File No. CT-98/2

THE COMPETITION TRIBUNAL

IN THE MATTER OF THE *COMPETITION ACT*, R.S.C. 1985, c.C-34, as amended, and the *Competition Tribunal Rules* SOR/94-290, as amended (the "Rules");

AND IN THE MATTER OF an inquiry pursuant to subsection 10(1)(b) of the *Competition Act* relating to the proposed acquisition of ICG Propane Inc. by Superior Propane Inc.

AND IN THE MATTER OF an application by the Commissioner of Competition for orders pursuant to s. 92 and other provisions of the *Competition Act* consequential thereto.

B E T W E E N:

THE COMMISSIONER OF COMPETITION

Applicant

- and -

SUPERIOR PROPANE INC and ICG PROPANE INC.

Respondents

AFFIDAVIT OF T. S. KEMP

COMPETITION TRIBUNAL
TRIBUNAL DE LA CONCURRENCE
File No. CT-98/2
No. du dossier
Comm v Superior et al
Exhibit No. A-2070
No. de la pièce
Filed on NOV 30 1999
Déposée le
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Greffier

COMPETITION TRIBUNAL
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SEP 1 1999
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PRODUIT
OTTAWA, ONT. 116

File No. CT-98/2

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Respondents

AFFIDAVIT OF T. S. KEMP

I , T. S. Kemp, of the City of Calgary, in the Province of Alberta, MAKE OATH AND SAY THAT:

1. I am one of the principals of Optimal Energy Inc., an independent consulting company with extensive experience in the supply and distribution of propane.

Optimal was retained by the Commissioner of Competition to provide a report assessing the requirements for sustainable entry into the retail propane distribution business in Canada.

2. Attached hereto as Exhibit "A" is a true copy of the Report which I prepared, with some assistance from W.J. McAdam and S.B. Sobczyk of Optimal. The contents of Exhibit "A" and the findings and opinions expressed therein are true to the best of my knowledge, information and belief.

3. Attached hereto and marked as Exhibit "B" is a true copy of my curriculum vitae.

4. I make this Affidavit pursuant to Rule 47(1) of the Competition Tribunal Rules.

SWORN BEFORE ME at the City of Calgary, in the Province of Alberta, this 18th day of August, 1999.

A NOTARY PUBLIC

T.S. KEMP

Entry Considerations Of a Retail Propane Distributor and Potential Impact of the Superior Propane Acquisition of ICG

by:

Optimal Energy Inc.

Confidential

This report has been prepared by Optimal Energy Inc. for the exclusive use of Industry Canada in their proceedings related to the acquisition of ICG Propane by Superior Propane. All opinions and data are those of Optimal Energy's unless otherwise noted.

August 18, 1999

THIS IS EXHIBIT "A"
referred to in the Affidavit of
T. S. Kemp
Sworn before me this 18th
day of August A.D. 1999
A COMMISSIONER IN AND FOR THE
PROVINCE OF ALBERTA

Steven T. Robertson
Barrister and Solicitor

Table Of Contents

1.0 Introduction

Optimal Energy Inc. under contract to Industry Canada has been requested to conduct an analysis around certain aspects of entering the retail propane business considering the Superior Propane acquisition of ICG Propane. The principals of Optimal Energy Inc. (W.J. McAdam, S.J. Sobczyk and T.S. Kemp) all have extensive experience in the natural gas liquids and propane industries both in terms of prior commercial experience with large companies and as consultants. Mr. Kemp has been the prime Optimal Energy contact supported by Mr. McAdam and Mr. Sobczyk.

The information and comments in this report have been developed from a number of sources. These include numerous reports and documents provided by Superior and ICG, public sources, government sources, company annual reports/filings and industry knowledge from past related business activities.

This report first looks at the setup requirements for establishing what would be considered a sustainable retail propane distributor. It then discusses the barriers to entry for a new propane retailer in the context of Superior and ICG as a combined competitor.

For purposes of this report, "Superior" shall refer to both the company Superior Propane Inc. and the Superior Propane Income Fund, "ICG" shall refer to the company ICG Propane Inc. and "Sup-ICG" shall refer to the merged company, in the case where the merger proceeds with no intervention.

