we provide to industrial
11 customers who were contracted, we do provide options of
12 different terms of contract and also pricing that depends
13 very much on volume changes.

14 So where a price is deemed to have reduced from a high
15 to a low price there are other market factors that need to
16 be taken into consideration such as the change in demand,
17 whether a site's grown.

18 We've had one example recently of a site that's
19 actually closed and amalgamated the production to any
20 facility and therefore doubled the size of another site.
21 The economies of scale and the locations have a major
22 impact on any change of pricing from the old pricing that
23 we inherited through to our new price options.

24 Just to summarise the section relating to the market
25 definition and the competitiveness of other gas options to
26 reticulated gas, we emphasise again that we feel the
27 appropriate market definitions will require firstly the
28 gas market and secondly the bypass market, and that within
29 that gas market LPG and natural gas are technically and
30 economically substitutable.

31 We've shown examples that there are many LPG retailers

1 and the barriers to entry are low. There are a range of
2 residential and commercial applications that cover both
3 fuels. It's got a ubiquitous availability. I'll just
4 refer you back to that map we showed which showed the
5 uptake of LPG throughout the geography of Auckland. Both
6 are used widely and the switching costs to LPG are low
7 during the life cycle of an appliance.

8 Within the bypass market there is vigorous competition
9 between pipeline and that's largely distributed to
10 distributor competition but there's also inter-fuel
11 competition that sits alongside that.

12 Probably at that point I'd like to hand over to Stuart
13 Shepherd who will talk about the next section on the
14 modeling assumptions.

15 **CHAIR:** Just before we do that I'll take a few questions if
16 you don't mind. I wanted to follow-up one other point
17 that was raised with us in the last presentation from
18 Wanganui Gas. It was in the context of their submission
19 from the retail arm of their business.

20 It seemed to me that they were expressing some concern
21 of some behaviours they see amongst some network operators
22 who happen to also be electricity network operators.
23 Their submission was that we should look at these three
24 issues because in their view it was having an adverse
25 impact on competitiveness and the competitiveness of gas,
26 and they were unnecessarily stringent applications of
27 prudential requirements, billing for network services in
28 advance and the last one they noted was zone price with no
29 apparent overall reduction in network revenues.

30 So it's an interesting submission coming from a
31 network operator themselves as an integrated business. It

1 suggested to me they think that's evidence of use of
2 market power, you wouldn't be able to do it if your
3 network operation was competitive. But they linked it
4 also to behaviour that tends to be associated with those
5 operators who also are involved in the electricity end of
6 the business.

7 So I'd like to invite your comment on that submission
8 if you would please.

9 **MR VAN BRINK:** Certainly our intent is to respond quite fully
10 in our cross-submission s to those issues because we do
11 have issue with them and believe they are incorrect
12 statements and perhaps can certainly be readily explained.

13 In terms of the prudential requirements it's a
14 standard commercial instrument that is introduced by
15 electricity and gas retailers in common. It reflects the
16 fact that we are not providing discrete or individual
17 products that can be recalled should a retailer fail, the
18 fact that the retailer may well cease to operate and we
19 would be left with having to carry foregone revenue while
20 other retailers take up supply to individual connections.

21 We certainly don't differentiate amongst retailers, we
22 look at a risk profile for the business and in our
23 agreements request prudentials that we believe are
24 reflective of the risk we do carry and they relate to a
25 month's worth of line charges or two month's worth of line
26 charges.

27 **CHAIR:** They put that issue to us and I accept that you may
28 require that of all of your retailers, but you might have
29 market power vis-a-vis all of your retailers. They
30 suggested to us that some do it and some don't, in their
31 case they don't and they deal with five or six retailers

1 as well.

2 So what is it that, given all your concern about
3 encouraging retailers to use natural gas rather than LPG,
4 why is it you persist with certain aspects of your
5 contracting that arguably may make it very difficult for
6 them, or less in their incentive for promoting the use of
7 natural gas.

8 **MR CRAWFORD:** A couple of points I'd like to add to what John
9 said that may help clarify things. Firstly retailers have
10 the option of providing either a bond which is
11 commensurate with their level of line charges and that
12 bond is adjusted upward or downward based on whether a
13 retailer is growing or contracting market share, so it's
14 relative to their size, that's the first point, if they
15 choose to go down the path of providing a guarantee.

16 They can also alternatively provide a credit rating
17 which a number of retailers, particularly the larger ones,
18 obviously provide as an alternative. The choice is with
19 the retailer as to which of those two mechanisms they
20 would provide to us to give us some degree of comfort that
21 our commercial risk is really managed.

22 So there is a relativity to the size of the retailer
23 that is embedded in those options which we feel
24 accommodates the smaller retailers quite well and it is
25 reviewed on a regular basis in terms of whether it is in
26 line with the dollar value of the exposure we carry.

27 **MR ALSOP:** Can I make a further comment, to the extent some of
28 these things are issues, we're not saying they are, we
29 feel they're normal commercial issues that are worked
30 through including with other retailers as Bryan pointed
31 out, but to the extent that they are issues there's

1 industry processes under the auspices of the GISG where
2 some of these issues will be discussed and looked at.
3 It's not to say they'll be addressed because they may not
4 be issues that Wanganui Gas is alleging.

5 So there are other industry processes in play where
6 some of these things can be worked through if in fact
7 that's needed.

8 **CHAIR:** That may be the case but that's not the point. The
9 point is, is if they're there and they wouldn't be if the
10 distribution market was competitive. In other words you
11 can only do that because you have some market power.
12 Whether there's in the future going to be a regulatory
13 response to deal with that market power that may be the
14 case, but I'm exploring this not because I'm worried about
15 where the solution is to that particular issue, but what
16 it might imply about the degree of constraint in the
17 distribution market, so that's why I'm pursuing it.

18 I know that that other leg of work is there and
19 generally this Commission has certainly been -- we're not
20 involved in the detail of it and we couldn't say overall
21 what the effect is, but there are some fairly positive and
22 in some cases pro-competitive aspects to that work going
23 on in the Government's regime, but I don't know if it
24 necessarily then says that there's not -- things like this
25 aren't evidence of at least some market power in a
26 particular market. I don't know, I'm just explaining to
27 you why I'm pursuing the question.

28 Okay. Did you want to comment now on either of the
29 other two points that Wanganui Gas made?

30 **MR CRAWFORD:** I'll ask John to comment on the billing point
31 that I think they raised. Just to perhaps close out this

1 point, I think it should be remembered that the exposure
2 which distribution companies face by nature of the service
3 they provide and the reality that disconnecting customers
4 is not a practical solution to commercial risk and credit
5 exposure to a retailer should not be forgotten. It's not
6 too long ago that TransAlta, for reasons I think we all
7 understand, nearly failed; they were the largest customer
8 of UnitedNetworks and prudent commercial practice drives
9 you to ensuring that you are protected from the failure of
10 those with whom you do business, and so it's no different
11 in this circumstance.

12 The reality is that we can't discontinue supply, we
13 would have to probably maintain supply to end customers
14 and somehow manage a switch to an alternative retailer in
15 the event of a retailer failing.

16 The likelihood of a retailer failing is quite real and
17 we feel that the things we have in place manage that
18 credit risk appropriately. So I'll get John to comment on
19 the billing issue.

20 **MR VAN BRINK:** Certainly the billing issue that we have in
21 terms of billing in advance is not an electricity industry
22 model that we introduced into the gas business. Vector
23 actually bills in arrears for electricity in the
24 UnitedNetworks banded(?) area where we have an interposed
25 relationship.

26 Billing in advance was inherited with the purchase of
27 the gas network and it hasn't changed since then. We have
28 actually made a couple of attempts, starting back in 2001,
29 to align the gas and electricity billing by moving gas to
30 billing in arrears.

31 Having said that, the gas billing in advance is

1 probably maybe a bit of a misnomer, in fact it's billing
2 for the month in which the services occur. So the bill
3 goes out to the retailer based on estimated volumes at the
4 beginning of the month during which the services are
5 provided and the retailer pays by the 20th of the month so
6 it's incurred in that month. So while it's billing in
7 advance it's not a full month in advance.

8 As I said we spoke to retailers on a couple of
9 occasions going back to 2001 and in 2002 again to see if
10 we could move the billing process to a billing in arrears,
11 and discussed with the retailers the implication of that
12 one-off shift in terms of a loss of a month's worth of
13 revenue, the funding costs of that. All the retailers
14 were consulted with and certainly I think there was about
15 three retailers who were not keen to make a move, one of
16 which was Wanganui Gas. So as a result of that we carried
17 on with the current situation, knowing that sometime in
18 the future we would like to address it because it is
19 simpler for us to have a single methodology for billing
20 customers, if we've got a single billing system.

21 Could I just make one quick comment regarding the
22 third issue brought up by Wanganui Gas; we did discuss it
23 earlier on, they did mention the increase in zonal pricing
24 was reflected in other areas. I just want to reiterate
25 again there has been a reduction in revenue as a result of
26 the zonal pricing move, not an increase or rebalance over
27 the total time.

28 **CHAIR:** Over both legs of the strategy there was an overall
29 reduction in revenue?

30 **MR VAN BRINK:** Correct.

31 **DR LAWRENCE:** I've got two questions; first one for

1 Mr Crawford. You spent considerable time telling us a lot
2 of anecdotal information about LPG versus natural gas, but
3 I think for most people it would be drawing a pretty long
4 bow to argue that it provides anything other than very
5 peripheral competition, and you would certainly need to
6 support that information with fairly robust information on
7 elasticities of substitution to argue for that line of
8 argument to be credible.

9 So, are you able to provide us with some robust
10 elasticities of substitution?

11 **MR CRAWFORD:** I'll have to defer to Stuart in terms of
12 modeling and elasticities, so if you allow me to do that.

13 **MR SHEPHERD:** I think it's part of the question we're taking
14 away from the Chair as well in terms of her earlier
15 question. I know there's going to be difficulties
16 involved in actually gathering that data into the extent
17 that it would normally be required.

18 I think it's fair to say, for this submission in the
19 conference we've focused on competitive activity around
20 the entry of new customers onto the network, and that's
21 what Brian particularly spoke to. I think the challenge
22 has been to demonstrate that our propositions hold in
23 other aspects in a more data-intensive manner, and that's
24 what we're taking away and will respond with.

25 **DR LAWRENCE:** Second question is to Mr Mackenzie.

26 I'd like to ask you, based on your experience as a
27 network operator, and this is going to some information in
28 your submission in general market characteristics rather
29 than what is specifically covered in the slides today, but
30 in paragraph 3.11 you make some comments regarding the
31 comparability of your network and the New Zealand gas

1 industry relative to, I think it's Melbourne and the UK.
2 In particular you list a number of factors that you claim
3 are different between the markets, and I'll read a couple
4 of those out; greater population density, colder weather,
5 more mature gas reticulation networks, access to abundant
6 quantities of gas and environmental considerations.

7 My question is, aren't all those factors equally, if
8 not more, applicable to comparisons between New Zealand
9 and the United States?

10 **MR SHEPHERD:** Perhaps I could respond to that because I've
11 been a bit closer to the benchmarking work that was done
12 by Pacific Economics Group than Simon has been.

13 I don't intend to go into any detail because Larry
14 Kaufmann from PEG will be presenting his material
15 tomorrow, but I think the key issue is that in that work
16 they attempted to take account of as many of those factors
17 as possible, so it's accepted that they are relevant
18 factors to consider in a benchmarking exercise, and Larry
19 attempted to do so.

