



GAS PIPELINES INQUIRY CONFERENCE ON DRAFT REPORT

27 July 2004

The Vector team

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Vector Gas - Key Facts

Coverage	Greater Auckland - from Tuakau in the south to Orewa in the North
Volume Consumption	11PJ pa
System Length	4,713km
Gate Stations	11
Regulating Stations	144
Customers (approx.)	70,000

Presentation overview

- Overview of Vector position
 - Market definition / competition analysis
 - Assessment and modelling issues / assumptions
 - Legal framework
-
- NB. WACC and benchmarking addressed by LECG and PEG (separate sessions; work sponsored by Vector)

Overview of Vector position

Market definition / competition analysis

- Competition is not limited in the market into which gas pipeline services are supplied
- The 'gas market' is the appropriate mass-market definition
 - transport substitutability for gas (reticulated networks and bottles)
 - technical and economic substitutability of different types of gas, particularly LPG and natural gas
- As found by the Commission, there is vigorous competition in the 'bypass market'
- Other energy options (besides gas) add further to competition (to varying degrees and in different circumstances depending on area/application)

gas... it's what we know

Winters here and there's a lot to be said for instant heat, limitless and continuous hot water. And the big benefit of going gas with Plumbing World... apart from some great offers and 12 months interest free... is our expertise. We specialise in gas, so we're well-qualified to advise you on the best gas solutions for your home, arrange the connection, select the appliances and organise the installation.

12 months interest free

For all gas appliances, connections and installation. Don't worry if you don't have a gas main in your street, as most gas appliances also operate on LPG.



free standard flue kit
worth up to \$499 with any Rinnal Timberflame gas fire purchased



free electronic controller
worth \$125 with any Rinnal Infinity continuous flow water heater purchased*



free LPG refill
One 45kg gas cylinder filled **free** with any **new** connection to On gas LPG when you purchase a gas water heater or heating appliance*



Get your copy of our **free** 'gas' catalogue in store now.



plumbingworld

*For purchases over \$500 including connections and installation as required. Interest free 12-month offer may not be available in all areas. Normal banking conditions apply. On gas offer is limited to certain brands & subject to On gas standard terms and conditions. Offer is not available on second-hand. Delivery conditions apply. Available in Rinnal Infinity models 20-32, Controller model MCH11A. All offers valid until 31 August 2004.

Don't worry if you don't have a gas main in your street, as most gas appliances also operate on LPG.

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Assessment / modelling issues

- Correction of the 'interest tax shield' significantly reduces, if not eliminates, any net benefits to acquirers
 - Appreciative of the Commission's approach to handling this issue; not discussed today (s70E response filed)
- A range of other assessment / modelling assumptions in need of amendment (further reducing any net benefits)
- A range of important regulatory matters in draft report not carefully analysed (incl. lack of consistency with precedent)
 - e.g. use of historical information, length of control period
- Significance of control warrants high confidence in findings
 - Control should be invariant to choice of point estimates within valid ranges

Legal framework

- The Minister has specifically asked for advice on
 - “any other matter that the [C]ommission may think relevant to a decision on whether control **should be introduced**”
- Draft recommendations are based on the narrow s52 test of whether control *may* be imposed
- The *may* results need to be considered alongside a range of other factors relevant to whether control *should* be imposed, including
 - net public benefits; a de-minimis test; the fact that (unless updated) the ODV Handbook is draft and outdated
 - the Commission demonstrating that control would benefit *end consumers*
- Any control declarations should be 6 years (not an unprecedented 11 as proposed by the Commission)

Comment

- Limited participation in inquiry by acquirers
 - No significant performance concerns raised by acquirers
 - No 'weighty' analysis for the Commission (rather, opportunistic support for the Commission's findings without robust support)
 - A direct contrast to the airports inquiry and other Commission work
- On the surface, this does not suggest regulation is required
 - Consumers are not reliant on regulatory procedures to resolve their issues

