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INTRODUCTION

- Powerco acknowledges the particular task which the Commission has been set. However, Powerco has three main concerns:
 - Use of a proxy historic cost based on ODV as opposed to transaction value to value Powerco's regulatory asset base
 - WACC is underestimated
 - Opex (eg, tax expense) is incorrect

STRUCTURE OF PRESENTATION

- Commission's model
- Competitive features of gas pipelines
- Regulatory asset base
- Asymmetric risk and WACC
- Opex (tax expense and regulatory levies)
- Investment risk
- Victorian Experience
- New Government Policy Statement

COMMISSION'S MODEL

- Commission's model like any forward-looking model is only as good as the quality of its inputs
- Modelling future outcomes is inherently uncertain
- Potential for regulatory error because of uncertainty about the multitude of assumptions and parameters used
- Commission has set out 22 parameters (page 49 transcript) which it claims to have treated conservatively. Powerco looks forward to engaging on these in its cross-submission

- Of the 22 parameters, there are three key parameters / inputs which are most material by a significant margin to the outcome of the Commission's model
- They are:
 - Regulated asset base
 - WACC
 - Opex

COMPETITIVE FEATURES OF GAS PIPELINES

- While gas distribution is a network industry and so has natural monopoly characteristics, it is more competitive than the Commission has recognised
- Crucially, gas is not an essential fuel (unlike electricity). Gas is a discretionary fuel
- New Zealand is essentially a greenfields market as the only around 10% of electricity consumers have gas
- Consumers have a great deal of choice in the form of alternative fuels and bypass. Consumers have significantly more countervailing power than with electricity

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- Gas (gas connections) is difficult to market
 - Uncertainty of gas supply
 - No control over delivered price
 - Rising price of gas
 - Embedded network owner / operators
- While new subdivisions generally have higher uptake, have had very poor uptake in some instances (eg, consumers using LPG when gas pipe within 10 metres)
- Powerco together with most other gas pipeline businesses operates an open access regime to its pipelines

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- The absence of a franchise system means that combined with open access, barriers to entry are few
- The costs for an industrial customer to by-pass gas distribution are significantly less than for electricity
 - Gate station about \$500,000 compared with new grid exit point substation cost of between \$5 to \$10 million
- Residential consumer could switch to LPG from gas for about \$200 to \$300

Australian Government Productivity
Commission: Draft Report - Review of the
Gas Access Regime

REGULATORY ASSET BASE

- This was dealt with by Mr Horton
- **Constructing** a regulatory asset base is subject to considerable uncertainty
- Will not repeat his points but Powerco wishes to emphasize that unlike Vector and NGC, it does not use ODV for financial accounting, tax or regulatory disclosure account purposes
- Powerco has no up-to-date ODV valuation (4 to 5 years old)
- Draft gas ODV handbook out of date. Update of electricity ODV handbook has resulted in significant uplift

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- As Mr Horton noted, the use of transaction values ensures financial capital maintenance whereas a mixed approach does not
- Further, Powerco considers that transaction values should be used for regulatory asset base as:
 - avoids uncertainty
 - ensures financial capital maintenance
 - while exhibit natural monopoly characteristics, there are competitive forces at play and consumers have significant countervailing power

ASYMMETRIC RISK

- Professor Bowman noted the range of asymmetric risks faced by gas pipeline businesses
- Powerco's main network is in Wellington – which is a region subject to the risk of damage or loss due to an earthquake
- The cost of insurance of Powerco's assets in Wellington is approximately 10 percent of cover sought (ie, premium = \$100,000 for every \$1,000,000 of cover)
- Means that insurance is not commercially feasible. Full coverage is not available

- The Commission needs to take into account the fact that this exposes Powerco – and its investors – to significant risk

OPEX – Tax Expense

- Powerco welcomes the Commission's acknowledgement that the interest tax shield has been incorrectly applied
- In light of that, Powerco has not presented on that topic. However, Powerco notes that error is adverse to Powerco by about \$1.85 million pa
- Powerco looks forward to the Commission's advice in due course as to how it intends to treat Powerco's figures
- Powerco will respond fully at that time

OPEX – Regulatory Levies

- Powerco notes that model does not take into account any levies payable under new gas industry legislation
- This levy could be significant – several million dollars per annum

INVESTMENT RISK

- In the event that price control is introduced, Powerco will need to consider its options carefully
- Need to justify to CEO and Board why particular investment and renewal decisions should be made
- Other options may be better e.g. converting natural gas networks to closed access LPG networks; invest in Tasmania instead
- In these circumstances, risk of regulatory error resulting in no investment is acute. Commission needs to be more cognisant of these issues

EXPERIENCE IN VICTORIA

- Changes to regulations will require all new homes:
 - to be 5 star energy efficient
 - water tank or solar hot water system with gas as a boosting fuel
- Anticipated that this will result in a reduction in gas consumption by new homes from 60-70GJ on average to 30-55GJ per year
- Estimates are that average consumption of between 30 to 35 GJ per household is required to break even (compared with NZ where average consumption less than 27GJ)
- Regulation may make supply to new homes marginal

GOVERNMENT POLICY STATEMENT

- Now recognised in the draft Government Policy Statement (8 July 2004)
- It provides that the Government is seeking the specific outcome that:
 - Incentives for investment in gas processing facilities, transmission and distribution, energy efficiency and demand side management are maintained or enhanced.

- Earlier GPS of March 2003 did not seek the specific outcome that investment incentives be maintained or enhanced
- New GPS recognises need for investment in gas pipelines
- Reinforces need for Commission to fully take this into account