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COMMERCE COMMISSION CONFERENCE

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ON THE GAS PIPELINES INQUIRY DRAFT FRAMEWORK PAPER

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COMMISSIONERS: Ms Paula Rebstock (Acting Chair)

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Ms Denese Bates QC

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Mr Shaan Stevens

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12 [10.05 am]

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CHAIR: Good morning ladies and gentlemen, I'd like to welcome you to the Commerce Commission's Conference on the Gas Pipelines Inquiry Draft Framework paper. I'm Paula Rebstock, Acting Chair of the Commerce Commission, I will be chairing this Conference. With me are Members of the Commission who will be making the decisions required to fulfill the Commission's responsibilities under Part 4 of the Commerce Act. They are Denese Bates QC to my left and to my right, Shaan Stevens.

22

Also assisting us with this matter are a number of Commission staff, many of whom will be known to you. Martin Lally will also be advising the Commission on the weighted average cost of capital, and will be attending the relevant Conference sessions.

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I'd like to welcome everyone, particularly those who have travelled from outside Wellington and those who have taken the time to meet with Commission staff and make written submissions on this matter. We are very appreciative that the Commission has access to the industry

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Opening Remarks by Chair

1 experience which is before us and look forward to an
2 informative Conference.

3 The Commission released a Draft Framework paper on the
4 16th of July setting out the process and the framework the
5 Commission proposes to use during the Gas Pipelines Inquiry.
6 Following the release of the Draft Framework paper
7 interested parties are asked to make submissions on the
8 draft by the 15th of August. At the request of some
9 interested parties the Commission extended the timetable so
10 that submissions were accepted until the 20th of August.
11 All submissions received are available on the Commission's
12 website.

13 As indicated in the Draft Framework paper, the
14 Commission has adopted a two-staged process for the inquiry.
15 The first stage focuses on defining the framework to be used
16 with the second stage focussing on the application of that
17 framework. This Conference is part of the first stage.

18 I'd now like to make some brief comments on the
19 procedures for this Conference. We've set down three days
20 for the Conference, aiming to complete it by the end of
21 Wednesday. An indicative timetable has been made available
22 to all interested parties. A full record of this Conference
23 will be maintained by both transcription and tape recording.
24 Could any person speaking please do so from one of the
25 microphones available and speak clearly and precisely. I
26 would also ask that each speaker state their name and the
27 party they are representing so that we can identify them
28 clearly.

29 I would ask that everyone, and especially persons not
30 engaged in presenting, keep noise to a minimum during the
31 Conference. It's quite hard for me to make this request,

Opening Remarks by Chair

1 but I will also request that all cellphones are switched
2 off. The Chair is the worst offender when it comes to
3 cellphones, but I'll do my best. It's not proposed to close
4 this Conference venue during the lunch breaks, however a
5 Commission staff member will be in attendance during those
6 times.

7 These Conferences are designed to allow the Commission
8 to test the submissions put forward by interested parties,
9 with questions and for parties to highlight the key points
10 of their arguments and their submissions to the Commission.
11 In some cases the Commission will request additional
12 information to be provided by the presenting parties. At
13 the time that this information is requested a date for
14 delivery of this information will be agreed and noted as
15 part of the record of the Conference.

16 The Commission will consider further written submissions
17 following the Conference provided they are received by 9 am
18 Friday the 19th of September. Any such submissions must be
19 confined to issues or matters raised for the first time by
20 other parties at the Conference. These submissions will be
21 placed on the Commission's website.

22 During the Conference the Commission shall provide for
23 as little formality and technicality as possible. This
24 Conference is not and is not intended to be an adversarial
25 proceeding. There will be no cross-examination. There will
26 also be no questioning of Commissioners or Commission
27 experts and staff by any party. There will, however, be the
28 opportunity for questioning of presenters by Commission
29 members, staff and Commission advisors. While the public
30 are welcome to attend during open sessions they do not have
31 speaking rights or the right to ask questions.