2.0 General Background

The retail propane business is primarily a distribution and delivery business with the end-use retailers often being involved in the appliance and equipment service area. The propane demand profile is very seasonal while production is more steady on a month to month basis. This means that there is a need for significant storage capacity to manage the production in the low demand months and a need for distribution of the product when the high demand months occur. Storage and distribution each have associated investments.

The Canadian retail propane market is composed of the following end-use segments ("EUS"). The EUS, point of sale, percentage shares and degree of seasonality in demand pattern are illustrated below in table 2.1. In addition, Figure 2.1 shows the seasonal patterns (based on 1998 StatsCan data) (seasonal being the ratio of first and fourth quarter demand divided by second and third quarter demand).

Table 2.1

EUS	Point of Sale	% Share	Seasonality (winter/summer)
Commercial	at place of business	35%	low-medium
Autopropane	at service station or in yard	25 %	low
Industrial	at plantsite	19 %	med-high
Residential	at residence	12 %	med-high
Agricultural	at farm	6 %	high
Construction	at site	3 %	med-high
Total		100 %	

Source: Statistics Canada 1998

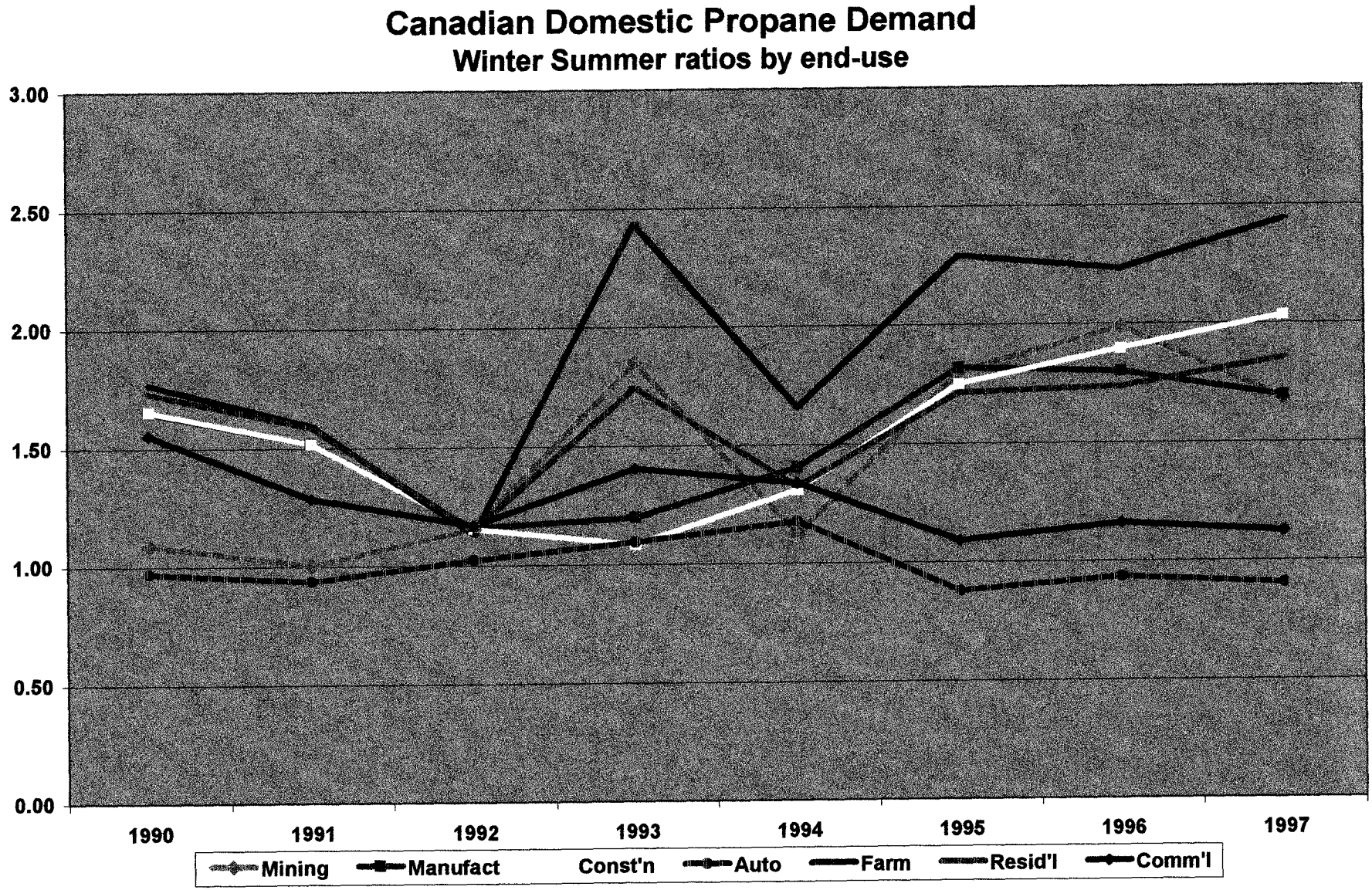
As can be seen above, all of the end use markets are served on a delivered basis. This means that the seller must have the transportation equipment and the access to supply with sufficient flexibility to meet the daily demand profile with no run-outs at the delivery point. The degree of seasonality is very important and the ability to match the supply with the demand is a critical capability in providing the service required and competing effectively.

