

1 4 SEPTEMBER 2003

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3 **CHAIR:** Okay, I'd like to reconvene the Conference on the
4 Commerce Commission's Gas Control Inquiry with respect to
5 the Draft Framework paper.

6 The session that we have remaining is a submission from
7 NECG, and I remind parties that we had gotten up to,
8 I believe, professor, your submission that was going to
9 begin on the building blocks analysis; is that right?

10 **PROF EVANS:** Competition analysis, I think.

11 **CHAIR:** Competition analysis; I apologise.

12 **MS BATES QC:** Page 8? That one?

13 **PROF EVANS:** Yes.

14 **CHAIR:** I would be quite happy, Professor Evans, if you wish to
15 just recap where we got to before, but I'll leave that in
16 your hands.

17 So, I'll welcome you, once again, and ask you to
18 continue with your submission when you're ready, thank you.

19 **PROF EVANS:** Thank you, Chair. I'm ready to go.

20 The topics that we were to cover in my presentation are
21 listed there, and it was a review of the economic problem
22 that the Commission is considering. Briefly, a review of
23 the organisational behaviour under incentive based
24 regulation, which might be the position that -- the sort of
25 regulation that might be contemplated for this industry, and
26 we had just finished that second piece where we'd gone
27 through the reasons why, in a monopoly situation, that price
28 cap regulation generally implies delayed investment or lower
29 investment, and we'd discussed the implications of that and
30 the implications of competition in relation to that. We had
31 elaborated on the issue of both the quality inhibition

1 problem as well as the investment problem that can arise
2 under price cap regulation.

3 So, in that section it's summarised as, that there is --
4 the greater the -- if we're thinking about more heavy-handed
5 regulation, because New Zealand is placed, and the gas
6 industry in particular, in a most unusual position of not
7 being regulated heavily, that we would be running -- by
8 imposing more heavy regulation, we would be doing something
9 which, from a greenfields approach, has not been really done
10 elsewhere and so we need to consider the extra costs and
11 extra benefits attached to that and I'm conscious the
12 Commission is aware of that.

13 In that section on organisational behaviour the summary
14 points were that there was prospect for socially wasteful
15 activity to occur in the sense of having divisions and firms
16 re-organised to deal with the regulatory aspect. There was
17 the lower investment issue, which was covered, and lower
18 quality issue, and thirdly, there was the issue of the
19 distraction from getting on with the job in running an
20 efficient business as opposed to getting on with the job and
21 addressing the regulatory parameters in ways that enhanced
22 the interests of shareholders.

23 So, I move from light-handed regulation to incentive
24 regulations and increase in intensity of regulation; such a
25 move can be expected to adversely affect dynamic and
26 productive efficiency; such effects would have to be traded
27 off against other regulatory outcomes.

28 Now, competition analysis. We don't have much to say on
29 an elaboration of what the Commission has already reported
30 on this. We do flag some issues which we think the
31 Commission might make more of. The Commission cites

1 previous precedents that gas energy and other energy forms
2 do not fall within the same market. It in our view time to
3 not perhaps adhere to those precedents and examine them in
4 the light of the material changes in factual circumstances
5 that we now find ourselves in.

6 The critical change is the decline in Maui gas; the
7 market is currently in a state of flux as prices reach a new
8 equilibrium. New things appear to be certain in the current
9 environment; customers cannot acquire gas contracts for more
10 than one or 2 years, that is to say there's quantity risk,
11 significance quantity risk, and prices are going up
12 substantially.

13 In contrast to other fuels, such as coal, have fairly
14 stable prices and can be acquired on long-term contracts.
15 Although electricity prices are increasing, they may not be
16 expected to increase quite to the same degree as gas.

17 I note that yesterday there was some discussion of
18 whether coal prices would increase, but there seems to be --
19 whilst I'm not an expert in this area, I am aware that
20 there's an international market for coal, and so,
21 New Zealand's demands on coal would have to be very
22 substantial before they affected the coal price.

23 Now, customers that are investing in long-lived assets
24 themselves require price certainty about fuel cost,
25 including transport. Put it another way; uncertainty about
26 availability and the price of gas has a cost so when
27 evaluating gas against other fuels, customers rationally
28 take into account the benefits of long-term fuel contracts
29 compared to the more uncertain benefits of short-term gas
30 supply contracts as seem to exist at the present time.

31 Now, the two power stations have already converted to

1 gas to alternative fuels, and we understand from NGC that a
2 number of other gas customers are contemplating switching
3 from gas to coal or biomass in response to rising prices and
4 increased uncertainty. We understand that Genesis has
5 entered into coal contracts going out to 2011, so clearly it
6 sees coal as a viable source for electricity generation.

7 Furthermore, Otahuhu C and EP3, a combined cycle gas
8 turbine generator set at Huntly are on hold pending gas
9 price and supply certainty, while plans are progressing --
10 at least the prints for them -- for a coal-fired generation
11 plant in the South Island.

12 I make one other comment about this; that I think in the
13 present uncertain situation, that new plants will probably
14 be built more flexibly. Huntly can be run, as I understand
15 it, almost changed in real-time between three fuel sources
16 now; oil, gas and coal, and one can well imagine that people
17 installing plants from this time will be perhaps installing
18 slightly costly arrangements that are flexible in a way they
19 haven't in the past.

20 The other notable feature of the gas market is that NGC
21 reports a much greater level of marketing activity to get
22 customers to switch to gas. As the Commission's already
23 been informed, in the domestic market gas pipeline
24 businesses have actively sought to facilitate relationships
25 with channel partners such as appliance retailers and
26 developers in an attempt to convince customers of the
27 lifestyle benefits of gas.

28 Given the relatively immature state of the gas market in
29 New Zealand and low level of penetration, competition for
30 the market is likely to discipline the behaviour of the gas
31 pipeline businesses in terms of the charges being set and

1 the product offerings made to convince customers that the
2 price and non-price advantages of gas are worth the extra
3 capital cost of installing gas appliances.

4 In the residential market where electricity is the
5 default option, gas has to be competitive to get customers
6 to install both, and for domestic customers that take up gas
7 when it comes to replacing appliances given the additional
8 costs of gas appliances over electric ones, gas pipeline
9 companies are at the risk of partial asset stranding where
10 gas appliances are replaced with cheaper electric ones.

11 So, a gas pipeline business is not a textbook monopolist
12 secure in demand for its services. It may be at this point
13 free of regulation and so that it has the choice to invest
14 or not invest, to have a customer or not a customer, but
15 there is competition -- but it is in the midst of a
16 competition to grow the market for gas and maintain
17 incentives for consumers to keep using it when they come to
18 replacing appliances.

19 Overall, we are of the view and the suggestion that the
20 Commission looks seriously at the inter-fuel competition
21 issue afresh now that the price of gas is such that it is
22 making it more problematical for its use in electricity
23 generation.

24 **MS BATES QC:** Can I ask a question. Contact put to us -- and
25 you probably won't agree with it, but this is the statement:

26 "Most gas users by volume find it very difficult to
27 substitute for other fuels because they have large
28 investments in specific assets, and they mention process
29 heat, petrochemical production and power generation."

30 Petrochemical production; it seems that there's not much
31 alternative there, is there?

1 **PROF EVANS:** Right, no.

2 **MS BATES QC:** But we did hear some evidence that for processes
3 we're getting higher levels of heat out quickly, gas is
4 certainly one good fuel, there may be others, and there was
5 some evidence, anecdotal, of people making moves to be more
6 flexible in their plant.

7 We heard some evidence -- not from the generators
8 themselves, who haven't really been represented at this
9 hearing -- but that that alternative means of providing the
10 fuel for generation was being looked at by some of them.

11 I suppose what I want to put to you is, do you think
12 there's sufficient before us yet, or is this really a
13 situation that's saying, this is happening, look more into
14 it and see how much of it is happening?

15 **PROF EVANS:** I think it is definitely the latter, but I think
16 there are very strong indications that the latter is really
17 worth doing well. It's not something that we should rely on
18 in the past.

19 There are, as indicated at the hearing, a number of
20 substitutions for gas that's taking place, and one would
21 expect to see that. Because, as you said, gas is really
22 quite a special fuel, it has low emissions high calorific
23 value and all of that, and as price goes up and it shifts
24 out of electricity generation, it's more likely to be used
25 in final demand or for petrochemical -- you know,
26 something -- some real value added product and that will
27 imply substitution away from other electricity generation.

28 **MS BATES QC:** Yes, the evidence is anecdotal at the moment;
29 would you agree with that?

30 **PROF EVANS:** Yes, it's quite strong -- I think it's quite
31 strong, but it certainly is anecdotal, yes.

1 **MS BATES QC:** And the other thing I wanted to mention to you is
2 transmission costs in those -- petrochemicals and in power
3 generation. Nobody's actually talked to us much about that,
4 and have you got any view on it?

5 **PROF EVANS:** It is -- I think the same sort of thing applies,
6 and I was going to get to this later in my presentation.
7 Would you mind if I return to this in the last section?

8 **MS BATES QC:** Absolutely.

9 **PROF EVANS:** It's a specific question that's been asked, and I'd
10 like to respond to it in that section.

11 **MS BATES QC:** I'll just end by saying that a lot of the
12 submissions that have been made to us relate to competition,
13 inter-fuel competition in the residential area and in the
14 SME and a bit bigger areas, not the great big users.

