

**ATCO Gas Australia Pty Ltd – Economic Regulation Authority Price Determination:  
A supplementary report prepared by Brent Stewart, December 2014.**

**1. Overview**

Herein is my supplementary report in relation to the matter of ATCO Gas Australia Pty Ltd (ATCO Gas) and the Economic Regulation Authority (ERA) Price Determination (the matter). This report is to be read in conjunction with my earlier report prepared for ATCO Gas contained in Appendix 6.8 of ATCO Gas' Response to the ERA's Draft Decision on required amendments to the Access Arrangement for the Mid-West and South-West Gas Distribution System' submitted on the 27<sup>th</sup> November 2014 (Appendix A).

I have been engaged by ATCO Gas to prepare a supplementary expert report that requires me to:

- 1.1 Provide my opinion as to whether the proposed ATCO Gas' BDM strategy would result in increased customer numbers and consumption per customer, and the ERA's Draft Decision in relation thereto.
- 1.2 Provide my opinion as to whether the increases forecast by ATCO Gas in customer numbers and consumption per customer, could likely be achieved with a BDM spend of \$1.76 million per annum (as allowed by the ERA), and the ERA's Draft Decision in relation thereto.
- 1.3 In the context of 1.1 and 1.2 above, provide my opinion as to whether ATCO Gas' proposed BDM expenditure meets the requirements of Rule 91(1) of the National Gas Rules.

A copy of the precise Terms of Reference for this report is attached in Appendix B. I understand that it is intended that my report will be submitted by ATCO Gas to the ERA as a supplementary report to its response to the Draft Decision. I also understand that my report must be expressed such that it may be relied upon by both ATCO Gas and ERA.

In the preparation of this report, I acknowledge that I have read, understood and complied with the guidelines issued in Practice Note CM 7.

**2. Qualifications and Experience**

I am a marketing professional with over 30 years of experience in the marketing services industry as a practitioner and executive. I am currently the Executive Chairman of Waveride Capital Ltd, a company I established in 2011 to assist enterprises with strategy, growth and investment. Before establishing Waveride Capital, I was a Global CEO with Synovate – one of the world's largest marketing intelligence and research companies, with revenues in excess of \$US1Bn and over 6,000 employees. In this role, I was responsible for the commercial leadership of Synovate's Geographies, including more than 100 offices throughout 64 countries. I was also responsible for the development and implementation of Synovate's global strategy and business plans, overall commercial leadership of Global Client Relationships and personally oversaw the Company's largest client, the Unilever Group. I joined Synovate as the CEO of Australia and New Zealand in 2005 and resigned from my Global CEO role in 2011.

Prior to joining Synovate, I was the Chairman and Chief Executive of Market Equity, a company I founded in 1992 which grew to become one of Australia's largest privately owned marketing and research companies. Market Equity was acquired by Synovate in 2005 to establish the Company's market research presence in Australia and New Zealand.

In my 30 years as a marketing, strategy and research consultant, I have advised numerous Australian and International companies and Government instrumentalities across a wide range of industries including technology, energy, agribusiness, retail, manufacturing and services. My professional expertise includes strategic planning, market research and consumer behaviour. I have expertise and experience in the design and conduct of strategic market research and marketing plans, including within the energy and utilities domain. Specifically, I have previously conducted work for Alinta Energy, Western Power, the Water Corporation and the Office of Energy.

In addition to my consulting experience, my general commercial experience includes Board level appointments for a range of Companies and Government instrumentalities. I am currently the Chairman of PDC Global Pty Ltd, Surgical Specialties Pty Ltd, Etherington and The WorkFocus Group Pty Ltd. I am also a Non-Executive Director of Argonaut Ltd. My previous Board experience includes Chairman roles for the Western Australian Egg Marketing Board, Novo Foods Ltd, Herdsman Fresh Essentials Pty Ltd and Maxim Litigation Consultants Pty Ltd. I have also served on several West Australian government committees and working groups, including as Chairman of the Pearling Industry Advisory Committee, the Western Australian Beef Strategy Group and Partnership WA – a reference group advising a former Premier on branding and positioning opportunities for the State.