Commercial and Industrial EUS have a low-medium to medium-high seasonality profile.
this means that the daily or monthly demand pattern is not as skewed as the Residential or Agricultural segments. The Agricultural segment is very seasonal, driven by the weather (moisture levels at harvest time) and the Construction segment seems to be more seasonal (site heating). The EUS that are generally available to new and even most competitors to Superior and ICG are those with the most seasonality.

The demand for propane tends to be spread out over large geographic areas. Customers are frequently found in rural areas and in a wide variety of dispersed commercial and industrial locations. Distances back to supply points are also generally large. It is thus very important for retail propane distributors to secure sufficient volumes to justify the capital (primarily transportation equipment, storage facilities and offices) required to service the demand.

Retail prices are generally negotiated on a confidential basis with an EUS customer at a local level. This provides little opportunity for price discovery. The contracting approaches vary by EUS and there is no desire by existing distributors to have the end price be known to their competitors in particular and in the industry in general. The one exception where retail price data is available is the autopropane segment where the "pump" price is advertised. Thus, with this one exception, there is difficulty in securing solid pricing (realization) data for most market segments on a delivered basis. This can lead to difficulties in assessing a market opportunity for a new entrant.

Figure 2.1



Source: StatsCan 1998

Optimal Energy Inc.

3.0 Set up Requirements and Operational Considerations for a Sustainable Operation

The following outlines a view on the requirements for setting up a minimum entry level for a sustainable retail propane business, including a storage tank. Sources of information for this review are Superior documents, inquiries, and general knowledge and experience.

Source documents referenced:

- SFS-071 Entering the Propane business
- SPI-S-453 Truck statistics
- Superior Propane Inc. Asset Performance Review 1995,
- Bates # 0161429, Box 19, Question J,K,and L – ICG Diagnostic Review of Deliveries in the Nanaimo and Drummondville Branches by KPMG.
- SFS-299 Land Values
- Base V1 spreadsheet
- Superior supplementary SFS-397; Spi_icgu spreadsheet

Superior stated in its responses to request F) v) that the costs to establish an entry level storage operation, using Provost Alberta as an example, were $123,415 (reference doc # 474488.5). This cost reflects only the costs to place a storage bullet but does not represent the costs to establish a greenfield operation and support it as an ongoing sustainable business concern.