Market definition / competition analysis

Summary

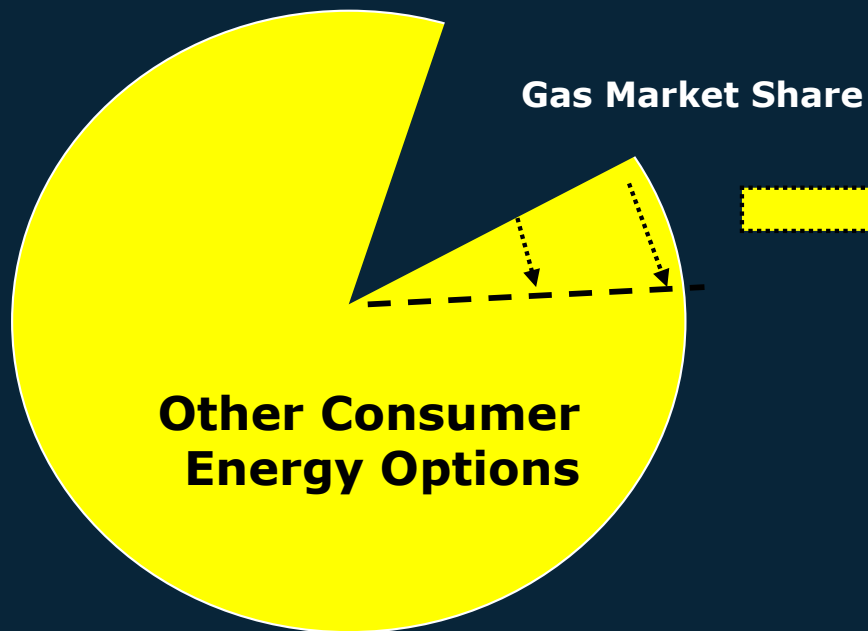
- Competition is not limited in the supply of gas pipeline services
- Gas is a discretionary fuel of choice that competes with other energy options to generally be the second fuel behind electricity
- The Commission has rejected an 'energy market', but not considered a 'gas market' (irrespective of type)
- Reticulated gas supply (whether natural gas or LPG) is one way of transporting gas to end consumers; bottled gas is another
- Transport substitutability for gas, as well as the technical and economic substitutability of LPG and natural gas for consumers, defines the 'gas market'

Growing gas demand

General strategy

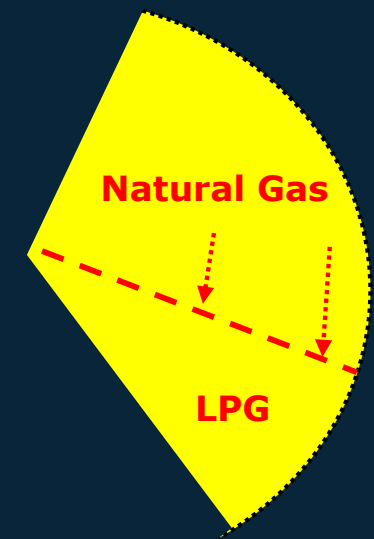
- Vector has limited presence in the retail market (other than large customers), but cannot rely on market growth incentives of others

Pure Energy Consumer Advertising Campaigns



Objective: Build Consumer awareness & encourage consideration of gas

Channel Partner Programme



Objective: Build channel partner preference & compete for share in channel

Growing gas demand

Vector's approach

- Channel Partner Programme
 - Vector's third party sales force; 14 Channel Partners
 - Incentivised to sell appliances that use reticulated gas
 - Competing incentives on sales people
 - Sales person has strong influence on customer gas choice; therefore, the competitive battle is fought as much "in the channel" as in the customer's mind and with other energy types

- Pure Energy Brand
 - Generic brand promoted by Vector to raise/grow awareness of gas