15 **PROF EVANS:** Yes, I think there will be some special purpose
16 users, as you've identified, that substitution's not really
17 feasible, but across a wide range there will be degrees of
18 substitutability across the range of uses. And, as you say,
19 domestically and also in electricity generation, I think the
20 substitution is demonstrable.

21 **MS BATES QC:** I think we need to look a bit closer at
22 electricity generation, but that's -- you know, we can come
23 back to that. But, thank you for that.

24 **MR BIELBY:** Can I make a very brief comment, I won't elongate
25 this. I think our friends at Contact were very fair
26 yesterday, they said they are also getting their heads
27 around, in this Inquiry, making some initial comments. But
28 I think you might well go to them and ask them how easy it
29 is out in the industrial and commercial market at the
30 moment, so I think that would be a very good line of
31 inquiry, and I'd be very surprised if they had any majorly

1 different answers.

2 Just secondly, I remind you, we did in our presentation
3 do an initial sketch and we definitely should pad it out for
4 you; we looked at the generation area, then industrial, then
5 the residential, and --

6 **MS BATES QC:** Yeah, I think what Contact were really aiming at
7 was the sort of higher, really great big users, and the
8 feasibility there. That brings in the generation, and there
9 was some evidence that there are alternatives being sought -
10 - a bit of evidence about generation, but just a question
11 about looking a bit further of that aspect of it.

12 **MR BIELBY:** I think you could, and again, without elongating:
13 To put a hard edge on this, if you were to get a major
14 industrial user in the door at the moment, and say, if you
15 put a tender out recently for gas, how easy is it to get gas
16 and get competitive terms, they'd say it's a very very tight
17 market. And at the generation level, I think the key point
18 we made to you was that, we've had this flexibility around
19 Maui for a long time and this evidence that indeed people
20 are looking at coal, they're looking at oil, is very strong
21 evidence of the tightness of the market and the constraints.

22 **MR STEVENS:** Just one follow-up question, when you're coming
23 back to Commissioner Bates' question; it was what you
24 mentioned on the benefit of gas in terms of high calorific
25 and low sulphur and dioxide emission basis. Have you
26 thought about the issue of potential carbon tax imposed on
27 that and how that would measure up against the alternative
28 fuels, such as coal and wood?

29 **PROF EVANS:** I don't have the technical knowledge to say what
30 the effect is if the carbon tax was a specific -- if it was
31 generic to carbon. But, on the face of it, relative prices

1 will change as a consequence of that, and we really don't
2 know what the level of that tax is.

3 **MR STEVENS:** On the basis that, if from your comments before, if
4 you're saying that gas is better in terms of calorific value
5 and lower emissions, then one would expect that, if carbon
6 tax was introduced, it will make the relativity between gas
7 and those alternative fuels even wider, which will make
8 substitutability even harder.

9 Would you agree with that?

10 **PROF EVANS:** No, because if gas is low on the tax front, then
11 coal will be high on the tax front. So, the relativities
12 will squeeze a little bit between the two, on the face of
13 it. Gas is, you know, depending on where they stand; of
14 course, if the price of gas is higher than coal now then, it
15 will squeeze. If it's lower than coal now, then it will go
16 the other way. But you'd expect, I think, a carbon tax to
17 have a larger effect on coal.

18 **MR STEVENS:** Which would make it harder to substitute, would it
19 not?

20 **PROF EVANS:** Yes, you'd have a higher hurdle to jump, that's
21 right. But it could be, looking forward, that -- and
22 indeed, if you take coal, the world price of coal is sort of
23 the world price of energy -- suggesting that but, you know,
24 some indication of where we're going here. It could still
25 end up expensive even allowing for the carbon, if it's price
26 properly on the coal, that coal might still be the choice
27 for generation.

28 **MS BATES QC:** Could I just come back to -- I'm sorry, I don't
29 want to interrupt your flow, but just so you know where
30 we're thinking on the transmission question which we've
31 heard not a lot about so far. How important is that and,

1 you know, where does it fit in with the price of the gas
2 that's paid by the generators? Is it something they're not
3 going to be particularly worried about?

4 **PROF EVANS:** No, I think they'll be worried about it, and I
5 think that any new plant that goes in will have a
6 contestable delivery mechanism for gas.

7 **MS BATES QC:** Yes, there has to be.

8 **PROF EVANS:** So, that will affect the price of transmission to
9 them.

10 **MS BATES QC:** Yes.

11 **PROF EVANS:** And it will be a long-term contract as well,
12 because there's no sense, you know, we discussed before,
13 having a short-term contract --

14 **MS BATES QC:** If you're looking at a decision as to which fuel
15 to use and you're looking at your cost of putting in your
16 plant to use it or to be flexible, you're looking at your
17 payback, you're looking at your certainty of supply and what
18 the price is likely to be and whether you can lock in a
19 price long-term, which doesn't seem to be all that easy with
20 gas at the moment.

21 I was just trying to work out where in that mix does
22 actual cost of transmission come in? Is it such a little
23 proportion of it that it's not being taken into account in
24 that mix that you'd look at whether you're going to switch
25 or not?

26 **PROF EVANS:** No, I think it would be important, but I think also
27 it would affect the choice that you would make. I think it
28 would be an important element, but off the top of my head I
29 don't know the import of that.

30 **MS BATES QC:** Would you agree, you might need to do a bit more
31 work around that?

1 **PROF EVANS:** What we're talking about here is, instead of
2 Contact say, or whoever its in Auckland building a gas
3 plant, they build a plant that can accept several fuels.
4 That will have several effects. One is, they would still go
5 and try and get the cheapest delivery of gas to that plant.
6 Secondly, the gas pipe suppliers to that plant would know
7 that if they priced it at all highly they're going to be
8 stuck with the plant using coal or oil, so there's inter-
9 fuel competition that's constraining them there.

10 The more I think about it, the more I think that it
11 would just be business as usual; that, if you are
12 establishing a new plant, you would try and get the least
13 cost way of -- you know, if it was gonna have gas --

14 **MS BATES QC:** That's if you're establishing a new plant, and you
15 may have different considerations than you do when you've
16 got large costs sunk in, you know, in a huge plant and
17 you're having to make a decision as to which way you go
18 then?

19 **PROF EVANS:** That's right, but then -- that's exactly right, but
20 then the transmission costs will be a factor in choosing
21 which fuel you go for.

22 **MS BATES QC:** Yeah, okay. Thank you.

23 **MR STEVENS:** Just one follow-up question, if I may, please. In
24 your view, do you know if it's better to build the --
25 looking at the generation plant; would it be better to build
26 the generation plant closer to the gas source and possibly
27 avoid the transmission issues, or would it be better to
28 build it closer to where it's ultimately going to deliver
29 the electricity to, and to transport the electricity?

30 **PROF EVANS:** That's a very interesting question. The thing
31 about gas is, it has very low transmission losses.

1 Electricity has quite high transmission losses, relatively,
2 and so it would depend on the calculation of course, but I
3 think the relative transmission losses would enter into that
4 calculation. And so, I'm not sure what the outcome would
5 be, but it seems likely that with a contestable delivery of
6 a pipeline, as was happening with Otahuhu B, that the plant
7 would end up in Auckland and the gas would be shifted to
8 Auckland, off the top -- you know, off the top of my head.

9 **CHAIR:** Have you attempted to do any sort of SSNIP analysis?

10 **PROF EVANS:** No.

11 **CHAIR:** You, presumably, have access to the information you'd
12 need do that?

13 **PROF EVANS:** Yes. I rely more, I think, on the sources of
14 competition for pipelines. I have to conceptually think
15 about how SSNIP works when you've got a 65 year old asset,
16 you know, in the ground, and at the moment I can't give you
17 a clean answer on that.

18 **CHAIR:** Okay. Can I just ask you; in a market like this, we've
19 heard a lot of evidence which was useful on what sort of
20 price changes you see for transmission distribution, when
21 suddenly one of these companies, a supplier, faces the
22 prospect of someone switching because of a bypass
23 opportunity or an alternative fuel. We were told at some
24 point that the change in price could be often even higher
25 than 20%. I found that quite a revealing bit of
26 information, that you see that sort of price shift, and that
27 it happens; you know, that it can build up to the point
28 where it is much and more than 20%, from what was said.

29 A lot of the evidence that we've heard, along of the
30 lines of the things you think we should look carefully at,
31 was sort of leading me to think, yes -- and I agree, we do

1 need to look at it, we need to revisit some of the issues
2 here and we can't rely on precedence.

3 However, when I hear a number like that, it really
4 causes me to stop and ask; well, there may be lots of
5 specific cases that we can come up with where there is
6 bypass possibilities, or where alternative fuels come into
7 play, but I really wonder how much it constrains the overall
8 market when you see these very sizeable changes at discrete
9 points in time.

10 I just really would like your comment on that
11 observation that we had yesterday, about 20% and more price
12 changes.

13 **PROF EVANS:** I think that you would expect to see significant
14 price changes in sort of isolated places where you have
15 large -- and I think they were industrial customers, or
16 large concentrated entities that can strike a deal and
17 actually do have an alternative. And so that, they are a
18 credible threat, more than a credible threat, to the
19 standard, you know, gas delivery approach. And so, in those
20 circumstances one could expect to see, you know, I think
21 significant price discounting.

22 In a way that's -- if it's well below what's required to
23 maintain that bit of -- certainly, it won't be below the
24 variable cost, but if it's high enough to cover the variable
25 cost, it could be in essence stranding that piece of
26 equipment, but they're getting some return on the stranded
27 piece of equipment; it would be stranded otherwise if they
28 did not take that action, stranded completely.