20 **DR LAWRENCE:** We'll have a considerable number of questions
21 for Dr Kaufmann tomorrow, but I go back to my question to
22 Mr Mackenzie; based on his knowledge as a network operator
23 of -- and obviously you have knowledge of how networks
24 operate, not only in New Zealand but also overseas, I
25 would just rephrase or re-ask the question whether you
26 would agree that particularly things like weather,
27 population density, abundant supply of gas, no mature
28 reticulation networks, are certainly things that very much
29 characterise the US market more so than the New Zealand
30 market?

31 **MR MacKENZIE:** My answer to that would be, firstly, my

1 experience extends mainly more on the electricity side of
2 the business than it does on the gas, but certainly from
3 understanding the gas networks and the environment that
4 occurs particularly in the US, obviously in certain parts
5 of it, then that would be a fair assumption.

6 **DR LAWRENCE:** The colder weather in particular, relative to
7 Melbourne, do you think New Zealand has considerably
8 colder weather than Melbourne? I was in Melbourne last
9 week, and I can tell you, Wellington is a lot colder this
10 week than Melbourne was last week.

11 **MS BATES:** It's not always the case though.

12 **MR MacKENZIE:** I guess the thing is, our comments are primarily
13 about Auckland.

14 **DR LAWRENCE:** Just to --

15 **CHAIR:** You can find observation points in any position,
16 Dr Lawrence.

17 **DR LAWRENCE:** Just to quickly finish off on that point,
18 Mr James from NGC made the observation yesterday that the
19 US market had a number of advantages over New Zealand, not
20 only climatic considerations but what he described as the
21 culture of consumption in the US market. I think what he
22 meant by that was the advantages of population density,
23 lifestyle conversations, higher industrialisation and so
24 on. So, you would agree with that comment by Mr James?

25 **MR CRAWFORD:** A couple of observations, I guess. I think it's
26 interesting that -- and I think in general I would say
27 that we are probably closer to that kind of environment
28 than we may well have been in the past. Anecdotally, it
29 was noticeable when New Zealanders were asked to save
30 electricity not too long ago, that there was quite a
31 significant amount of the population who saw that as

1 somewhat counter to their right to use as much electricity
2 as they care to, and I think there is an element of
3 society now that is very focused on their right to consume
4 if they so choose.

5 For instance, one of the issues around gas is that
6 people are attracted to gas because they can have longer
7 showers, they can indulge themselves and they can do so at
8 their pleasure. So, I think we're becoming more of a
9 consumer-driven society and are more perhaps like patterns
10 of behaviour in the US, from a consumer point of view,
11 than we may once have been.

12 **DR LAWRENCE:** I think the more important issue there relates
13 to things like space heating for instance where you're
14 certainly going to have much more need for space heating
15 in the US, particularly the northern part of the US, and
16 you've also got to contend with issues like permafrost,
17 for instance, which I don't think you'll encounter in
18 Auckland.

19 **MR CRAWFORD:** Occurs in Queenstown sometimes, but that's an
20 LPG network, of course.

21 **DR LAWRENCE:** In the North Island you won't; thanks.

22 **MR MacKENZIE:** I'd just like to add from another observation
23 which is more analogous to what we see happening in
24 electricity as well. We certainly see, to Brian's point,
25 the lifestyle choices actually impacting more on what's
26 happening with regards to electricity from a consumer
27 perspective in the sense of what consumers are looking for
28 from comfort, utility from the products that they take. A
29 good example of that would be the likes of central heating
30 and air-conditioning. That is a significant increase on
31 that on our network. I'd also note, that seems to be a

1 consistent theme in Australia.

2 When you look back into the US where that was
3 probably, because of the extremes in weather conditions
4 there, you could probably argue that that was like a
5 necessity when consumers were actually building their
6 homes or apartment blocks. Now it is becoming much more
7 of a product of choice both in electricity and of course
8 none of it can be driven by gas.

9 **MR SELL:** We've heard a lot and read a lot of your
10 observations about the market, but really following up on
11 Denis' point, I think we really do need quite a
12 substantial amount of evidence to back that up.

13 I guess my feeling is that a lot of what's in your
14 submission, I'm afraid, comes across as circumstantial and
15 maybe this is just an economist's way of looking at
16 things, and I apologise for that, but I think what I would
17 particularly like to see would be an analysis of the
18 market that really breaks the market down and quantifies
19 for us those segments of the market that are subject to
20 whatever it is, bypass, LPG or whatever the other
21 competitive disciplines are; quantifies that perhaps by
22 volume, quantifies it by revenue and then gives us some --
23 as convincing evidence as you can for why that particular
24 threat in your view is really constraining your prices.

25 As an example, I guess in the Commission's Draft
26 Report there are some figures which I think may have been
27 quoted from an NGC submission that might be a few years
28 old, but they talk about LPG and I think \$40 a gigajoule,
29 and natural gas at \$12 to \$21 a gigajoule and electricity
30 at \$28 a gigajoule. Taken at face value, that seems to
31 suggest that LPG's no threat at all. But if those figures

1 are out of date, or if you have other evidence or there's
2 other factors, please let's see them.

3 **MR MacKENZIE:** Our response on that is, we take the point and
4 that's something we'll return with cross-submission on.

5 **MR CRAWFORD:** Further to that, I think we recognise the
6 challenges that quantifying, I guess, some of what we've
7 been talking about, present. There are issues of access
8 or even the existence of data upon which you can base some
9 valid assumptions, particularly when you start talking
10 about LPG; it's not subject to disclosure, it's
11 commercially sensitive information held by other parties.
12 So, there are some issues around that.

13 I guess the other comment I'd make as a marketer is
14 that there are significant behavioural things at work here
15 in terms of consumers which defy economic analysis and
16 price, for instance, as a driver for many of the decisions
17 that residential customers make in regard to gas is not a
18 significant issue.

19 If you look down the priority and the process by which
20 consumers in the residential market at least make those
21 decisions, they are driven -- I think Simon touched on it
22 just now -- by lifestyle choices, aesthetics, a number of
23 other factors that rank much much higher than line charges
24 as a percentage of the total energy bill. That part of
25 the energy bill is far from their thoughts at the moment
26 when they walk in the store to buy an oven or to buy some
27 central heating, and we've looked into that and are
28 confidential that's the case.

29 What often happens, and I think I may have said this
30 before, is that in order to justify the decision process,
31 post that decision they will rationalise it with their

1 friends as saying it was an economically rational
2 decision; I've made a good decision in economic terms as
3 well as lifestyle terms. So, it's very difficult to put
4 some economic analysis around some of those drivers other
5 than price but, as Simon said, we hear the Commission in
6 terms of their needs and we'll try and meet it in any way
7 we can.

8 **MR SELL:** Again, I would presume I would have survey results
9 and focus group results and that type of thing, and if
10 that's evidence for what you're saying, then that would be
11 really helpful I think.

12 One other question, and it has to do with the economic
13 value write-downs. Again, this is probably more a
14 question for response in the cross-submission rather than
15 here and now but, on the face of it, it doesn't feel right
16 to me that there's a minimal economic value write-down and
17 yet we're hearing from you that you're subject to
18 extensive competition.

19 I guess I would be interested to see -- John, you
20 talked about the pricing methodology that you've
21 implemented, the zonal pricing methodology that you've
22 implemented. The question I would ask I guess would be to
23 what extent have you priced, or are the prices in the
24 marketplace according to that methodology? To what extent
25 have you discounted below those price levels and then
26 what's happened as a result of those discounts? Has it
27 led to or will it lead to economic value write-downs in
28 the future? Because, the two would seem to me to
29 logically go hand in hand. I don't know if you want to
30 answer that now or in cross-submissions.

31 **MR SHEPHERD:** Can I seek clarification, Paul, in terms of what

1 you're looking for? In the Vector submission we question
2 the logic between observing economic -- inferring from
3 economic write-downs -- sorry, inferring from the absence
4 of economic write-downs that competition was not present.

5 Could you explain the logic that you or the Commission
6 is using so that we can understand what information it is
7 that you're requiring?

8 **MR SELL:** Yeah, I would tend to agree with you that the lack
9 of economic write-downs doesn't necessarily suggest that
10 competition is very close, but given -- but what it does
11 imply, if you're saying that there's very strong
12 competition, I guess that's implying that right across
13 your network a whole raft of competitors are this close to
14 you, but none of them are actually coming in -- none of
15 them are actually forcing you to drop your prices if you
16 like. That just seems a little bit far-fetched, to be
17 honest, given that there's -- across your network there's
18 a range of prices, and obviously there's a range of
19 different competitors and you would suspect therefore that
20 there would be some instances where your prices are
21 uncompetitive, and if you discount them, that therefore
22 the supply to those customers is uneconomic. It's more of
23 a sort of distribution probability-based argument, I
24 guess, that I'm thinking of.

25 **MR SHEPHERD:** That's useful.

26 **MR ADAMS:** Just going back to the argument of LPG constraining
27 gas prices. When you think about it, I guess LPG and
28 natural delivered gas have quite different cost structures
29 and it may be that an argument why -- you know, you can
30 show that, you may be able to show there's substitution
31 taking place and that LPG is constraining gas prices, but

1 it may be that that's because the gas distributor or the
2 gas supplier is behaving rationally in pricing up to the
3 point at which LPG becomes substitutable. In other words,
4 if we put LPG and natural gas in the same market, we're
5 falling into this cellophane fallacy trap that the
6 Americans have dealt with a bit.

7 **MR SHEPHERD:** Perhaps I could respond to that.

8 That may or may not be the case, I'm unsure, but just
9 controlling just the network part of the sector is very
10 unlikely to address that issue, it would seem to me.

11 **CHAIR:** That seems to be quite a separate issue to what is
12 being asked here, is it not? What's the connection
13 between that point and the question that was put to you?
14 I don't understand.

15 **MR SHEPHERD:** I think the connection is that the -- first, the
16 proposition as I understand it is that it could be that
17 gas, so to say, should be priced much lower than LPG. Is
18 that -- am I correct?

19 **MR ADAMS:** What I'm suggesting is that gas is substitutable
20 with LPG at a price where gas -- the gas price contains
21 quite a large or a significant monopoly rent element to
22 it.

23 **MR SHEPHERD:** Right. And, working through that proposition,
24 how are you going to -- how would you suggest discovering
25 if that is the case, particularly in the wholesale price
26 for gas?

27 **MR ADAMS:** Well, we're looking particularly at the
28 distribution side and we're undertaking this building
29 blocks approach, of course.

30 **MR SHEPHERD:** That's accepted, but the service is only useful
31 to the consumer if linked with the energy component.

1 **MR ADAMS:** The argument that's been put to us is that the
2 retail market is competitive and you wouldn't normally
3 expect to see significant rents in a competitive market.
4 So, if there are rents there, we could presumably assume
5 it comes from the distribution and transmission part of
6 the market.

7 **MR SHEPHERD:** Have you considered the possibility that they
8 may be captured in the energy market at the point of
9 wholesale?

10 **MR ADAMS:** Anyway, the focus of this inquiry is on gas and
11 transmission -- distribution and transmission, and we're
12 attempting to assess whether there are more than
13 competitive rates of profits being earned at that part of
14 it.

15 **MR SHEPHERD:** I understand the scope of the inquiry is on the
16 distribution transmission only, but I would suggest to
17 undertake the analysis you're suggesting, that the scope
18 of that research needs to be much wider, otherwise there
19 are very significant unanswered questions in the
20 proposition.