Pure Energy marketing material

- (Packs provided to the Commission (commercial-in-confidence))
- Does not mention Vector as a company or show its brand
- Focuses on growing the demand for gas
- Makes no reference to reticulated gas
- Vector has to invest heavily in this advertising to grow final gas demand (even though Vector is only one part of the value chain)
- (Example follows)



LPG industry

- A large number of LPG retailers with relatively low barriers to entry
- Ubiquitous / nationwide supply
- Wide variety of residential and commercial uses
- Supply through reticulated networks or bottles
- Significant growth; LPG is on the move

Uses of LPG

- Residential

- Cooking (incl. BBQ's), space heating (fixed or portable, including patio heaters), water heating

- Small commercial

- Cooking, space heating, water heating, process heating, steam raising, incineration
- Hospitals, horticulture, manufacturing, hospitality, hotels, prisons, schools, leisure (e.g. swimming pools), dry-cleaning

- Large commercial

- More limited use due to quantity or pressure requirements - these areas are generally those in the 'bypass market'

Example of reticulated LPG

www.citygas.co.nz



*Citigas is Todd Energy's Dunedin based gas and LPG distribution and supply business. **We are committed to delivering you either reticulated specification gas or LPG cylinders to your doorstep** - depending on your energy requirements!* Citigas, originally the Dunedin Gas Light and Coke Company, was founded by Stephen Hutchison in 1862. **A Gas Works and pipeline were constructed for the reticulation of coal gas** that was produced by heating coal to around 1,000 degrees Celsius. Initially this coal gas was used for street lighting only and later extended for domestic consumption in the 1870's. The pipeline system was later extended in the 1940's and is now over 100 km in length. **Coal gas, together with Oil gas and Water gas from the 1960's onwards, was reticulated in the Citigas pipeline network** until 1987. Today, with the support of 100% owner Todd Energy, Citigas offers pipeline specification gas and LPG cylinder supply throughout Dunedin. **At Citigas we are committed to supplying you with an efficient energy source that is competitively priced compared with alternative fuels such as electricity, diesel, fuel oil and coal.**

