PRESENTATION BY POWERCO

CHAIR: I'd like to reconvene this session and welcome Powerco and ask you to please introduce yourselves for the record and begin your submission when you're ready, thank you.

MR BARBOUR: Thank you Madam Chair. Madam Chair, fellow Commissioners, my name is Nigel Barbour and I am Powerco's General Manager Commercial and Corporate and with me are Victoria Heine, and John Hancock. When John introduced Powerco's submitters last week he commented that our presentation was split into two, and that the company would be appearing this week to give the company's perspective on the matters at hand.

Given the split nature of our presentation it is possible that we will defer answering questions which relate to our experts' fields of expertise since they're not here today, but we're happy to have them answer it in the cross-submission, it's a regrettable consequence of being unable to make the timing work.

With respect to timing today, as it's really just me providing comments from a company's perspective, with Victoria and John here to chip in on anything particularly that arose from last week, we feel quite confident that we could probably get our comments through by 12 o'clock and have made the points we want to make, if that assists the Commission at all.

CHAIR: I'm sure it will. I don't hold my breath on these things, so we'll see how we go.

MR BARBOUR: And finally Steven Boulton sends his apologies, he would like to have been able to attend in person but unable to do so.

CHAIR: He livens these proceedings up, so we've missed him on this occasion, but we certainly understand why he was not able to be here.

MR BARBOUR: He livens up most meetings he's at. Powerco acknowledges the task that's been set for the Commission by the Minister of Energy and the main theme of my presentation today and the main concerns, from the company perspective, are, in terms of the outputs of the model that you've generated, is the use of in ODV based valuation as opposed to a transaction value to value Powerco's regulated asset base; that the WACC assigned to us is understated and opex in particular a tax expense is incorrect. I'll expand upon these points as we go through. As I said earlier it's very much from the company's perspective and particular questions on the regulatory economics we'll pick up in cross-submissions.

In terms of the structure of the presentation, I'm just going to make some observations on the Commission's model. I want to talk a bit, and this is probably similar with what other presenters have talked about in terms of the competitive features of gas pipelines. I'll then turn to discuss the regulatory asset base. I've got an example of, in relation to WACC, and Professor Bowman made some comment about insurance last week, I'll pick it up in terms of an example of risk. I'll touch briefly on opex in particular, just noting something on tax expense and some new levies that look like they're coming through.

I'm going to make a few comments on investment risk, there's been an interesting paper out in Victoria recently which I haven't had fully time to digest, but had some interesting comment, I'll share some of those, and I want

to touch on the new Government Policy Statement which is still in draft but has changed quite dramatically, or we think, since the Minister of Energy first set the Commission the task at hand.

Like any model it's only as good as the quality of its inputs and as we're all familiar when we're modeling anything, future outcomes is inherently uncertain, and in this case the potential for regulatory error arises as a result of the uncertainty in relation to the assumptions and parameters used.

We note the Commission has set out 22 parameters when Powerco presented last week and they came up on page 49 of the transcript. We'll be engaging on these further in our cross-submission. But when we've looked at them in the few days we've had since last Thursday, in our minds there are really three key parameters or inputs to the model, and if these are not robust, then because of their materiality over the others they'll simply dwarf the effects of the others and any conservativeness in the other parameters will be swamped. Really where we sit at this early stage of our analysis on these 22 parameters, the three that seem key to us are the asset base, WACC and opex.

While gas distribution is a network industry and has natural monopoly characteristics, we're of the view, and this is what we see on a daily basis, that it is more competitive than the Commission has recognised. I was talking with John about it this morning and I said one of the most unusual things from a business perspective is I actually have to market gas connections, I don't have to market electricity connections.

In my mind on a business perspective that tells me something about there is a difference. A new subdivider putting in a subdivision will come to the lines companies in the area for an electricity one. Whether or not they choose to put gas in is something up to them. We generally have to go out to them and talk about it. We do have to market it.

The second point I've got there is gas as a discretionary fuel in New Zealand, it's not an essential fuel unlike electricity. New Zealand is essentially a greenfields market with only 10 percent of electricity consumers having a gas connection. Electricity connections are a little over 2 million with gas connections of a bit over 210,000 in total.

It's interesting to note that if you just compare, say, New Zealand with Victoria for a second and that the average -- and NGC talked about this, I think their presentation was yesterday morning and they had a chart on the average consumption -- but certainly our own modeling is consistent that the average consumption in New Zealand is about 27 gigajoules, yet the study recently, which we'll attach to our cross-submission, by the Victorian Government, is that their average consumption is 60 to 70 gigajoules.

The study is quite interesting, because it talks about -- it takes their regulated for, you know, their gas distributors are regulated as are their retailers. It takes their regulated WACC which is a bit over 7 percent, which we don't agree with, but it takes their regulated WACC and comments that in order for the Victorian distributors to break even reticulating a new subdivision

or development where you've got an open trench, which means you've effectively got no civil works costs, you're just coming along to throw pipes in a trench after somebody else has been in the same trench and put the water mains in and the power and telephone, and with uptakes that are significantly higher than New Zealand, their break-even consumption volume is between 30 and 35 gigajoules per annum, far higher than New Zealand's 27.

Consumers have a great deal of choice in New Zealand about alternative fuels and bypass. I see this on a daily basis in my areas where we have market gas a lot heavier -- much more than we market electricity and we also see it in the market power that, or the countervailing power that consumers have with electricity, in comparison to electricity.

I've talked about marketing of gas, but certainly it is difficult to market. You look at the current climate and Powerco's in the connections game really as a distributor. You've got uncertainty of gas supply, you've got the price that we, or pricing deals we might be offering for new connections, doesn't necessarily get reflected in the delivered price. We're only one part of the supply chain that's then bundled into the final price.