By way of professional qualifications, I am a former Chairman of the Market Research Society of Australia in Western Australia and have served on the National Board of Directors of both the Australian Market and Social Research Society and the Association of Market Research Organisations. I was also an Associate Fellow of the Australian Marketing Institute, a professional member of the American Marketing Association and a member of ESOMAR, the European Society of Marketing Research. I have obtained QPMR status (Qualified Practicing Market Researcher) and was previously a registered Marketing Consultant with the former Department of Commerce and Trade, a licensed Business Planning and Export Marketing consultant under the Federal Government's AusIndustry program and a Foundation Member of the Marketing Skills Program, a Federal Government initiative to enhance the marketing orientation of Australia's export industries. I am a Fellow of the Australian Institute of Company Directors.

By way of educational qualifications, I have obtained Bachelor of Science and Bachelor of Psychology degrees from the University of Western Australia.

### **3. Summary of the Matter**

ATCO Gas has been the operator of the Mid-West and South-West Gas Distribution System (the Network) since 1<sup>st</sup> August, 2011. ATCO Gas is a subsidiary of the ATCO Group, an experienced international operator of regulated utilities. ATCO Gas' stated long term strategy is 'to increase throughput across the Network, encouraging wider use of gas in homes and commercial businesses whilst continuing to support the rapidly-expanding Perth metropolitan area' (Appendix C, Page 8).

The ERA is an independent statutory authority established by the Parliament of Western Australia. The stated purpose of the ERA is to benefit the WA community by promoting an efficient and customer focused economy (<http://www.erawa.com.au/about-us/fact-sheets/what-we-do>).

The ERA approves the terms and conditions that gas pipeline owners/operators can offer companies wanting to use their infrastructure.

The terms and conditions for "access" define the benchmark price and basic terms and conditions that parties can fall back on if they are unable to negotiate.

Reasonable terms and conditions for "access" to a gas pipeline are important, as they enable retailers to transport the energy they purchase from gas or electricity suppliers to customers. While parties can negotiate other arrangements, an access arrangement sets the price and basic terms and conditions for a typical service that would be sought (<http://www.erawa.com.au/about-us/fact-sheets/our-energy-related-work>).

There have been three approved Access Arrangements since the gas regulatory regime commenced in 1999. The most recent review commenced in 2010 and was completed in 2012. The access arrangement review for the 2014 to 2019 period (AA4) commenced in March 2014. The prior Access Arrangement (AA3) covering 2010-2014 took effect in May 2011 (<http://www.erawa.com.au/gas/gas-access/mid-west-and-south-west-gas-distribution-system/access-arrangements>).

Under the provisions of the National Gas Rules (NGR), the ERA is required to make a draft decision that indicates whether it is prepared to approve the access arrangement revision proposal as submitted and, if not, the nature of amendments that are required in order to make the proposal acceptable to the Authority. An access arrangement draft decision must include a statement of the reasons for the decision (Appendix D, Paragraph 10).

On 17 March 2014, ATCO Gas submitted its proposed revised access arrangement, access arrangement information and other supporting information for the Network to the ERA.

On 14 October 2014, the ERA published its Draft Decision on ATCO Gas' Access Arrangement Review Proposal. The draft decision of the ERA was to not approve the access arrangement revision proposal. The ERA's reasons for not approving the access arrangement revision proposal are set out in their Draft Decision. The proposed amendments to the access arrangement revisions before the ERA will approve it are also set out in their Draft Decision (Appendix C, Paragraph 25).

A fundamental aspect of the Access Arrangement review and the Draft Decision is the ERA's assessment of the efficiency of proposed expenditure. ATCO Gas proposes to spend operating expenditure of \$24.61 million on business development and marketing (BDM) for the fourth access arrangement period, a substantial increase over the actual BDM expenditure in the third access arrangement period (Appendix E, 7.6.1, Page 160).

ATCO Gas also forecasted growth in the number of customers and consumption per customer (of 2.1% each) in the fourth access arrangement period, including as a result of ATCO Gas' increased BDM activities.

In the Draft Decision, the ERA determined that ATCO Gas' proposed BDM campaign would not have the impact on customer usage that was forecast by ATCO Gas, and that the forecast increase in customer numbers would be achieved without the increase in BDM spending (Appendix D, Paragraphs 118 and 120).

On 27<sup>th</sup> November 2014, ATCO Gas submitted its Response to the ERA's Draft Decision (Appendix J). In this, ATCO Gas provided a revision of its proposed expenditure on business development and marketing activities along with the forecast impact of these activities on customer numbers and consumption (Appendix J, Chapter 6).