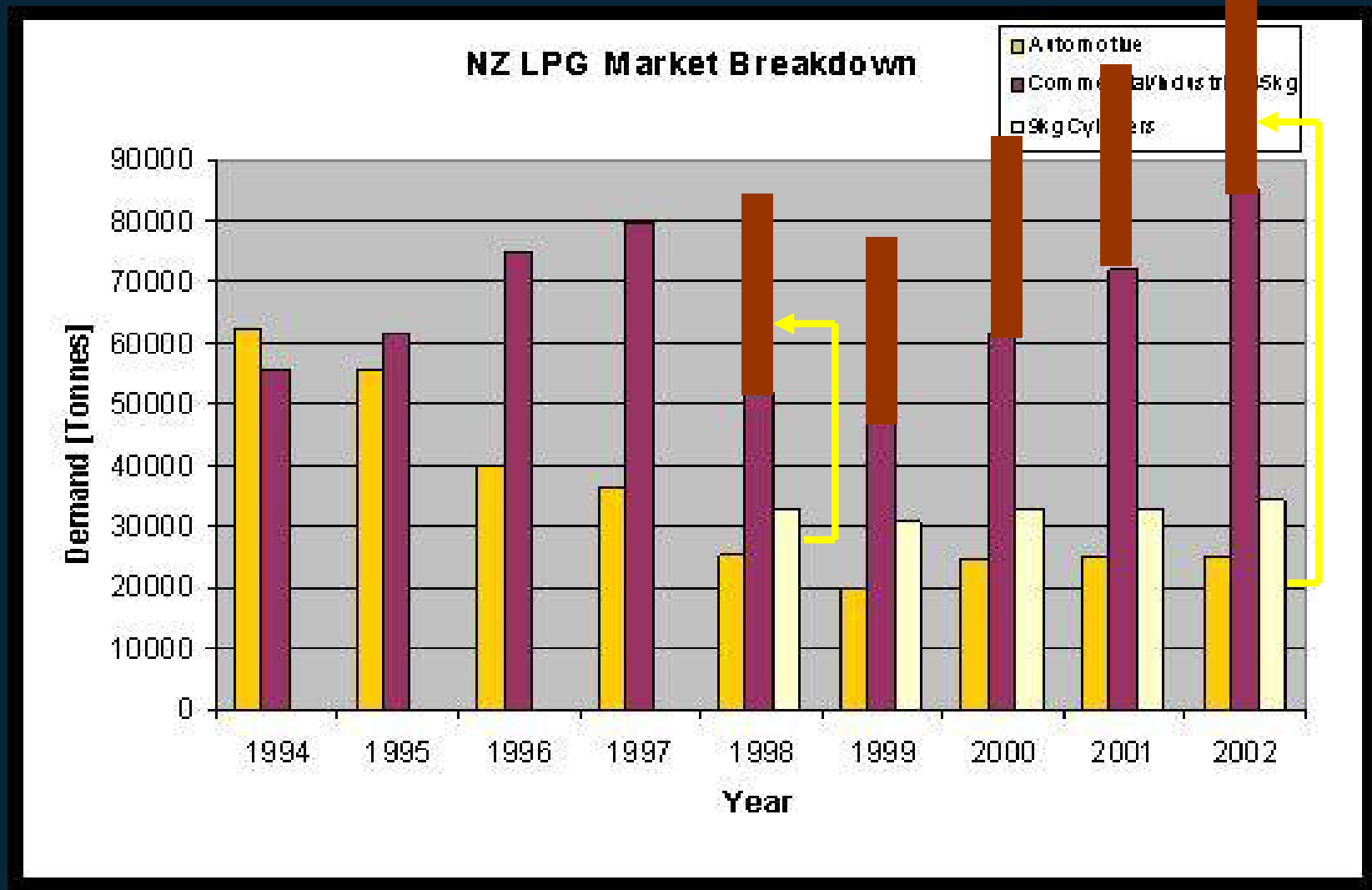
Other reticulated LPG networks

- Queenstown
- Christchurch (2)
- Wanaka
- Dunedin
- (Probably others)

- Implications
 - Inquiry arbitrary in focussing on natural gas reticulated networks (outside CC control)

 - Market definition must include LPG

LPG on the move (1)



LPG on the move (2)

(LPG Association media release, 30 April 2004)



"The energy debate, which has heated up since the termination of Project Aqua, has seen much attention focused on building security of energy supply with gas as the preferred source for base load generation. However, **gas which is used extensively for residential and commercial supply throughout the country, particularly in the South Island where it takes the form of LPG, has been virtually ignored. LP Gas supply is strong, reliable and price competitive as the users in these areas well know.**

The Minister is quite right when he makes the point that there is now an active energy market in New Zealand, as a result of which the residential and commercial market for LP Gas has grown by 50% in the last five years with demand in the residential sector skyrocketing.

Consumers are discriminating. LP Gas is cheaper than electricity as an energy source. It offers a 'comfort and warmth' factor, is convenient and portable and it is environmentally friendly with minimal residues being released into the atmosphere.

The great advantage of an energy market, despite some of its shortcomings in a small country, is that consumers are able to make choices in terms of their own needs. Many people like the level of control that LP Gas allows them to have over their energy requirements and security of supply"

LPG on the move (3)

(Rockgas media release, 16 June 2004)