You've got the rising price of gas and you've got embedded network owners and operators who, if you take a residential apartment, there might be only one meter on the road, you can't then if you're in that apartment complex have any choice as to who your supplier of energy is. The owner of the body corporate owner has done a deal, sold the pipes within the network to an embedded network owner who then effectively runs it as a closed

network supplying the individual dwellings within that apartment at whatever price that owner wants to sell them at.

Obviously brownfield conversions or breaking into the brownfield market is difficult with gas and the costs are higher, and from a business perspective we generally focus on marketing gas connections and new subdivisions. We found with experience that you'll get a higher up-take, but even then it has been very poor in some instances.

I know some of our predecessor companies reticulated some subdivisions, I think around, say, 50 lot subdivisions and we got less than 10 connections. You drive around those subdivisions today, there's a gas main going down the street and there's LPG bottles on another 30 houses. Certainly we don't -- it's very much unlike electricity where we lay a pipe down a street, we lay a wire or cable underground in a new subdivision, we'll be guaranteed that everyone will eventually connect up to it, we take a lot more risk in laying pipe in the ground for gas, even in new subdivisions.

The last point on this slide is that together with Vector, ourselves, NGC and Wanganui Gas, we all operate an open access regime to our pipelines.

The absence of a franchise system, unlike Australia and other jurisdictions means that the barriers to entry are very few. If you take -- I did some numbers in terms of an industrial customer in terms of their costs of building a bypass network versus an electricity one. The main cost for a large industrial consumer of electricity and/or gas is your connection to the national grid in the case of electricity, or NGC's transmission system in the

case of gas.

A gate station for gas is about $500,000, whereas for a new grid exit point substation you're looking at about $5 million to $10 million. It's a 10 to 20-fold increase in costs and certainly it means, just on those numbers, that if a large industrial wanted to -- their costs of laying, building their own bypass network aren't that significant when you compare it to, say, an electricity one. So when I look at it from a marketing of it and delivering of gas connections, to me they have far greater power over me than say an electricity one.

In terms of residential consumers, this is just switching from LPG to gas, and these numbers were used last year, 2 to $300, effectively that's for the new jets and manifolds in the house. That's both heating and cooking. Vector had some useful numbers in their presentation I see about costs of just converting cooking which was significantly less and they also had some numbers where one appliance manufacturer or plumber was actually offering to convert for relatively low cost or no cost.

If a consumer just has a gas bayonet heater in their hallway, really other than the cost of -- there is no cost to switch, all they're doing is deciding not to use that gas heater, ringing up their gas retailer, being disconnected, we'll then remove the meter and they just buy themselves a new heater, whatever type of heating they're going to use. Certainly from where I sit, and where Powerco sits, we see that there is significantly more competition with respect to gas than say electricity.

For reasons of length of the slides I haven't put the

full quotes, but we noticed in -- and I don't have the final version of it, it is due out we understand reasonably shortly -- the Australian Productivities Commission's report on the review of the gas access regime. They had some very interesting observations and I can see this is from the draft report, and I don't know what's in the final one although from their website last night they had commented that that report has been delivered to the Minister, so hopefully it will be out soon.

Just to quote a couple of paragraphs from their report.

"the existence of gas pipelines that exhibit natural monopoly characteristics is insufficient to conclude that these pipelines have enduring market power and that they are likely to use, to inhibit competition in upstream and downstream markets. In addition to the supply characteristic, consideration needs to be given to the nature of the demand characteristics for the services of pipelines. A number of competitive forces and factors can impact on demand and constrain market power.

The demand for gas is a derived demand, derived from the demand for the goods or services produced using natural gas as an input. Gas is often supplied to industries that produce commodities sold in competitive market, such as mineral processing and electricity generation. In such industries natural gas can be a significant component of the total cost of production and the end use might be sensitive to the transport price.

Further, large end users may represent a large proportion of a pipeline's capacity therefore have

significant countervailing bargaining power. In addition, gas often has other close substitutes in end use, such as coal. In these circumstances any rise in the relative price of gas is likely to result in significant loss of sales and a decrease in profit, particularly in the medium and long-term, as users reduce their consumption of gas".

Those are just some interesting comments which I thought tended to line up with my personal experiences in terms of running a gas business from the revenue side.

CHAIR: I guess the interesting question will be where they take those observations in terms of their recommendations, in terms of the access regime.

MR BARBOUR: I agree. Certainly the draft report tended to talk about more of a monitoring regime, but you're right, until the final report is out it's just me quoting a few things from a draft report.

CHAIR: I think they're relevant, it's absolutely appropriate to draw our attention to it. What was the date on that?

MR BARBOUR: That was August 2003. They had their conference in February this year and the report was delivered to the Minister in April or May from what was on their website, but the final report is not available yet.

CHAIR: That's what I thought, and the final is likely to have what their actual recommendations are about the future of the access regime if I understand correctly.

MR BARBOUR: Yes. I don't intend to provide or go over the regulatory economic submissions put forward by Mr Horton last week, but I want to make the following points. Constructing a regulatory asset base is subject to considerable uncertainty. We think we're a little bit unique. We don't use ODV in relation to our gas business

for any purpose. We don't use it for financial accounting, we don't use it for tax or regulatory account disclosure purposes. Our ODVs are four to five years old.

When the Commission wrote to us last year and this year for information, obviously we provided some historic cost information, we also provided information based on ODVs, but that was based on those old ODVs using, and including additions valued in accordance with the Draft Gas Handbook which I think had a draft date of around 2000 which now means it's about four years out of date.