29 So, as to the extent to which it constrains the network
30 as a whole, I think that's just one element and it is
31 indicative that bypasses of all kinds, fuels, new pipes and

1 so on, is really important in disciplining pricing. So,
2 it's just a question of, you know, how you assess that right
3 across the market.

4 **CHAIR:** But in a market where you have site specific contracts
5 that can vary considerably to contracts you have in place
6 with a vast majority of your business, how much constraint
7 is that at the end of the day? It may be increasing, but it
8 may still be off a small base and it can be isolated.

9 **PROF EVANS:** Well, it could -- again, you have to look, as we've
10 just said, right across the network and see what constraints
11 are facing them in the other areas of other customers. They
12 may not nearly be so dramatic as that, but if they can cover
13 their variable cost, then they should go down at least to
14 that level on economic grounds, and it does show that in
15 certain elements at least of their network that they have to
16 dig quite deeply to retain customers.

17 The question that I think you're asking is, what's it
18 like across the rest of the network, and that goes to the
19 competition issues that we've already been discussing with
20 respect to consumers and commercial customers and so on, and
21 it won't be obviously so dramatic there, but it needs to be
22 evaluated.

23 **CHAIR:** I wondered if you could -- you talked a bit about sort
24 of evidence you want to look at when you do competition
25 analysis, and I want to get a sense of how you would think
26 about and compare the competitive constraints as they apply
27 in the distribution market as compared with the transmission
28 market.

29 I mean, we've kind of got it all here together, and in
30 fact I wonder whether we don't need to try to pry it apart
31 and ask ourselves first, what are the competitive -- what is

1 the competitive environment that we need to look at in terms
2 of distribution; what is it in transmission?

3 You know, I found much more powerful arguments, I think,
4 about the distribution part of the market than I have the
5 transmission market.

6 **PROF EVANS:** I think the transmission market still, if you are
7 trying to grow distribution, the transmission is part of
8 that. And so, the final demand substitution possibilities
9 that exist for gas, you know, are derived through the
10 distribution networks as well as to the transmission
11 networks.

12 In addition, the transmission networks have the specific
13 large customers that plug into them as well, and so, I think
14 the same sort of argument as we've been putting forward
15 applies, that one is looking at the potentiality and
16 actuality of substitution that's taking place in those sets
17 of pipes, if you like. But, the transmission pipeline, the
18 demand for it is a derived demand from final demand just as
19 with the distribution, and so, inter-fuel competition is
20 important there as well.

21 **CHAIR:** In what ways are the constraints different? Can you see
22 any way that you would say, well -- I mean, I don't know if
23 it's your proposition that we should just treat distribution
24 and transmission together as if it's one market, or do you
25 accept that they are two different markets and they have --
26 there's different competitive elements at play in the two?

27 **PROF EVANS:** I think there's aggradation, unfortunately. At the
28 extreme end, yes, they are different, but it's really hard
29 to say where you would pull the line -- you know,
30 differentiate except on an arbitrary basis.

31 **CHAIR:** So, would you treat them as one market or would you

1 treat them as --

2 **PROF EVANS:** I'm still thinking about that Commissioner, yes. I
3 think I'd be inclined to treat them as one, that's my
4 reaction to your question, but I think it's worthy of
5 thought as to whether or not they -- the question that was
6 raised before, about where you would put an electricity
7 generator, for example, is a constraint on transmission
8 pricing. It's the same sort of thing as, where would I
9 locate a large commercial entity within a distribution
10 network. That's a constraint on the distribution end, just
11 in the same way as, shall I generate the electricity in
12 Taranaki or shall I, you know, generate it in Auckland; that
13 is a discipline on the pipes -- you know, the transmission
14 system.

15 **CHAIR:** Yes, we can identify a lot of specific things that might
16 be a discipline, but whether it's a sufficient constraint --

17 **MS BATES QC:** At the moment.

18 **CHAIR:** -- in a competition sense is a different matter, and
19 this is what I'm struggling with the evidence thus far; it's
20 a bit piecemeal and, I'm sure, as you know, in any market
21 you can find all sorts of evidence, but whether it's
22 sufficient to add up to a constraint that meets a
23 competition test is the matter we have to deal with. And,
24 I've yet to see the evidence to answer the question one way
25 or the other.

26 **PROF EVANS:** I think one area in terms of the potential
27 regulation is the issue of investment, and if there's new
28 investment in transmission, then obviously that will be
29 contestable, and given that that's potentially contestable,
30 given that that would be the actuality, that that
31 potentiality there will affect or should affect the pricing

1 of, you know, existing transmission.

2 **CHAIR:** Yeah, I wonder if that really holds in a market that is
3 not generally growing. So, there may be investment
4 opportunities where there happen to be new fields, but the
5 rest of the market is declining in a sense that the amount
6 of gas to go through may be quite stagnant, and why anyone
7 would contest the bit that is stagnant and arguably going to
8 decline in importance, I'm not sure.

9 **PROF EVANS:** I think, if we don't find gas, then --

10 **CHAIR:** That's right, there's not gonna be a lot of contesting
11 that business.

12 **PROF EVANS:** That's right, but on the other hand the gas pipes
13 are not going to be fully utilised either, and there's going
14 to be an awful lot of stranding, and if we find gas anywhere
15 then we're going to have the sort of decision that was
16 suggested before; do we put a gas-fired generator down in
17 the Wairarapa or do we put it in Auckland, which does imply
18 a constraint.

19 **CHAIR:** I just want to go back to one other question where you
20 were talking yesterday about performance under different
21 types of regulation, and even for the purposes of the
22 control Inquiry we will have to specify some form of
23 regulation to base the analysis on.

24 Certainly in the past the Commission has tended to
25 signal that it would use a CPI-X sort of form of regulation,
26 yet we see in the electricity area with the lines companies
27 that, well, at some point there may be a form of CPI-X
28 regulation if companies breach the thresholds and then fall
29 under control as a result of an investigation.

30 The regime that it seems to me that's primarily
31 impacting on the company's performance and their responses

1 is the threshold regime, and I'm trying to come to a view on
2 how we should specify the counterfactual and the factual in
3 terms of, well, what form of regulation is likely to be
4 there. And, whatever we think about the threshold regime,
5 that is what the Government has previously put in place for
6 electricity; it might be reasonable to assume -- though I
7 certainly have no prior knowledge of it -- but if control
8 were recommend it may be that that's what they would use in
9 this case as well, a targetted regime rather than a
10 necessarily universal regime.

11 Do you have any sort of view on what we should use as
12 the form of control to base our comparison on?

13 **PROF EVANS:** I think in general terms that, to talk about either
14 threshold or price cap is getting quite specific and that as
15 a counterfactual I think one would just think about
16 incentive regulation with a price cap set according to the
17 characteristics of the industry somehow as a first working
18 proposition.

19 It seems to me that the next step is the step of saying,
20 how do we implement this thing?

21 **CHAIR:** I agree, but you can see quite big implications that are
22 left unclear by that, setting it at a very general level,
23 and if I might -- one of the issues you raise and rightfully
24 so is impact on investment, and yet we know the different
25 ways that price cap regulation is implemented can have a big
26 impact on a lot of these matters, and it's not a simple --
27 it's not just simply driven by whether it's price cap or a
28 light-handed form -- the form.

29 So, for instance, if you look at a regime that has large
30 P naught adjustments, you might suppose that has all sorts
31 of effects that you just don't get in regimes that don't

1 have it, and they could be quite sizeable; they could make
2 the difference between -- things like that can actually
3 completely change whether a test is met or not met.

4 So, while I agree in principle it's better to keep it at
5 a higher level and try not and get into too much detail, the
6 actual specifics can make a big difference to the outcomes.

7 **MS BATES QC:** Following on from that -- do you want to continue?

8 **CHAIR:** Well, I just want to hear what Professor Evans says, and
9 then we'll come back.

10 **MS BATES QC:** Sorry.

11 **PROF EVANS:** I agree with you entirely, that basically the
12 question of mechanism design, that the design, even the
13 little bits, really really matter and have a significant
14 different sort of effect.

15 When I talk about price cap regulation, incentive
16 regulation, you're looking at starting off at the point
17 where you think, you know, we have a viable entity going
18 forward and a way in which one could have those prices
19 maintained or whatever it is over time some way.

20 I think if there's a major major where you have changes
21 in a regime, not just the sort of problem that it gives
22 uncertainty back to the company and it gives uncertainty to
23 the people regulating, but it also gives uncertainty
24 downstream, because it makes it very hard for parties to
25 write long-term contracts if they don't know -- you know, if
26 they can't set those in place.

27 I do know that -- well, I understand that Transpower's
28 pricing policy, for example, where they go back and change
29 the price according to overs and unders, is an issue about
30 having a long-term firm arrangement for interconnection, it
31 will be the same for gas, that enables someone like who's

1 putting in a generator to actually budget for the charges.
2 And so, I think that that's a major issue in whatever scheme
3 would be put in place as a price cap scheme, if it was to be
4 that, that allowed for stability over time.

5 But, getting to specifics, more specific than that, at
6 this stage I would be uncomfortable.

7 **CHAIR:** Yeah, I completely accept that. I guess that when I
8 heard the submission on comparing light-handed with heavy-
9 handed, I don't really have difficulty with anything that
10 was said. However, I do know that when you actually come to
11 do the cost-benefit analysis, you do have -- you know,
12 implicit in some of the assumptions you make, there can be
13 quite different views about what price cap actually means,
14 and at some point -- I've always believed that you should
15 make these assumptions as transparent as possible, but then
16 you risk this problem that it appears that you're doing what
17 is the next step rather than the current one.