"In terms of today's commercially-available energy supply options, **LP Gas is an 'almost unique' distributed fuel which maximises energy efficiency It is clean burning, easily transportable to point-of-use, hugely versatile, cost-effective and in plentiful supply. Nor does it require massive investment in infrastructure and reticulation systems to make it more accessible to all New Zealanders.** ... [T]he benefits to the country and to consumers would be the same, but there would be no need to invest massive funding to develop expensive reticulation networks. **It is already nationally-available and consumers are not faced with line charges.** Economically and strategically, incentivising greater use of LP Gas [as opposed to gas pipeline expansions] offers significant positive outcomes for consumers and the country for very little additional cost. ... **The New Zealand LP Gas market has grown nearly 50 percent in the last five years, underlining the fuel's popularity and accessibility. The biggest growth area is in the domestic and light commercial sectors."**

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Insights from Plumbing World ad

- (Plumbing World is a Vector Channel Partner)
- Advert tries to promote gas above other energy options
- Seeks consumers choosing gas on the basis of marketing-driven initiatives (as distinct from organic growth)
- Advert is explicitly agnostic to reticulation and type of gas
 - Vector's mystery shopper research shows that many Channel Partner personnel have a preference for LPG, which they express to the customer, or have no preference for either natural gas or LPG
- Advert illustrates the competing nature of incentives on Vector's Channel partners, i.e. promoting LPG on the basis of a free refill
- (Further evidence provided to Commission in submission of the increasing nature of LPG appliance sales (and growing market share relative to natural gas))

Scatter plot explanation

- Certified installations only (> 9kg; "Gasfitting Certification Certificate")
 - Does not include BBQs, patio heaters, portable heaters (there are estimated 500,000 of the latter alone in NZ), nor homes with gas hobs using 9kg bottles)
- Covers 1997 – 2001 only
- Graph has 2,500 dots (some overlay each other); 400 dots not plotted given no (x, y) coordinates
- As of now, Vector estimates there are 11,000-12,000 dots on this map (being all up to date **certified installations**)
- A high degree of competition with LPG across Vector's network

Switching costs (1)

- CC has previously indicated it has a concern with 'lock in', i.e. up-front competition but then no ongoing competitive constraint
- 'Lock in' is not a competition concern in itself
 - A feature of a wide range of competitive markets
 - Larger customers choose contract lengths
 - Significant portion of capital stock continually up for renewal
- But 'lock in' between natural gas and LPG is low

Switching costs (2)

- For mass-market applications, switching to LPG mid-cycle is viable
- Pipeline installation costs for consumers, once incurred, are sunk (and, therefore, not a relevant economic switching consideration)
- Switching costs to LPG are low (around \$50 for cooking)
- Many websites provide information on switching to LPG and promote the fact that appliances can readily be converted
- Some suppliers provide for an option where a customer temporarily uses LPG whilst waiting to be connected to reticulated gas

Switching costs (3)

LPG - Microsoft Internet Explorer provided by Vector Information Services

File Edit View Favorites Tools Help

Back Forward Stop Refresh Home Search Favorites Media History Mail Print Edit Discuss

Address <http://homepages.paradise.net.nz/dougbren/LPG.htm> Go

What's Involved in conversion from Natural Gas to LPG?

1. Determine if the appliance is approved to run on LPG.
2. Determine if the appliance will run on LPG.
3. Change the injectors on the main burners to LPG injectors.
4. Change the pilot injector to LPG.
5. Change the low flame setting for each burner in the appliance. e.g. 4 burners in a hob and six in a gas stove.
6. Remove the natural gas regulator and reconnect the pipe work.
7. Re-label the appliance LPG.
8. Apply for a LPG service.
9. Install concrete pads for the bottles if outside. The large 25 and 45 Kg bottles must be in a position the LPG supplier will change them over when empty, other wise you will be changing them. If you want just a hob or cooker you could put a 9kg or smaller bottle next to the appliance. If in a cupboard it will need to be ventilated. Avoid cupboards if possible.
10. Fit change over valves and pipe work to the bottles.
11. Call the Natural Gas Utility and request disconnection of meter and closure of account and final reading.
12. If installing more than 100kg of LPG i.e. large users, a Dangerous Goods Licence will be needed. Perhaps a Resource Consent might be needed depending on the Town Plan in your area which might change in the future for large quantities.