Opening Remarks by Chair

1 Commissioners have read all the submissions carefully,
2 so please make any summaries of submissions as succinct as
3 possible. We do not wish and indeed may not allow you to
4 read your submissions to us. It would be appreciated if
5 speakers focus on the key issues in their addresses to the
6 Commission and keep to the time allocated to them.

7 The Commission is open to hearing any points you wish to
8 make. We do, however, point out that the Commission has a
9 Statutory duty to conduct the inquiry under Part 4 of the
10 Commerce Act, therefore submissions that critique the
11 legislation or question whether an inquiry is necessary will
12 be less helpful than those that focus on the best method to
13 meet the objectives of the legislation.

14 It is expected that a number of experts will be
15 attending and presenting at this Conference. I would like
16 to stress that their role is as experts in their field. An
17 expert is not to act as an advocate for any particular
18 party. If the Commission considers that experts are in fact
19 acting as advocates for a particular party, their submission
20 will be treated as though they are part of that particular
21 party's submission rather than as expert opinion.

22 I hope that this Conference will be able to avoid
23 confidential material. However, if a submitter considers it
24 necessary to present material which is confidential, subject
25 to that request being reasonable, the Conference will be
26 closed during that discussion to all persons except
27 Commission members and staff and advisors, the party
28 providing the confidential material, and to legal counsel
29 and relevant experts who provide appropriate confidentiality
30 undertakings.

31 Transcripts from closed sessions will not be made

Opening Remarks by Chair

1 publicly available. I emphasise, however, that we have a
2 strong preference for as much as possible of this Conference
3 to be held in public sessions. Please note that
4 transcriptions of all public sessions will be made available
5 on the Commission's website as soon as possible after each
6 day's proceedings.

7 If you have specific information contained within your
8 submissions that is confidential, but does not require an
9 entire confidential session, please note the status of the
10 information before commencing to discuss it so that we may
11 consider and, if necessary, rule that it be excluded from
12 the public transcription record.

13 I would ask also that if at any point in the proceedings
14 someone becomes aware that confidential information is being
15 discussed in an open session, if you could alert me to that
16 immediately, I would appreciate that assistance.

17 That concludes the administrative matters relating to
18 the Conference procedures. At this time I would like to ask
19 if anyone has any questions relating to the procedure for
20 this Conference or any other issue I have raised. [**No**
21 **comments**]. If questions on procedures or the agenda do
22 arise during the Conference, please do not hesitate to raise
23 these with submission staff in the first instance.

24 The Commission is looking forward with interest to
25 hearing the submissions that will be presented at this
26 Conference. I'd like to thank you all once more for your
27 attendance and begin by asking the representatives of
28 Contact Energy to present their submission, and I'll welcome
29 you both and ask you to state your names for the record,
30 please.

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PRESENTATION BY CONTACT ENERGY

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3 **MR HUNT:** Thank you Commissioners, my name is David Hunt, I'm
4 the General Manager, Corporate Development, at Contact
5 Energy.

6 **MR LOVE:** My name's Alex Love, I'm a member of the Fuels Trading
7 Team at Contact Energy.

8 **MR HUNT:** We have a fairly brief presentation that we'd like to
9 run through this morning, and then happy to obviously
10 address questions, or as we go if you prefer.

11 Really just to set the context; Contact Energy is a
12 significant buyer, user and reseller of gas. We do not have
13 any investments in the gas pipeline sector per se, so our
14 interest here is as a user and as a reseller principally.
15 That use of gas, just to put that into context, is within
16 our own generation business. We are, I believe, other than
17 Methanex, the single largest consumer of gas in New Zealand,
18 and we have a substantial interest in this sector.

19 We welcome this inquiry, we believe it provides an
20 opportunity to scrutinise a large and very important sector
21 within the economy. We believe it should help to ensure
22 that gas plays the -- its full role in meeting New Zealand's
23 energy needs, an issue that has become more critical I think
24 than perhaps it has been for many years.