To enter into a greenfield retail propane business or to establish a branch site and have a sustainable operation an owner operator would require at least 2.0 million litres per year (MMl/y) of customer business with an approximate mix as shown in table 3.2. The setup requirements are shown in the following table:

Table 3.1 Capital Items for a startup greenfield retail propane operation:

Single Axle Trucks- (2)	$150,000 to 200,000
Storage Bullet (30,000 USWG Laid in)	$100,000
Customer Tanks Mix of 320, 500 & 1000 USWG	$285,000 to 380,000
Land	$50,000 to $100,000
Building and equipment	$50,000 to $100,000
Supply Bond	$40,000
Contingency	$100,000
Total Capital Costs Range	
Low	**$675,000**
High	**$920,000**

Assumptions:

- Average volume per customer 5000 to 6000 litres/year
- Number of Customers 300 to 500
- Mean price per storage unit $950/unit
- Fill volume per delivery 50% of tank size
- Average 2 visits per month per customer
- Deliveries ratio is 2 times higher winter to summer

It is recognized that used equipment might be available to reduce some cost areas, however accessibility to equipment is always an issue if purchasing from a competitor.

As an example, the expected financial performance of a small retail propane competitor, in a startup mode may look as follows: (This analysis was developed and compared to the Superior Propane Inc. Asset Performance Review 1995)

Assumptions:	
Number of Customers	300 to 500
Storage Equipment	1 30,000 USWG Unit
Customer Tanks	between 300 to 500
Number of Vehicles	2 bulk single axle delivery units
	1 service
	2 other
Office	Yes
Number of Employees	5 (2 drivers, 1 service, 2 administrators)
Estimated Capital Employed	$700,000

The customer makeup for a small operator would largely be residential, commercial, agricultural and industrial. It is unlikely that a new operator would gain any large anchor auto propane or large industrial customer accounts because these are generally secured under national account contracts. Given its size, the small retail distributor will likely be a price follower and will not have the ability to significantly influence the EUS price level.

Table 3.2 Estimated Sales Margins and Customer Makeup

Market Segment	%	Margin c/litre	Weighted Average c/litre
Residential	40.0	23.6	9.44
Commercial	17.5	15.6	2.73
Agricultural	20.0	11.1	2.22
Industrial	17.5	4.9	0.86
Other	5.0	7.1	0.36
	100		15.61

Table 3.3 Volume Impacts on Revenue and EBITD

Volume	2.0 MMl/y	2.5 MMl/y	3.0 MMl/y
Net Revenue	312 K$/y	390 K$/y	468 K$/y
Cash Operating Costs	300 K$/y	305 K$/y	310 K$/y
EBITD	$12 K$/y	85 K$/y	158 K$/y

Cash Operating Costs assumed:

Salaries make up the largest component of costs,	
- Drivers 2	100 K$/y
- Service Technician	50 K$/y
- Administrator 1	40 K$/y
- Administrator 2	20 K$/y
Total Salaries	210 K$/y
Site Operating Costs	25 K$/y
Delivery Vehicle Costs	25 K$/y
Other Vehicle Costs	20 K$/y
Working Capital	10 K$/y
Equipment Costs	10 K$/y
Total Cash Costs	300 K$/y

The main variable cost will be vehicle delivery costs which, in accordance with the Superior Propane Inc. 1998 Truck Statistics (SPI-S-453), are approximately 1.0 Cpl.

From this table it is evident that in order to achieve a reasonable level of return on investment, the owner operator would need to secure annual sales in excess of 2.0 MMl/y. Thus the scale effect to bring volumes up above the 2 MM/y level is very

important for sustained operations. In essence the owner would be operating at a breakeven level paying salaries with sales volumes of 2.0 MMl/y and making approximately a 23% pre tax return on investment at 3.0 MMl/y. Financing costs have not been included in this assessment and, if highly leveraged, could further impact performance.

Typical Operating Parameters of a Retail Propane Branch

The following describes factors and efficiency considerations for a typical retail propane operation. This background information is provided to demonstrate the setup and operational considerations a new retail propane distributor would need to factor in to the decision to commence a grassroots operation.

Branch Tankage

Site operational tanks are normally 30,000 USWG tanks (114,000 litres). For a 3.0 MMl/year operation the tank would expect to turn over approximately 26 times per year or 2.2 times per month. A busier operation may see its inventories turn over up to 4.0 times per month (once per week). Remembering that these are yearly averages, if the turn over rate was much greater than 4 times per month, an additional tank would likely be required to support winter flows. This is a practical limit and is driven by the need to schedule supply deliveries from gas plants or other supply sources into the storage bullet and to have enough inventory to meet customer demands. Delivery trucks also need to have access to both load and unload from the tanks.