The running Costs are similar or higher than electric. The lowest electric power price is 5.6 cents per kilowatt night rate for water heating or space heating verses 12 cents approx or more for LPG. There are lots of electric rates depending on what you want the power for.

Should you change from Natural Gas to Electric?

The process is more simple.

1. Check with us to determine if the house has sufficient electric power to install an electric stove. Some houses don't. This means a larger cable from the street needs to be installed. Remember electric space heaters are relatively cheap compared to gas appliances.
2. Electric water heaters are storage type. You will need more storage than with gas. A tank takes about 5hrs to heat from cold. Ask for the night rate if you are a small hot water and heating user. If using the night rate for heating you will need a nitestore heater .
3. Check Electric rates. Calculate electricity used compared to gas.
4. After you have done the home work to make sure your not making a mistake install new electric appliances. Take out gas appliances.
5. Call Natural Gas Utility and request disconnection of meter and closure of account and final reading.
6. Remember electricity is sometimes cut off, gas rarely is ever cut off.
7. Cap off the gas pipes.
8. The result - no more gas daily charge. Your energy cost drops to 5.6 to 6.5cents per kilowatt although its rising for the night rate. If you use a lot of hot water you will need to go the next step up to the controlled rate 9-12 cents per kilowatt and rising. If you are an even bigger user stick with Natural gas at 6 to 8 cents per kilowatt. The line charge will be irrelevant.

Internet

Switching costs (4)



Temporary LPG Connection - Microsoft Internet Explorer provided by Vector Information Servi...


File Edit View Favorites Tools Help

Address <http://www.gas.co.nz/retailers/tempconn.htm> Go

Gas Products | FAQ | Cylinder Gas | Natural Gas | Contact Info | New Connections

Water Heating
Continuous flow heaters
Storage water heaters
Flame Effect Fireplaces
Designer Fireplaces
Energy Saver flued heaters
Portable convection heaters
Flued radiant heaters
Ducted central heating
Pool heating
Craftsman Gasfitters

Temporary LPG Connection



Need gas now but waiting for natural gas to be connected.....

Connecting natural gas can take several weeks from the time you sign up. We recommend that you sign up early with a natural gas facilitator to ensure the gas is connected on time. If you have not been able to complete this process before you move in then we can help.

- Simply Gas have a **temporary LPG connection** kit that consists of:
 - two cylinders of gas
 - regulator and hoses
 - wall brackets and chain

We will set you up as a temporary LPG customer for the period that it takes to connect the natural gas. This is a fixed charge of \$253.00 (inclusive GST) which includes all of the above. We book in to pick up this equipment two months after it was delivered.

It is unlikely that the natural gas connection will take this long so let us know when it is connected and we will collect our equipment. If there is an ongoing delay we will arrange an extension.

You will need to provide an area for the cylinders, which is compliant with [LPG installations](#). We do not provide a concrete slab.

The appliances will need to be converted to LPG and then back to Natural Gas. North City Heating has a service where they have spare LPG jets and manifolds for all appliances and they convert the appliance prior to delivery at no charge. When the gasfitter is on site to connect the natural gas he will change the appliances back to run on natural gas.

Contact Simply Gas 09 815
service.