21 **CHAIR:** Is it your submission that the wholesale market --
22 that there's market power there and any reduction in price
23 at the transmission and distribution end would be captured
24 by wholesale now; is that your submission?

25 **MR SHEPHERD:** No, it is rather that, to test the proposition
26 at the delivered -- to test the proposition that the
27 delivered energy price, including energy and distribution,
28 has some form of so-called monopoly rents in it requires
29 testing whether those rents have been captured in some or
30 all steps of the value chain, not just in the one that is
31 within the scope of the inquiry.

1 **MR ADAMS:** Isn't it your proposition that there is competition
2 at the delivered energy level between LPG and gas, and
3 that ensures that there cannot be monopoly profits earned
4 in the distribution and transmission side of the market?

5 **MR SHEPHERD:** I think our proposition is that there's
6 competition at the retail point for across gas and LPG,
7 what we've termed the gas market, and that the demand for
8 distribution is derived from that and the fact that there
9 are differing transport means or modes for the gas market
10 gives rise to competition in distribution.

11 **MR ADAMS:** I don't want to take this too far, but clearly if
12 the prices at retail level contain some monopoly rent
13 element to it, while there's competition at those prices,
14 it doesn't necessarily prevent monopoly rents being earned
15 in the distribution and transmission side.

16 **MR ALSOP:** Could I just note that the cellophane fallacy, that
17 Dick's raising is a well documented competition issue
18 which related to price relativity in this case between LPG
19 and natural gas and also elasticities and substitution
20 which we've had some direct feedback from on the
21 Commission and staff, so I wonder if we're best to wrap
22 this all up in the more analytical and data-intensive
23 response that we've undertaken to come back to the
24 Commission. We note the comment that's been raised, and
25 we'll make sure we'll make some comments on that in the
26 cross-submission if that's acceptable?

27 **CHAIR:** That's a good suggestion. Make sure you do pick it
28 up, because I think Dick's raised an important issue and I
29 think it is important that you address it in cross-
30 submission.

31 I'll see if there are further questions from staff.

1 We can continue then with the presentation, thank you.

2 **MR SHEPHERD:** I'll now speak to the issues raised in the
3 Vector submission in relation to the assessment the
4 Commission makes in its Draft Report and its modeling and
5 the assumptions that are made in that modeling.

6 I'd like to speak to six issues that we've chosen due
7 to the size of their impact, but before I do I'll just
8 mention again, as Simon mentioned earlier, that the
9 correction of the tax shield issue isn't in this list.
10 We'd be happy to take questions on it, but given it's been
11 dealt with in another forum, we thought it not good use of
12 time to include it here. Also, given it's a relatively
13 technical issue.

14 **CHAIR:** I've mentioned earlier in the proceeding that the
15 Commission has acknowledged the issue around tax shield,
16 and you'll be aware that we've sought additional
17 information. We've indicated that we will, at the time
18 that we get what we believe is the information we can rely
19 on going forward to the final document. Before we do
20 that, we will consult on that aspect of it in written form
21 and give interested parties probably ten working days to
22 respond. So, you'll have an opportunity in writing to see
23 how we treat that and give us any comments on it, so
24 unless there's more general comments you'd like to make, I
25 propose that your approach is appropriate.

26 **MR SHEPHERD:** I think that's an excellent approach and we can
27 deal with it in that forum.

28 The six issues I would like to talk to are the time
29 period used for assessment. I'll go through the list and
30 then deal with each one; the suggested departure from ACAM
31 costs, the assumption that's made in the Draft Report that

1 control would improve productive efficiency, populating
2 the Commission's suggested dynamic efficiency model, the
3 de minimis test and asset valuation. I also recognise
4 there are a range of other analytical issues you may well
5 want to question us on, but I'll deal with these six as a
6 starter.

7 I'd also note that it's come up in the questions that
8 Vector, along with NGC, commissioned PEG to undertake a
9 benchmarking study. I'm not intending to speak to that,
10 Larry is presenting that work himself tomorrow morning, as
11 you're aware.

12 The first one is the time period used for
13 recommendations. In the Draft Report the Commission uses
14 both historic and forecast information to derive its
15 estimates of benefit or loss. We would note this is in
16 contrast to its usual practise of using just forecast
17 periods; or, in some cases, using a historic period as a
18 base year from which to move forward in terms of
19 forecasts. Examples of that, that precedent, is the
20 Airports Inquiry where a base year was used and then
21 forecast periods ranging between two and five years; the
22 investigation into unbundling the local loop in
23 telecommunications which is entirely forward-looking, and
24 public benefits test that the Commission routinely uses
25 for authorisations is, as far as I'm aware, always based
26 on forward-looking information.

27 It seems to us that using forward-looking information
28 is entirely consistent with the nature of the question
29 that the Commission is attempting to answer, and that is
30 whether the particular intervention, in this case control,
31 would give rise to net benefits or not. It would seem

1 that the appropriate information set is a forward-looking
2 one and that the use of historical information is of
3 itself really not relevant or appropriate to that question
4 other than perhaps providing the basis for a forward-
5 looking view.

6 Some of the reasons that the Commission appears to
7 have used in the Draft Report for using historical
8 information is that, one, that it was necessary in order
9 to increase the window of assessment; that is, to increase
10 the length of period under assessment. It seems to us
11 that strictly isn't necessary; if a longer period were
12 needed, one could simply forecast further forward. We're
13 not suggesting that a longer period need be used, but
14 rather, we would suggest a period similar to the period
15 that one is intending to regulate for is probably the most
16 appropriate period. You'll hear in a few minutes, from
17 Vector's view that a five to six year period is superior
18 to an 11 year period. But, be that as it may in terms of
19 what exactly that period is, none of those arguments about
20 the period of control, I think, argue for using historic
21 information.

22 Secondly, as I understand it, control is not intended
23 to be punitive in some way, and that just reinforces, I
24 think, the lack of relevance of historical information,
25 and historical information --

26 **CHAIR:** I'm not sure I understand what you mean by "punitive".
27 If you mean it's not meant -- you wouldn't go back and try
28 to remove past excess returns, that seems to me a
29 different issue to whether the earning -- in the past you
30 saw excess returns earned is informative, so you can quite
31 logically -- and I think even in Airports we did look at

1 past excess returns, and we did think it was possibly
2 informative; and not be implying that you think if control
3 were imposed that you would be going back to try to
4 recover the past excess returns, if that's what you mean
5 by "punitive"?

6 **MR SHEPHERD:** What I meant by "punitive" is that control would
7 be imposed for the reason of, as it were, best termed, I
8 think, paying back perceived excess returns in the past,
9 even though looking forward the analysis indicated that
10 that wasn't occurring, whereas if I've interpreted your
11 comments correctly, Commissioner Rebstock, is that you may
12 use historical information as an indicator or predictor of
13 what is going to occur in the future?

14 **CHAIR:** I was simply trying to clarify what you meant by
15 punitive, but we'll come back to the question about how
16 much information value is in past performance.

17 We've heard a range of submissions on this point and
18 we don't have actual information going forward; we have
19 forecast information. It wouldn't surprise you, I'm sure,
20 to hear me say that often the best prediction of the
21 future is the past, unless there's some good reason why
22 that may not be the case.

23 I indicated the other day, when I think about the
24 Airport experience, and we heard a lot of submission on
25 what was going to happen to demand growth for airport
26 services; it turned out that the past probably was a
27 better predictor than forecast that the companies had
28 presented to us, if you look at it with hindsight.

29 So, I'm not sure why we would put more weight on
30 forecasts that are not actuals, they're simply a forecast
31 with all of their imperfections, than we would put on

1 actual information that we had, that we could observe.
2 I'm not sure why one is of greater value than the other.
3 I don't think we have to decide whether one -- we should
4 have one or we should have the other, but they seem to
5 both yield useful information about what is possible going
6 forward.

7 I might just put to you that I think, if there was no
8 concern that any of these companies had ever earned excess
9 returns up until now, I find it very doubtful that we'd be
10 sitting here today doing this inquiry. So, I think the
11 suggestion somehow that if we saw significant excess
12 returns being earned in the past, we should be oblivious
13 to that in terms of our analysis, I think would be a
14 difficult proposition for the Commission to accept. Where
15 we've used less rather than more information in the past
16 maybe reflects the information that was available as
17 opposed to what you might ideally do. Given the lack of
18 information generally, I'd suggest it's a big ask to
19 expect the Commission to throw out actual observations of
20 behaviour.

21 **MR ALSOP:** Can I make a comment, please?

22 There has been some significant debate as to whether
23 there has been excess returns and whether the inquiry was
24 actually needed. I think an important difference to
25 consider with the Airports Inquiry, at least in my
26 understanding, was that the historical information was
27 contextual to the Commission's recommendations and it
28 didn't factor in the numerical analysis which lead to the
29 Commission's recommendations based on the s.52 test.

30 It appeared to us that the historical returns perhaps
31 gave the Commission comfort that there'd been a pattern of

1 behaviour for some of the subject companies that might
2 have given the Commission more comfort in its
3 recommendations based on forward-looking analysis. So it
4 seemed to be contextual as opposed to incorporated into
5 the analysis.

6 The difference with the gas pipelines inquiry is that
7 historical and forward-looking information have both been
8 included in the Commission's model and if you like netted
9 off depending on the relativity between historical and
10 forward-looking information and therefore factored into
11 the recommendation, so there is a change in the
12 Commission's approach between Airports and gas.

13 A further comment to make if there is no intention to
14 claw-back any historical excess returns and that actually
15 begs the question as to how relevant the historical
16 information is to setting control on a forward-looking
17 basis; that still leaves the point alive as to whether
18 historical information is contextually relevant. You're
19 putting to us that it does have a contextual value, but I
20 think it's important to differentiate between contextual
21 interest about pattern of behaviour in the industry versus
22 relevance to numerical analysis, and we're making a point
23 about the latter.

24 **CHAIR:** I don't think necessarily what was done in one
25 particular case is an argument for or against. First of
26 all, there are many reasons why you take different
27 approaches with data at different points time, for
28 instance in electricity we might have taken a particular
29 approach because of what data was available, and certainly
30 past performance, while we never attempted to claw-back
31 past excess returns, we certainly took account of past

1 information which I'm sure you're aware of.

2 So, I'm not sure if trying to have a discussion here
3 about what we did in one case as opposed to another case
4 is where we should -- you can make what submission you
5 want, but I think it's the principle of what is
6 appropriate that should drive what we do here.

7 **MR ALSOP:** We're happy to accept there may be valid
8 differences for a differentiated approach between aspects
9 of the Commission's work. I guess what we would hope to
10 see is some transparency around the reasons for a
11 different approach being taken, and from our reading of
12 the Draft Report those reasons didn't come across clear to
13 us at least.

14 So if the Commission persists with its current
15 approach we'd hope to see in the final report some more
16 transparent analysis around why a different approach is
17 relevant here compared to Airports. That may be the case
18 if the reasons are worked through, but we don't think that
19 is the case.

20 **MR WYDEVELD:** I think you're right, that in the Airports the
21 historic excess return analysis was contextual, but that
22 was also only because we couldn't actually do the net
23 acquirers benefits test in the past. So, if you will, we
24 only had a half test, we could only measure one of the
25 variables of our test in the past, so therefore the only
26 role it could ever play was a contextual role.

27 Here we can actually do the analysis, a net acquirers
28 benefit test into the past, and therefore its role doesn't
29 necessarily have to be limited to a contextual role.
30 That's picking up also on Paula's point about different
31 situations.