Certainly our experience in terms of our dealings with the Commission and the revisions to the electricity ODV handbook is that there has been a significant uplift in values.

CHAIR: Can we quote you on that, that it was a significant uplift?

MR BARBOUR: Yes, we -- I think Steve at the conference in March gave some indication, did he John, on what our uplift was looking like then.

CHAIR: I shouldn't have said that, but sometimes people in other forums tell us that what we did wasn't as significant as it ought to be and maybe that's Powerco's position, but, no, it was a significant uplift, but I guess what the impact will be on analysis such as this has to take account of how that uplift is going to be treated doesn't it.

So while I take your point -- what I wonder in Powerco's case, and you can save me from having to find it in the paper because I know it's here, but not all of the companies use the -- nor do they have to use the Draft

Handbook asset lives or maximum values, and if I recall correctly, and I may very well not recall correctly, I think Powerco was one of the companies who simply took the upper limit of -- took the maximum values always on all assets; is that right, using the Draft Handbook?

MR BARBOUR: There's effectively three ODV valuations that make up Powerco's most recent ones. Two of them, which would account for about three quarters of the value, were done by UNL for its networks and AGL for its network.

CHAIR: They were each done in a different way?

MR BARBOUR: Separately of anything that Powerco did. With respect to what we did for the original Powerco network in its last valuation I don't know off the top of my head.

CHAIR: That's fine. We can go back and have a look at that. But I just note for you the Commission generally didn't take a strict interpretation on staying within the handbook and in many cases where companies did not stay within even the maximum values where they provided the reasoning the Commission accepted that, so the situation with the way we've treated this ODV handbook in this case is slightly different than what happened when we did the asset recalibration exercise on electricity. But I do accept the point that generally companies have felt, in at least some respects, constrained to move too far away from the Draft Handbook.

MR BARBOUR: The point about the lack of an up-to-date valuation and the Handbook is really to illustrate that, in Powerco's case, since the only value that is certain for our assets is transaction values, that in any attempt, because the company has ceased using it, so we haven't spent any time trying to work out what on ODV is, the only

certain values we have are transaction values, and --

MR STEVENS: Do you think it's possible that the transaction values may contain some capitalised potential future monopoly rent?

MR BARBOUR: From a business perspective, no. We believe that there is sufficient competitive pressures because of our greenfields New Zealand market, the difficulty of marketing gas, the fact we only got to 10 percent of all consumers of electricity connection. The ease of people to switch, you know, I've talked about the industrial consumer, for less than $1 million if they were a significant user of gas they could build their own bypass network quite comfortably and they'd chop out the retailer as well as us, buy their own gas directly.

A residential consumer, depending on whether they're just using a bayonet heater or whether they've got, say, an Infinity hot water system combined with a Rinnai inbuilt timber flame heater, the cost of ceasing to use gas are zero to $300. We see consumers walk with their feet all the time. When we presented in September last year and in our submission in August last year we listed some numbers on disconnections. We're still expecting to have about 2,000 people disconnect this year. You don't get that with electricity. We accept gas has some natural monopoly characteristics, but we think for the reasons sort of traversed that there is sufficient going the other way that, no, there aren't any monopoly rents.

CHAIR: Let's put this a different way to you, leaving aside Powerco's situation and even leaving aside the gas distribution network, if we had a natural monopoly that

was not constrained in the ways that you suggest Powerco is, would you accept that the Commission might need to be concerned about acquisition values possibly incorporating an element of capitalised monopoly rent that we simply couldn't just assume that that was not the case, would you accept that just in an in principle case where you do have a natural monopoly with market power?

MR BARBOUR: On the scenario you've raised I would accept the Commission should have a good look. Whether or not that would result in the decision to control I don't know, but I accept you should be inquisitive.

CHAIR: Sure, thank you.

MS BATES: I just want to follow-up on inter-fuel competition and I've asked this question of some other submitters and I don't know how much data we have, I might have to check with the Commission staff, but you've given some figures, you say, of inter-fuel competition at the residential level.

MR BARBOUR: Residential and industrial. The residential one, Vector's actually spent quite a bit of time in their PowerPoint presentation yesterday crunching some numbers. When we did our submission last August we worked it out it was around 2 to $300 for a residential consumer and that would be with hot water heating, cooker and probably a heating system to convert. Because for a residential consumer who wants to keep gas but switch from reticulated natural gas to LPG, what they're really doing is you're disconnecting their meter, then you are putting a concrete pad and putting two bottles on it normally, if you've got that sized load.

MS BATES: I understand that, I suppose I'm interested in the

level of this happening, and, you know, normally if you identify your competitors in the market then you have some idea of how they are affecting your market share in the various sectors in which you operate, and for us to put the weight you want us to put on inter-fuel competition I would suggest that we need that kind of evidence, and I'm wondering if you are able to supply it.

MR BARBOUR: In terms of the exact number of LPG customers we don't have that information. I know we suggested last year that the Commission could use its information powers to gather it. There is a register of people who have LPG and that will soon be updated. What we do know is the people who are disconnecting. We don't know the number who are disconnecting going to LPG, simply because there is no national registry where a retailer -- because LPG is effectively, whilst its bottled it's a closed network, you've got one supplier of the gas and there's no competition for the supplier of the gas and the bottle. So there's no registry in which people can swap suppliers of gas and bottles on. There is a registry of who has LPG at their house. So I can't go into that registry or find a vehicle like that that says, right, they've switched from me because here is their ICP number in the gas registry to here is their ICP number in a LPG registry.

MS BATES: Let's attack it from another perspective then. Is it your residential market declining?

