Barry Upson

Chairman – Powerco Limited

Gas Distribution Sector

- Powerco owns and operates a number of small localised gas networks teed off from various gate stations along the main transmission trunk.
- Gas distribution industry is largely a fixed cost industry – the investment is a sunk cost with best growth opportunities now coming from backfilling existing streets.
- Powerco’s strategy has been to grow its connection base by acquisition to improve its economies of scale.
- As a fixed cost industry, the price for providing a distribution service would typically be a daily fixed charge.
- Attracting and retaining capital investors is key to funding future growth

Distribution Competition

- Powerco plays only a small part in the gas market chain.
- It has no influence over:
  - the supply and price of gas from the wellhead.
  - the cost of transmission to its various gate stations.
  - the retailers motivation, marketing or final pricing of gas to consumers.
- In some major residential areas it competes with another distributor.
- And gas competes with all alternative forms of energy
- **Why do we need regulation?**

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Market Strategy

- For majority of its customers Powerco charges a large proportion of its service on a variable price basis rather than as a fixed daily charge.
- Powerco voluntarily adopted this strategy as a means to gaining increased gas market penetration.
- Powerco has therefore assumed a significant volume risk.
- Powerco works with retailers to promote gas services by offering special incentives for new connections.
- Powerco therefore has little or no control over the gas distribution market as retailers determine the final market strategy including price and supply availability.
- **Why do we need regulation?**

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Investor Issues

- Asymmetrical regulatory regimes typically cap returns to WACC with no floor.
- Investors regard regulated businesses as yield and not growth stock and are extremely conscious of regulatory risk.
- Any reduction in level of dividend will affect yield.
- Asymmetrical regulation will reduce free funds from operations (FFO) because of no upside.
- FFO is derived from EBITDA less cash tax.
- FFO provides the cash to pay the return to investors and for reinvesting in the infrastructure assets.

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Powerco Capital Structure

- Powerco's credit rating recently reaffirmed at a stable BBB+/A2
- This rating allows Powerco to be highly leveraged (60%)
- Reduction in market value through lower dividends would result in a lower credit rating and breach of banking covenants.
- Any downgrade would adversely affect the cost of capital – both debt and equity.
- Investors would demand corrective action e.g. asset sales / reduction in reinvestment to maintain investor returns.
- Any reduction in FFO will ultimately result in reduced investment in the asset base.

Infrastructure Investment

- Only safety valve for cash flow reductions is to reduce investment in assets by a similar amount.
- Investment is needed to:
  - Maintain and upgrade the network.
  - Expand the network in response to increased demand or to service new consumers.
- Investment ensures:
  - Services are provided safely and reliably
  - Services can be provided efficiently
  - Powerco is able to respond to consumer demands
- Consumers suffer in medium/long term through non availability

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Powerco Gas Investment Returns

- Most recent ROIs have been poor:
  - 2003 3.56%
  - 2002 5.69%
  - 2001 5.40%
- Comparing ROI to theoretical WACC results in long term risk to consumers and no benefit to the economy.
- Powerco cost of equity (as demonstrated in recent equity raising) was 10.3% - some 1 – 2% above Re used in theoretical WACC.

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Nature of Investors (1)

- Powerco's ability to retain or attract investors is becoming more difficult.
- Investors are international or influenced by international events
- Local and world events have made investors in energy infrastructure more jittery
- Since the 1993 reforms, large overseas investors have left (TransAlta, Aquila) or reduced holdings (AGL, Alliant) in the New Zealand energy sector.

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Nature of Investors (2)

- Today's investors are more astute, have more choice and are more mobile. They seek to maximise return for the perceived risk.
- Investors are not interested in regulated industries where WACC is seen as a cap and not the mid-point in a range.
- Investors ask themselves, why invest in a sector where there is little chance of achieving EVA zero, yet alone positive? There is no upside.

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Conclusion

- New Zealand desperately needs greater investment in the gas sector, not least because of its role in electricity generation.
- Regulation is seen as a deterrent by investors who have better investment alternatives.
- Lack of investors will be a detriment to the long term benefit of consumers and the New Zealand economy.
- Powerco plays only a small part in the gas sector.
- Powerco is squeezed by both the supply and demand side and regulatory controls will add a further unnecessary burden on a struggling competitive sector.

Conclusion

Powerco will cease reinvesting in the sector in New Zealand if the opportunity to make better returns is contained.