1 **CHAIR:** I think we have heard that submission, and I suspect
2 that Dr Lawrence will want to pursue questions on this
3 point as well, but we'll come back to that.

4 We'll let you get a little further into this and then
5 we'll interrupt you again. Thank you.

6 **MR SHEPHERD:** The second one is the suggested departure in the
7 Draft Report from ACAM costs. There are two points here
8 we'd like to highlight. The first is that the Commission
9 expresses a view that gas businesses may have loaded a
10 disproportionate share of common costs to their gas
11 activities, but it doesn't provide any evidence to support
12 that view, and in Vector's case, Vector developed its
13 information, responded to information requests using ACAM
14 principles and assembled that information consistent with
15 those principles, and furthermore, had an entry from PwC
16 to provide opinion on its use of those principles which is
17 appended to Vector's submission.

18 Furthermore, it has prepared that information to an
19 auditable standard which it was requested to do, and we
20 suggest that the Commission, if it has a concern in this
21 area, that it perhaps audit the information as opposed to,
22 on the basis of a concern look for other principled
23 approaches. That's a first point; that's one of, does the
24 information reflect the ACAM principles? We're suggesting
25 there's a way of testing that.

26 The second one is whether the principles themselves
27 are appropriate or not. The context here is that the
28 Commission has suggested reducing ACAM based common costs
29 by 10%, 20% and 30% in the final report. However, we'd
30 note that the use of unadjusted ACAM cost information is
31 consistent with a number of things that the Commission has

1 done over recent times, and we list some examples here.

2 The Commission used ACAM based information to reset
3 threshold in electricity, and by that I mean that the
4 information that was provided by electricity companies
5 under disclosure and used by the Commission and its
6 advisors to assess relative productivity levels was not
7 adjusted for those electricity businesses that were
8 running other businesses. So, there was no common cost
9 adjustment for companies that were running other
10 businesses which the suggestion in the Draft Report would
11 argue for.

12 The Commission has confirmed the use of ACAM in its
13 recently issued electricity disclosure regs, and it used
14 ACAM in an unadjusted form for the same tests as being run
15 here in the Gas Inquiry when it was undertaking the
16 Airports Inquiry.

17 Lastly, it's not a Commission view, but the MED in the
18 late 90s or early 2000 endorsed ACAM for disclosure
19 purposes. In its view it was the only robust method to
20 identify so-called monopoly profits and avoid arbitrary
21 allocations. So, there's a body of work precedent and
22 another organisation or institution that, in the case of
23 the Commission, has used ACAM consistently, and it's been
24 recommended in the gas sector.

25 Vector's therefore recommending that the Commission
26 remain consistently with that approach rather than
27 introduce what appear to be arbitrary modifications to it.

28 **CHAIR:** I'd just like to interrupt you there and note, which
29 I'm sure you are aware, that the Commission did not review
30 the electricity disclosure regs at the last period, but
31 indicated that it intended to review it, and that process

1 is starting. I don't think you can take that as anything
2 other than a practical way to deal with the work flow in
3 that area, and I'm sure that that has been made clear as
4 well.

5 The second point I wanted to make is that, what we
6 might do going forward in electricity is yet to be seen,
7 and I can imagine that it will be an issue live in that
8 forum as well. That will be when the Commission indicate
9 what its view is on that particular matter in that
10 context.

11 I would note also that these disclosure regs were not
12 done for the purpose for which we are trying to use the
13 information from them today. What MED did in that context
14 some time ago you cannot infer that would be the
15 Commission's position on these matters when it puts its
16 mind to it.

17 I would like to ask you one question. Do you think it
18 would be a reasonable approach for the Commission to allow
19 a situation where we had a result that using stand-alone
20 costs for multiple activities led to a situation where a
21 business was more than recovering their total common costs
22 as a result? Do you think that would be an approach that
23 would have integrity in terms of what you might think a
24 Regulator might do?

25 **MR SHEPHERD:** I think it may well be an acceptable approach if
26 the alternative intervention were to be less efficient.

27 **CHAIR:** But generally, if it can be avoided without the
28 inefficiency that you refer to, would you agree that might
29 be an undesirable result?

30 **MR SHEPHERD:** I think the question of whether it could be
31 achieved is the key one.

1 **CHAIR:** Yes, but would you agree that, in principle, the
2 Commission should not take an approach that would allow
3 the businesses to over-recover their total common costs
4 across their businesses?

5 **MR SHEPHERD:** I think the wider principle is the efficiency
6 one.

7 **CHAIR:** I'm happy to take the qualification, but I'm wondering
8 if you've answered my question.

9 **MR SHEPHERD:** I think so, because the implications of
10 attempting to do something other than ACAM seem to me to
11 give rise to distortions that at least so far the Draft
12 Report hasn't addressed.

13 **CHAIR:** It's sufficient, for regulatory purposes, for a
14 Regulator to basically take the position that anything
15 between stand-alone costs and incremental costs would be
16 acceptable, and the result could change business by
17 business simply because of where a business chose to pick
18 in that range.

19 So one company who had sound justification for where
20 they picked in that range, did it properly, might be found
21 to have earned excess returns as a result of that and one
22 that took an extreme position because it would have a
23 certain impact on the final result wasn't and that's an
24 acceptable regulatory outcome because the range could be
25 quite significantly dispersed.

26 **MR SHEPHERD:** I think it's sort of suggesting that the only
27 trade-off that's at play here is the one that you've
28 described.

29 **CHAIR:** I think what it's suggesting is that the Commission
30 needs satisfaction about the justification for what the
31 company has done, and I think what we are really

1 challenging you to do is to provide that justification.

2 I think that justification is required and it
3 should -- I think, because of some of the issues I've
4 mentioned, we do need to satisfy ourselves that whatever
5 approach you've taken, because there is a wide range
6 available to you and I suspect that it can have a
7 significant impact on the outcome and, therefore, it does
8 deserve that sort of guidance. I don't doubt that it may
9 have the same potential impact in electricity, and it's
10 precisely why it probably deserves some closer analysis in
11 that context as well.

12 **MR ALSOP:** Could I make a comment?

13 I certainly agree with the proposition that all
14 companies should be held to account to demonstrate a
15 justifiable approach to the application of ACAM
16 principles. I guess for our part we felt we were taking a
17 proactive approach in terms of having PwC look at the
18 integrity of Vector's application of the principles and
19 the opinions being annexed to the submission
20 transparently. If the Commission has any residual
21 concerns or further concerns we're happy to take those up
22 through a separate process, or as Stuart alluded to in an
23 earlier slide, the option of an independent Commission
24 audit is also there as well.

25 **CHAIR:** I guess the suggestion, Peter, of an independent
26 audit -- the point, in a way, that I'm trying to get at
27 here, is this something about what is an accepted
28 accounting practise, this is about what in a regulatory
29 environment is an appropriate treatment.

30 So there's an issue of principle here about what's
31 appropriate in a regulatory context. I'm not saying to

1 you, not expressing a view one way or the other about
2 whether what you've done is sufficient or whether you
3 haven't attempted to address the issue, but I think it's
4 important for you to understand what it is that the
5 Commission is concerned about so you can ensure that
6 you've addressed those issues.

7 **MR ALSOP:** I certainly agree it's a very important matter of
8 regulatory principle and, like many others, it deserves
9 careful and transparent treatment in the Commission's
10 final report.

11 As Stuart commented earlier, an important question in
12 thinking about this; if not ACAM, then what else? Then to
13 date we've seen what, in our view, is a fairly arbitrary
14 reduction being proposed to ACAM costs.

15 I think horizontal integration between electricity and
16 gas activities or gas and other activities can be
17 efficiency enhancing. I think that would be hard to
18 refute as a general proposition, or at least it can be
19 efficiency enhancing.

20 So care needs to be taken then, if not ACAM then will
21 something else destroy incentives for efficient horizontal
22 integration and that needs to be carefully thought through
23 and robustly analysed in terms of what that approach would
24 mean, how it would be implemented and what that would do
25 for incentives for horizontal integration in the future or
26 otherwise in terms of separation of existing business
27 activities that are horizontally integrated. So a very
28 important regulatory principle, it needs careful
29 analytical treatment if there is indeed a Commission
30 proposal for something robust other than ACAM.

31 **CHAIR:** I think you should take the -- something that has not

1 been done but has been suggested to you as one possibility
2 is a challenge to provide us with a better means to do it,
3 that that can be justified in a regulatory context.
4 That's how you should take the 10%, 20% and 30% as a
5 challenge to you to provide us a better basis to do it,
6 but one that meets certain principles of regulation.

7 I think we're probably reasonably clear on the
8 submission here, but again, I'd encourage you to focus on
9 the issue at hand here rather than whether what was done
10 in the past was in a different context, was done this way
11 or another way. We'll hear those submissions, and we're
12 certainly mindful of it, but we're looking for a
13 principled approach in this context.

14 **MR SHEPHERD:** Just to go onto the next one, which is the
15 assumption that control would improve productive
16 efficiency. The Commission view in this case is that
17 control is estimated to achieve, or would achieve a 1
18 percent improvement in total costs, both operating and a
19 portion of capital costs, but then taking into account
20 indirect costs, the Draft Report lands on the 0.66
21 percent.

22 It seems to us reading the report that the key driver
23 in coming to that view was the results from the Meyrick
24 benchmarking report which placed New Zealand gas
25 businesses in terms of productivity levels very low
26 relative to Australia.

27 In particular, I'm inferring here a little between the
28 two reports, but if we go back to the draft or the
29 framework report -- the draft framework report, it has a
30 statement there, and I quote:

31 "Overall it is possible that incentives for cost

1 efficiency may be reduced rather than increased by
2 control".

3 There is no track that I've been able to find between
4 that view in the framework paper and then the view taken
5 in the Draft Report, the draft final report, that there
6 would indeed be an efficiency or a productivity gain other
7 than that the Meyrick report, which I'd emphasise itself
8 was highly qualified due to largely data problems and
9 comparability problems.

10 As we mentioned, Pacific Economics Group is presenting
11 both a critique of the Meyrick report and a benchmarking
12 report comparing New Zealand companies with the US
13 tomorrow morning, and you already have the results of that
14 which suggest that the New Zealand companies are
15 performing very well compared to -- or at least the NGC
16 and Vector entities are performing very well compared to
17 US companies.

18 So, it would seem to me that if indeed -- that I've
19 inferred correctly from the report that the concern about,
20 or the assumption that control would lead to productive
21 efficiency gains has its basis in the benchmarking study,
22 then if that benchmarking study itself is challenged, it
23 would seem to me appropriate to reconsider the assumption
24 derived from it that control would lead to productivity
25 gains.

26 In addition to the point you just made about the
27 benchmarking report, there's no rationale set out in the
28 Draft Report as to how control would lead to an increase
29 in productivity. I think it's an important omission in
30 the sense that there are a number of studies which suggest
31 that it may be the opposite. Unfortunately, the studies

1 that are referred to in the Vector submission are not on
2 all fours with the comparison being made here, because
3 they typically track changes in regulation from some sort
4 of rate of return environment to a so-called incentive-
5 based environment, and often there is an ownership change,
6 a transition from public sector to private sector at the
7 same time, so it's difficult to -- there's limited
8 evidence on this point one way or another, but I'm not
9 aware of evidence either from research or theoretically
10 that control is likely to lead to improved productivity
11 levels. So in summary, Vector suggests that the impact in
12 this point be set at 0 or some negative value, and
13 certainly not a positive value.