MR BARBOUR: Yes.

MS BATES: We've got the figures, have we, of by how much it's declining?

MR BARBOUR: We had some figures in our submission last year and this year we're expecting 2,000 disconnects with 1,000

new customers coming on. We put some figures on our AGM yesterday which showed that as well, whereas at the same time electricity's gone up.

MS BATES: Yes, correspondingly, so updating stuff would be useful I think.

MR BARBOUR: We're happy to provide that.

MS BATES: What about in the other sectors?

MR BARBOUR: Such as?

MS BATES: You've got commercial, I know 95 percent of yours are residential, aren't they?

MR BARBOUR: Off the top of my head I think about 95 percent of connected parties are residential. We've got -- I can't remember anyone disconnecting in recent times, there's been a few shut down, but I think shut down for economic reasons.

MS BATES: What are we talking about now?

MR BARBOUR: Industrial. I know there is a few who are getting very close to probably ceasing to use gas altogether.

MS BATES: Are you able to put numbers around it at this stage, no?

MR BARBOUR: I'll have to see how confidential those numbers are with my team in terms of the guys marketing it.

MS BATES: If you're going to put up the argument of inter-fuel competition in this sector I suggest you need to put some evidence before us to make us take it seriously.

MR BARBOUR: I might be able to provide price sensitive information, but it is price sensitive to the consumer as well, because we're only one part of the chain and normally we don't price to the end consumer. To the extend the end consumer's shared their pricing with us I

might be able to provide it via a confidentiality order if the end consumer's given us information that's theirs.

MS BATES: That won't be a problem, we can give you a confidential order for that.

MR BARBOUR: It's mainly because Powerco -- it's the retailer that gives them the final delivered price and often we get responses back from the end consumer to say "what does this look like?" and they hand over pricing, it's their information, it doesn't necessarily reflect ours. That's why it's potentially confidential to the consumer. But I'm happy to provide it under a confidentiality cover.

MS BATES: What about -- the other thing I wanted to ask you is, if you could give a profile of the company's revenue by sector.

MR BARBOUR: By sector, whether we segment revenue in terms of electricity and gas?

MS BATES: No, I'm just looking at gas.

MR BARBOUR: No, we don't.

MS BATES: You don't break it down at all.

MR BARBOUR: We haven't provided it in any public forum. The company's held that quite tightly because it's --

MS BATES: I think that would be useful for us to know again on the inter-fuel competition argument which you're putting quite a bit of weight on, we want to see how much it is likely to affect your company.

MR BARBOUR: You want a breakdown of, say, mass market revenue versus industrial revenue?

MS BATES: Yes.

MR BARBOUR: I'm not quite sure how that -- where that adds to it in terms of evidencing a churn in terms of customers. Because connections would give that, would they not, in

terms of number of people coming and going within those categories?

MS BATES: No, not quite I don't think, I think that to see how it actually impacts on your revenue then we'd need to know where you're getting most of your revenue from.

MR BARBOUR: It might be that we can do something, but I might have to ask for a confidential order over that.

MS BATES: I expect you would, yes.

MR BARBOUR: It's quite price sensitive information potentially.

CHAIR: The Commission never expects information like that to be made publicly available. That shouldn't be a barrier here.

MR BARBOUR: If I can think of any other way to answer it too, I'm not sure the revenue one per se will answer it without the connection stuff.

MS BATES: Can you put the revenue stuff in and then if you can think of anything that adds to that then that would be helpful.

MR BARBOUR: Okay. Just finishing off the last slide I had on regulated asset base. Mr Horton, in his presentation last week, noted that the use of transaction value will ensure financial capital maintenance, whereas the use of a mixed approach does not. And that from a company perspective we consider that transaction values should be used as they avoid uncertainty.

We've already discussed this. This is the only value that Powerco has that it is confident in. We haven't run an ODV for any purpose, we would have any particular confidence in it. If we were to use it ourselves, if I was wanting to use ODV in my business today or tomorrow

for something, I wouldn't rely upon one that was now five years old, I'd redo it, I'd probably redo an entire valuation from scratch.

In addition, the transaction values will ensure financial capital maintenance and we believe that because of the competitive forces and countervailing power that consumers have, there is no issue with monopoly rents.

CHAIR: What did you rely on when you purchased the UNL assets, if you had valuations that were unreliable?

MR BARBOUR: Obviously we modeled the entire electricity and gas part, but we would have --

CHAIR: Was it done on a cashflow basis?

MR BARBOUR: Yeah, it was a discounted cashflow model.

CHAIR: It wasn't based on asset valuation at all, or value of the underlying assets, it was done on a cashflow basis, pure cashflow basis?

MR BARBOUR: Yeah.

CHAIR: And you weren't troubled by not having an up-to-date asset valuation?

MR BARBOUR: In essence, yes.

When I introduced I said I'd provide an example of a risk that Professor Bowman talked about where it's not managed in the way necessarily that a CAPM model might hope. Just take one network; all of our networks have a degree of earthquake risk by virtue of where they are. Wellington is a very useful example, sits on a major fault. Most people have read the newspaper and seen that there is an issue getting earthquake cover at all in some places in Wellington, some buildings have had very significant issues.

We, what they call T&D cover, which is transmission

and distribution insurance on wires and pipes, has been unavailable now for a few years. Traditionally material damage insurance will stop about a few metres outside past the gate station or grid exit point, so the main -- where you've got a big substation or a gate station in the case of gas, a few metres beyond that that's where the insurance stops and the network then isn't insured again unless you choose to insure the meters or the zone sub in the case of electricity in between. This cover has been unavailable in the markets for a little while, there's no-one reinsuring it at the moment.

