

**POWERCO**

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## Real Commercial Issues for Powerco (1)

- New Zealand is like a greenfield site (only 1 in 8 electricity consumers have gas supply)
- New Zealand does not have a franchise system
- Powerco is NOT vertically integrated and is disadvantaged by this position against its competitors and other cross owned supply chain providers
- Consumers are looking for a productive output for lifestyle (or business use) eg heat, cooking capability – they are not interested in gas pipelines.
- Consumers have the market power – they have multiple options, and control the delivered service demand and use patterns
- Natural gas is simply an option to deliver lifestyle or business requirements – it is not an essential service

## Real Commercial Issues for Powerco (2)

- Powerco is exposed to “barrier to entry” to extend into the supply chain.
- Distributors have to “market” their business to grow penetration and throughput eg Powerco’s “GetGas” campaign
- “Customer capture” by retailers disadvantages gas distributors
- Political pressure does not reflect economic realities
- Distribution companies are seen as “Patsies” – easy targets for manipulation and control because of “monopoly” stereotyping.

## **The 3 Themes:**

- Current constraints on gas distributors
- Impact of under-investment in infrastructure
- Behaviour of vertically integrated companies

## **Current constraints**

- Delivered service competitors - other energy sources / interfuel competitors
- Physical pipeline competitors

# Interfuel competition (1)

## Other competitive options for consumers

- Electricity
- Fuel oil
- LPG
- Coal
- Wood
- LNG (future)

## **Interfuel competition (2)**

### **Low Volume consumers are disconnecting**

- Following the introduction of Genesis' new gas pricing plans about 400 low volume users in Taranaki disconnected
- When Contact Energy introduced its new gas pricing plans about 2000 consumers in Wellington and Central regions disconnected – most low volume consumers

## **Interfuel competition (3)**

- Interfuel competition constrains transmission and distribution charges
- These charges form only part of the delivered price of gas
- Cost of converting to LPG low compared to cost of converting to electricity (other than for “low” users)
- Non-vertically integrated distributors (like Powerco) will be adversely affected by residential consumers switching to electricity, LPG, or wood (compounded by utility rating)
- LNG not currently supplied in NZ but potentially will be in short-medium term (Murray Jackson, Dominion Post, 26 August 2003)

## Interfuel competition (4)

Consumers are switching from gas to LPG or installing LPG on account of low conversion costs / no fixed daily charge