14 We move to the next point which is in relation to
15 dynamic efficiency and populating the model that the
16 Commission proposed. In the Draft Report the Commission
17 put forward -- it was really two models to estimate
18 potential dynamic inefficiencies from control. One had to
19 do with markets not being served that otherwise would have
20 been, often referred to as "missing markets", and the
21 other is impact on quality.

22 Vector, in its submission, populated the first of
23 those models with estimates as to how it would respond if
24 its gas business were controlled, and the essence of those
25 estimates were that, if it were controlled in such a way
26 that it were unable to obtain a return on its cost of
27 capital, it would have no incentive to invest in growth
28 and growth is a significant component of the revenue
29 streams that were in the forecast information.

30 So, in the submission there's an estimate of how those
31 revenue lines would diminish through time, and that's

1 restricted information so I won't go to the numbers
2 themselves. But the key idea here is that there would be
3 a very significant loss of consumer surplus from that
4 activity, or that lack of activity from not investing by,
5 as I say, simply populating the Commission's model with
6 Vector estimates.

7 We also modified the Commission's model for
8 illustrative purposes given that it seemed to be probably
9 an unreasonable assumption that the demand curve were
10 linear over the full range, and so, once again that's in
11 the submission. The modification is just for illustrative
12 purposes, which we emphasise. We're not suggesting that
13 the particular point estimate implied are correct; it's
14 rather to demonstrate, I guess, sensitivity with respect
15 to an important assumption.

16 It seems to us a key issue that that approach
17 highlights is a potential trade-off between the price
18 levels set under control and the extent to which dynamic
19 efficiency becomes, or inefficiency becomes an issue.

20 **CHAIR:** I'm letting you continue because what I would like you
21 to do is get through these points here and we will
22 continue, but at 6 o'clock I'd like to have a short break
23 because we're going very long today, so I think we need to
24 take 5 or 10 minutes at that point, so that's --

25 **MR SHEPHERD:** Right. The next one is the de minimus test.
26 I'll try and move through this fairly quickly because I
27 think it's relatively straightforward, the point we're
28 trying to make here is really asking the question of what
29 is the level of net benefits where control would be
30 worthwhile?

31 The Commission in the Draft Report doesn't clarify an

1 answer to that question, but it does apply a de minimis
2 test to Wanganui Gas and conclude that the benefits at
3 that level were insufficient to warrant a draft
4 recommendation for control, but it's not clear at what
5 point that would change.

6 There are some precedents to look to, and those
7 precedents aren't incorporated in the analysis either.
8 One is in telecommunications in their unbundling
9 recommendations where a number of estimates of benefits
10 were made, very wide ranges. But there's one that appears
11 to have been accepted by the Commission, of \$30 million
12 over five years, and that was perceived as modest and not
13 sufficient to warrant in that case unbundling.

14 It seems to us that's one point in terms of precedent
15 and experience that one could look to. The Minister of
16 Commerce -- it's not the Commission, I know -- but,
17 decided not to control Auckland Airport where estimated
18 benefits to consumers were \$2 million per annum; that's
19 another point. I guess the primary point we want to make
20 is, we think this is quite an important issue in terms of
21 a cutoff point and as much as anything being clear about
22 what the process the Commission uses to arrive at a de
23 minimus test.

24 **CHAIR:** Just for the sake of transparency, I want to indicate
25 to you that I believe the comparison with LLU -- and I
26 take your point that this is a general principle -- is
27 difficult because we were comparing different regulatory
28 options, we weren't just looking at whether a regulatory
29 intervention was justified or not.

30 The Commission accepted there was a problem and we
31 were looking at different approaches, so I just make that

1 point to you, that it was very much a different
2 environment to here and, like with all these things, we
3 were also weighing up certain considerations of
4 probability of achieving certain outcomes, which we will
5 have to do here. In that respect this is similar.

6 **MR ALSOP:** We certainly accept the general point that there
7 may be differences between applications, however I'll make
8 the point in the legal framework section, that is part of
9 providing advice to the Minister on whether control should
10 be imposed, in our view a relevant consideration is
11 potential different policy approaches if in fact any are
12 required, or different regulatory options. So in our view
13 that is part of the Commission's mandate to satisfy the
14 terms of reference, so in that sense there's also a
15 similarity to the Telco.

16 **CHAIR:** Sure.

17 **MR SHEPHERD:** The last point I'd make as we near 6 pm is asset
18 valuation, and here the historic financial costs in the
19 case of Vector aren't available prior to 2000 due to it or
20 its predecessor or one of its firms, UNL, having acquired
21 the business from another entity and it not coming with
22 those records. Vector's view is that ODV anyway is the
23 more appropriate valuation methodology.

24 However, we'd make the point that the draft ODV
25 handbook should be updated, as indeed the electricity one
26 is being updated now and, given the significance of
27 recommending control, Vector suggests that that should
28 occur prior to completing this process if possible.

29 Two important principles for a robust assessment as
30 they go to asset valuation, in our view, is that in order
31 to calculate the potential excess returns in a period, the

1 valuation methodology over that assessment period needs to
2 be held constant. In Vector's case, in terms of the
3 information it provided, there was in 2003 the
4 implementation of an ODV handbook which gave rise to quite
5 a significant uplift in value, and that value in turn was
6 counted as income in the Commission's model, where what it
7 reflects is the implementation of a different valuation
8 method, or at least different set of values and asset
9 lives and so forth.

10 In our view, what should be applied here is that the
11 valuation method and values and asset lives be set in a
12 constant over the period as introducing a new method part
13 way through the period is distortive, it's not providing a
14 clear picture of what the Commission is attempting to
15 calculate at all.

16 **CHAIR:** Can you just remind me; Vector used all of the
17 parameters in the ODV handbook, in the draft handbook.
18 Did you stay within those boundaries?

19 **MR SHEPHERD:** That's correct. In the 2002 valuation, that's
20 correct. The previous one, that is, the previous
21 valuation which was undertaken in 1999, was not based on
22 the handbook. So, the 2002 valuation aligned the
23 valuation with the draft handbook.

24 **CHAIR:** Asset lives and everything?

25 **MR SHEPHERD:** Yes, asset lives and values. And, it was
26 audited accordingly.

27 The second point we're keen to make is that, where
28 assets are so-called found, or there's other corrections
29 in a valuation, given what the Commission is attempting to
30 calculate, they also should not be taken in as income. A
31 good example here are easements, where in Vector's case

1 there are some quite large easements, large in terms of
2 dollar values that were taken into 2002 valuation; for
3 completeness, that did not feature in the 1999 value, but
4 were present in terms of -- were present at the time but
5 didn't feature in the valuation. So they were, so to say,
6 found or first reported in 2002.

7 In terms of rectification of this, Vector has already
8 provided the Commission with a modified set of valuations
9 which address the issue I'm talking about in terms of
10 applying the draft ODV handbook, and similarly that
11 address the easement issue of reporting the easement for
12 the first time.

13 **CHAIR:** Okay, I'd like to break and we'll continue again at 10
14 past, and I just want to give the stenographer a chance to
15 rest. So please don't go very far so we can get through
16 this as quickly as possible. Thank you very much.

17 **Adjournment taken from 6.00 pm to 6.10 pm**

18 **CHAIR:** I'd like to ask everyone to be seated please. What
19 I'd like to suggest that we do at this point is take
20 questions on all the material thus far from experts and
21 staff, and I'd like to ask that in the next 20 minutes we
22 make sure that any questions that we have from Mr Crawford
23 get covered because he has to leave, and so that covers
24 anything from submissions that won't be covered in the
25 analysis.

26 So the legal issues I think we can leave until after
27 he goes, but I want to make sure that any issues we want
28 to raise with Mr Crawford in particular get covered in the
29 next 20 minutes, so I'll turn first to Dr Lawrence please,
30 any questions you have on the submissions thus far on any
31 of the material? No. We'll take any questions for Mr

1 Crawford first.

2 **MS BEGG:** My questions are really in the way of comments and
3 requests for additional information.

4 Just on the modeling of dynamic efficiency, the way
5 you discuss it in your submission perhaps suggested to me
6 that you might not have been aware that the Commission had
7 actually modeled dynamic inefficiency in its assessing net
8 public benefits etc, so I just wanted to check whether you
9 were aware we had actually populated our model and
10 inserted numbers into the analysis?

11 Then my next question really related to the approach
12 you've taken. The Commission in its missing market
13 analysis effectively assumed that the customers in the
14 missing market would be close to the marginal customers,
15 so it assumed quite elastic demand.

16 CRA, when they commented on our model, they proposed
17 using the elasticity and doing -- extending that through a
18 linear extrapolation which, as you point out, is perhaps
19 the other extreme of those assumptions. I thought that
20 the approach that you were suggesting was perhaps a useful
21 middle ground where you've drawn a curve. I know you say
22 that it was just illustrative, but you have put in some
23 numbers in the submission which I understand are
24 confidential, but I'd just like you to, perhaps in cross-
25 submissions, give the Commission a bit more information on
26 what your assumptions were so that we can replicate what
27 you've done so we can have a better understanding of your
28 approach.

29 As part of that it's interesting, I think CRA for
30 example were suggesting -- the Commission in its modeling
31 suggested that 0.5 percent of the market would be a

1 missing market, and that would be pretty much constant
2 throughout, and if the underlying market grew, well, the
3 missing market would grow a bit too and we've been told
4 that's quite conservative.

5 CRA have assumed as an alternative that that 0.5 would
6 be added each year, so in effect their missing market
7 doubles from 0.5 to 1 and then increases by a third to one
8 and a half; we haven't actually had a chance to discuss
9 that with them, but I wondered how that would tie in with
10 what your assumptions were, which also weren't clear from
11 your submission. You've assumed your growth would be
12 affected, but I'd be interested in more detail on that.

13 **MR SHEPHERD:** Certainly, if I just take each of those points
14 in turn. In terms of providing additional information,
15 that will be quite straightforward; we can set that out so
16 it's clear.

17 In terms of the extent of the missing market; the way
18 we estimated was from the forecast, from Vector forecasts
19 themselves where in those forecasts there are revenue
20 uplifts from driving market share, and we've removed those
21 and we've indicated the extent to which we've removed
22 those in the text, but we can provide that clearly in the
23 information that we provide in the cross-submission such
24 that, when marketing initiatives are removed, the rate of
25 growth declines slowly and settles at what could be
26 thought of as sort of organic growth that arises in the
27 absence of active marketing.

28 So, rather than just sort of using coefficient and
29 percentages of market, we've gone back to the forecasts
30 themselves and projecting that forward. We can make that
31 clear.

1 **MS BEGG:** Just a bit more information would be useful.

2 **MR SHEPHERD:** On the first point, the extent to which the
3 Commission had included these limits already, my
4 understanding was, it hadn't included estimates with
5 respect to markets not being served that were intended --
6 were forecast to be served implicitly in the information
7 provided, so I'm not sure I've understood that correctly.

8 **MS BEGG:** There was a modest adjustment for the missing market
9 effect, but we assumed quite elastic demand on the
10 assumption those people who weren't being served basically
11 would be the more elastic customers, so there is an
12 estimate.

13 **MR SHEPHERD:** Explicit in the model?

14 **MS BEGG:** Yes.

15 **MR SHEPHERD:** We'll review that.

16 **MS BEGG:** In addition to that we also assumed that under
17 control you might have an impact whereby, you know, under-
18 investment resulted in a more congested pipeline, and we
19 have modeled that through assuming that would result in
20 greater interruptability, so that was the other element
21 about dynamic.