We as part of an overall risk management exercise thought we'd retest the market again this year. We sought -- provided some information to various insurers at Lloyds who confirmed that there was no reinsurer willing to reinsure it and their pricing was 10 cents for every dollar of cover we sought. So if I wanted to sure my pipes in Wellington, then whatever value I ascribed to that they wanted 10 percent of it as their yearly premium. Obviously that's not commercially feasible and that cover isn't available, but investors wear that risk at the moment.

That's a point that Professor Bowman was making about when you get asymmetric risk coming up. This is just I thought an interesting example of where a significant proportion of the value of the network is not able to be insured at anything other than very high rates.

CHAIR: Does the Government's earthquake insurance scheme cover commercial losses?

MR BARBOUR: I think we'll have to respond to that one, I'm reasonably certain it doesn't but --

CHAIR: I just don't know, I've got no idea.

MR BARBOUR: We'll pick it up in our cross-submissions. But certainly for a company like this, because this applies to both electricity and gas assets, it is a significant risk you take. Wellington happens to be unique, there is going to be a big one some time and probably sooner here than elsewhere.

CHAIR: Do you have flood and other natural disaster insurance beyond earthquake?

MR BARBOUR: Not for the pipes and transmission and the wires, no. That became uneconomic in the mid-90s once it really got beyond 1 percent. What we insure is the zone subs, the gate stations, where we own them, buildings and in some instances the meters, particularly the gas meters, they tend to be a little bit more expensive than electricity ones. That we can get, insurers are happy to provide that, but at the moment insurers aren't writing this cover and Lloyds' underwriters who are, are doing it on a rate on line basis.

I've indicated before in terms of the modeling there was really three areas of most concern to Powerco, one was regulated asset base, two was WACC and other than sort of one example of asymmetric risk I haven't provided any comment on that. The next one was opex and particularly tax expense and regulatory levies. On tax obviously we welcome the Commission's acknowledgment on this, we haven't presented on this topic any further here today. I note in passing that the size of the error is about 1.85 million per annum adverse to us and we're looking forward to the Commission's advice on how it intends to treat Powerco's figures going forward.

CHAIR: We've indicated there will be further written consultation on that.

MS HEINE: We had planned for Joanna Perry from KPMG to appear today to address this issue, but in light of the Chair's indication last Thursday we decided not to occupy the Commission's time on that issue, but she will be involved obviously in further submissions down the track on that point.

MR BARBOUR: Another item on opex, since we provided the numbers in terms of our estimates of opex going forward earlier this year to the Commission you'll be aware the Minister of Energy and the Government under the new Electricity and Gas Industry's bill, which is coming to its final reading, gives the gas industry a chance to set up a co-regulatory model, a Government's body. That body will have the power to make levies. One of its functions will be to, in effect, get a registry up and running. The Government's been very keen and talks about it in its Policy Statement.

The levy will probably primarily relate to the cost of that registry. At the moment customers switch gas on the basis of their being, for every open access network the distributor of that network owns and operates the database of record. So you've got four databases of record, electricity you've got one run by the National Reconciliation Manager which reconciles and switches customers through those. So there's moves to improve that.

One scenario which has been talked about within the industry body being set up to be the Regulator, or the Co-Regulator, is the licensing of the business rules and

computer system from the New South Wales gas market company. I know the initial estimates of that per annum are about 2.5 million per annum. That would be recovered via an industry levy. For simplicity that might be recovered at one point in the value chain. If it's recovered from the retailers it doesn't really concern us in terms of an opex item. However, if it's recovered from the distributors, then as Powerco has just under half of all connections, then presumably we'll get half of the levy. Certainly our estimates of opex don't reflect anything of an extra several hundred thousand potentially, over a million dollars in terms of industry levies.

It's a pity Steve isn't here to do this because investment risk is one of his pet topics.

CHAIR: We could probably pretty well imagine that.

MR BARBOUR: As the person responsible for marketing gas and my success in marketing it ultimately determines how much is rolled out, I need to justify that to Steve from my board as to how much investment and renewal investment we'll be doing. Depending on what's ultimately the outcome of this decision and what the Minister does, then I'll be under pressure to look at other options to make sure that every dollar of development and renewal capex is getting the return the company wants, and there are other opportunities for that money, capital is scarce, we've got a network roll-out in Tasmania. At this stage we've got stage 1 with customers connected, stage 2 going up to 38,000, we keep discovering new load all the time there. So it would be easy enough if we're getting better money there to divert the money into development capex there.

A second thing which we're looking at now,

particularly given the difficulty of marketing gas, and an adverse -- in the company's view an adverse regulatory decision might contribute another input to looking at this further is where there are networks, particularly the end of long spurs, transmission spurs, is it viable to close the network completely, turn it into an LPG reticulated network. We wouldn't have to convert any consumer per se. You can inject a bit of oxygen before it goes into the pipes, so from the consumer's perspective they'd see no change. We would save ourselves or save the consumer potentially transmission costs. We would have the capex costs of building the tanks to store the gas. That cost is not necessarily that significant. We would take on a lot more commodity risk in terms of we'd be the retailer, but it certainly would give us a lot greater control of our marketing efforts and trying to increase penetration. I'd be able to control the delivered price and know when I talked to a developer, or householder, or a business about what their price would be, I'd know what their delivered price would be, whereas at the moment I can give them some indication of what the distribution component is, but that's only part of the chain. For people making decisions on converting or staying with gas they want to know a bit more information than that.

CHAIR: Is it just simply because the price of LPG isn't as volatile in the current market?