#### **4. Professional Opinions and Basis for These Opinions**

In reviewing and providing the opinions contained in this report, I have been provided with the following documents which together inform ATCO Gas' BDM strategy and proposed expenditure:

- ATCO Gas Strategic Marketing Plan Project, prepared by Churchill Consulting, March 2012 (Appendix F);
- ATCO Gas Qualitative Research, prepared by Meerkats, October 2012 (Appendix G);
- ATCO Infill Program Focus Group Report, prepared by Right Group, January 2013 (Appendix H);
- ATCO Gas Marketing Plan, prepared by ATCO Gas, June 2013 (Appendix I);
- ATCO Gas' Response to the ERA's Draft Decision, December 2014 (Appendix J);
- ATCO Gas' Confidential Marketing Material, October 2014 (Appendix K).

This report also references a further document that reports the findings of independent quantitative market research conducted specifically to evaluate the effectiveness of the proposed ATCO Gas' BDM strategy. This research was conducted throughout November and December 2014 by Metrix Consulting Pty Ltd (Metrix Consulting) and a summary of this research is outlined separately in Section 5 of this report. The full report is contained in Appendix L.

#### **4.1 Provide my opinion as to whether the proposed ATCO Gas' BDM strategy would result in increased customer numbers and consumption by customer, and the ERA's Draft Decision in relation thereto.**

I have set out the objectives and key themes of the ATCO Gas' BDM strategy in my previous report along with my opinion of the supporting logic (Appendix A). In its draft decision, the ERA's analysis of ATCO Gas' proposed BDM operating expenditure (paragraph 253) identifies over two thirds of expenditure allocated to the two main themes of the BDM strategy in advertising and promotion (42%) and incentives (22%). This is consistent with the stated objectives of the BDM strategy and in particular:

1. Raising the awareness of the value in the use of natural gas.
2. Promoting gas connections for existing and new builds.
3. Promoting gas appliances.

The ATCO Gas' BDM strategy is primarily targeted at increasing consumer awareness of the benefits of gas as an energy source, stimulating gas consumption through targeted messages and encouraging switching behaviour and new connections through financial incentives.

The use of advertising and promotion to influence consumer behaviour is well documented and there exists a vast body of empirical evidence in relation to the subject matter. It is beyond the scope of this report to provide an exhaustive chronicle of the academic literature on advertising effectiveness but numerous studies have been performed and published across multiple disciplines including psychology, sociology, economics, communications, advertising and marketing that demonstrate the ability of advertising and promotion to influence consumer behaviour.

Some of the more influential thinking on advertising effectiveness includes that of the Harvard Economist, Professor John Kenneth Galbraith, who wrote 'The Affluent Society' in 1958. In this, Galbraith asserts that classical economic theory was true for the eras before the present, which were times of "poverty"; now, however, we have moved from an age of poverty to an age of "affluence", and for such an age, a completely new economic theory is needed. Galbraith's main argument is that as society becomes relatively more affluent, so private business must "create" consumer demand through advertising (The Affluent Society, Houghton Mifflin Harcourt, 4<sup>th</sup> Edition, 1998).

In the Australian context, a recent White Paper published by Australia Post in conjunction with Marketing Magazine examines the effectiveness of advertising and promotion from the perspective of both marketers and consumers. The large scale study commissioned for the White Paper was conducted by an independent third party, QOR, and was based on a National sample of 9,641, providing results with an accuracy of plus or minus 1.7% at the 95% confidence level. The purpose of the study was to determine how the general public in Australia views advertising and what people consider to be the most effective channels to reach them and influence their behaviour and attitudes.

Amongst other things, the study found that a majority of consumers (62%) are positively predisposed towards advertising whereas marketers' expectations were that this would be a minority (35%). The White Paper concludes that "people are nowhere near as negative about advertising as marketers think they are" (Appendix M, page 2). The White Paper also contains findings in relation to the effectiveness of particular media channels, including industry specific data, such as for utilities.

It should be pointed out that there is not universal agreement regarding advertising effectiveness and the literature is equivocal on a direct correlation between advertising and effectiveness metrics such as sales for example. Many different theories prevail in relation to the mechanics of advertising and promotion effectiveness and variables that have been attributed to influencing advertising effectiveness include messaging, channel, media weight, media mix, media placement and clutter. Successful execution of advertising and promotion therefore plays an important part in determining effectiveness.