Internet

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Switching costs (5)

Excerpt from article: Fresh Start offers LPG as option for gas clients - The Daily News [Taranaki, New Zealand] 19 May 2000

“Fresh Start spokesman Richard Tweedie, of Wellington, said the Todd Energy subsidiary would be **offering customers** who switched to Fresh Start for electricity and gas **the option of getting their gas through LPG.**”

Mr Tweedie said that, apart from installing the two 45kg gas bottles and adjusting the home's gas burners, there were no problems in a home running on LPG. The charge for LPG would be variable and would free customers from fixed [gas pipeline] charges, he said. **“Ultimately it is about choice. We are offering customers a competitive choice if they want it...”**”

The 'bypass market'

- In Auckland, Vector agrees there is vigorous competition in the vicinity of Nova's pipeline (including from other energy options)
- 'in the vicinity of' must be defined to include all areas where bypass would be possible
 - Such areas should be defined relative to gate stations and existing competing networks
 - A range of energy options generally considered by large users given the significance of energy costs to their operations

Market definition

Summary

- The appropriate market definitions for the Inquiry are:
 - Gas market
 - Bypass market
- Within the gas market, LPG and natural gas are technically and economically substitutable
 - Many LPG retailers and low barriers to entry
 - A range of residential and commercial applications
 - Ubiquitous availability
 - Both used widely (refer scatter-plot for Auckland penetration)
 - Switching costs to LPG are low during the life-cycle of appliances
- Within the the bypass market, there is vigorous competition between pipelines (as well as with LPG and other energy options)

Assessment and modelling issues / assumptions

Key issues

- Time period used for assessment
- Suggested departure from ACAM costs
- Assumption that control would improve productive efficiency
- Populating the Commission's dynamic efficiency model
- The de-minimis test
- Asset valuation

- (Happy to take questions on other issues raised in submission)

Time period used for recommendations

- Commission has used historic and forecast information
- This is in contrast to its usual practice of using forecast periods only (other than base year), for example
 - airports inquiry
 - investigation into unbundling the local loop
 - public benefits test in relation to authorisations
- Use of historical information not relevant/appropriate
 - assessment period can be lengthened by extending the forecast window
 - control not intended to be punitive for past performance
 - historical performance a poor predictor of future performance (e.g. due to ownership changes, due to changing market dynamics (such as supply issues post-Maui))
 - would the Commission control on the basis of historical excess returns alone?
- Vector recommends consistency with usual Commission practice of using forecast periods only

Suggested departure from ACAM costs

- Commission view: gas businesses may have loaded a disproportionate share of common costs to their gas activities
 - no evidence provided to support this view
 - Vector's approach consistent with ACAM principles (PwC opinion)
 - information prepared to an auditable standard – the CC could audit if it has concerns
- The Commission has suggested reducing ACAM-based common costs by 10, 20 or 30% in the final report despite
 - using ACAM-based information to re-set the thresholds in electricity
 - confirming the use of ACAM for electricity disclosures
 - using ACAM for the same tests in the airports inquiry
 - MED has also endorsed ACAM for disclosure as the only robust method to identify so-called monopoly profits and avoid arbitrary allocations
- Vector recommends consistency with previous Commission precedents in the use of ACAM

Assumption that control would improve productive efficiency

- Commission view: control would achieve 1% improvement in total costs, but taking into account indirect costs uses 0.66%
 - Key driver: apparent inefficiency of NZ gas businesses relative to Australia (based on Meyrick report)
- PEG identifies the inadequacies of the Meyrick report and, using a more credible approach, finds Vector's performance superior to US firms
- No rationale provided as to how or why control would improve productive efficiency relative to no control
 - studies suggest the opposite
- This suggests the impact of control on productivity should be set at zero or some negative value

Populating the Commission's dynamic efficiency model

- The Commission put forward a model to estimate dynamic inefficiencies from control
- Vector populated that model with estimates as to how it would respond if its gas business were controlled
- The results indicate control would result in substantial economic harm (loss of consumer surplus) if prices were set at a level that precluded Vector earning its full cost of capital
- The results highlight a trade-off between small and short term benefits to existing consumers from setting prices using a low WACC, relative to larger and longer term losses to consumers and the economy from doing so