MR BARBOUR: New Zealand's really unique in LPG. Whether it's because we've got two islands, in some sense it's very similar to the experience we've got in Tasmania where they've had no history of reticulated natural gas and the LPG industry in New Zealand is really strong if you

compare it with say mainland Australia, UK or US. You've got the South Island base where you've got LPG networks in Dunedin, Christchurch, Wanaka, Queenstown, all closed and being run that way and all doing reasonably well. Given the LPG industry in particular a sort of a springboard or base to compete with the reticulated natural gas industry on a much more vigorous basis than it would overseas. Normally you wouldn't expect them to be able to enter that realm. Certainly it's our experience here and it was the experience we anticipated and we're certainly seeing it in Tasmania as well.

I've already talked about this, in the interests of time I picked up this point under my general comments on the competitiveness of gas. We'll provide a copy of this study when we put in our cross-submission. In the last couple of minutes, as I said earlier, the Government has amended its initial Policy Statement which, admittedly this Policy Statement has not been gazetted yet, there is a new s.26 statement still in draft but they are seeking final comments now. It's going to have a new objective, I think in paragraph 2, which sits above the objective for sustained downward pressure, but it will be a new one that says that incentives for investment are maintained or enhanced.

CHAIR: I know you said you weren't going to talk about the experience in Victoria, but I just want to make sure I understand the significance of what you've presented here.

MR BARBOUR: It's an example of illustrating, I suppose, the difference in uptake and volume and break-even points in a brownfield environment with say a greenfield one. To illustrate that we won't get -- if you look at the study I

think the Victorian distributors regulated rate of return or WACC is about 7.1 so it's based on a break-even for those distributors on that WACC.

It's more therefore -- I'd put it in there, some interesting contextual stuff about if you look at that and take the New Zealand experience which is we often don't get access to shared trenches which means that your volume to break-even on that has to go up a couple of gigajoules, up to 5 I think. We don't get the same numbers of people connecting when we do a new subdivision. It all indicates that the break-even point for an investment in New Zealand is higher than, say, the Victorian experience.

CHAIR: It doesn't tell us anything about where the break-even point is in Australia does it?

MR BARBOUR: No. The study does. In the study it's about 7.1.

CHAIR: I assume in this Australian change in regulations that it will result in more efficient use of electricity as well?

MR BARBOUR: I would assume so. Whether it does or doesn't I don't know.

CHAIR: Do you know when the draft Policy Statement is to be finalised?

MS HEINE: I'm not certain, submissions closed on I think Monday, so we anticipate I think it will be relatively soon.

CHAIR: Okay thank you.

MR SELL: I'd just like to just touch on the issue that's been raised already about the use of the acquisition value as effectively the regulated asset base in the Commission's analysis. I am, as I'm sure you've inferred, also from

other discussions with the Commission, quite concerned about the inherent circularity of that. I guess the suggestion is that if party A has this asset and bought it for $100 and then onsells it to party B for $150 then party B is somehow entitled to increase their prices by 50 percent as a result. Could you comment on that issue?

MR BARBOUR: I'll comment on it from where I sit as a business practitioner selling gas connections in terms of the regulatory economics. If I haven't answered it to your standard I will get Geoff Horton to answer it in our cross-submission. But certainly where we sit is we don't believe there are monopoly rents. When I look at my sales in terms of customers, how easily they can convert, the number of customers I lose and simply the customer's power, to me I can't see how I can have any monopoly rent there.

MR SELL: I'm sure you've read in the Commission's Draft Report about the, I think it's the cellophane case, the fallacy inherent in that. I guess I find it a little bit difficult to reject that as a possibility in your situation as well that you may be pricing up to monopoly levels and therefore seeing quite a lot of market pressure, not surprisingly as a result of that. If that's not a simple one to answer now I think we'd be happy to see that addressed by yourselves or Geoff Horton in your cross-submission.

MS HANCOCK: Maybe, Mr Sell, as you weren't here last Wednesday*(sic)* when Geoff was giving his evidence, Commissioner Bates asked almost exactly the same question of Geoff around the -- in a sense the Commission has two problems to answer, there's an sort of efficient pricing

problem and then there's a sort of consumer producer surplus question and they're different questions.

The answer is on page 47 of the transcript from that day, but Geoff's principal thesis is the burden of proof lies with the Regulator not with the company to demonstrate where an investment that was made in good faith at the time and was considered by the company to be an efficient investment is inefficient. So that was the way that Geoff answered it. I think if that doesn't answer your question we can ask him to amplify on that, but it did seem to answer Commissioner Bates at the time.

MR SELL: I think it would be helpful if there was more on that in the cross-submission as well because I think it is a pretty fundamental point.

My other question was about the dynamic efficiency effects and this is something that we have probed a little bit with the other distribution businesses as well. If I was to suggest that the Commission might control the business using a weighted average cost of capital that was effectively the same cost of capital of the business used, just as a scenario, would that make the dynamic efficiency effects or disadvantage go away?

MR BARBOUR: I might -- John, you can chip in at the end of this, but I'm going to sort of answer only part of it. In terms of a company valuing an investment it's all on a project by project basis, so we don't really have a WACC for the overall distribution business. If were doing a network extension to a large industrial, say a wood processing plant, who traditionally their credit risk is quite significant, there the WACC for that project would be higher than if we were doing a network extension to a

500 lot subdivision where the developer was selling the houses with gas appliances already in, because you've effectively spread your credit risk over those 500 and you might have a lag time in terms of when it's filled up, so we don't really have an overall WACC. That probably partly answers it, John could answer the last part of it.