18 **PROF EVANS:** That's right.

19 **MS BATES QC:** Sorry, I apologise for interrupting you, because I
20 just was thinking about something I hadn't anticipated that
21 you hadn't given the answer.

22 But just carrying along from my colleague's questioning,
23 and coming to the benefits and costs test; bearing in mind
24 I'm not an economist, but if you don't have some specificity
25 around what sort of regime you might put in, then it may
26 have quite an impact on what the costs are when you're doing
27 your costs benefit test, it seems to me.

28 And I just wanted to ask you about that, because it's
29 something that you've actually referred to when you're
30 talking about costs of control. You say, "meaningful
31 benefits and costs must be estimated directly". So, how

1 does that fit in with not being too specific about it? And
2 I suppose that's my long-winded way of asking the question,
3 but do you get the point?

4 **PROF EVANS:** I do, thank you, and I think it relates to the
5 earlier question to a degree. Against light-handed
6 regulation already -- I mean, any regulatory form has
7 Ministerial oversight, any of them, it doesn't matter
8 whether it's -- in some sense, more or less. And so, under
9 a light-handed regulation you have -- the firms in the
10 industry are being generally watched, one might argue how
11 tightly it's being monitored, but you could imagine, as is
12 happening now, that the industry could have been examined at
13 any time and things change. So, in a sense there is always
14 the threat of some kind of regulation sitting there, so
15 under light-handed regulation there's a threat but it's just
16 not specific in any sense.

17 When I mention price cap regulation, I think it wouldn't
18 matter too much how you implemented it as to its affect on
19 investment. It would almost certainly have some deleterious
20 effect on investment. There's a whole literature in trying
21 to -- how can you regulate these firms and get them to
22 invest at the same time? And this literature is generally
23 saying that, if -- and New Zealand is a very unusual case.
24 If you start out with light-handed regulation and impose any
25 form, even if it's P naught being emphasised differently or
26 the price cap being chosen differently, that inhibition will
27 affect investment in some way.

28 So, what we're suggesting there is that one might think
29 about trying to estimate, assess, for example the say,
30 welfare costs in delayed investment and things of that kind.
31 Now, it's highly problematic because you don't -- you have

1 no actual data to put that against, except a few particular
2 studies that have been done in other industries about
3 dynamic efficiency and so on, but it's something to be
4 estimated directly.

5 The reason that we were less happy with saying let's
6 scale the benefits, say, is that -- you know, to find
7 perhaps they're reduced by some costs is, it sort of
8 prejudices the idea that the benefits will be greater than
9 the costs, and we need some sort of handle on each one
10 separately.

11 **CHAIR:** Thank you for that. I don't think that's an easy point
12 to agree to, but we always find it a problem finding the
13 alternative approach. Maybe we should continue with your
14 presentation; we'll come back to that point, I'm sure.

15 **PROF EVANS:** The Commission's also identified there may be other
16 constraints on pipeline owners such as bypass and
17 countervailing power of buyers. At this stage the
18 Commission appears to have concluded alternative energies
19 that may or may not constrain prices. What we would suggest
20 is that the Commission take a view of these factors in a
21 collective sense. For some customers it may be the ability
22 to switch to alternative fuel; for others it might be the
23 ability to enter into a long-term contract, and for others
24 it might be the availability of bypass options. Considering
25 all these factors together, it could well be prices that are
26 constrained to the competitive level -- prices are
27 constrained to the competitive level.

28 To sum up the key points we would make on the framework
29 for competition is that there is now considerable evidence
30 to revisit the question of competitive position of gas in a
31 potentially wider energy market. That demand for gas

1 pipelines is derived from gas, thus substitutes in demand
2 for gas are substitutes for pipelines, that the competitive
3 constraints on gas pipeline owners need to be viewed in a
4 collective sense -- and I think we've already discussed
5 that -- and that there would be significant growth in gas
6 for final demand, that pipeline investment will be required,
7 there's no reason why this investment will not be
8 contestable regulatory institutions permitting.

9 One can only conjecture about what the future of gas
10 actually is, but if it is used more in final demand then
11 there will obviously be some more investment in distribution
12 required; if not, in transmission.

13 I now turn to the building blocks analysis. The
14 Commission's proposed a building blocks analysis. The first
15 question that immediately arises is how to define the nature
16 of the business and calculating costs and revenues. A
17 standard problem is the use of accounting information to try
18 to determine economic costs and revenues.

19 Theory suggests the use of the avoidable cost allocation
20 mechanism to establish the stand-alone costs of the relevant
21 business. It's important to use the stand-alone cost basis
22 because costs of contestable and separable activities should
23 not be caught in the analysis. For example, the costs of a
24 retail business should be excluded from the analysis because
25 over time it might be that retailing is best undertaken by a
26 stand-alone multi-utility retailer. Regulating on some
27 other accounting basis, such as fully distributed costs
28 which is an arbitrary allocation of costs over business
29 units, would potentially prevent businesses from selling off
30 business use through other investors who could run them more
31 efficiently.

1 Once the economic costs to the pipeline businesses are
2 determined there is still likely to be difficulties in
3 determining the efficient costs of notional new entrant and
4 making a comparison with actual prices and revenues on a
5 backward-looking basis. A large component to the building
6 block analysis is in determining the efficient level of
7 capital recovery over time.

8 NGC's other experts will, it's got here, but I will say
9 "have" discussed the nuances of determining WACCs and
10 reasonable margins associated with different types of risk.

11 We would just mention two or three points. While the
12 WACC apparatus is a forward-looking concept, the Commission
13 is necessarily evaluating performance on a backward-looking
14 basis. Economic profits can turn out to be different to
15 costs if the forecast demand levels of expenses turn out to
16 be different than expected and, as we've seen, demand is
17 quite volatile.

18 Investments are made with hurdle rates in mind and not
19 simply made when a project is MPV positive based on a simple
20 WACC. If events turn out better or worse than expected,
21 then that is a reward or a cost to investors who have had to
22 take the investment risk. Indeed, hurdle rates that exceed
23 the WACC are likely to be consonant with replacement cost
24 price setting and required to induce timely investment.

25 This issue, of course, is important in gas or relatively
26 more than important, I would argue, because pipelines have
27 no constraint on whether or not they supply customers.
28 There's no universal service.

29 Given the constraints on data availability, and in
30 particular the fact that the Commission will only be able to
31 observe the profitability of a period less than the economic

1 lifetime of pipeline assets, suggests the Commission might
2 be cautious in interpreting the results. One important area
3 to be cognizant of is that pipeline assets under the ODV
4 regime are depreciated over the physical life of the assets,
5 which can be up to 65 years.

6 The possibility of asset stranding, given the status of
7 gas as an optional fuel, must be considered to be high and
8 some form of accelerated depreciation and modification for
9 uncertainty about this would actually be more sensible, but
10 perhaps not be permitted by accounting convention or ODV
11 rules.

12 That's just a reference to the debate that took place
13 yesterday between Dr Lally and Professor Boyle.

14 **CHAIR:** Professor, can I just ask you to speak a little bit more
15 slowly for the transcriber? Thanks.

16 **PROF EVANS:** Apologies. One way to check on the limitations of
17 the building blocks analysis is to attempt some form of
18 international benchmarking to check on the building blocks
19 results. This would provide the Commission with a check on
20 whether gas pipeline prices in New Zealand are out of line
21 with other countries appropriately normalising for cost
22 differences.

23 I'm the first to acknowledge that such a process is also
24 extremely difficult and fraught, but there might be certain
25 comparisons that could be made that would buttress the
26 results of a stand-alone analysis.

27 We note that consideration of benchmarked price
28 structures themselves might be informative about the
29 industry's performance, but that because multi-part tariffs
30 are common, price comparisons are fraught with interpretive
31 difficulties unless the structures are the same or an

1 exhaustive set of comparisons are made.

2 Where you have multi-part tariffs, as has been discussed
3 before, you get much more efficient outcome than where you
4 have the textbook monopoly single price situation. That's
5 fine. The problem is, that it's very difficult to make
6 price comparisons because the different elements of the
7 charges yield different demand. If there's a high fixed
8 charge, my demand is different than if there's a low fixed
9 charge, and the very different bundles that are consumed
10 under this make the comparison extremely difficult, but
11 nevertheless the existence of multi-part tariffs in their
12 shape might be informative to the Commission about the
13 performance of the industry.

14 There is some evidence, and some argument to say that
15 the more competitive the industry, perhaps the more
16 elements -- the variable charge is important, but it might
17 be worthy of investigation, just the structure of charges,
18 as to understand better the performance of the industry.

19 I'd also make one other point, I think, about charges
20 and that is that long-term contracts are important in this
21 industry, as with any of these electricity or gas
22 industries, and that in those sorts of situations the
23 tariffs themselves which last for quite a long period have
24 to be considered in their contribution to the take, if you
25 like, because they confer either a benefit or a cost to a
26 company that is not, you know, immediately obvious from just
27 looking for its up-to-date tariffs.

28 Of course, benchmarking can be very difficult so some
29 form of literature search to see what other success --
30 others have had in benchmarking the gas pipeline sector
31 would be appropriate before committing resources to such a

1 study, but it's probably -- well, it is a reasonably
2 plausible way, with lots of caveats around it, that the
3 Commission might be able to gauge the degree of productive
4 efficiency of New Zealand businesses.