22 The second point I wanted to raise and suggest you
23 consider when you come back to the Commission on ACAM; my
24 understanding of ACAM is that it's based on Baumol and
25 Sidak's work and that in its application it would not
26 allow a company to recover more than the total of common
27 costs.

28 My understanding of how it should apply is that it
29 should apply to coalition of companies and activities so
30 that some the sum of them can't add to more than the
31 total, so you might want to look back at that.

1 The other thing I get from looking at that Baumol and
2 Sidak work is that ACAM specifies an efficient allocation
3 of common costs is anything between stand-alone costs and
4 incremental costs, but it doesn't necessarily suggest that
5 a monopolist should be allocated stand-alone costs.
6 Although MED has applied it in that way, it seems to me
7 looking through the theory that that's not a necessary
8 outcome of the model, so I'd be interested if, when you
9 review it, whether you come to the same conclusion that I
10 have, that efficient costs are between those two extremes,
11 which would mean that ACAM, while it sets boundaries, it
12 doesn't actually tell you where in that range you should
13 set your prices. So, I'd be interested in your comment on
14 that.

15 **MR SHEPHERD:** Certainly, we'll cover that.

16 **CHAIR:** I'll just ask if there are any questions for
17 Mr Crawford, but before you go I'd just like to thank you
18 for being available today and for your indulgence with
19 respect to the time.

20 **MR CRAWFORD:** I'd just like to thank the Commission for
21 accommodating my travelling requirements, so thank you.

22 **CHAIR:** Dr Lawrence, we'll continue with the questions on the
23 session up to this point.

24 **DR LAWRENCE:** Just go back to the slide you had on productive
25 efficiency, and you make a couple of statements I'd just
26 like to follow-up briefly.

27 One is in regard to the PEG study, and you actually
28 make some fairly assertive comments in your submission in
29 chapter 9, saying that the PEG work resolves many of the
30 methodological and data-related issues that compromise the
31 reliability and validity of the Meyrick study. Then you

1 go on to further say that PEG's results are derived using
2 a methodology superior to that used by Meyrick.

3 We would readily concede our work is less than perfect
4 given the data constraints in particular that we faced,
5 but I think there are also quite a few issues that need to
6 be raised in regard to the PEG work. I think you will
7 find that the PEG work is subject to similar, if not
8 greater, problems than our own study.

9 Now, I could go through those in detail with you now,
10 but it's probably better to wait until the morning and go
11 through those with Larry. But, I will just make one
12 observation on your submission, because there is an error
13 of fact in there. That is in regard to the productivity
14 growth study where you make the comment, and most of your
15 chapter is taken out of PEG agency's reports, I might add,
16 but I don't recall seeing this in PEG's report, so I will
17 make the point now.

18 You make the comment that the TFP changes are
19 calculated on six years, and that was too short a time
20 period, and approximately ten years of data would be
21 required to estimate a reliable industry long-run TFP
22 trend. You may be under some confusion there, because I
23 think the public version of the document is somewhat
24 truncated but, just for the record, there's actually
25 12 years of data used to calculate the growth trends, not
26 six.

27 The other issue that I wanted to raise, because you
28 were somewhat confused I think when you made this point
29 and I just wanted to clarify; you make the statement on
30 that slide that no rationale is provided as to how or why
31 control would improve productivity relative to no control.

1 Then you make the statement, studies suggest the opposite.

2 I'm not clear; could you tell me which studies suggest
3 the opposite, and on what evidence you base that
4 statement?

5 **MR ALSOP:** Just before Stuart responds to that, I just make an
6 apology if there is an error in the submission and thank
7 you for correcting that for the record and certainly agree
8 with your sentiment about deferring the substantive
9 discussion of the pros and cons of different benchmarking
10 approaches to Dr Kaufmann's session tomorrow, thank you.

11 **MR SHEPHERD:** The comments I was referring to in section 6.89
12 and following, paragraph 6.89 following in the Vector
13 submission; there's one quote in 6.108 from a study by
14 Catherine Waddams Price, a September 2000 paper, where we
15 quote this part, the study is much wider than this, but
16 her finding was much greater increases in efficiency
17 associated with industries or those parts of them which
18 are exposed to competitive forces than with those which
19 are not and for which price caps apply.

20 The context of her study was the UK regulation and
21 privatisation experience through the 80s and 90s. Then
22 there's one at 6.111 from Vogelsang 2002.

23 "price caps are viable because they have built-in
24 adjustments that increase the regulatory commitment period
25 and because they are subject to review every few years.
26 The latter, of course, brings in ratcheting and has led
27 some observers to equate them with rate of return
28 regulation".

29 Those are the two primary ones that I'm referring to.

30 **DR LAWRENCE:** You'd have to agree that's pretty scant evidence
31 and subject to varying interpretations and a slightly

1 different situation that they're comparing to the
2 implication that you're drawing on the slide.

3 **MR SHEPHERD:** I do agree that it's, I think, more generally,
4 and I mentioned this, that the research in this area I
5 don't think is strong, typically because the situation
6 we're faced with here is a little bit abnormal relative to
7 international experience where the question here is going
8 from no regulation other than disclosure requirements and
9 general competition law to a regulatory environment, and
10 because that is not typical in other environments, as you
11 well know, studies don't tend to test that transition,
12 they tend to test transitions that are more typical in
13 other jurisdictions such as from one form of regulation to
14 another. I mention that in my presentation.

15 If I could just perhaps finish off by re-
16 emphasising -- the key point I was trying to make here was
17 that I don't think the Commission provides a rationale for
18 the assumption, and in fact in the draft framework paper
19 it concluded the opposite assumption, that costs may
20 indeed increase under control, it is productivity
21 decrease.

22 **DR LAWRENCE:** I think it might be worth looking at some of the
23 work of Dr Kaufmann where he actually sets out frameworks
24 that demonstrate how price cap style regulation aims to
25 mimic a competitive market, and hence increase the
26 pressures for productivity improvement in industries that
27 essentially have monopoly -- natural monopoly
28 characteristics, so I think that is probably a more
29 relevant reference than the ones you've quoted.

30 **MR SHEPHERD:** If there is literature that provide the
31 underpinning for the Commission's rationale, I think we'd

1 appreciate that that was surfaced so we could comment on
2 it.

3 **MR SELL:** This is a question for Stuart Shepherd.

4 On the dynamic efficiency model you make the statement
5 on your slide, and it's also made in the report which
6 comes across to me as pretty much of a tautology that
7 results indicate control would result in substantial
8 economic harm if prices were set at a level that precluded
9 Vector earning its full cost of capital. I think there's
10 a -- I'd like to suggest there's an underlying additional
11 assumption that's not stated there that presumes that
12 Vector's so-called full cost of capital is actually -- or,
13 as stated, is actually the efficient level of WACC for a
14 firm of that nature.

15 Because, you seem to be implying that the level of
16 investment that's going on at the moment is optimal, and I
17 think there are some quite particular and unstated
18 assumptions that are required to assume that the current
19 level is optimal and, therefore, a reduced level of
20 investment would be a disbenefit as opposed to the
21 opposite assumption, that perhaps the current level of
22 investment is greater than the economically efficient
23 level.

24 **MR SHEPHERD:** I'm not sure if that is the case, but just let
25 me just test it. Where I think the sort of circle's
26 broken is that the proposition that we're putting forward
27 here is relative to a set of forecasts that have been used
28 in a model, and those forecasts assume a level of growth
29 arising from marketing initiatives by Vector.

30 The change, and it's the delta, it's the change
31 matters here I think, the change that we're suggesting

1 would arise if Vector is required to set prices below
2 levels which it considers would not return its cost of
3 capital, then its response to that would be to not invest
4 in those marketing initiatives and everything that goes
5 with it, and it's that change that we introduce into the
6 Commission's model.

7 So it seems to me -- I think that hangs together,
8 given the context. We're not suggesting the initial
9 forecasts are of necessity optimal; they are, rather, the
10 Vector forecasts given an attempt to optimise its position
11 in its market.

12 **MR SELL:** The point I guess I'd like you to just consider is
13 that an optimum applies that if investment is greater or
14 less than society or acquirers are worse off, so it seems
15 to me that you are implicitly assuming and making the
16 statements that where Vector's at at the moment is an
17 optimum.

18 I think, if you accepted that logic, the issue comes
19 down to what's the appropriate WACC, and that's been
20 discussed in other forums and the suggestion that I put --
21 I put the same proposition to NGC this morning is that
22 perhaps it requires an examination of the WACC in
23 conjunction with the risk profile, because I think the
24 risk profile that the Commission has assumed in its
25 analysis is perhaps slightly different also, and for valid
26 reasons, from the risk profile that Vector would consider
27 when it is analysing new investments.

28 **MR SHEPHERD:** I think the last point is a very good point. I
29 think there is a way through this. Perhaps the best way
30 for us is to write it up in the cross-submission with
31 careful attention to the issues you are raising and ensure

1 that they're covered off or explained.

2 **MR SELL:** We'd be happy to see that, yeah.

3 **MR MELVILLE:** This is just in relation to ACAM, and in the top
4 slide on page 19 you reference MED endorsing ACAM, which
5 is indeed the case, but MED have put out a paper on ACAM
6 about amending the Gas (Information Disclosure)
7 Regulations, and about how ACAM would operate for gas and
8 in particular where stand-alone costs would be allowed.
9 They talk about allowing stand-alone costs for a gas
10 business, and the incremental costs would go to the
11 competitive business.

12 Then, when in the situation where you've got a
13 business that is multi-utility in that it's gas and
14 electricity, they're considering, in the paper, combining
15 the electricity ACAM and a proposed gas ACAM together, and
16 they would allow stand-alone costs for gas and electricity
17 utilities combined, so you have one set of stand-alone
18 costs for the two combined.

19 I just wondered if you had any comment on Vector's
20 methodology of ACAM in relation to that -- my
21 understanding is, you've given a stand-alone cost for gas
22 alone and in other areas where the electricity also has
23 stand-alone costs allocated to it.

24 **MR SHEPHERD:** I expect the best way of answering that is, if
25 I've understood the question correctly, it's probably
26 similar to Sue's in relation to the Baumol and Sidak work.
27 In addition, if you are able to forward us the paper
28 you're referring to we could incorporate that in our
29 cross-submission.

30 **MR ALSOP:** I wasn't actually aware of that MED paper, Paul, I
31 was under the impression that Cabinet had not so long ago

1 re-affirmed the existing ACAM position for the disclosure
2 regs, but I haven't seen the paper so I'll take a close
3 look at it, thanks.

4 **MR MELVILLE:** I will state that the paper was one of proposing
5 to amend the Gas (Information Disclosure) Regulations, so
6 it was a proposal paper.

7 **MS BEGG:** I just had a point to make on the asset valuation.
8 The Commission has, or certainly intended to treat
9 easements as found assets, so I think that's the approach
10 we already have done -- adopted.

11 Just on the revisiting the asset valuation for the
12 predecessor company to Vector, I think that that one's a
13 bit of a big ask in that the ODVs that were adopted at
14 that time were audited and accepted by the company as
15 reasonable, and presumably their pricing and behaviour was
16 based on that ODV. So, to unwind the ODV itself without
17 looking at what else would have changed if there'd been a
18 different ODV, I think that's problematic as a
19 proposition. I just note that concern.

20 **MR SHEPHERD:** Do you see it as equally problematic to just
21 simply roll forward the 1999 valuation through the whole
22 assessment window?