25 In terms of what we'd like to talk about today, it's
26 really to focus on what we see as the big picture issues.
27 We are, to be candid with you, in the process of gearing up
28 to respond to the questions within this inquiry, and I think
29 at this point many of the issues go into detail that we are
30 not at this point able to fully engage on, but we would be
31 looking to ensure that we can at the point when there's a

1 draft report from the Commission. Nonetheless, there are
2 some issues that we think it is worthy to comment on at this
3 point.

4 Really, just a reminder. In terms of gas, how important
5 it is to the economy; it's both an important fuel in its own
6 right in meeting New Zealand's energy needs, but it's also
7 important because of the role it plays within the
8 electricity sector, and there on page 4 you will see we've
9 included some graphs sourced to Ministry of Economic
10 Development data outlining both those points.

11 If we turn first to the issues that we think is worthy
12 of some consideration, it's the question of what services
13 are covered within the inquiry. We think it's very easy to
14 talk about pipelines and in one's mind think about that as
15 being an issue of transporting gas from point A to point B.
16 In reality in our view there are quite a number of closely
17 associated issues and it will become quite important as to
18 where the line is drawn between what is covered by the
19 inquiry and what is not.

20 There on page 5 we list a number of issues that we
21 think -- just to run quickly through them; some are clearly
22 within the scope in our view and some may be matters of
23 debate. Transportation of specification gas. Most gas in
24 New Zealand is so-called spec gas. There is, though, an
25 increasing importance of non-spec gas, particularly as Maui
26 runs down. And obviously within one pipe you can't blend
27 both. Gas blending itself is a potential issue.

28 **CHAIR:** If you don't mind me interrupting you, Mr Hunt. I
29 wonder when you look at these matters in terms of what
30 should be covered by the inquiry and what shouldn't, what's
31 your primary sorting device in terms of the criteria you

1 use?

2 **MR HUNT:** Essentially, whether one might have concerns about
3 market power, because generally natural monopoly
4 characteristics prevail. I think where it gets difficult is
5 where, it may not be natural monopoly, but the costs of
6 replication are so high that it might as well be, I suppose.
7 It's a, can you really unbundle those services, I guess, and
8 make them contestable.

9 **CHAIR:** Okay, all right. Thank you.

10 **MR HUNT:** Gas storage. The pipelines themselves are a major
11 storer of gas on the short-term basis. So for example last
12 year, if you recall there was a bulldozer that went through
13 the pipeline coming south to Wellington; essentially at that
14 point the southern part of the North Island was running on
15 the pressure that was in the pipeline further south, it's
16 like a bottle, if you like. Again, that's an important
17 issue going forward, particularly as Maui runs down and the
18 ability to meet intra-day swings from line pack becomes more
19 important.

20 Gas compression, essentially what keeps gas moving. Gas
21 flow management. This, if you like is the equivalent of the
22 system operator type role for Transpower.

23 Metering, allocation and reconciliation services. There
24 UFG is unaccounted for gas. Again, you can think of that as
25 an equivalent of transmission losses.

26 Monitoring of quality and odourisation. All of those
27 are in our view potentially within the scope and some line
28 needs to be drawn as to where the boundary exactly is.

29 **CHAIR:** In the case of services that are largely contracted out,
30 does the fact that they're contracted out tell you anything
31 you think is relevant to determining what should be covered

1 and what shouldn't?

2 **MR HUNT:** I suppose, to the extent they are contracted out, it
3 would suggest they can be more easily unbundled, but other
4 than that nothing comes to mind just at the moment I guess.
5 I'm not sure there is much contracting out of services in
6 these categories. Metering, yeah.

7 **CHAIR:** Metering, I think, is one of the ones that it's been
8 suggested by some other parties that it shouldn't be part,
9 that it is contestable.