5 Overall, we would urge the Commission to be very
6 cautious about a simplistic operating cost plus depreciation
7 plus rate base times the WACC comparison against actual
8 pipeline costs. For the reasons already given, and for the
9 reasons I think discussed yesterday, profits might differ
10 from costs in ways that are not indicative of, other than a
11 reasonably -- and I say "reasonably" because we don't have a
12 perfectly competitive market in any of these industries, and
13 so, it might differ from costs in a reasonably competitive
14 way. Thus, it's important to be sure of the sources of
15 profits and the extent to which there are justifiable
16 reasons for the existence of them.

17 Even where there is price cap or revenue cap regulation
18 there is the possibility of earning profits that exceed WACC
19 where a business has been particularly efficient. So, we
20 might see the same thing under light-handed regulation.

21 The Commission suggests price control can potentially
22 bring about improvements in allocative productive and
23 dynamic efficiency. This is where we have more disagreement
24 with the Commission's framework. While there is arguably a
25 case that there would be benefits of reduced prices given
26 that there is positive economic profits being made, while
27 there is an arguable case that there would be benefits from
28 reduced prices yielding allocative efficiency gains, and
29 even if market power exists, such gains can be expected to
30 be small because of multi-part tariff structures; it is very
31 difficult to develop a theory that regulation will improve

1 incentives for productive or dynamic efficiency over the
2 light-handed regime.

3 In terms of productive efficiency, price cap regulation
4 and light-handed regulation rely on the same mechanism, the
5 prospect of improved profitability to generate productive
6 efficiencies. The disadvantage is that, with price cap
7 regulation, regular price cap reset process can dull
8 incentives in the last few years before the regulatory reset
9 to make gains as the firm is better off saving them for the
10 next period. In contrast, under light-handed regulation
11 incentives to make efficiency gains are more constant over
12 time.

13 In terms of dynamic efficiency, for the reasons already
14 given in relation to investment, we would see this as being
15 potentially a major cost that the Commission, be enjoined
16 too discover, particularly in the gas pipeline sector where
17 there's currently a low level of penetration of gas,
18 significant investment is required to increase the level of
19 penetration and firms are free to choose whether they do
20 this. By limiting returns under a cap the Commission could
21 feasibly discourage future investments, so consumers who
22 would potentially benefit from further reticulation of the
23 gas, or maintaining or upgrading the existing network, could
24 miss out on all this consumer surplus that otherwise would
25 have been available. A lot of this would depend on the
26 margin of WACC that a regulator would allow to compensate
27 for stranding risks and the commitment to retaining that
28 methodology and volatility in demands and costs. But the
29 overall direction is likely to be a reduction in dynamic
30 efficiency under price controls. I think we've already
31 covered that issue.

1 Just on this issue of dynamic efficiency, we note a
2 comment on the Commission's paper about a reduction in
3 prices improving dynamic efficiency in downstream markets.
4 First, we note that price reductions are not really a
5 dynamic efficiency effect, they're a static efficiency
6 effect, because all we're saying is, we're comparing a
7 situation where prices are different from those where they
8 are now, and so, that's not really about the environment and
9 incentives for investment and innovation. And, lower prices
10 will affect levels of output and so on in related markets of
11 course, but this is really an adjustment to a new static
12 equilibrium.

13 Secondly, we would point out that it is possible to
14 double-count efficiency gains effects, and I'm sure the
15 Commission's not going to do this, but we mention it because
16 it has occurred in some analyses that we're aware of.

17 Where you have a derived demand, as we have for gas
18 pipelines, being derived from the willingness to buy gas by
19 all those who wish to use gas, then the consumer surplus and
20 producers surplus changes that arise in that market capture,
21 in essence, the benefits and the costs attached to changes
22 in that market. That it would not, for example, be correct
23 to add in changes to the forestry market to the gas market -
24 - to the gas pipelines market, so long as the gas pipelines
25 demand curve is derived as the derived demand curve
26 expressing all the willingness to pay.

27 We do go through that in our submission and just caution
28 that welfare in these markets, if you were to add up across
29 markets, is in fact -- runs the possibility of double-
30 counting.

31 The other key issue the Commission's framework paper

1 does not dwell on is the potential for reductions in quality
2 under price cap controls. Price caps tend to create
3 incentives to cut the level of quality, or if customers want
4 increased quality there's no financial incentive to provide
5 it because prices can't go up to pay for it. Quality of
6 supply is of critical importance to customers.

7 Estimates in the electricity sector suggest that the
8 cost of lost opportunities when there are outages can be of
9 the order of 100 times the unit cost of electricity. The
10 value of lost load is, by some estimates, much higher than
11 \$5,000 a megawatt hour. To the extent that quality is
12 under-provided under a price cap, there could be a
13 significant social cost attached.

14 We would be the first to admit that benefits and costs
15 are extremely difficult to quantify in the project that's
16 been set the Commission, but we think the Commission must
17 make the attempt. The alternative put forward in the
18 Commission's discussion paper, to scale the benefits of
19 control down to reflect that some of that benefit would not
20 be achieved would be offset by indirect costs, would be an
21 outcome that's rather based on assumption rather than
22 calculation. While this has the attraction of simplicity,
23 the approach is has no economic basis.

24 Potential benefits of control are related to reduced
25 transfers and reduced deadweight losses, but there's no
26 reason to expect that increases in production costs or the
27 deadweight losses accompany investments not made,
28 particularly the one on investments, and even the production
29 cost reductions -- production costs cost of regulation can
30 be high because it applies to all units produced. There is
31 no reason that those calculations should bear proportionate

1 relationship to the benefits.

2 What we are recommending overall is that the Commission
3 should adopt an approach where some attempt is made at
4 directly estimating indirect costs of control. This might
5 be done by using a rule of thumb type estimate of losses of
6 productive efficiency or dynamic efficiencies and increased
7 outages. We suggest a number of potential methods that
8 might be investigated, which I don't express here, but we do
9 note the Commission has used similar techniques in the
10 Electricity Governance Board determination.

11 Impact of regulatory uncertainty. I think one thing we
12 can probably all agree on is that no regulatory form is
13 perfect, as there's is no deregulatory reform either, and
14 under light-handed regulation, as with any regulation, there
15 may be uncertainty about the point that a Minister might
16 wish to intervene that affects decision-making.

17 It has been advanced that there is potential for other
18 upstream or downstream industries to be discouraged from
19 investing in gas assets because of fears that the regime may
20 not delivery efficient prices and quality standards over
21 time, potentially leading to expropriation of rents over the
22 longer term.

23 OMV and PEANZ in their submissions raised the issue
24 that, if there is uncertainty about pipeline prices and the
25 potential for capturing rents at the pipeline level, then
26 there could be impacts on the desire to explore. While
27 there may be some conceptual validity to this concern,
28 neither party offered evidence of such a problem.

29 It is interesting to note that we observe exploration in
30 areas not currently served by any pipeline capacity.

31 The important thing here is that, gas pipelines are a

1 derived demand, they offer a service that's derived, and so,
2 pipeline owners would extract rents from the upstream
3 production at their peril. The gas exploration market is
4 already thinned by international standards, so creating
5 uncertainty about access or prices would be a highly
6 dangerous strategy for pipeline owners.

7 Pipelines are specific assets, the demand for which is
8 volatile and depends, in the long-term, upon exploration.
9 This predisposes the situation of mutual dependence, but one
10 which pipeline owners bear the stranding risk because at any
11 stage explorers can exit the market taking exploration
12 equipment, although much of that would be stranded as well,
13 to other countries, leaving -- extraction equipment would be
14 stranded, exploration equipment less so -- leaving pipeline
15 owners with stranded assets.

16 It's difficult to tell what level of exploration
17 activity there would have been with more heavy-handed a
18 regulation, and if the dulling effect of low Maui gas prices
19 had not been present, but the key concern for gas explorers
20 is the presence of cornerstone purchasers, such as Methanex
21 and thermal generators to take large quantities of any new
22 field's output. Given the proximity of Methanex and TCC to
23 the Taranaki gas fields, pipeline costs are unlikely to be
24 significant parts of the cost to these cornerstone users.

25 Also, with the lack of concentration in pipeline
26 ownership and processing facilities in the Taranaki region
27 that NGC has demonstrated in their map at the outset of
28 their presentation, competition between pipelines to major
29 users would presumably provide a level of comfort to
30 explorers that cost effective means of getting gas to market
31 are available.

1 We understand from NGC that a new electricity generator
2 near Auckland would require a new pipeline to be built
3 providing further discipline on pricing behaviour.

4 Finally, long-term contracting is likely to constrain
5 any exercise of market power in the gas pipelines. Fields
6 would not be developed unless satisfactory commercial
7 arrangements could be reached on the long-term access.
8 Overall, in a context where the gas exploration market's
9 already thin by international standards, it would be
10 surprising to see pipeline owners risking asset stranding by
11 attempting to extract rents from the upstream gas market --
12 production market.

13 Pipeline owners also have an incentive to ensure that
14 conditions for access to pipelines are efficient, especially
15 in the current environment. The risk to the pipeline owner
16 is that it's left with stranded assets because a lack of
17 exploration activity brings supplies to the market in a
18 timely manner. In that regard we observe that NGC has
19 recently acted as a facilitating role which is already
20 aggregating different supplies of gas from different fields.