23 **MS BEGG:** I don't have a major concern with that.

24 I note that a whole lot of assumptions and
25 approximations have had to be made in this assessment and
26 one of those, for example, is that we've ignored all
27 revaluation gains prior to the assessment period, which is
28 obviously a positive assumption for the companies, and I
29 just don't think it's possible really to unwind everything
30 like that; that we have to -- if the companies accepted
31 the numbers as audited we'd be opening a can of worms, I

1 think, if we were to go back and reassess all those sorts
2 of data.

3 **MR ALSOP:** We have heard and sort of agree with the general
4 principle, Sue, that in some instances there's a need to
5 consider what's appropriate for regulatory purposes.
6 While those valuations may have been audited at the time
7 and accepted by companies -- if they were audited, I
8 assume they were, I don't know personally -- but if they
9 were they were audited on the basis of ODV principles
10 which is quite a different approach to the application of
11 a detailed and prescriptive handbook around asset lives.

12 The fact that we can back apply the handbook to get a
13 consistent valuation basis across the Commission's
14 assessment period in our view is an important thing to do
15 from a regulatory perspective to ensure consistency of
16 asset valuation approach.

17 **MS BEGG:** The problem is, the other decisions that were based
18 on that, what you're calling now a flawed ODV, we can't
19 also make adjustments or unwind that to ensure
20 consistency.

21 **MR SHEPHERD:** I think I could appreciate the problem, and
22 perhaps we'll give it some thought in the cross-
23 submission. It seems to mean the wider problem is a
24 snapshot one, is assessing conducting this assessment over
25 a very short period of time relative to the asset lives.
26 So, maybe in that -- if one were to go back and reflect on
27 that, there may be an answer in terms of this particular
28 aberrant valuation stream.

29 **MR SELL:** Can I just make a further comment on that?

30 I think, for the reasons Sue has outlined, I would
31 tend to agree. I think it is difficult to reopen or

1 revise the valuation, but I think the reconciliation that
2 Vector has done is useful.

3 I think, when we did our part of the exercise of
4 reporting to the Commission on the ODV valuations it was a
5 question we asked of Vector; we asked for that
6 reconciliation, and I think to have that on the table is
7 helpful. What I would suggest is that you might look in
8 your cross-submission at forming a view as to how that
9 component, or the different component of the revaluation
10 should be treated in coming up with the returns that the
11 Commission is measuring, because I suspect that's where we
12 will end up squaring the circle on that matter.

13 I guess, just finally, I think Stuart, just to respond
14 to the point you made just then about the difficulties
15 arising from using a short time period, I'd make point
16 that I don't think there's anything conceptually flawed at
17 all about using short time period. You can use periods as
18 short as one year and still produce a valid analysis.

19 What's important is how you treat the various factors
20 between the beginning of that time period and the end of
21 the time period, including the valuation and how that
22 tracks and any revaluations, and how you articulate them
23 through whatever the income measure or the earnings
24 measure as the Commission is doing. So, we would
25 appreciate your consideration of that.

26 **CHAIR:** I'd like to now go back and finish the presentation,
27 if we could please, thank you.

28 **MR ALSOP:** I think I've drawn the short straw in a bunch of
29 non-lawyers of talking to legal framework to some well-
30 respected lawyers on the bench. Legal framework, the
31 first slide is what we've called should not may, I think

1 that's well understood for whether control should be
2 imposed as distinct to whether control may be imposed.

3 The draft recommendations in the Draft Report are
4 based quite explicitly by -- in paragraph 2.73, based on
5 the s.52 test of whether control may be imposed. In
6 Vector's view the may results need to be considered
7 alongside a range of other relevant factors to whether
8 control should be imposed, and we'll come to a range of
9 those factors. It's not an exhaustive list. There may
10 indeed be a range of others.

11 In terms of our view supporting the proposition that
12 control should be imposed, that stems from the terms of
13 reference which in our view very clearly set out the
14 Minister's expectation, presumably learning somewhat from
15 the Airports Inquiry that he was interested in advice on
16 the should question. There was a bullet point, among
17 others, that asked for the Commission's advice on any
18 other matter that the Commission may think relevant to a
19 decision on whether control should be introduced.

20 A couple of other excerpts from the terms of
21 reference, I'll just read these from para 4.11 of our
22 submission.

23 "in determining whether to make a control
24 recommendation to the Governor General the Act allows me
25 under s.56 of the Act to require the Commerce Commission
26 to report on whether to make such a recommendation --
27 *that's the recommendation to the Governor General* -- the
28 purpose of this letter being the terms of reference is to
29 request the Commission report to me no later than
30 1 November 2004 on whether or not an order and Council
31 under s.53 of the Act should be made".

1 Again that relates to whether the question of whether
2 control should be imposed.

3 Further evidence, in our view, is s.56 of the Commerce
4 Act which pertains to reports from the Commission to the
5 Minister and subsections 1 and 2 of that section, or 1
6 refers explicitly to whether an order in council should be
7 made, and subsection 2 relates to the Commission having
8 regard in its report to all matters it considers necessary
9 or desirable.

10 So again a very inclusive approach, in our view, to
11 considering all relevant factors to whether control should
12 be imposed.

13 **MS BATES:** Can I interrupt you at this point before we take
14 this any further.

15 The question of may or should has to be put in the
16 context of what the section actually says, and I make the
17 first point that in its actual findings, in every case the
18 Commissioner has said use the word "should be controlled
19 or not as the case may be", so it's actually applying --
20 its view formed is in cases where it's recommended that it
21 should be controlled.

22 It would defy logic to say that control should be
23 imposed just because you have the jurisdiction to propose.
24 Obviously you go through the -- you go through the
25 processes of deciding whether you're within the criteria
26 in s.52 and, having got to that, then you see if there are
27 any other matters which may negative the position you've
28 got to.

29 Under s.52 you can't get there unless there's a
30 limited competition, and then the next bit, it's necessary
31 or desirable in the benefit -- if it's necessary -- if you

1 come to the view that it's necessary or desirable in the
2 interests of acquirers that there be control, then you're
3 looking at the other factors that come into play to
4 possibly negative that view or change it in some way.

5 **MR ALSOP:** I guess the devil is in the detail of how you come
6 to a view that control is necessary or desirable. The
7 Commission has said quite explicitly in its report, para
8 283, that the Commission has given consideration to all
9 relevant factors. In our view, that's a pretty easy
10 statement to make, particularly when you look at the
11 recommendations that are based solely, including by clear
12 reference in 273, that the recommendations are solely
13 based on the s.52 numerical analysis.

14 **MS BATES:** But a net public benefits test was carried out and
15 found not to alter the conclusion that had been arrived
16 at, so I think that's --

17 **MR ALSOP:** We would accept that all relevant considerations
18 can be considered and addressed in an appropriate net
19 public benefits framework. We would have a question,
20 however, as to whether all relevant issues have in fact
21 been considered in coming to -- taken into account to
22 date.

23 Just a further quick point on that is, it's not
24 transparent in the report what some of the other
25 considerations are. The recommendations are solely based
26 on the numerical analysis and other relevant factors. For
27 example, I put to the Commission before in the context of
28 a comparison to the local loop unbundling work that, in
29 our view, it was incumbent on the Commission to consider
30 as part of its advice to the Minister possible other
31 policy or regulatory approaches, if any in fact are

1 required, in making its advice to the Minister. There's
2 no consideration of that as a relevant consideration to
3 whether regulatory control should be put in place.

4 In our view, the Minister, in clearly emphasising
5 should, is asking the Commission quite appropriately in
6 our view given its expertise in competition and regulatory
7 matters, to have a much stronger advisory role in this
8 area to tell the Minister whether control should in fact
9 be imposed.

10 In our view, the Minister is expecting a broader
11 policy type, or broader regulatory consideration and
12 advisory capacity from the Commission which we don't feel
13 the Commission's engaged in to date.

14 **MS BATES:** That's why he asked for a net public benefits test
15 to be carried out. Is your point that a net public
16 benefits test isn't extensive enough, or that there are
17 other considerations that can't be measured that ought to
18 be taken into account?

19 **MR ALSOP:** Probably the first of those. There are factors
20 that I don't think have been adequately captured in the
21 net public benefit assessment to date. For example, the
22 one about alternative policy approaches; I don't think any
23 treatment at all, or any consideration at all has been
24 given to that.

25 Stuart would just like to make a supplementary point.

26 **CHAIR:** On that point I think -- you referred to the LLU work.
27 In that context we did actually do the full analysis on
28 the alternatives. It's not the case here, there may be
29 other policy options that exist outside our jurisdiction
30 that the Government might want to contemplate, but this
31 isn't like LLU where we did the full analysis of those

1 other regulatory options.

2 So, I understand the point you make and we probably in
3 the Airports case alluded to other options that the
4 Minister could give consideration to stopping short of
5 recommending them, and I suspect that expecting the
6 Commission to advise in detail on other forms of control
7 or policy approaches in a situation unlike LLU where we
8 did the full analysis on those other approaches would
9 be -- there's a natural limitation to how far we could
10 possibly take it.

11 **MR ALSOP:** It's not clear to us that this aspect of the
12 Commission's work is that conceptually different to the
13 LLU case.

14 Going back to Airports, the Commission noted in its
15 recommendation with respect to Auckland that note that the
16 Commission has not considered the full range of control
17 mechanisms available under the Commerce Act.

18 So what we see is that the Commission's position is to
19 respond to the Minister and hand over that consideration
20 as to what other control mechanisms might be and what
21 other policy approaches might be, whereas we see the
22 Minister actually requesting the Commission's views on
23 that, appropriately so.

24 **CHAIR:** I understand that point; what I'm trying to say to you
25 is in the LLU we did a full analysis of a range of options
26 so we could make comparisons between them, because we had
27 fully analysed them.

28 In this case the Commission has not fully analysed
29 policy approaches, we've taken a factual and a
30 counterfactual and compared it. We might be able to make
31 some comments on them, but taking it to the extent that we

1 might in an environment where we did look at alternative
2 options, I'm just pointing out to you that there is a
3 limit to how far it may be prudent for a body such as ours
4 to go on the basis of not having done the full analysis on
5 anything other than one particular option.

6 **MR ALSOP:** We accept there could be a limit; we would be
7 curious to understand a little bit further why you see
8 such a fundamental difference between the LLU case where
9 the Commission was obviously minded to explore other
10 options in detail there. It maybe doesn't need to be
11 explained here, but perhaps for transparency in the final
12 report --

13 **CHAIR:** I understand what the question is.

14 **MR SHEPHERD:** Just a point of clarification.

15 Commissioner Bates, if I understand correct, you are
16 suggesting that the draft recommendation incorporates the
17 results of the net public benefit test. In the case of
18 Vector, the net public benefit test is a negative amount,
19 it's a detriment, so I would have thought that that logic
20 would have led to a recommendation of no control.

21 **MS BATES:** That was the foreign ownership issue.

22 **MR SHEPHERD:** Not in the case of Vector.

23 **MR ALSOP:** Maybe, while Commissioner Bates is considering
24 that, I'll just make a comment that maybe it is the
25 Commission's view that the net public benefits is relevant
26 but it's somehow been discounted in coming to a
27 recommendation based on should, but again for us it comes
28 back to transparency around what the consideration is of
29 those relevant factors in terms of arriving at that
30 recommendation and weightings; it's obviously not going to
31 be a quantitative weighting between factors, but it would

1 be helpful to understand the Commission's thinking more
2 about how those factors pack together to the final
3 recommendation.