Delivery Trucks;

Trucks that are used to make customer deliveries need to include pump off equipment, and metering. Standard delivery trucks and capacities are;

Single Axle	3500 USWG (US Water Gallons) (13,257 litres)
Tandem	5000 USWG (18,940 litres)

Actual working tank sizes vary from vehicle type to vehicle type. As shown in the Superior Propane Inc. 1998 Truck Statistics (SPI-S-453), tank sizes for single axle trucks were usually 3500 USWG. For tandems, tank sizes are 5000 USWG and up to 6500 USWG (24,620 litres). The working tank capacities for propane needs to take into account required vapour capacity left in each tank or approximately 85% of the USWG capacity.

In addition to these trucks, 5 axle trucks equipped with offloading meters are used for larger customer deliveries. These trucks are allowed to pick up from bulk loading racks and deliver to customer tanks. The capacity of a 5-axle truck is

35,000 litres. Due to the size and operating expense, this type of equipment is not as suitable for making residential deliveries or a large number of commercial/industrial deliveries compared to the smaller trucks (If they were, then they would have replaced all of the smaller trucks). It is more often that 5 axle units are used to make short haul delivery directly from supply sources to branch storage tanks or longer haul deliveries to customers with larger sized tanks. Offloading volumes per customer site are generally larger when using these vehicles as this is the most economical application vs the smaller trucks. From the SPI Tractor/Trailer statistics, individual deliveries range from 1000 litres to 4000 litres with an overall average of 1850 litres per customer delivery. At maximum efficiency, these vehicles deliver 7.7 MMl/year (document SPF-S-453). SPI statistics indicate actual deliveries of 6.2 MMl/year per vehicle, for an 86% delivery efficiency, are more typical.

For bulk deliveries between supply points and branch tankage where distances are longer 7-axle or B train equipment is generally used. These deliveries can be made either through directly owned equipment or contracted with larger bulk carriers.

Customer Tankage

At each customer site tank sizes are normally 1212 litres (320 uswg), 1894 litres (500 uswg) or 3788 litre (1000 uswg). Some smaller tanks are also used depending on the type and demand profile of the customer. At the larger end, 2000 uswg customer tanks are also used. When filling tanks or any storage equipment, a small vapour space must be left in the tank. This means that they are also only filled to approximately the 85% level of the uswg rated capacity. Tanks are rarely ever empty when filling; thus only partial fills or top up volumes are offloaded into the tanks. A norm would be to consider 50% to 60% of the tank size as a delivery volume into a tank.

Delivery Frequencies

Normal operations for a driver would be to work an 8-hour shift for 5 days per week. Within this time period, a driver can be expected to make between 5 to 10 customer deliveries depending on distances and delivered litres per call. Initially, at the beginning of each shift, an hour would be used to load the truck and receive daily delivery routes. Deliveries at each customer site would take approximately 20 minutes. This would include hooking up, offloading propane through small diameter metering and hosing, and invoicing and logging the customer delivery. The remaining time would be spent driving between customer sites. Thus, a driver would normally expect to make one truck load delivery per day depending on location and distances to customers. This means that half the time is spent making deliveries and half is spent driving.

Depending on routes, an additional load might get started in an 8 hour shift or a driver might also work overtime to complete a partial load, particularly during the winter in the high demand period. In some urban areas where deliveries include a high percentage of automotive sites and the distances between sites are closer, a driver could complete 2 loads per day. These of course would be balanced with the lower frequency industrial and residential type deliveries over the year coupled with tank size considerations at the customer sites.