21 The pipelines are a long-lived asset and the use of the
22 pipelines is not a one-off gain situation. The pipeline
23 owners have significant sunk investments to protect and
24 would not wish to threaten those investments with stranding
25 because investors up and down -- in upstream and downstream
26 markets would be discouraged.

27 While clearly it's appropriate for the Commission to
28 test out whether existing regime and future enhancements are
29 delivering sufficient certainty to upstream and downstream
30 suppliers, on the face of it there does not appear to be a
31 strong economic rationale for that behaviour that deters the

1 use of existing pipelines.

2 By way of final summary comment, the Commission's task
3 is unusual in modern economies, and that it is to assess the
4 economic efficiency and effect on acquirers' interest of
5 increased price regulation, particularly in relation to a
6 discretionary commodity. The central issue is one of
7 prospective economic net benefit that will trade-off quite
8 limited short-run allocative efficiency and acquire effects
9 against lower productive efficiency; longer term allocative
10 efficiency, e.g. Dynamic efficiency.

11 Assessment is to be conducted in a very uncertain
12 environment and which is likely that investment in pipelines
13 will be required but be subject to considerable risk of
14 stranding, and also an environment where some economic
15 profits will be very likely necessary for dynamic
16 efficiency. Against this background we suggest the
17 Commission is justified in going through a process of
18 investigation, and we note the difficulties of measurements
19 and conceptualisation that we have mentioned apply to this
20 investigation will represent the practical difficulties of
21 heavier price regulation.

22 Thank you.

23 **CHAIR:** Thank you for that. Just one follow-up question. We've
24 had a bit of competing evidence about the way gas explorers
25 see this issue about the pipelines, and I do wonder, in a
26 market where there's considerable excess demand, even if
27 they could -- the gas production side could put some --
28 might have some countervailing power with respect to the
29 transmission business, I just wonder how strong that is in
30 an excess demand type environment, that they're likely to
31 exercise the sort of countervailing power that I think you

1 are suggesting they can and will do?

2 **PROF EVANS:** I think, if you have any substantial discovery,
3 that the technology and the infrastructure that goes with
4 that will be -- competing infrastructure will be benchmarked
5 against whatever's offered in the way of utilisation of
6 that.

7 In other words, if there was a substantial -- another
8 substantial find of gas that was even near a major
9 transmission line, that if it was a substantial element of
10 gas, that the calculation which is exactly sort of an ODV
11 calculation, would be made by those that owned the gas field
12 in order to deal with the pipeline owners, and it seems in
13 this industry that it is a credible threat, so that is a
14 constraint.

15 Also, the incentives are for the pipelines to want to
16 provide, as you said, surety in order to get gas flowing
17 through their pipes, and so -- and they do have a specific
18 asset that's sunk there, and so, they are in a position in
19 which they, if they're taking a longer term view as they
20 must be having long-lived pipes, will be not wanting to
21 dissuade the parties from using their pipes.

22 I'm not sure that it is -- I think there is still a
23 constraint there.

24 **CHAIR:** But you'd accept that it might be dampened by sort of
25 market circumstances?

26 **PROF EVANS:** I think it would be affected by it.

27 **CHAIR:** Okay. I'll see if there are further questions.

28 **MS BATES QC:** Just a couple by way of clarification. I've got
29 the confidential version of the NGC submission; I don't know
30 if you've --

31 **CHAIR:** We've got one bit of confidential information, and it's

1 in brackets, is that right?

2 **DR HODGSON:** There's only two numbers.

3 **MS BATES QC:** Yeah, I was just looking at page 21, and I was
4 wondering if you have it with you.

5 I don't think this is confidential, but I do have that
6 version. Page 21 sets out the pipelines that are covered in
7 the transmission and distribution, so it's fairly
8 straightforward.

9 I'm just wanting to check that I've got it right. In
10 terms of competition in the transmission area, it's not that
11 these pipelines are actually in the transmission competing
12 with each other in providing transmission services?

13 **PROF EVANS:** My knowledge of the location, ownership of those
14 pipelines, I'd have to be refreshed to know.

15 **MS BATES QC:** Oh, I'm probably addressing that to the wrong
16 person but, since we're here, if you don't mind, I just want
17 to check that I'm right about that.

18 **PROF EVANS:** I know about the obvious ones, but the others, I'm
19 not familiar with.

20 **DR HODGSON:** I think it's probably easier to show Lew the
21 schematic; that's the Taranaki ones -- [**refers to document**]

22 **MS BATES QC:** If it's easier for someone else to answer, I'd be
23 quite happy. But, I think, if you look at page 21, and I'm
24 following page 21, we might be more ad idem, okay?

25 So, if you're just looking at the list down there, NGC,
26 Maui, Todd, Swift; I take it they aren't competing with each
27 other in providing transmission services?

28 **DR HODGSON:** Well, the Maui pipeline and our Kapuni to north, to
29 Rotowaro pipeline are parallel, but at the moment the Maui
30 one is an open access, so it's -- if you like, going forward
31 they may well compete, but at the moment we'll consider

1 them --

2 **MS BATES QC:** But at the moment they don't?

3 **DR HODGSON:** No.

4 **MS BATES QC:** So, competition is coming from other sources?

5 **DR HODGSON:** Yes.

6 **MS BATES QC:** If you accept that it's there. It's not because
7 you've got transmission companies competing with each other?

8 **DR HODGSON:** No, that's correct.

9 **MS BATES QC:** Okay, and when you're looking down to the
10 distribution, I think there is some overlapping there?

11 **DR HODGSON:** Well, NGC's view is probably -- has been expressed
12 in our applications by United Networks. I know that Vector
13 yesterday were talking about competition in the Whangaparaoa
14 Peninsular, where there aren't actually even pipelines in
15 the ground.

16 **MS BATES QC:** Yeah, I know, I think we've done a clearance about
17 that. At that stage it wasn't put to us that there was much
18 evidence of competition between the two pipelines at all.

19 **DR HODGSON:** That is NGC's position, it would be very -- to the
20 best of our knowledge, no-one has ever swapped pipeline
21 company.

22 **MS BATES QC:** That's what we thought. So, it's not competition
23 coming in -- I mean, there's not much switching between
24 distribution networks?

25 **DR HODGSON:** To the best of my knowledge, I don't think we know
26 of any.

27 **MS BATES QC:** I don't want a definitive answer necessarily, but
28 you might like to think about this when we all get back
29 together again, but just I'm just looking at sources of
30 competition; it's not there?

31 **DR HODGSON:** There is -- this is not NGC, but I understand that

1 people have switched to the Nova networks where they have
2 big customers.

3 **MS BATES QC:** That's right, so there's some there.

4 **DR HODGSON:** In South Auckland, where there are the
5 horticultural areas, I think the example is, there's
6 competition to get pipes in the ground at the place, but
7 we're not aware of people -- this is the greenfield pipes.

8 **MS BATES QC:** Yeah, so there's competition but which system is
9 going to be used by the new people?

10 Oh yes, the other thing I wanted to put to you; I was
11 interested, in page 22 of your submission -- sorry,
12 Professor Evans, did you want to add to that, did you?

13 **PROF EVANS:** No, please...

14 **MS BATES QC:** It was interesting that you set out in page 22 of
15 your submission a list of the people that you thought ought
16 to be involved in this Inquiry, and if you look down that
17 list now, you'll see that there were -- that there seemed to
18 be an under-representation of users.

19 Have you got that list?

20 **DR HODGSON:** I've got that list, yes. I guess we put that list
21 together looking at both people that had been involved in
22 the Gas Industry Steering Group and also -- and, if you
23 like, the electricity lines debate.

24 **MS BATES QC:** Yeah, I'm not debating the list, I'm just
25 wondering if you had any opinion on why more acquirers
26 hadn't --

27 **DR HODGSON:** I suppose my opinion would be that there's no
28 problem of pricing.

29 **MS BATES QC:** I don't know. You might be interested to know
30 what Genesis said about it, and this is Genesis' submission.
31 Genesis did not appear but put in a submission:

1 "Genesis does not have any indication that NGC
2 transmission has sought to achieve excessive profits from
3 its monopoly position but under the current light-handed
4 regulatory approach it may have the opportunity to do so,
5 hence a somewhat stronger regulatory stance with performance
6 criteria and the threat of intervention of a specific
7 thresholds breach would appear appropriate."

8 **DR HODGSON:** I suppose that could apply to a number of markets
9 and some which are supposedly contestable as well.

10 **MS BATES QC:** They went on to say that, for various reasons,
11 there were strong concerns that they had about the need for
12 regulatory control on Maui Developments Limited, and I think
13 those were concerns around uncertainty as much as anything
14 else.

15 **MR BIELBY:** Can I just say, we were very struck by that
16 paragraph as well, and we'd be most interested to know if
17 they've got any further particular thoughts to support that
18 argument.

19 **MS BATES QC:** Yes, all right. Thank you.

20 **MR STEVENS:** What would the implications be if the Commission
21 decided to separate out geographically some of the markets
22 where there were different competing pressures, from NGC's
23 perspective?

24 In other words, how feasible would it be for NGC to
25 separate out some of its -- parts of its transmission or
26 distribution business?

27 **MR BIELBY:** Could I start by answering that by saying, just
28 following from the earlier discussion with Commissioner
29 Bates, indeed the way of course that clearance applications
30 have been dealt with to date is to define, at least to the
31 distribution level, local markets from a conceptual point of

1 view, so that's the background we've come from, that the
2 local distribution networks came out of the local Power
3 Boards or whatever, and they were treated as local
4 monopolies within the transmission system in a different
5 market, if you like.