Two common marketing methods to evaluate and refine the effectiveness of marketing programs involve the use of market research and test marketing. Both of these methods have been employed by ATCO in the development of the ATCO Gas Marketing Plan (Appendix I). Firstly, the research conducted by Meerkats and the Right Group (Appendices G and H) was an attempt by ATCO Gas to

better understand the target market. Specifically, in the case of the Right Group research, the key aim of the research was to identify and recommend which promotional strategies will be most likely to convert non-users to install gas hot water systems. Secondly, ATCO Gas has employed a form of test marketing by way of a pilot program targeting new gas connections at Capricorn Estate in Yanchep (Appendix N, page 92).

The pilot program campaign targeted 600 established homes in the Capricorn Estate where the gas pipeline was in the ground but not in the homes. The campaign employed a variety of initiatives including a campaign website, outdoor signage, local newspaper advertisements, direct mail and a rebate for new connections/conversions.

ATCO Gas has reported that the pilot was successful in achieving 150 new connections (Appendix O). This has also generated incremental consumption in natural gas (Appendix O). The learnings from the Yanchep Campaign are intended to be rolled out across the Perth Metropolitan Area as part of ATCO Gas' Marketing Plan (Appendix I, page 101).

Section 5 of this report references quantitative market research conducted by ATCO Gas in November and December 2014 to better ascertain the impact of proposed marketing messages on new connections and consumption amongst Perth Metropolitan householders. I am of the opinion that the available evidence from the research strongly supports the case for investment in advertising and promotion and financial incentives to increase consumption of Natural Gas.

The proposed marketing and advertising of the benefits of natural gas are likely to be most effective in increasing connections and consumption amongst existing households, particularly the messaging around the benefits for cooking and cost savings relative to electricity. The proposed financial incentives of a free hot water system and \$350 cash rebate are also likely to be most effective in increasing connections and increasing consumption through the take up of additional gas appliances (Appendix L, page 22).

It is reasonable in my opinion to expect that the ATCO Gas' BDM Strategy would result in increased customer numbers and consumption by customer. Specifically, the ATCO Gas' BDM Strategy could reasonably be expected to:

1. Increase the level of new connections from existing home owners not currently connected to gas.
2. Increase the number of gas appliances installed in new homes amongst new home owners that are likely to connect to gas.
3. Increase the number of gas appliances in households already connected to gas.

My opinion is qualified to the extent that it assumes successful campaign execution and an adequate level of investment. It is further my opinion that ATCO Gas has taken all reasonable steps to ensure that both of these conditions are satisfied as referenced in the opinion provided in my earlier report (Appendix A) and as evidenced by the findings of the market research (Appendix L, pages 26 – 28). Otherwise, my opinion is based on the following facts and observations:

- 4.1.1 ATCO Gas' BDM strategy has 64% of its budget allocated to advertising and promotion of messages and incentives that a) have been identified as having resonance with the target market in exploratory market research and b) have yielded proven results by way of new connections and increased consumption in a test marketing pilot program (Appendices N and O).
- 4.1.2 The quantitative market research commissioned to inform this supplementary report demonstrates the likely effectiveness of the proposed marketing messages of ATCO Gas' BDM Strategy in increasing connections and consumption (Appendix L).
- 4.1.3 My prior experience with commercial marketing campaigns has demonstrated to me unequivocally the capacity for well targeted advertising and promotion expenditure to influence consumer behaviour of a similar nature.

- 4.1.4 There is a vast body of empirical evidence that concludes favourably in respect of advertising and promotion's ability to influence consumer behaviour.

Based upon my review and interpretation of the ERA Draft Decision (Appendix D), there does not appear to be any assertion that ATCO Gas' BDM strategy would not result in increased customer connections and consumption by customer. However, in its Draft Decision, the ERA "considers that ATCO's proposed business development and marketing campaign will not have the impact on customer usage that ATCO foresees" and "considers that the adjusted business development and marketing operating expenditure would still deliver ATCO's proposed marginal increase in the number of customers" (Appendix , paragraph 118). I can find no evidence in the Draft Decision supporting either of these assertions.

**4.2 Provide my opinion as to whether the increases forecast by ATCO Gas in customer numbers and consumption per customer, could likely be achieved with a BDM spend of \$1.76 million per annum (as allowed by the ERA), and the ERA's Draft Decision in relation thereto.**

ATCO Gas' BDM expenditure in 2013 was a reported \$1.76M (Appendix C, paragraph 256), including a significant component of labour costs by way of marketing and business development personnel of \$1.13M relative to a very modest expenditure on advertising and incentives of \$.038M. In its Response to the ERA Draft Decision, ATCO Gas' revised BDM expenditure for AA4 is \$20.8M (Appendix J, paragraph 376), with the majority of the proposed increase in annualised expenditure over the period attributed to advertising and incentives (Appendix J, Figure 6-14). These are the activities that have been identified to have the potential to increase connections and consumption.