MR SELL: Just before John answers that, I think -- can I just confirm, you do have hurdle rates therefore and you do also -- what I'm hearing is you also take into account asymmetric risk for the particular end users that you're looking at serving?

MR BARBOUR: For individual projects we have an individual hurdle rate, yes.

MS HANCOCK: Was there a specific point about dynamic efficiency you were trying to get to in asking the question about WACC?

MR SELL: What we're trying to get to here is the question of is there an inherent reason why control leads to dynamic inefficiency, or does it only arise because there's an extra and perhaps slightly implicit assumption being made that the control regime in some way will fail to recognise the cost of capital and/or the risk factors of the business?

MS HANCOCK: Again it was something we talked about quite a lot last Wednesday with both Professor Bowman and Geoffrey Horton, where in a control regime clearly companies don't have the discretion to set prices at levels that satisfy their appetite for risk, and that there is considerable uncertainty in deriving an artificial asset value for regulatory purposes where you're effectively making one up out of a bunch of inputs rather than using one that has

been tested in a commercial environment.

I think Professor Bowman's points were quite similar around the discovery of the WACC. I think his point was is there substantial uncertainty, the sort of range of WACC he was talking about was a lot bigger than Professor Lally's range, yet based on similar analytical techniques. So the point about control would simply be, if you're constraining companies within that, clearly quite a lot of investments that are actually efficient -- in a situation where there's a regulatory error, investments which are efficient will not go ahead because revenues will be constrained below an efficient price. So it's a trivial point really, but I think that is the answer to your question.

MR SELL: Yes, okay thanks.

MR ADAMS: In your submission you state that given the distribution costs comprise only a proportion of total cost to end users the Commission should not assume that any reduction in distribution charges will affect total cost or necessarily be passed on to end consumers by retailers. Given the degree of competition that gas faces, isn't it reasonable to in fact adopt that assumption, that in fact any cost reductions as a result of control would be passed on to end consumers?

MR BARBOUR: I think it depends on -- this is really a question on having to guess as to what Genesis or Contact or those parties are doing in terms of where their gas price is heading and others, but it really depends whether they're interested in -- ultimately whether they want to grow the market or not, and it's their drivers. I can't comment on what their drivers are.

I think your comment would be right if it was -- if the market was growing and everyone in it was committed to growing it, because then everyone, then the parties that made up the value chain, transmission, distribution, wholesale and retail, would respond collectively to the price competition from, say, other fuels, but that assumes that everyone is pushing in the same direction.

MR ADAMS: Vector, in its submission, stated that it had an experience where it had reduced its charges to -- in one particular area and that only 50 percent of that reduction was passed on by the retailer to the end consumer. I think it may have been that it was only for a very short period. Do you have any experience similar to Vector's?

MR BARBOUR: Not on the gas side in terms of a simile like that, mainly because the gas price has been relatively stable; some networks have just bought. Our electricity experience would be consistent with that though.

MS BEGG: Just one question on asymmetric risk. I thought the information you provided us was interesting. The way the Commission's modeled the asymmetric risk is to treat the costs of adverse events to incorporate that into the modeling, so you'll find that if the adverse events are similar to what was expected, the Commission's approach will lead to a reasonably neutral assessment of those costs.

The question I have is do you think over the period of analysis that, say, the storm event and other type adverse events have been unusually low or unusually high, because in those circumstances our approach would possibly under or overestimate Powerco's profits. I note on the earthquake event where you're suggesting quite significant

insurance costs, obviously there hasn't been an earthquake, so any potential costs are not included in our analysis and our approach may overestimate Powerco's returns because of that, but I just wondered that in terms of other asymmetric risks what was your feeling.

MR BARBOUR: I'm not sure what I'm about to say is going to answer your question in total. But to talk about the storm, for example, a weather event like that, whilst incredibly severe, tends to affect mainly poles and wires and the cost of replacing those are relatively low and so you've got storm costs in terms of the new poles and just replacement cable and manpower costs. So whilst severe, you're overall costs and impact on the business from a financial perspective is low.

However, the main thing with, say, an earthquake event is its on a completely different scale. It might not affect as large a geographic area, but the area it does affect is gone, and you've not just lost the cheap parts of your network or easily fixed parts, you've lost everything including the very expensive parts, which take a year to rebuild.

If you lost -- I'm more of an expert, or have more familiarity with electricity than gas, so if we lost a grid exit point in a major earthquake or volcanic eruption, it would probably be -- by the time we agreed with Transpower what the specs would be, we ordered the transformers from ABB which are made to order not sitting there on the shelf, you'd be a year or so before it was up and running again. You might have a temporary one installed in the meantime, but you've also in the interim, if it's something so large as a grid exit point or a gate

station, in effect every customer who hangs off the end of that, unless there's interconnectedness is not getting anything, so not only have you got the cost of rebuilding, you've got all your lost revenue.

MS BEGG: That suggests to me our treatment of things like storm events is probably fine because the assumptions -- you do have storm events and they occur from time-to-time, they'll affect cost but not to a large extent. You're just pointing out that it's perhaps more significant for these unusual but catastrophic effects, so perhaps we need to give more thought to that.

I thought your indications of the insurance costs were interesting, and if there was any other information that went to that point I think we'd find that interesting.

MR BARBOUR: I think that's right, I haven't looked at the model itself, but I think the major event one probably require some further illustration and I'll see what I can get from our brokers in terms of supporting information for that.

MS BATES: I take it you don't insure against loss of revenue, or do you?

MR BARBOUR: No, the pricing of that, though, is similar. We did ask at the same time roughly. The problem is trying to model what the loss of revenue is.

MS BATES: That's an uninsured risk.

MR BARBOUR: At the moment, yes.