De-minimis test

- What is the level of net benefits where control would be worthwhile?
- The Commission has not clarified the de-minimis test it intends to apply, but did not recommend control in the case of Wanganui Gas due to low levels of estimated benefits
- In telecommunications (unbundling), the Commission did not recommend regulatory intervention where benefits were estimated at \$30m over 5 years
- The Minister of Commerce decided not to control Auckland Airport where estimated benefits were \$2m per annum
- Vector considers the Commission should transparently analyse what the appropriate de-minimis test is for determining whether control should be imposed

Asset valuation

- Historic cost records do not exist in Vector's case
- The draft ODV Handbook should be updated - the significance of recommending control warrants correct asset valuations
- Important principles for robust assessment
 - In order to calculate potential excess returns over time, a consistent asset valuation methodology must be used for every year of the assessment
 - Any changes in value resulting from assets being found or correcting errors in previous valuations should be treated as restatements (not revaluation gains)
- In Vector's case
 - Large valuation increase reported in 2002 a result of applying the draft ODV Handbook (c.f. 1999 which was done without the handbook; evidence provided to Commission in submission to this effect)
 - Easements are a found asset

Legal framework

Should not may (1)

- Draft recommendations are based on the s52 test of whether control *may* be imposed
- The *may* results need to be considered alongside a range of other factors relevant to whether control *should* be imposed
- The Minister, presumably learning from the airports inquiry, has emphasised the *should* question
 - “any other matter that the [C]ommission may think relevant to a decision on whether control **should be introduced**”
- s56 – pertaining to reports to Minister – also refers to *should*; as well as the CC considering all relevant matters

(List not exhaustive)

Relevant issues to the *should* question

- Net public benefits - the appropriate *should* test in Vector's view
- De-minimis test for when control worthwhile
- Different forms of control / policy approaches
- Draft and outdated nature of ODV Handbook (unless updated as Vector suggests)
- Impact of recommendations on foreign investment
- Broader industry considerations
 - Low penetration rates in New Zealand (need for gas growth)
 - Vertical integration in gas industry (creates competitive challenges)
 - Extent to which end-consumers would benefit from control

Length of control declarations

- If regulation is required, Vector supports a 6-year declaration (1yr implementation, plus 5 control) – the CC proposes 11 yrs
- 5-yr regulatory period almost universally accepted
 - 5-yrs the norm overseas
 - the CC's work on airports and electricity
 - Parliament's view for electricity lines and telecommunications
- There should be a significant hurdle for rolling over regulation to a second 5-yr period, i.e. a new declaration if required
- If used, an 11-yr declaration would likely require a price reset half-way through

Interests of acquirers

- Both direct (retailers) and indirect (mass-market end consumers) legally important to inquiry
- CC should articulate how any control recommendations would benefit end consumers
 - an important factor in whether control should be imposed
- Analysis assumes pipeline prices are, in effect, passed through to consumers – not the case, given repackaging by retailers
 - implications for estimated allocative efficiency improvements

Counterfactual

- Electricity and Gas Industries Bill almost a reality; a much more intrusive regulatory environment in the near future
- EGI Bill sets out a range of areas for regulatory attention, e.g.
 - regulating the terms and conditions (including prices) under which gas distributors supply their services to domestic consumers
 - governance arrangements, including for distributors
 - rules for the offering, availability and unbundling of gas distributors' services
 - information disclosure requirements
- CC suggests a no-control recommendation would mute threat of control in future
- In Vector's view, the threat would be enhanced as the 'line in the sand' for control would be more clearly defined
 - and this more-focussed threat would achieve most gains achievable from control, at much lower cost

Summary of Vector views

Summary of Vector views

- Competition is not limited in the gas and bypass markets and, therefore, control may not be imposed

- With respect to the Commission's numerical analysis
 - Correction for the interest tax shield (accepted in principle by the CC) all but nullifies the draft control recommendation for Vector

 - A range of other assumptions and modelling parameters, if treated more appropriately, further reduce the case for control

- The Minister has requested advice on whether control *should* be imposed (not just *may*); a range of other factors also suggest control is not required



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