The EMCa report commissioned by the ERA concluded that in the period covering AA3, ATCO Gas underspent its forecast BDM budget by \$5.4M "whilst it reviewed its marketing strategy" (Appendix E, paragraph 553). Reportedly during this time, the consumption per connection amongst residential customers has been in decline (Appendix C, Figure 35, Page 75) and there has been a trend of a slowing rate of new connections relative to annual dwelling growth in residential households (Appendix F, page 18). ATCO Gas has stated that its BDM strategy commenced in mid-2013 in order to address declining consumption (Appendix C, page 75).

It is therefore my opinion that the available evidence and supporting rationale for maintaining ATCO Gas' BDM expenditure at 2013 levels is both questionable and without proper foundation. On the basis of the market research conducted by Metrix Consulting (Appendix L), I am of the opinion that maintaining expenditure at 2013 levels would not achieve the forecast additional connections and consumption forecast by ATCO Gas, particularly in the absence of advertising and promotion along the lines of that proposed in the ATCO Gas BDM strategy. The 2013 BDM expenditure by ATCO Gas did not include any substantial expenditure of this nature.

It is further my opinion that any increase in connections and consumption per customer in the B2 and B3 segments beyond the baseline forecasts will most certainly require stimulation of demand beyond the BDM efforts pre-dating this report. The trend data in relation to consumption, the continued rate of disconnections and slowing rate of new connections relative to annual dwelling growth indicates that maintaining expenditure at current levels could result in decreased customer numbers and/or consumption by customer over the life of AA4. It is my opinion that an increase in BDM investment as proposed by ATCO Gas would most certainly increase the likely achievability of the forecast additional new connections and increased consumption per customer. On balance, I am of the opinion that the increases forecast by ATCO Gas in customer numbers and consumption per customer could not be achieved with a BDM spend of \$1.76 million per annum as allowed by the ERA.

My opinion is based on the following facts and observations:

- 4.2.1 ATCO Gas' BDM expenditure to date has achieved a year on year increase in new connections throughout AA3 but this has largely been achieved through the growth in new households and the attendant high penetration of new household connection to gas. During AA3, existing BDM expenditure has not achieved an increase in consumption per consumer in the B2 and B3 market segments.
- 4.2.2 The quantitative market research conducted (Appendix L) supports the earlier findings of exploratory market research which concludes that residential consumers will react favourably to advertising and promotions that address misperceptions in relation to gas, promote the cost benefits of gas vis a vis alternatives and offer sufficient financial incentive to act by way of new connections and the use of gas appliances that will lead to increased consumption (Appendices G and H).
- 4.2.3 The 2013 BDM budget and committed expenditure by ATCO Gas did not have provision for the type of advertising and promotion activity described in 4.2.2. Without this type of advertising and promotion activity and the concomitant expenditure to conduct it, the available evidence suggests that the rate of new connections will continue to slow as a percentage of new dwellings and consumption will continue its trend of marginal decline. This casts significant doubt on the achievability of increasing customer numbers and/or consumption by customer at 2013 ATCO Gas BDM expenditure levels.
- 4.2.4 The quantitative market research conducted by Metrix Consulting provides evidence that there is significant market potential to increase connections and consumption with effectively targeted messages such as those proposed by ATCO Gas' BDM strategy. The market potential of the proposed marketing activities is in excess of the increases in connections and consumption forecast by ATCO Gas in its Response to the ERA Draft Decision (Appendix J, paragraph 149). Specifically, ATCO Gas' forecast 4,017 additional connections from the B2 and B3 segments, an additional 1500 hot water systems and an additional 2,500 other gas appliances (Appendix J, Table 6-20). The Metrix Consulting research concluded the market potential of the proposed BDM initiatives to be between an additional 11,900 and 14,760 new connections, 6,760 hot water systems and 37,320 additional gas appliances (Appendix L, page 28). In the absence of ATCO Gas' proposed BDM expenditure on advertising and incentives, it is unlikely that any significant component of this market potential will be achieved.