MS SARMA: In your submission you said the gas business is riskier than the electricity business, you've got effective competition from LPG and bypass. Yet we see that the -- and also that your operating conditions are quite difficult, yet what we see is that the premiums over

ODV paid for gas business are similar to those paid for electricity businesses. So either we are seeing irrational investor behaviour or we are seeing the picture is probably not as dismal. Can you comment on that?

MR BARBOUR: We think the price that we pay is the efficient price and there weren't any monopoly rents built in there, and John commented earlier if that is the Commission's concern then Mr Horton last week provided some comments on who had the onus on those questions.

MS SARMA: Is it more risky than the electricity business?

MR BARBOUR: Yes. I can't lay a gas pipe in the street, you can guarantee I'll get 100 percent take-up, and that to me intuitively says it's a riskier business.

MS SARMA: Why would you pay the same premium for gas as you would for an electricity business?

MR BARBOUR: We think the price we pay was the right price and we don't have the monopoly rents in it, and we've already provided some comments on why we think the ODV's significantly out of date.

MS HANCOCK: I think the use of Mr Horton's advice is that if there's going to be a regulatory test for monopoly profits then all the parts of the building block need to be internally consistent. I think he made some very important points about the depreciation profile for very risky investments. That if you're valuing something at historic cost in a risky environment, then you would expect your returns to be front-loaded to make sure you get your money out before something goes wrong.

And a lot of the history of the revenues for these assets is simply unknown. The Commission has admitted it's tried to create a historic cost value, but the inputs

its used to create that number are not historic costs, they're based on what's called an ODV, but the ODV isn't the same as the sort of ODV that a pure economist might see it as. I had some quite interesting conversation s with Geoff explaining the difference between what he thought an ODV was and what the ODV Handbook that New Zealand uses for the gas industries.

So when you make assertions about a multiple on ODV, in a sense, it's not really telling you anything about anything, it's really just an observation about two numbers.

MS SARMA: That may be so, but the thing is we are comparing between electricity and gas businesses and you're asserting that one business is riskier than the other and given the ODV basis in New Zealand for electricity and gas is on a similar basis because they both came from MED; my question is that given that one business is riskier than the other, would you expect to pay the same kind of premium for both the businesses? I must be missing something in this picture.

MS HANCOCK: The Chair makes the point if your valuation is based on cashflows, cashflows which are disciplined by a competitive market with substitutes, then you don't necessarily need to look at what the regulatory asset value is in order --

CHAIR: I don't think the Chair made that point. I think you should focus on answering the question rather than try to restate what I've indicated, because I think the question is an interesting one.

MS HANCOCK: In a sense yours is an observation about the difference between two numbers really.

MS SARMA: Not difference, I find there is a similarity for me in the two numbers. I'm just puzzled that, you know, if I was an investor and I had two businesses in front of me one was riskier than the other would I pay the same for the riskier business? Probably not.

CHAIR: We'll leave that question with you and if you wish to add further comment on it we'll be happy to receive it. I'm mindful of the time now and I think we probably need to bring this bit to a conclusion. I'll ask if Powerco has any further comments you wish to make.

MR BARBOUR: No thank you, Madam Chair.

CHAIR: I'd like to thank you Powerco. We did spend a great deal of time with the external advisors that you made available to us and we're grateful to the company for that and also for you making the time today so that we could talk about the company specific issues. Thank you very much for your submissions. We'll look forward to the cross-submissions in the next stage.

We're at the part of the proceedings where we are going to go into a confidential session with Greymouth Petroleum. Before we do that I would like to make a few remarks that I normally do after that session, but I don't expect to return for those closing remarks, so if you could bear with me for just one minute I'll quickly cover that before we move into the closed session.

During the conference the Commission has made a number of requests for further information from presenters. The list of information to be supplied will be posted on the Commission's website by the end of tomorrow. I would ask affected parties to check the list and advise the Commission if there are any matters that have an omitted

or inadvertently stated on the list that shouldn't have been. I will now ask that all requests for information are responded to by Friday 13 August.

The second comment I'd like to make is that we would ask that all presenters who have provided the Commission with printed material over the last three days, and of course this excludes confidential material which I think at least Vector provided us with some confidential material, whether they were presentations or additional material, we would ask that you provide electronic copies to the Commission within three working days so that they can be made available on the Commission's website. We'd ask you to e-mail copies to David Steele, please, at the Commission.

Finally the Commission will consider further written submissions following the conference provided they are received by 12 o'clock noon on Friday the 13th of August. Those submissions must be confined to issues or matters raised in written submissions by other parties or raised for the first time at the conference. These submissions will also be placed on the Commission's website.

I will at this time thank everyone who has provided submissions on the inquiry and say that we have greatly appreciated the access to industry, economic and legal expertise throughout the four days of the hearing.

I will at this time also record my thanks to Commission staff and external advisors and note that there is considerable amount of work now that must be taken forward. Also our transcriber and communications assistance has been superb, we are always grateful for the support that we're given.

Finally we have had to do quite a bit of adjusting of the timetable and I would thank all participants for being flexible in that and I believe everyone needs to have the opportunity to be heard and we need to have the opportunity to sufficiently question interested parties and your assistance has made that possible.

So before we go into the closed session I will ask if there are any questions that anyone has before we close the open session. Any question from any interested party? [**No comments**]. If not I will thank you once again for your participation in the proceedings thus far and I will ask that anyone who is not able to participate in the closed confidential session to leave now and I will want to ascertain anyone who does stay has the authority to do so. So if we take just a few minutes please to do this changeover, thank you.

Public session concluded at 12.25 pm,

Resuming in confidential session

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