Again from the Superior Propane Inc. 1998 Truck Statistics (SPI-S-453), delivery volumes per customers are:

Atlantic region	439 litres/call
Quebec region	513 litres/call
Ontario Central Market	567 litres/call
Ontario Toronto	1032 litres/call
Prairie Region	1155 litres/call
Alberta Region	1625 litres/call
BC region	2016 litres/call

The higher deliveries per call in Western Canada reflects larger tank sizes being used. However, the distances driven to make these deliveries is also notably higher resulting in the litres per kilometer driven being in line on a national basis. In the Atlantic region, distances between customers is less than 10 KM. In the western region, distances are between 20 Km to 40 Km.

Individual drivers would only work for 48 weeks per year when considering vacations and other absent workdays. This would imply a driver efficiency of 92% or additional costs to backfill for these missed delivery days. One driver is generally assigned to one truck. Overtime is also a fact of this business when required to meet customer demands in the peak winter months, thus adding costs for these peak working hours. Annually on average, this would mean that a Single axle truck and Tandem truck, making 1 complete delivery load per 8 hour shift day over the year, would be capable of delivering 2.5 to 2.9 MMl/year and 3.8 to 4.5 to MMl/year respectively for a 100% operating time efficiency rate. These maximum theoretical operating efficiency delivery rates are seldom if ever achieved due to a number of practical reasons.

Maximum annual capabilities for delivery trucks need to take into consideration seasonal demand profiles. In summer, delivery demands are normally 50% of the winter demands; thus in addition to overtime, fleets are often sized to take into account this peak period. Vehicles will also require maintenance; thus some additional out of service time may be expected (estimated at 5% per year). This is why most retail distributors need and will have redundancy in their fleet capacity. Several examples of configurations with excess delivery capacity can be found in the Superior Propane Inc. Asset Performance Review 1995 document in the "Market Assessment and Ranking Summary" section.

4.0 Barriers to Entry For New Retail Propane Distributor Considering a Combined Superior-ICG Company

Sup-ICG Combined Volumes

		BC/Yukon	Alberta/NWT	Man/Sask	Ontario	Quebec	Atlantic	Corporate
Bulk	MM l/y	185.6	399.9	179.5	465.4	347.8	129.4	1707.6
Auto	MM l/y	247.1	213.2	47.2	223.6	26.4	8.2	765.7
Other	MM l/y	4.8	9.3	8.2	5.6	12.1	0	40
Total	MM l/y	437.5	622.4	234.9	694.6	386.3	137.6	2513.3

In accordance with the Superior Propane Inc. Asset Performance Review 1995, the combined Canadian traditional and automotive market is approximately 3,444 million litres per year. Assuming constant demand since 1995, the combined entity would represent 73% of the Canadian market.

Market Share

Figures 3.1, 3.2 and 3.3 (Source: Superior Asset Performance Review 1995) show the market share across different regions for ICG, Superior and Sup-ICG. In all regions, Sup-ICG will have a dominant market position. The significance of this is that they will essentially have the majority of anchor accounts for each region. The most notable example of this is automotive EUS. Anchor accounts allow a company to achieve a core density of business.