The ERA Draft Decision in relation to 4.2 references EMCa's conclusion that the BDM expenditure that ATCO has chosen to spend from 2011 to 2013 can be considered a reasonable and efficient level, based on ATCO's commercial incentives to incur operating expenditure at an efficient level and to try and increase demand (Appendix E, paragraph 256). EMCa goes on to state that "EMCa considers that the amount that ATCO has spent on business development and marketing in 2013 provides a reasonable basis for forecast expenditure for the fourth access arrangement period" (Appendix E, paragraph 256). I can find no supporting rationale provided for EMCa's conclusion in this regard.

I maintain my opinion that the ERA's Draft Decision to maintain expenditure at 2013 levels (Appendix D, paragraph 118) is without proper foundation. Specifically, I can find no compelling evidence for the statement "the Authority considers that the adjusted business development and marketing operating expenditure would still deliver ATCO's proposed marginal increase in the number of customers" (Appendix D, paragraph 118).

#### **4.3 Provide my opinion as to whether ATCO Gas' proposed BDM expenditure meets the Requirements of Rule 91(1) of the National Gas Rules.**

Rule 91(1) of the National Gas Rules provides:

*“Operating expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services.”*

In the ATCO Gas Arrangement Access Submission, benchmark expenditure data is provided in Table 14 (Appendix C, Page 77) that concludes “ATCO Gas’ proposed marketing and development costs are significantly lower than the comparison businesses and will continue to be with the increased level of expenditure”. The latter refers to the proposed expenditure to execute the ATCO Gas BDM strategy in AA4. On AA3 levels of expenditure, the comparative data shows ATCO Gas marketing expenditure at 1.0% of revenues, representing the second lowest percentage marketing spend of the comparative set and the lowest marketing spend per customer at \$2.09 per customer. Taken over the 5 years of AA4, the budgeted spend of 1.6% of revenues and \$5.34 per customer places ATCO Gas somewhere in the lower median range of expenditure on both metrics. I understand that this information has been provided to the ERA by ATCO Gas as a follow up to their Response to the Draft Decision.

In its Draft Decision, the ERA acknowledges that ATCO Gas’ “proposed expenditure is commensurate with a select peer group” and goes on to say that “ATCO has not been able to demonstrate that the investment by other regulated gas businesses has been effective, because each of the benchmarked business development and marketing programs is in its infancy. Therefore the Authority considers that the benchmarking information does not provide evidence that ATCO would be acting efficiently and in accordance with good industry practice in undertaking its proposed program” (Appendix D, paragraph 261).

The ERA Draft Decision also cites confirmation of this finding “by EMCa’s review of ATCO’s NPV analysis of its proposed business development and marketing program” (Appendix D, paragraph 262). It is not within the scope of my report to evaluate ATCO Gas’ NPV analysis or the basis of the ERA Draft Decision in this regard.

If benchmark expenditure data is a reasonable proxy for determining whether “operating expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of delivering pipeline services” then ATCO Gas’ proposed BDM expenditure meets the Requirements of Rule 91(1) of the National Gas Rules. This is not solely based on the peer review data referenced in the ATCO Gas Access Arrangement Information Submission (Appendix C, Page 77) but corroborated by reputable industry estimates and guidelines which point to considerably higher benchmarks for marketing expenditure as a percentage of revenues:

- The CMO Survey Report conducted by McKinsey & Co, American Marketing Association and Duke University reports business to consumer services companies average marketing expenditure at 10.9% of revenues as at August 2014 (Appendix P, page 26).
- The International Data Corporation (IDC) Tech Marketing Investment Planner, 2014: Benchmarks, Key Performance Indicators, and CMO Priorities reports companies earning less than US\$250M average marketing expenditure at 9.1% of revenues (<http://IDC.com>).

Benchmark data can also mask variability however and may not necessarily be reflective of the business case for specific BDM investment. A more robust business case for BDM investment requires the prediction and measurement of return on investment. This, together with my earlier assertion that advertising and promotion effectiveness requires successful execution and an appropriate level of investment, leads me to conclude that a proposed BDM budget within acceptable peer or industry benchmarks does not alone meet the requirement of Rule 91(1) of the National Gas Rules. I am also of the opinion that a lack of evidence in relation to the effectiveness of ATCO Gas’ peer group’s BDM expenditure is insufficient grounds in itself to reject the ATCO Gas BDM strategy and proposed expenditure.