10 **MR HUNT:** Yeah, I think you'll see there we've simply put a
11 question mark next to it.

12 **MS BATES QC:** The ones that you have put a question mark beside,
13 do you actually at this stage have any particular view that
14 you want to express, whether it be tentative or not.

15 I just want to know, those in the list that you have got
16 a question mark beside, at this stage do you want to express
17 any tentative view that you might have about them and if you
18 do have a reason for the tentative view, give it to us.

19 **MR HUNT:** I think I'll give you two answers if I can. Firstly I
20 think we'd probably prefer to come back and give you a more
21 formal answer, but an answer at this point from the table.

22 Our view is, probably metering falls outside, there are
23 sufficient grounds for believing that contestability
24 prevails there. The others I think our tentative view would
25 be to err on the side of caution and put those within the
26 scope. But if we could come back to you within a couple of
27 days, we'd be happy to do that.

28 **MS BATES QC:** Thank you.

29 **MR HUNT:** The question is asked in the framework paper, how
30 effective is the present disclosure regime; our view is that
31 it is not very effective for a variety of reasons. Firstly,

1 in our view the ODV inputs are not sufficiently
2 standardised. We find it difficult to relate disclosures to
3 specific customers over specific distances. At this point
4 there is no readily accessible clearing house for the type
5 of information that we would find useful, and that in turn
6 means it's difficult for us to carry out the analysis that
7 we would be looking to do, and then finally the regime
8 itself does have exemptions and we think some of those
9 exemptions are quite important.

10 **MR STEVENS:** Just one point on that please, Mr Love. What value
11 would you get from some of the information disclosure should
12 that be available from the gas pipeline business?

13 **MR HUNT:** In some cases, where we're able to get better
14 information, then we could look at seeking to find bypass
15 alternatives. That's one area, and certainly that has been
16 a -- something that we've looked at from time to time in the
17 past.

18 **MR STEVENS:** And with Nova Gas, for example, what would you
19 benefit from any information disclosure on that?

20 **MR LOVE:** Well, I guess -- Alex Love, Contact Energy -- I guess
21 in the case of Nova Gas it's probably less important since
22 we, I suppose, we could assume there is some competition.
23 I'm aware that Nova Gas of course is -- has an exemption,
24 one of the exemptions I suppose we've referred to. I guess,
25 no, we would like to understand their costs.

26 But I guess some of the other areas that we've looked at
27 are the capital, the amounts of capital assumed in the ODV
28 valuations, do they really reflect the real costs of
29 establishing those pipelines; it's those kinds of issues and
30 trying to relate what we pay to what other people might be
31 paying, all those kinds of issues. It's very difficult to

1 see those things from the ODV -- sorry, from the information
2 disclosure.

3 **MR STEVENS:** Thank you.

4 **MR HUNT:** If we come to the definition of the relevant markets.
5 We support the Commission's preliminary view on that issue,
6 that there are -- this is in terms of transmission here,
7 there are two transmission markets; the Taranaki to Rotowaro
8 point to point transportation, there are two lines
9 potentially, though we come back and make a point about this
10 in a moment, and then the balance of the North Island.

11 Again in thinking about relevant markets we think it's
12 important to be aware of that distinction between
13 specification and non-specification gas. The framework
14 paper asks whether, or what evidence there might be for
15 concluding that market power has been used, and we would
16 have to say that the evidence is really circumstantial
17 rather than conclusive, partly because of the informational
18 difficulties that we talked about earlier.

19 It's hard to draw very firm conclusions, but we would
20 note that there are even on the disclosure data that is
21 there, and it's not in our view wholly adequate, but what
22 there is there, it can be quite hard to explain some of the
23 discrepancies that one sees based on issues such as customer
24 density.

25 We have been aware of instances where threatening to
26 bypass has elicited significant reductions in charges for
27 affected customers, and simultaneously charges have moved
28 elsewhere upwards for other customers. Again, you can't
29 make a definitive conclusion from that, but it does -- it is
30 suggestive of market power being used.