6 I guess the direction we've been heading, as with the
7 retail markets, is to say increasingly looking towards
8 whether there is sufficient competition to treat things in
9 wider markets as we have in the retail, electricity and gas,
10 but that's the conceptual point of view.

11 In terms of physical, if that was your question...

12 **DR HODGSON:** I think the -- in terms of the distribution
13 network, we sort of deal with the costs and revenues as a
14 business unit, so there would be a fairly high degree of
15 estimating to try and allocate costs if you wanted to break
16 us up into, sort of, mini NGC distributions as such.

17 As it is, probably -- I guess we obviously can show the
18 information in terms of transmission and distribution
19 separately, but I think we would have some difficulty in
20 presenting a broken up distribution level.

21 **MS BEGG:** Just a question on the point about the pipeline
22 business possibly capturing rents from the production
23 sector. Suppose we did find that NGC had exercised market
24 power and we were doing an assessment of the benefits for
25 regulation. Should we be thinking then of the benefits of
26 constraining NGC's prices in terms of how that would
27 increase the rents to production and the benefits from that,
28 rather than the benefits that might go to consumers?

29 I just wondered, if NGC's capturing some of these rents,
30 where would they most -- and there's a transfer of income,
31 where it should be going in an efficiency sense?

1 **PROF EVANS:** Where you have an upstream market that's really
2 competitive, then you expect the -- sort of, the cost
3 structure of the market that it's drawing on to be passed
4 through to the final consumers. Where it's less
5 competitive, it's not clear that that would happen.

6 So, in the pipelines market, if there is such a market,
7 would be -- the derived demand for that market is derived
8 from gas. So, if you determine that there's a market power
9 there and you impose a price cap as a consequence of that,
10 then the efficiency effect is the higher throughput, if you
11 like, of the pipeline that results from that, and -- but the
12 effect, where the transfers go and the ultimate instance of
13 the transfers is extremely difficult if one wants to sheet
14 it back to consumers. It's very very -- it's extremely
15 difficult.

16 **MS BEGG:** Yeah, I was just wondering whether, if the producers
17 are correct that some of the rents have been taken from
18 them, and if they got a greater share of it, there'd be a
19 greater incentive to produce. I guess it's very difficult
20 to determine how that all feeds through into benefits to
21 consumers.

22 **PROF EVANS:** Well, if we've defined the market for the pipeline
23 properly, the welfare effects will be captured entirely by
24 that market. It's then just a question of the incidents and
25 where the rents actually are transferred to, and that seems
26 to me to be -- well, it is extremely difficult where it's
27 not a direct final demand industry, which neither the
28 production gas, the pipelines, or even the generation
29 industry are directly serving final consumers.

30 **MS BEGG:** I had another question on inter-fuel competition, and
31 this sort of related to the SSNIP question that was asked

1 earlier, and that is, you'd expect a business with market
2 power would price up to the point where it starts to feel
3 competitive constraints and that, in the case of NGC, might
4 be the constraints imposed by inter-fuel competition.

5 The fact that we observe constraints being imposed by
6 inter-fuel competition, does that tell us anything about
7 whether or not NGC has got market power and is exercising
8 it?

9 **PROF EVANS:** It certainly says that market power is limited.
10 What you're saying I think is that, you could have fringe
11 competition that's busily working away, but there could
12 still be rents left in that industry.

13 **MS BEGG:** And you'd expect, you know, that if you do have market
14 power, you'll price up till those constraints start to
15 effect you?

16 **PROF EVANS:** Well, that's what fringe competition is, you price
17 up just below where the fringe competitors enter and
18 preserve your market. So, that's definitely possible. It's
19 not likely to be that case if you demonstrate that they're
20 losing customers and that they're cutting -- yeah,
21 particularly losing customers. That is a scenario which is
22 a possibility.

23 **MS BEGG:** I suppose it's difficult for us to disentangle that
24 because, you know, as I said, 10 years ago people could
25 wheel out examples of inter-fuel competition when the price
26 of gas was really low, and 10 years later we're hearing the
27 same arguments, and it's true I think that the market's
28 changed quite dramatically, but it's hard to determine
29 whether that means that now there is constraints where there
30 weren't before, or whether in both cases you're still
31 exercising market power to some extent, so...

1 **PROF EVANS:** Yeah, I think that you have to be really careful
2 interpreting these things, there's no question about that.
3 But also, there's sort of no question either that people are
4 switching away from gas in various ways to a significant
5 extent.

6 **MS BEGG:** And that's more significant than in the past? I
7 presume there's always switching of some sort.

8 **PROF EVANS:** Absolutely.

9 **MS BEGG:** But there's a net loss?

10 **PROF EVANS:** Absolutely.

11 **MS BEGG:** You noted a number of reasons why a building blocks
12 approach is needed to be used cautiously, and I think we can
13 all agree that it's not at all a straightforward process,
14 but I wondered whether you were rejecting that approach
15 entirely, and in particular for us trying to assess whether
16 NGC had market power, whether there was any use for a
17 building blocks approach or an assessment of profits,
18 whether it could give us valuable information?

19 **PROF EVANS:** I wouldn't think it was valuable information, but I
20 don't see what else the Commission can actually estimate in
21 lots of ways. You're sort of stuck pursuing some empirical
22 evaluation, and the Commission will be expected to have a
23 view about that, so they're going to in some ways be
24 involved in doing that.

25 I think that, you just need to look at the variability
26 in demand on that just to know that the outcomes that you
27 see are going to be really problematic, they won't vary like
28 that because -- for various reasons, and so, I think that
29 that's a major issue, but I think the Commission is so-
30 called stuck with looking at it.

31 Just on that question; the question was raised yesterday

1 about the use of historical cost or ODV, and it seems to me
2 that that relates to what you think you're measuring
3 conceptually. If you are looking at -- if you are using ODV
4 to measure the performance in the past, then what you are
5 saying is that at each time you measure that, how do the
6 profits look against the viable firm at that point in time
7 in an -- you know, that's able to sustain itself going into
8 the future.

9 If you use historical cost, I'm still a little puzzled
10 as to what you're measuring because, in terms of -- thinking
11 about it as a viable firm looking to the future, those
12 historical costs are sort of sunk. What you're really doing
13 is you're saying, look, how can I -- under ODV it's saying,
14 look, if my price covers ODV, I can replace my network,
15 business as usual, and so it's a viable business going
16 forward.

17 If there's anything in the ODV methodology at all, it
18 should be that historical costs are different from ODV,
19 because otherwise the optimisation that's involved, you
20 know, was not really relevant. And so, when I think about
21 calculating profits on the basis of historical costs, what
22 you're saying there is, look, we have these historical
23 costs, we've added them up and we can see that their
24 profitability with respect to those historical costs is
25 this. It doesn't really tell you how profitable they were
26 in the past, so whether or not they have been recovered. It
27 doesn't tell you whether looking forward or at that point in
28 time this is a viable business even. Whereas, the ODV one
29 does have a conceptual basis I think at a point in time.

30 I only raise this because we've done these sorts of work
31 before, we did the study of TranzRail, and the way in which

1 we assessed the viability of TranzRail was to look at the
2 replacement cost of its network and calculate the economic
3 profit that flowed from that, but I think there is a
4 conceptual difference between -- even setting regulation
5 aside -- between the way in which you view an historical
6 cost analysis of the past and an ODV analysis of the past.

7 **MS BEGG:** I had a question just on the Commission's framework
8 for assessing the factual and the counterfactual. In your
9 approach you propose using a comparative institutional
10 approach, and you compare -- which involves comparing sort
11 of the real world expected outcomes, which is with control
12 and without.

13 I just had a question there on, what's the role of the
14 Commission's benchmark, workable competition, in that -- the
15 workable competition benchmark in a comparative
16 institutional framework? Do you need to use it, or can you
17 just compare these two situations? In which case, what are
18 you using to assess whether there's efficiency benefits from
19 one compared with another?

20 **PROF EVANS:** I'm not sure, Sue, I'm on the same page with your
21 question.

22 **MS BEGG:** Just at the analysis you do where you compare the
23 counterfactual and the factual, that's with control and
24 without control, and you look at the incentives that arise
25 in those different situations. In doing that, are you also
26 making comparisons with the workable competition benchmark,
27 which is the approach the Commission has used, or is the
28 analysis largely independent of that benchmark?

29 **PROF EVANS:** I think it's the second step, as to whether or not
30 first the hurdle of whether competition is limited has been
31 met, and then this is a second step, and typically in a

1 cost-benefit analysis of this sort one would like to factor
2 in its effect on competition per se, but I think in most
3 cost-benefit analyses that's extremely hard to do and that -
4 - you know, it's not typically done in a standard cost-
5 benefit analysis. So, in a sense it's the second element.

6 **MS BEGG:** Just a final question, which might be more for NGC and
7 it's just an information question. You raised the point
8 that quality can be affected by -- the incentives to provide
9 quality would be affected by regulation, and I think we all
10 accept that, but I just -- we haven't had much discussion of
11 quality, and I just wondered if the NGC people can just give
12 us a bit of a run-down on what the quality issues are that
13 might be affected.

14 **MR CUMMINGS:** I guess the main one being security of supply,
15 outages, pressure, would be the two main quality factors.
16 So, reliability and pressure.

17 **MS BEGG:** It would be pretty rare, I presume, that the pipeline
18 would -- that you'd get interruptibility to end consumers,
19 other than those consumers that have taken interruptibility,
20 that would be a major failing, would it?