Subject to the qualifications in the paragraph above, and with regard to my opinions in 4.1 and 4.2 of this report, the balance of evidence supports that ATCO Gas' BDM Strategy and proposed expenditure meets the Requirements of Rule 91(1) of the National Gas Rules more so than the ERA Draft Decision to retain expenditure levels at AA3 levels. My opinion is based on the following facts and observations:

- 4.3.1 ATCO Gas' proposed BDM expenditure as a percentage of revenues falls within industry parameters as evidenced by its peer review and other published industry benchmarks.
- 4.3.2 The ERA is correct in its assertion that being commensurate with a peer group does not provide evidence that ATCO Gas is acting efficiently and in accordance with good industry practice. Nor does it prove otherwise. In the absence of evidence to the contrary, benchmarking is at least a responsible attempt to demonstrate a reasonable level of expenditure.
- 4.3.3 ATCO Gas' Response to the ERA Draft Decision cites an example of a gas utility achieving an incremental increase in new connections attributed to advertising and promotion. While there is no return on investment analysis provided, it supports the opinion provided in 4.1 and 4.2 that effectively targeted advertising and promotion can achieve an increase in connections and consumption (Appendix J, paragraphs 384 and 385).
- 4.3.4 The NPV analysis provided by ATCO Gas is the primary source of ERA's questioning in its Draft Decision as to whether ATCO Gas' proposed BDM expenditure meets the Requirements of Rule 91(1) of the National Gas Rules. This is beyond the scope of this report to examine but the key consideration in determining this is the likelihood and extent of the proposed BDM expenditure impacting on the number of new connections and increased consumption.
- 4.3.5 To the best of my knowledge, in the absence of perfect market conditions, quantitative primary market research is the scientific method of choice to estimate the market potential of proposed marketing initiatives in determining likely consumer behaviour.
- 4.3.6 In regard to 4.3.5, quantitative market research demonstrates significant latent market potential amongst Perth Metropolitan householders to increase both gas connections and consumption (Appendix L). It is my opinion that this will not be achieved without advertising and promotion to stimulate demand. Without this, it could reasonably be argued that a lack of marketing effort/expenditure to capture this is inefficient and contrary to the Requirements of Rule 91(1) of the National Gas Rules.

## **5. Market Research**

ATCO Gas commissioned this supplementary report to address the opinions provided herein. The supplementary report draws heavily from the results of primary market research conducted by Metrix Consulting, an independent market research company. It is my opinion that this research provides a more conclusive basis for quantifying the potential for the ATCO Gas BDM Strategy to increase new connections and/or consumption amongst residential consumers in the Perth Metropolitan Area.

A précis of the market research that was conducted is as follows:

### **5.1 Research Purpose and Objectives**

The overall purpose for conducting the primary research is to investigate the propensity for the ATCO Gas BDM strategy to increase gas connections and stimulate gas usage. The research focused on the Perth residential market, being the primary target market of the ATCO Gas BDM strategy.

The specific objectives of the research were:

- To evaluate the potential impact of different marketing messages and initiatives, including rebates, on propensity to connect to gas (if not connected) and to increase gas consumption through switching to gas appliances.
- To assess the relative impact of different marketing messages and incentives proposed or currently in use by ATCO Gas, and to estimate the potential impact of these on gas connections and volumes in Perth.
- To establish a benchmark of current preferences for gas versus electricity, and current perceptions of these energy alternatives.
- To establish a benchmark of brand awareness and understanding of ATCO Gas.

## **5.2 Scope of Research**

The research comprised a quantitative online survey with n=400 Perth home owners, combined with a booster sample to ensure a total sub-sample of n=100 prospective new home builders. The sample was spread geographically across the Perth metropolitan area, and included a natural sub-sample of homes with and without a gas connection.

## **5.3 Research Methodology**

An online approach was employed as the most time and cost-effective methodology that enables a suitably representative sample. Importantly, it also provides the capacity to expose respondents to visual stimuli by way of marketing materials and concepts as part of the survey.

The sample of 400 households provides overall results with a forecasting accuracy of  $\pm 5\%$  at the 95% confidence level. To examine the opportunity in the new home market, the sampling included a booster sample to achieve a total of n=100 respondents who are considering building a new home in the next 2 years.

The survey design and questionnaire was developed by Metrix Consulting and approved by myself and the Marketing Manager of ATCO Gas prior to commencement. As part of this preparation, Metrix Consulting was provided with recent and proposed marketing materials from ATCO Gas to evaluate the potential effectiveness of proposed marketing initiatives and alternative marketing messages.

The research design and conduct was supervised by Julie Beeck, an Executive Director of Metrix Consulting (Appendix Q).