31 Then finally, actual instances of bypass, which would

1 seem to us to indicate that there has been some pricing
2 significantly above marginal costs.

3 **MR STEVENS:** One point if I can ask you on that, Mr Hunt. Have
4 Contact been able to secure a discount from a pipeline
5 transmission to secure a customer? Have you been able to
6 negotiate that?

7 **MR LOVE:** Yes, I'll try and answer that question. Yes, we are
8 aware of one circumstance in which we were involved in and
9 that was for the transport of gas to the Otahuhu Power
10 Station.

11 **CHAIR:** I just want to follow-up the point made, Mr Hunt, on
12 whether the instances of actual bypass suggest that prices
13 have exceeded marginal costs, and I wonder if marginal costs
14 are the right test here given the nature of the industry
15 that we're dealing with. It seems to me in a high fixed
16 cost industry you can't go simply on marginal cost. I just
17 want to see if you accept that general proposition.

18 **MR HUNT:** We do, and indeed it would be impossible for new
19 pipelines to be built, or existing pipeline operators to
20 service their capital if prices reflected, you know,
21 marginal cost all of the time.

22 I suppose the issue here though is, it seems to us that
23 where there is a natural monopoly asset, if it is being in
24 effect duplicated, then that would be something that would
25 be a surprise to most observers I think, unless there was
26 obviously full utilisation already.

27 **CHAIR:** Right. Okay, thank you.

28 **MR HUNT:** If we turn to look at the potential for inter-fuel
29 competition. Certainly it is our view that the scope for
30 large gas users is very limited in the short-term. Almost
31 without exception they have large sunk specific assets that

Contact Energy

1 are really dependent on gas, whether that be for making
2 processed heat, petrochemical production, or power
3 generation. And so for them it's not really a viable option
4 to switch to another fuel in the short-term.

5 For smaller users it is a bit more realistic, but
6 nonetheless they too tend to have some sunk assets. So I
7 guess our view is that there is some scope for competition,
8 but it's not huge, and particularly for some parts of the
9 gas using --

10 **CHAIR:** I might ask you whether Contact has ever tried to
11 estimate the price sensitivity in terms of different types
12 of consumers switching in response to an increase in either
13 electricity or gas; have you looked at that in detail?

14 **MR HUNT:** I'm not aware of us ever having done any elasticity
15 studies per se. I'm certainly aware they have been done in
16 other markets, but I don't believe we've -- I'm happy to
17 check on that but I'm not aware of any.

18 **CHAIR:** In your own commercial experience, have you seen any
19 strong evidence of switching in response to price changes in
20 any of these segments?

21 **MR HUNT:** We've seen -- yeah, it's probably sort of indicative
22 of this -- we've seen instances where, and this is the only
23 one that comes to mind, but small users and I'm talking
24 residential users here, who, even within residential users
25 at the smaller end of the scale there have been a number of
26 users who have switched from using piped gas to bottled gas
27 and that's primarily a fixed charge issue, and so I guess
28 there's that. But I can't think of other evidence that I'm
29 aware of, of linking the price to the behaviour.

30 **CHAIR:** And the example you gave is one where you think they
31 switched because the pipeline cost was too high?

Contact Energy

1 **MR HUNT:** Well, I wouldn't -- that may be the issue, but it's
2 really I guess -- the issue I'm thinking of in particular is
3 a couple of years ago now I think, where Contact as a gas
4 retailer was not reflecting fixed charges through to its end
5 consumers, fixed charges that we were seeing from our
6 suppliers; and to better reflect those charges through we
7 started to charge a fixed charge, or increased the level of
8 the fixed charge. And as a response to that we saw some gas
9 users turn from, as I say, piped gas to bottled gas. And
10 these are people who might have just one gas ring for
11 example, or a gas stove; not a high load hot water or space
12 heating.