Figure 3.1 - Traditional Propane Market Share By Region

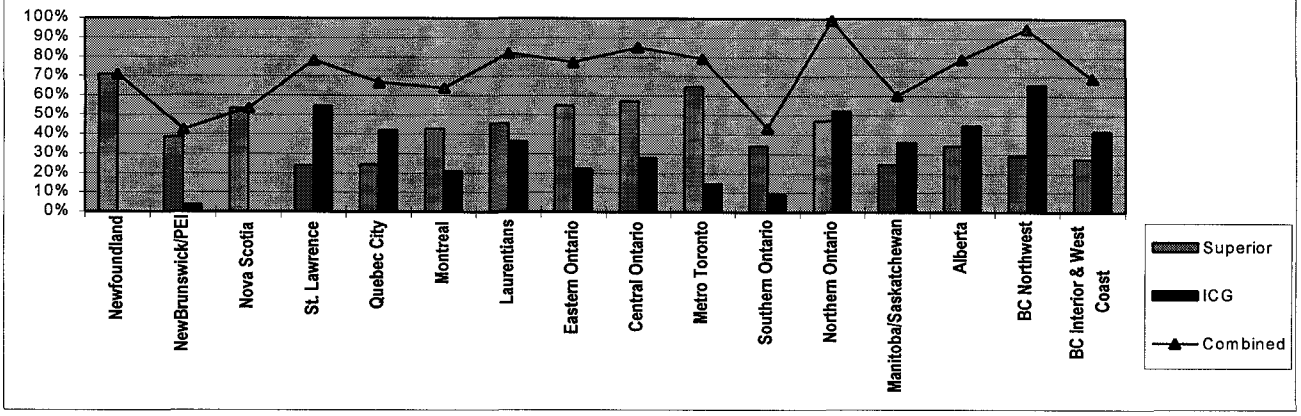


Figure 3.2 - Auto Propane Market Share By Region

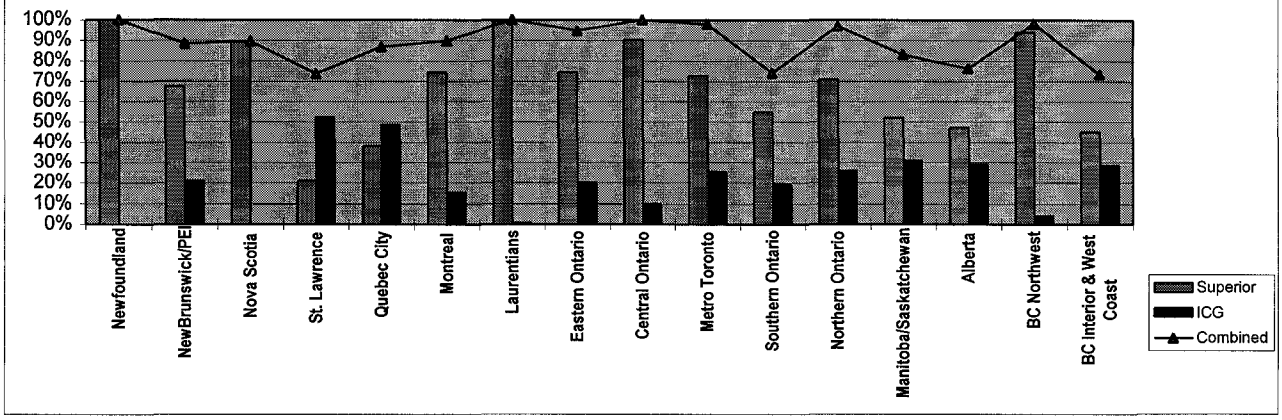
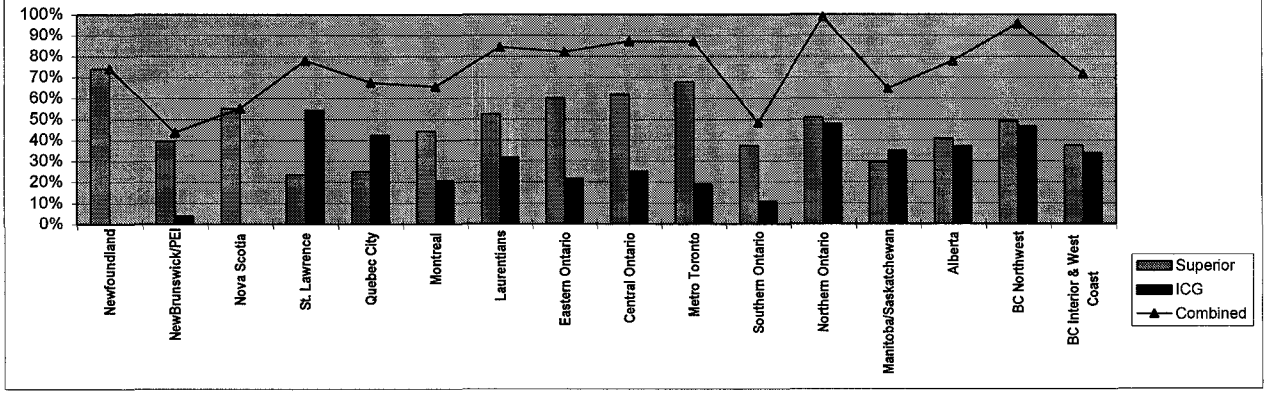


Figure 3.3 - Total Propane Market Share All Segments



Areas where Sup-ICG would have less than 75% of the combined market share are centred around regions with relatively open access to supply. An exception to this is in Atlantic Canada where Irving Oil does not provide open access to its refinery supply and markets its own propane at a retail level.