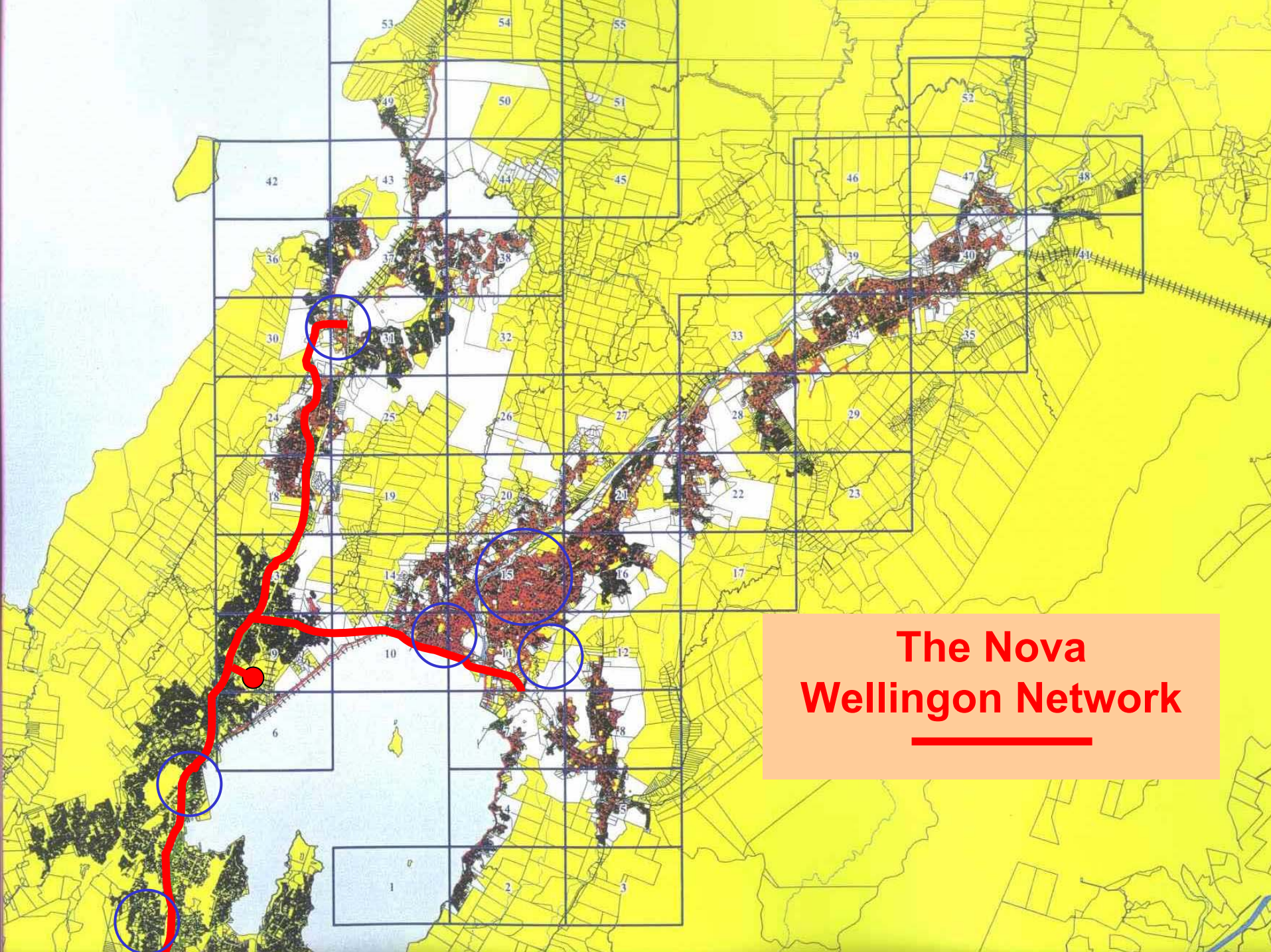
- Connection kit (regulator, hoses and valves) - \$190
- Cylinder rental - \$35 - \$40 (per quarter)
- Appliance conversion (replacing jets and manifolds) - \$200
- LPG 7.64 cents/kWh (no fixed daily charge)
- Compare with costs of natural gas to Contact Energy's residential customers: 4.2 – 15.5 cents/kWh, plus daily fixed charge of 50 cents

## Interfuel Competition (5)

	Fixed Charge (cents/day)	Variable Charge (cents/kWh)
Powerco's line charges	24.53	2.97
Contact delivered gas charges	87.00	5.70

# Physical Pipe Competitors and Customer by-pass

- Powerco faces real competition from the Nova in the Wellington, Hawkes Bay and South Taranaki regions
- Nova also operates in the Auckland area
- Competition with Nova constrains Powerco's prices
- In addition to competition with Nova, consumers living near a NGC gate station have the option of connecting directly to NGC's transmission network



**The Nova  
Wellington Network**

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## Nova (1)

- Nova expanded into Wellington after being given free access to trenches dug for Telstra/Saturn cables in the Wellington area
- Nova acknowledges in its submission (para 3.2) that its networks have materially increased competition in the relevant areas
- Genesis in its submission (para 3.3) commented that Nova possesses the ability to be anticompetitive by means of cross-subsidisation given that it is also a retailer of gas and has access to 'cheap' gas via its ultimate holding company Todd Energy
- Nova can trade as a retailer on Powerco's and Vector's networks to build clusters of customers and then migrate them to its network once sufficient load has been contracted

## **Nova (2)**

Existence of Nova's networks is not evidence of misuse of market power for the following reasons (para 3.54):

- (a) Provision of services to a wide range of customers requires establishment of an extensive distribution network. Pricing for services on such a network where the aim is to recover costs related to shared infrastructure is always difficult and may provide the opportunity for cherry picking of the customer base;
- (b) Bypass has occurred despite the fact that Powerco operates an open access regime;
- (c) There is no history of access disputes between Powerco and gas retailers;
- (d) Nova Gas as a vertically integrated business can cross-subsidise its distribution business