13 **MR STEVENS:** Can I ask a follow-up question please Mr Hunt.
14 Some of the other submitters have said in their submissions
15 that organisations which are both electricity -- retail both
16 electricity and gas are incentivised to use gas for
17 electricity generation rather than sell to the end users.
18 Do you have any comments on those submissions?

19 **MR HUNT:** Yes. I don't follow the logic I suppose. From our
20 perspective, whether -- and I'll be quite open -- our
21 objective is a commercial objective and whether a unit of
22 gas gets turned into revenue through a power station or
23 going through someone's gas stove, the issue for us is
24 what -- you know, what is the end financial result from that
25 process? So unless there was something that always creates
26 a bias against, you know, direct sales to customers, then I
27 don't see why we would ever have a view one way or the
28 other.

29 **MR STEVENS:** Are there higher margins per customer, say, on the
30 gas retailing business vis-a-vis the electricity retailing
31 business?

1 **MR HUNT:** I probably -- to give you a definitive answer need to
2 go back and consult with colleagues, but as a general
3 proposition the observation I would make is that the gas
4 market in New Zealand is going through a lot of change at
5 the moment as Maui runs down, and so we're seeing higher gas
6 prices coming through the market generally.

7 Now, in terms of what particular use of gas produces the
8 best financial result for a company on a given day, I think
9 it will vary through time to be perfectly honest with you.
10 Some days it's power stations because spot prices may be
11 very high during winter. On other days it might well be
12 retail customers because, you know there's lots of water
13 around, power stations are turned off.

14 I think the view that we take is based more around kind
15 of long-term movements, and there I would be surprised if in
16 the long-run all of these different uses of gas weren't
17 producing much the same financial result. You know, things
18 will kind of even out. **[Pause]**.

19 Alex was just pointing out to me that we in effect run
20 an internal transfer price between the different bits of the
21 business, so the part of the business that Alex works in
22 sells gas to our power station group and to our retail gas
23 group, and it's the same price.

24 **MR STEVENS:** How sensitive do you become to the price of
25 electricity -- sorry, how sensitive does the changes in
26 price from gas become then, even when you're doing that
27 transfer pricing issue?

28 **MR HUNT:** I think it's sensitive in the sense that it in effect
29 changes our behaviour and it obviously -- price signals
30 ripple out through our business and to our end-use
31 customers. How all those different customers react to that

1 is something that, you know, we're still learning about to
2 be perfectly honest, these are changes that are happening as
3 we speak, as New Zealand turns from Maui gas to other
4 sources of gas.

5 **MS BATES QC:** Just, my impression is, when you're running a gas
6 business and an electricity business, and obviously you're
7 going to run those businesses to get the maximum profit out
8 of each, that there's a real conflict in terms of being able
9 to provide competition, in that you will do what best suits
10 you, but from the consumer's point of view it won't best
11 suit the consumer.

12 **MR HUNT:** I think if we were the sole supplier of gas and
13 electricity that might well be the case. I'd make two
14 observations. Generally speaking where we are a supplier of
15 gas we're not the major supplier of retail electricity, and
16 vice versa. And even where we are able to supply both and
17 have -- and generally speaking our so-called incumbencies
18 don't overlap, but even when they do there are other
19 suppliers, there are other suppliers of electricity and
20 there are other suppliers of gas. In fact, Contact has lost
21 a lot of gas customers over time because of that effect.

22 **MS BATES QC:** The two arms of your business cannot be in
23 competition with each other?

24 **MR HUNT:** Yeah, right. That's true in I guess a literal sense.

25 **MS BATES QC:** Well, it's probably true in a practical sense.

26 **MR HUNT:** Well, it's -- no, I'm not so sure. For example, if a
27 customer rings and says, can you help me find someone who
28 will connect my new house up to gas, if they want to be
29 connected to gas we won't say "oh have you thought about
30 electricity" and vice versa. We don't operate that way, so
31 we're not -- there isn't a --

1 **MS BATES QC:** At that point.