Bulk Cavern Storage

Cavern storage is an extremely important feature in the supply network of Superior and ICG and this is one area not duplicated by any other retail operator. For example, the Marysville, Michigan storage position allows Superior to take supply on a "ratable" basis [steady daily production from refineries or gas plants]. It also allows Superior to capture seasonal commodity uplifts in pricing and to purchase spot volumes when discount opportunities arise. Exchanges and trades, which generally have a positive impact on supply price, are also effectively executed and balanced from these central storage and commercial location.

Justification for these storage operations can be found in the Superior Propane Income Trust Prospectus, September 25, 1996 (Commissioner's Document 1A-5818). As quoted, " Despite the apparent surplus of domestic supply, Superior must operate its supply activities in the context of the industry's North American market. The flexibility to trade propane supplies into and out of Canada increases the security of supply, provides opportunity to reduce the cost of propane supply and contributes to the ability to perform under its term supply contracts. Accordingly, Superior is actively involved in trading propane throughout North America primarily through the four major North American propane trading centres located at Conway, Kansas: Edmonton Alberta; Mt. Belvieu, Texas; and Sarnia, Ontario. The key objective of trading propane at these four centres (and associated storage and pipeline systems) are to enhance Superior's supply security and to ensure that propane supply is being consistently acquired in the most cost effective manner".

The storage also provides the critical balancing mechanism between regional supply and demand. Few if any other retailers, have the size to secure these types of storage positions and capability. It becomes much more difficult and expensive to manage a regional operation that is remote from these centres. Consequently, if one were to look at retail business patterns, most small independents will develop around open access supply areas, such as the Sarnia area.

Producer Supplier Options and Logistics Impacts

Sup-ICG, with the exception of a few selective refineries, will have access to supply at virtually every producing location in the country. Sup-ICG will thus have an implied supply advantage and flexibility that cannot be matched by any other retail propane competitor.

Sup-ICG should be able to selectively choose the most advantageous supply locations and drop others, thereby extracting the most out of supply arrangements. Sup-ICG will also be in a position to leverage supply from location to location for trades and exchanges and, will in essence, be able to create preferential access to supply and location adjustments. These advantages can be utilized in a number of ways;

- Pressuring supplier price location arrangements
- Using competitive advantages when bidding on new contracts
- Servicing National accounts
- Negotiating more favourable bulk transportation rates (volume discounts) with trucking and rail companies.

Competitive Practices

Superior in the past has been a very strong competitor. Given the scale and competitive advantages of Sup-ICG, it is expected that they would not change in their approach to both hold and acquire new customers. Sup-ICG will be able to use their full competitive advantages in pursuing new customer accounts.

Considerations Facing a New Entrant

The barriers to entry into this business are formidable. The issue is not that an individual may not be able to get the appropriate licenses or purchase the necessary equipment; it is the ability to capture and secure anchor customers, the risk of capital invested, and the ability to maintain a level of threshold business necessary to sustain a profitable operation. This sustainable retail propane distributor, will be characterized as a company who is fully involved in the business and has achieved a threshold volume in excess of 2.0 MMl/y from a mixed customer base. Companies who have not achieved this level are likely in the business as a sideline either because they already have other related activities or have placed a propane dispenser at a retail gas station. These groups would not be characterized as a real measure of competition.

The issues that a new entrant would need to consider include:

1. On what basis can it compete; what mechanisms would they be able use to differentiate themselves from Superior or other existing distributors? It is difficult to see that a new entrant would have any price advantages.

2. On what basis would customers want to switch to propane other than a new installation? In areas where there is growth potential, a new entrant would need to secure an anchor customer so that volumes would be large enough to justify the ongoing business.