## **5.4 Key Findings**

The findings of the market research are detailed in an independent research report from Metrix Consulting, outlining responses to the various marketing messages and strategies proposed by ATCO Gas, and the potential impact of these on gas connections and gas usage (Appendix L). From my reading of this report and interpretation of the findings, I am of the opinion that the research supports the case for investment in advertising and promotion and financial incentives to increase connections and/or consumption of Natural Gas. The basis of my opinion draws from the following key findings of the Metrix Consulting research:

- 5.4.1 Within the target market, Natural Gas is perceived as a preferred alternative to electricity for cooktops, hot water storage and home heating. In each of these instances, current usage is significantly lower than consumer preferences indicate, representing a significant market potential for increased consumption (Page 11, Appendix L).

- 5.4.2 Even with appliances where electricity is predominantly favoured over Natural Gas, there appears to be a gap in the usage of Natural Gas relative to preferences amongst the target market, albeit from a smaller base. With both ovens and air conditioning, there is a sizeable group of consumers who prefer gas but don't currently use gas for either appliance (Page 11, Appendix L)
- 5.4.3 With regard to new connections amongst prospective home builders, each of the proposed marketing messages in the proposed ATCO Gas BDM Strategy has a significant net positive influence on consumer likelihood to connect to gas and have gas appliances in their new home. However, there is no evidence to suggest that the marketing messages alone will convert intention to actual behaviour (Page 19, Appendix L). Conversely, the proposed cash rebate for installation of gas appliances appears likely to be effective in increasing the number of gas appliances that consumers might otherwise have connected (Page 24, Appendix L).
- 5.4.4 With regard to new connections amongst existing homes without a gas connection, each of the proposed marketing messages in the proposed ATCO Gas BDM Strategy has a positive influence on consumer likelihood to connect to gas. In particular, the marketing messages involving a free hot water system and the benefits of gas for cooking, appear to have the largest potential to increase incremental connections (Page 22, Appendix L).
- 5.4.5 With regard to existing connections, there is some incremental market potential with each of the proposed marketing messages in the proposed ATCO Gas BDM Strategy to induce switching between electricity and Natural Gas. This is quite variable according to the individual appliances, depending on the current penetration of the appliance and the underlying appeal of gas for that purpose. The largest market potential for switching exists with gas ovens, followed by gas for home heating (Page 23, Appendix L).

## **6. Concluding Comments**

In the preparation of this report, I have made all reasonable inquiries that I deem to be desirable, relevant and appropriate and I believe that no matters of significance that I regard as relevant have, to my knowledge, been withheld from this report.

Yours sincerely

Brent Stewart

- Appendix A: ATCO Gas Australia Pty Ltd – Economic Regulation Authority Price Determination: A report prepared by Brent Stewart, November 2014
- Appendix B: ATCO Gas Terms of Reference – Economic Regulation Authority Price Determination, A supplementary report prepared by Brent Stewart, December 2014
- Appendix C: ATCO Gas Access Arrangement Information Submission, March 2014
- Appendix D: Draft Decision on Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution System, October 2014
- Appendix E: EMCa Review of Technical Aspects of the Proposed Access Arrangement, Report to ERA (Redacted), June 2014
- Appendix F: ATCO Gas Strategic Marketing Plan Project, March 2012
- Appendix G: ATCO Gas Qualitative Research, prepared by Meerkats, October 2012
- Appendix H: ATCO Infill Program Focus Group Report, prepared by Right Group, January 2013
- Appendix I: ATCO Gas Marketing Plan, prepared by ATCO Gas, June 2013
- Appendix J: Response to the ERA’s Draft Decision, prepared by ATCO Gas, November 2014 (amended December 2014)
- Appendix K: Confidential Marketing Material, prepared by ATCO Gas, October 2014 (Appendix K).
- Appendix L: Domestic Gas Market – Proposed Marketing Strategies, prepared by Metrix Consulting, December 2014
- Appendix M: White Paper, Views on media channels – marketers and consumers views on effectiveness, Australia Post and Marketing Magazine, June 2014
- Appendix N: ATCO Gas Capricorn Estate Overview, October 2014
- Appendix O: ATCO Gas Capricorn Estate Consumption Analysis, November 2014
- Appendix P: CMO Survey Report, McKinsey & Co, American Marketing Association and Duke University, August 2014
- Appendix Q: Professional Profile of Market Research Consultant: Julie Beeck, Metrix Consulting