2 **MR HUNT:** At that point, and I think that's probably the point
3 that matters because most people once they've chosen gas, or
4 electrical hot water or heating, it's difficult to change in
5 the short-run.

6 **CHAIR:** When you say that you've lost quite a few of your gas
7 customers, was that lost to other retailers that have both
8 gas and electricity? Or does it -- we've always wondered
9 how, you know, whether having both gives you a bit of a
10 competitive advantage over people challenging one or the
11 other. When you look at areas of overlap are there many
12 areas where you overlap with another retailer that retails
13 both gas and electricity?

14 **MR HUNT:** Again, we'd be happy to come back to you with more
15 definitive data. My recollection is that quite a number of
16 our gas customers are being lost to small stand-alone gas
17 retailers.

18 **CHAIR:** Right.

19 **MR HUNT:** Auckland Gas Company is one that comes to mind. I
20 think we've lost customers to Genesis, I think we've lost
21 customers to Wanganui Gas. So, I think it varies, but what
22 the balance is between them, I couldn't say.

23 **CHAIR:** Right, okay. Thank you.

24 **MR HUNT:** Still thinking about competition, if we turn to the
25 question of competition between networks. I guess our high
26 level conclusion is that the scope for inter-network
27 competition is fairly limited in New Zealand, which perhaps
28 isn't surprising. There is obviously one piece of
29 transmission network that is in effect replicated, the
30 Taranaki to Rotowaro line. We would note, though, that on
31 that route the demand for gas moving north is around 120

Contact Energy

1 terajoules per day, and the NGC line as we understand it,
2 the capacity is around 30 terajoules per day. So,
3 competition is certainly potential, but it's -- it may be
4 more limited in practice than one might suppose. I should
5 say this is partly looking forward a wee bit as well.

6 The other point is that bypass is -- competition is only
7 going to be feasible where bypass is a real threat, and that
8 obviously doesn't apply to the greater parts of most
9 networks, it's really where there is concentrated load such
10 as CBDs or high industrial areas.

11 **CHAIR:** Can I just go back to the first point about the 30 TJs a
12 day with the NGC line, and I guess the question always is,
13 is well how much does there need to be in order for it to be
14 a constraint, and in the case of this business I'm -- I
15 mean, some markets you'd think 30 compared to 120 is pretty
16 significant and might -- you don't have to be able to fully
17 contest every bit of it, but -- so I just wonder how you
18 would think under what circumstances and for whom does this
19 30 TJ really allow for contestability and what circumstances
20 wouldn't it?

21 I mean, for instance if you are looking for an
22 alternative, would this be sufficient to meet your
23 requirements? Is there enough capacity there to meet
24 Contact's requirements?

25 **MR LOVE:** Yes, there would probably be sufficient capacity on
26 NGC if we had access to all their capacity, for Auckland.

27 **CHAIR:** But you'd need access to all of it basically?

28 **MR LOVE:** Yes.

29 **CHAIR:** And have you ever been able to leverage these two
30 against one another in terms of our own negotiations? If
31 you can't answer in an open forum, just tell me.

1 **MR LOVE:** No, well, I think everyone knows that there are
2 different arrangements at present on the Maui pipeline than
3 prices, bundles, there are no unbundled charges for
4 transportation, so all our Maui gas is transported on the
5 Maui line; we would only use the other line for --

6 **CHAIR:** Now that there's talk about the Maui line being made
7 available, do you see any changes in your ability to
8 negotiate terms and conditions on the other line?

9 **MR LOVE:** I guess that's possible, but on some occasions we've
10 actually gone to NGC and asked for capacity on their line
11 north, particularly during periods of Maui outage where
12 we've wanted to get our gas in Taranaki north without using
13 the Maui line and we've been told that there hasn't been
14 capacity available. We also understand that NGC operates
15 their line in ways where it may not be transporting gas
16 north, but I guess you'd need to ask NGC about those issues
17 [Pause].