## **Impact of Under-Investment (1)**

- Overseas experience - lack of investment in gas transmission and distribution and “sizing” to avoid regulation:
- How it can be done better – Powerco’s investment in Tasmania
- Recent experience in Victoria

## **Impact of Under-Investment (2)**

- To date, NZ's light-handed approach to regulation has encouraged investment and innovation in the business environment (or as a minimum not discouraged it)
- In more regulated climates, a short-term focus on consumer savings has led to a backlog of vital investment in infrastructure
- Poor quality price control leads to long-term economic danger, illustrated by recent supply blackouts in the United States

## **Impact of Under-Investment (3)**

- Governments have been forced to invest at the stage where it becomes too risky and expensive for suppliers to do so
- Independent analysis is essential to decision making regarding asset renewal and investment
- National economic cost/benefit test should be conducted - the broader assessment should include risk to the government's initiatives and impact of "denied" investment
- Powerco welcomes initiative of the energy research centre based at the Auckland Business School

## Powerco's Australian Experience (1)

- Australia provides significant growth opportunities (>100 years of gas supply)
- December 2002: Powerco selected as State of Tasmania's preferred developer for construction and operation of gas distribution network
- April 2003: State of Tasmania awarded Powerco contract to build, own and operate backbone network to supply key industrial consumers
- September 2003: Currently in negotiations for contract to build, own and operate core urban network supplying domestic and small industrial commercial consumers
- Powerco competed successfully to develop gas reticulation infrastructure (could build network up to 100,000 consumers state-wide = almost 50% of NZ's gas connections )

## Powerco's Australian Experience (2)

- Progressive approach of Tasmanian Government, recognises value in promoting infrastructure investment, focus on broad economic growth and providing consumers with options to further drive competition
- State of Tasmania to contribute \$9m to business set-up and developing Stage 1 backbone network, with balance funded from Powerco.
- Progressive build over 18 months

## Powerco's Australian Experience (3)

- State of Tasmania granted franchise for 7 years and 7 year regulatory holiday
- Removal of legislative capacity to price and profit regulate the gas distribution sector
- Cash contribution by Government to set up the distribution business
- Interfuel competition is constraining force + physical pipe competition following set-up period
- Customers have the market power as they already use alternative fuels (they do not have to change anything)
- Customers have capital constraints and aggressive payback period demands
- Not all customers can take the “long-term” view
- Distributor exposed to real business risks
- Customers demand a range of options

## Vertically integrated companies

- Gentailers (dual energy or dual energy?)
- Vertically integrated distributors

## Behaviour (1)

- When gas supply constrained, dual energy retailers incentivised to maximise revenues by swapping gas between generation and retail businesses. May “shed” gas customers e.g.
  - loss of 400 gas customers on Genesis’ introduction of a fixed daily charge
  - Loss of about 2,000 customers on change of Contact Energy tariff rate
- These retailers have significant countervailing power
- A cut in distribution price will simply result in a wealth transfer to these distributors

## **Behaviour (2)**

- Vertically integrated distributors can cross-subsidise the distribution business (see Powerco & Genesis' submissions)
- Vertically integrated distribution competitors can trade as a retailer on Powerco's and Vector's networks to build clusters of customers and then migrate them to their own network once sufficient load has been contracted

# The BIG Assumptions in the Framework (1)

- Distribution companies will continue to invest into development and construction of gas pipelines (not valid)
- Gas infrastructure maintenance and asset renewal will continue with regulation (not valid)
- Capital Investors can be readily attracted to invest in the sector following regulation (no evidence)
- Gas distribution entities are monopolies except where physical proximity of pipes can be proven (not valid)

## **The BIG Assumptions in the Framework (2)**

- Asymmetric risks are fair and reasonable for the sector (seems grossly unreasonable)
- Sharing of benefits means guarantees for consumers but companies must carry all risk (not balanced at all)
- Regulations must be developed for what companies MIGHT do – the worst case view (not valid)
- Distribution companies can readily extract so-called excessive returns (not valid)

## **Conclusion**

- Gas distribution companies already constrained (consumers have the market power and no capital risks)
- Crucial that asset replacement investment and new investment not prejudiced for short-term consumer gain
- Powerco confident Commission will build a balanced regulatory outcome