4 **CHAIR:** The situation was that the Commission based its
5 decision on the net acquirers test, and we did believe
6 that was the correct test to apply.

7 I take your point that -- and in fact we cautioned
8 against the net public benefit test for at least the
9 reason of the issue around foreign ownership issues. So,
10 I do take your point about some of these other issues and
11 it's a -- the Minister, as you know, has invited the
12 Commission to exercise its judgment about what might be
13 relevant, and you've invited us to do that as well and we
14 will be careful to explain where we have included other
15 factors and where we haven't.

16 But people have suggested we might ought to, but
17 because we've been invited and given the opportunity to
18 express a view on other matters doesn't necessarily, I'm
19 sure you appreciate, doesn't necessarily mean that we will
20 think that there are other relevant factors that should
21 come into it. So that judgment will be exercised.

22 **MR ALSOP:** I accept that general point. But for our part it
23 is a little more than the Commission identifying to the
24 Minister what are relevant factors. Our read of the terms
25 of reference is the Minister is actually expecting the
26 Commission to do work and give a detailed consideration, a
27 reasonable consideration to those issues in actually
28 coming up with a recommendation on should.

29 On the next slide we have a range of relevant factors
30 that we believe are relevant to the should question. The
31 net public benefits, as has been discussed, and again we

1 think all issues can, at least conceptually, be
2 encapsulated within that framework, the de minimus test
3 which has been addressed in the presentation so far,
4 different forms of control or policy approaches have been
5 mentioned, as has the draft and outdated nature of the ODV
6 handbook as a relevant consideration unless updated as
7 Vector has suggested.

8 The impact of recommendations on foreign investment.
9 At the moment the Commission has reported transparency
10 results based on foreign ownership and in essence handed
11 over the judgment on that issue to the Minister. We think
12 that's an issue that the Commission itself should form a
13 view on and broader industry considerations and some
14 examples are listed there.

15 The next slide relates to length of control
16 declarations. The Commission has proposed 11 years on the
17 basis of one year of setting the declaration and then a
18 regulatory period of ten years. If regulation were
19 recommended and agreed by the Government to be necessary,
20 Vector supports a six year declaration which would be
21 based on one year implementation and a five year
22 regulatory period. That's consistent with what we observe
23 in most overseas regulatory regimes, also in the
24 Commission's precedent work in Airports and the setting of
25 electricity threshold, and again, if there's valid reasons
26 for a different approach in terms of the regulatory period
27 here, we'd be keen to have those --

28 **CHAIR:** I just want to clarify, the declaration is for how
29 long the regime will be in place, it's not the reset
30 period, and it's not clear to me at all that overseas
31 jurisdictions don't do exactly what I think the Commission

1 actually has in mind. In fact, they don't even do that;
2 they don't put a sunset clause in at all, they just go on
3 indefinitely until someone decides to review them and
4 possibly consider removing them.

5 But they certainly -- I agree with the observation
6 that a five year reset period is common, and the
7 Commission has no difficulty with that and has set this 11
8 years with the notion that that would include a reset
9 after five years in the sixth year. So what we're saying
10 is, there should be a sunset clause after the second
11 period, after the second -- you have one reset period, and
12 before you go into another reset you look at whether you
13 still need to have any regime whatsoever.

14 So, I'm not sure that we're talking about the same
15 thing here, because it seems to me there's two different
16 concepts going on here. As you know, in electricity we
17 set a period of five years, but there's no sunset clause
18 there at the end of that five years. So this thing about
19 the Commission's work on electricity, in that context we
20 set a five year threshold regime, but there's no sunset
21 clause in the sixth year that says the whole regime will
22 end at that period; there's just a reset that happens.

23 That's what we're saying here. Yes, there would be a
24 reset after probably five years, it's a reasonable
25 assumption, but the sunset clause is at the end of the
26 second regulatory period.

27 **MR ALSOP:** That's useful comments. It wasn't quite clear to
28 us from the Draft Report that there was intended to be two
29 five-year periods within the ten, and I guess we made the
30 comment in our submission that, if that were the case, one
31 might have expected a 12 year Commission draft view on the

1 basis of one plus five; one for the recalibration reset
2 plus another five; it sort of read fairly clearly to us it
3 was one plus 10.

4 The comments about overseas regimes are taken that is
5 a good distinction between the regime being in place and
6 the regulatory period.

7 I think in respect of electricity lines while there's
8 no time bound sunset period for the thresholds there is a
9 statutory restriction on the length of declarations of
10 control for the investigation and the implementation of
11 control through the subsequent steps of that regime, as in
12 the case of the Telecommunications Act for regulation of
13 telecommunications services.

14 **CHAIR:** Yes, but there's no sunset clause that removes the
15 regime altogether, and the Government seeking advice on
16 the declaration period is drawing out at which point that
17 should come in. I know that there's confusion in what the
18 Commission said, because I've picked it up in several of
19 the submissions; it was not understood.

20 But I guess the question for you is, does your
21 recommendation hold regardless of what the correct
22 understanding of the declaration involves?

23 **MR ALSOP:** It certainly does. In our view, there should be a
24 significant hurdle for rolling over regulation to a
25 subsequent regulatory period. Certainly accept the point
26 that you're pointing out that overseas regimes have done
27 that and left that decision to Regulators and perhaps it's
28 become a bit of a non-decision and the regimes have just
29 rolled over into subsequent period.

30 In our view there should be a significant hurdle and a
31 report back for a Ministerial decision or Parliamentary

1 decision to decide that regulation is again required for a
2 further period and then if that is the case then that
3 referred back to the Regulator for implementation and
4 enforcement role. So, if you like, getting a separation
5 distinction between the regulation making and the
6 regulation implementation.

7 So, yes, our view does hold, I think it's been a
8 useful discussion to have further clarity around the point
9 that's been discussed, but our view holds.

10 The next slide is about the interest of acquirers. I
11 can cover this slide fairly quickly as the key point for
12 us has been covered so far. We certainly accept that both
13 direct, being retailers, and indirect end consumers are
14 important in the legal construct of the inquiry; however
15 an important factor in whether control should be imposed
16 in our view is the Commission being able to articulate how
17 many control recommendations would benefit to end
18 consumers. We've taken on board the feedback from the
19 Chair earlier that we need to consider that observation in
20 the context of our view on market definition and we'll
21 certainly do that in the cross-submission coming back.

22 The Commission's analysis based on average prices
23 assumes that pipeline prices are in effect passed directly
24 through to consumers such that the pipeline tariff
25 structure and level of tariffs set by pipeline operators
26 are borne by end consumers and make their responses
27 accordingly.

28 We just make the observation that -- it's perhaps an
29 obvious one but make it nonetheless -- that there's
30 significant repackaging undertaken by retailers given
31 their end consumer interface in the mass market to come up

1 with tariff structures etc that they believe are best for
2 their end consumers.

3 The next slide's about the counterfactual and the key
4 point we wanted to make here is was really underscoring
5 the importance of the counterfactual, which I think would
6 be hard to dispute, and to emphasise the imminent nature
7 of the Electricity and Gas Industries Bill and a suite of
8 regulatory measures that are set out in that Bill and
9 about to become law, including a number that pertain to
10 distribution activities. That's not to suggest that where
11 over companies think many of those or, all of those, are
12 justified, but that they exist and there may be regulatory
13 activity in those areas or industry processes if in fact
14 there are issues to work through.

15 So on the slide are some examples regulating terms
16 and conditions including prices which raises an
17 interesting interface issue with the Commerce Act and the
18 Commission's inquiry.

19 **CHAIR:** In what sense does it include price?

20 **MR ALSOP:** I think these are -- I don't know, is the short
21 answer. I think these are direct quotes from the
22 Electricity and Gas Industries Bill.

23 **CHAIR:** I would like you to look into that a bit further,
24 because it's not my understanding that it refers to price
25 in the sense that we're talking about price and revenues
26 in this context, but if you could come back on that,
27 Peter, that would be useful.

28 **MR ALSOP:** Sure. We did point out to the Commerce Select
29 Committee considering that Bill the scope for language
30 such as this, which I am pretty confident is a quote, but
31 I may be wrong, "to pose jurisdictional and interface

1 issues", but we'll take a look at the reported back
2 version of the Bill again and revise accordingly.

3 On the counterfactual, the Commission suggests a
4 recommendation of no control would, in its view, mute the
5 threat of control in future. In Vector's view, we have a
6 different view that, if the recommendation of no control
7 was made, the threat of control in the future would
8 actually be enhanced by the very process we've just been
9 through, and the line in the sand for control, including
10 with the Commission's transparent treatment around issues
11 like de minimis and other relevant considerations, the
12 line in the sand would become much clearer and that's the
13 point we wanted to make.

14 A further related point is that the more focused
15 threat, and people knowing where the line in the sand lay,
16 would actually achieve the lines share of regulation at a
17 much lower cost. These are general points about really
18 regulatory philosophy and the efficacy of regulatory
19 threats that are well enunciated and clear to potentially
20 regulated parties.

21 So, those are the only observations we wanted to share
22 with you on the legal framework, and the only remaining
23 slide is a quick one page summary from Simon. So, thank
24 you.

25 **CHAIR:** Can I just see if Commissioner Bates wants to follow-
26 up? [**pause**]. Please continue with the conclusion, thank
27 you.

28 **MR MacKENZIE:** Thanks. I actually probably don't want to
29 dwell on that, I think that in summary the Vector views
30 are well articulated there, however given our discussion
31 this afternoon clearly the Commerce Commission has given

1 us a challenge to come back with some more analytical
2 rigour in some areas, particularly around market
3 definition, and we take that on board.

4 We would also, obviously following discussions this
5 afternoon, also welcome some more transparency and
6 potential rigour and views around some of the important
7 matters such as ACAM and the should versus may kind of
8 issues, so I think that's where we really find ourselves
9 now.

10 **CHAIR:** Thank you for that, Mr Mackenzie.

11 I just note, this process is meant to allow these
12 discussions so that you know where we need assistance and
13 provided with an opportunity to provide it, and we hear
14 your views and can take them on board, so I'm not troubled
15 by this; I don't think you should be either, the process
16 is really designed to exactly elicit that sort of dialogue
17 between companies and the Commission. So, I'll just see
18 if anyone has any further questions that they want to
19 raise.

20 I would, in conclusion, like to thank you Vector, and
21 I do apologise for having you here at such a late hour, I
22 know that is difficult, but it was important to get
23 through the issues that you have, and I know that Vector
24 always takes great care in its submissions and brings in a
25 great deal of external advice and expertise that the
26 Commission needs to have access to, so we're very grateful
27 to you for that.

28 I know we're doing the PEG proposal tomorrow, so we
29 will adjourn until we get to that point, but I do want to
30 thank the four of you before we finish today. I just
31 might note that the Commission today has been sitting

1 since 8 o'clock this morning, and so, I must also thank
2 you other participants, especially Wanganui who seems to
3 be willing to stay throughout the whole proceedings, but
4 also our communications people and technical support, and
5 of course staff and our external experts and
6 Commissioners. I've probably used up all of the goodwill
7 that I might have for working people very hard, so I'd
8 just like to thank you everyone for their assistance today
9 in getting through the material.

10 We will adjourn until, I'm afraid to say, 8 o'clock in
11 the morning with PEG on behalf of Vector and NGC, so thank
12 you very much.

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**Hearing adjourned at 7.05 pm to
Wednesday, 28 July 2004 at 8.00 am**

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