21 **MR CUMMINGS:** You mean, due to capacity constraints?

22 **MS BEGG:** Yeah, capacity constraints, or like a bulldozer
23 through the pipeline.

24 **MR CUMMINGS:** The latter example is a more common one where we
25 get third party interference. There's a correlation between
26 how much third party interference we get with how much we
27 spend going out and informing the public and doing those
28 sorts of activities.

29 **MS BEGG:** In terms of pressure, that affects end-user's
30 equipment, does it? Is that why that's --

31 **MR CUMMINGS:** Correct, yes.

1 **PROF EVANS:** Can I follow up on that. There is another
2 dimension to quality I think, and that's in product
3 differentiation, and the way in which that would take place
4 in an industry like this is the different kinds of contracts
5 that are offered, and I can provide the Commission with a
6 reference that's studied the effect of -- on the shape of
7 contracts of price cap regulation in the UK, and it
8 concludes that basically the structure of the prices was
9 aimed at affecting the next price cap and had nothing to do
10 with consumer benefits. So, I think of quality as involving
11 both the direct elements but also the product
12 differentiation.

13 **DR HODGSON:** Could I just add a couple of responses to a couple
14 of your questions which Lew addressed, specifically with
15 regard to the OMV submission, the written one which I think
16 you were drawing on in terms of the question about rents.

17 The figure that they gave there of \$1.60 for the
18 producers; it's my belief that that is somehow based on the
19 Maui contract. To the best of my knowledge, the current
20 Maui contract price is above \$1.80. You then have the
21 energy resources levy that applies to that. You also have,
22 by various mechanisms, the Crown margin, and that has been
23 put in place in different ways for ourselves and Contact.

24 So, the actual Maui price, if you take it from where
25 the buyers get it from the Crown, is closer to \$3 than to
26 \$1.60, and I think when some of the producers have been
27 using these figures -- and they did so during the gas review
28 process -- it is a little misleading in terms, if you took
29 out the Crown margin and the ERL then the producers are
30 getting substantially more for their gas. And I'm sure -- I
31 mean, the Commission has the powers to inquire as to what

1 the actual current numbers are, but certainly I would make
2 that point.

3 I think also in terms of the wholesale gas prices that
4 users are facing, I think we have to recognise that one or
5 two of the very large users are coming off long-term
6 contracts now, and the price of gas that they were actually
7 getting was probably closer to the -- if you look like at a
8 wholesale level, closer to the \$3 mark; they're now facing
9 prices that are over \$5 per gigajoule and for some of them -
10 - I'm sure the Commission may want to go to some of those
11 people that we had listed as acquirers -- they may not even
12 be getting people offering them gas going forward.

13 **CHAIR:** Commissioner Bates has a follow-up.

14 **MS BATES QC:** Well, it's not a follow-up, just one or two things
15 I want to pick up on. One of them is in Swift's submission.
16 It said that it didn't consider that the remove to NGC's
17 south pipeline should be included in the Commission's
18 deliberations because it was dedicated to NGC and, "it's not
19 being developed with a view to additional use as a provider
20 of third party transmission services".

21 Do you agree with that?

22 **DR HODGSON:** Our position is, along the definition that the
23 Commission had, that the pipelines that are exiting
24 production stations and, therefore, feeding on to end-users,
25 are part of the Inquiry now. I guess Swift would, if they
26 are getting no revenue, or feel they are getting no revenue
27 for that pipeline, may say they can't be getting any profits
28 if they are getting no revenue, but that's a subsequent part
29 of the investigation.

30 **MS BATES QC:** So, Swift are getting no revenue?

31 **DR HODGSON:** I'm not familiar with the details of that, so I

1 can't possibly give you a definitive answer on that.

2 **MS BATES QC:** But I thought that it was supplying it to you?

3 **DR HODGSON:** No that -- as I understand it, Genesis is the
4 purchaser of Rimu gas.

5 **MR CUMMINGS:** I think you're talking about the physical
6 interconnection with our pipeline.

7 **MS BATES QC:** Yeah. Sorry, have I got mistaken about that?

8 **DR HODGSON:** Yes, the interconnection is necessary for them to
9 get the gas into the pipeline, but the actual purchaser of
10 Rimu gas is Genesis Energy Limited.

11 **MS BATES QC:** That's the purchaser, but presumably -- where do
12 you fit in with this?

13 **DR HODGSON:** Well, it's a bit complicated. There is a gas swap
14 in place. The Rimu gas goes into the Kapuni South line
15 physically and feeds the demand down here, however the gas
16 sale agreement is with Genesis Energy. We supply -- NGC,
17 instead of supplying physical gas here, supplies physical
18 gas at Huntly, and swaps, so it's...

19 **MS BATES QC:** No, thank you. The only other one I wanted to ask
20 you about was the Maui developments and its proposal to the
21 industry which it talks about in its -- well, Todd talks
22 about it in the submissions. They say:

23 "It would be more accurate to say Maui Mining Company,
24 Shell, Todd and IMV have made a proposal to the industry
25 consisting of detailed draft contracts on the basis on which
26 third party gas may be transported in the Maui on-shore
27 pipeline. Maui Mining Company's engaged with the industry
28 with a view to reaching an agreement on the regime."

29 How far down the track's that?

30 **DR HODGSON:** There's three outstanding issues as we see it.

31 There's the question of ringfencing, which they have not put

1 a proposal forward on; there's what's called the Master
2 Meter Agreement, which is an issue between them and NGC, and
3 there's also the question of who actually pays for the
4 meters at the interconnection points, which again is an
5 issue between them and NGC.

6 Do we know, Steve, when that's going to get resolved?

7 **MR BIELBY:** The most likely scenario in terms of negotiation,
8 you may see an outcome in, say, one or two months, with a
9 tailwind and no major issues.

10 **MS BATES QC:** Okay, thank you.

11 **CHAIR:** Okay. Thank you for taking those questions and for
12 coming back today, Professor Evans, to finish that
13 presentation.

14 I'll just ask Mr Bielby if you have any further comments
15 you'd like to make?

16 **MR BIELBY:** Only one very briefly, and I'm sorry it's a bit
17 tangential, but Commissioner Stevens asked earlier about the
18 power stations and whether it's better to build a pipeline
19 to Auckland and have your power station up there.

20 There's one short answer to that: A couple of years ago
21 we had a site in Auckland and we had a site in Taranaki next
22 to our Stratford power station, and we were looking at both
23 those options and doing some very in-depth analysis. Very
24 interestingly -- and the reason I raise it is, we pumped for
25 the Stratford site in Taranaki, and that's interesting
26 because we're a transmission company. So, despite the fact
27 we're a transmission company, we decided Taranaki was the
28 better site and we'd ship the electricity north by power
29 line. There's a whole bunch of factors there, I wouldn't
30 take it too much further, because it depends on the site and
31 so on, but that might give you a broad feel for the way we

1 run our business and also that we see things as being
2 entirely contestable, so there was no way that we were
3 locked into a transmission based approach.

4 Interestingly then, our friends at Contact are looking
5 at building a site in Auckland, but there's also a site down
6 in Taranaki, and neither of them could go first.

7 That was my only comment, a bit tangential, but I don't
8 think there's anything else we wanted to say. No, thank you
9 very much for your willingness to listen to our submissions,
10 thank you.

11 **CHAIR:** I would like to thank NGC; the submission has been very
12 thorough, it's covered all aspects of the Inquiry in terms
13 of the issues we needed to canvass at this stage, and we are
14 grateful to you for that.

15 I will make just a few closing remarks and I'll try to
16 be brief so that we can let everyone get back to the rest of
17 their schedules for the day.

18 This does conclude the Conference on the Gas Pipelines
19 Inquiry Draft Framework paper. I'd like to close the
20 Conference with the following remarks.

21 First, during the conference the Commission has made a
22 number of requests for further information from presenters.
23 The list of information to be supplied will be posted on the
24 Commission's website by close of play midday tomorrow. I
25 would ask all parties to check this list and advise the
26 Commission if there are any matters that have been omitted
27 or inadvertently stated. I now ask that all requests for
28 information are responded to by 5 pm today week.

29 Secondly, all presenters who have provided the
30 Commission with printed material over the last three days,
31 whether presentations or supplementary material, are asked

1 to provide electronic copies to the Commission within three
2 working days so that they may be made available on our
3 website, and if you could e-mail those copies to David
4 Steele please.

5 Finally, the Commission will consider further written
6 submissions following the Conference provided they are
7 received by 9 am Friday the 19th of September. Any such
8 submissions must be confined to issues or matters raised in
9 written submissions by other parties or raised for the first
10 time at the Conference. These submissions will be placed on
11 the Commission's website.

12 On behalf of the Commission, I'd like to thank everyone
13 for the submissions on this Inquiry. We've especially
14 appreciated the access to industry economic, financial and
15 legal expertise.

16 I'd also like to thank the Commission staff and external
17 advisors for the work done, and also for what will be
18 significant work ahead. And, of course, we'd like to thank
19 our transcribers and communications people who have been
20 very flexible in assisting us throughout the Conference, and
21 I must also thank my colleagues who have -- some of us are
22 into our fourth week in a row of Conferences, and so, I'm
23 grateful to them.

24 If there are any further questions, I'm happy to take
25 them now. **[No questions]**.

26 Therefore, at this point I'll thank you once again and
27 declare the Conference closed. Thank you.

28

29

Conference closed at 2.25 pm

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