18 David's just suggested I remind you of the capacity on
19 the Maui line. Now, I think it's probably something like
20 600 terajoules; it's huge compared to the NGC.

21 **CHAIR:** Oh I see. Sorry I misread what's here. So, it's
22 comparing -- yeah.

23 **MR HUNT:** I suppose the point really is that if the NGC line
24 becomes fully utilised then capacity is -- competition is --
25 there's no scope really until it becomes available with some
26 more capacity again. And it's still 25% of the market, but
27 it's much smaller than the Maui line.

28 **CHAIR:** But even, I would have thought that even if the capacity
29 was fully utilised, that would be set in contracts; there
30 would be competition for those?

31 **MR HUNT:** At the moment it's a year to year nomination correct?

1 **MR LOVE:** For the NGC.

2 **CHAIR:** But normally the shorter the term of the contracts the
3 more effect it has on constraining the market.

4 **MR HUNT:** That's right. One of the uncertainties for both the
5 Maui and NGC lines is what regime will apply going forward;
6 to what extent -- the point exactly that you raise, what is
7 the nature of the contracting regime? Is it short-term
8 contracts, is it long-term contracts, is it a balance
9 between the two?

10 **CHAIR:** Right.

11 **MR HUNT:** We now look at the framework that the Commission has
12 proposed for carrying out its inquiry. Our view is that
13 the -- we support the Commission's proposed approach. You
14 obviously recognised that it's a complex task that you're
15 engaged in. We believe it appears sensible to us to try and
16 assess the efficient level of pricing, both using what
17 empirical data is available and also the building block
18 approach that's been talked about. Comparing those with the
19 results of that analysis with what you actually observe and
20 also considering the potential costs of applying control.

21 In terms of the public benefits test per se, our reading
22 of the material is that the Commission is proposing a
23 framework based on measuring the net public benefits, net
24 public detriments; that you are not placing weight per se on
25 pure distributional effects and we support -- if we're
26 correctly understanding what's proposed, we support that
27 approach.

28 We would note, however, that the -- and this perhaps
29 comes back to the point that the Chair was just making
30 earlier about marginal costs -- that it's very important how
31 efficiency is measured, and we certainly would be concerned

1 if -- and maybe it's just a theoretical construct, but if
2 someone could successfully argue that they were, you know,
3 productively efficient, there were no dynamic losses and
4 they were able to charge what they liked as long as marginal
5 costs were equivalent to their -- sorry, prices were
6 equivalent to marginal costs, that they were able to provide
7 a two part tariff or similar.

8 So, it's not a straightforward issue, and I'm sure
9 you're aware of that. That is one of the issues that we'd
10 like to think a bit more about as we move sort of into the
11 next stage of the process.

12 Another thing that we are very conscious of and I
13 suppose I'll be honest with you here; although we have no
14 investments in pipelines and, therefore, our primary
15 interest is as a consumer, we also have some similarities
16 with pipeline owners, though, in as much as we have large
17 sunk assets. And so one of the things that always concerns
18 us generally speaking about regulation making is to ensure
19 time consistency, and I guess we think it's probably worth
20 just making the observation that, you know, we as a large
21 consumer of pipeline services, along with other consumers in
22 the economy, could potentially gain significant financial
23 benefits in the short-term from price control, aggressive
24 price control, even if it weren't justified, but there would
25 obviously be some downside to that further along the track.

26 And in particular that would in our view tend to
27 undermine incentives to invest and maintain pipeline assets.
28 Those costs could be quite severe, both in the short-term
29 and over time and, therefore, that's something that -- and
30 that's not, you know, a new issue, but nonetheless it's one
31 that is important and we think deserves very careful

1 consideration.

2 **CHAIR:** What would you consider an aggressive form of price
3 control?

4 **MR HUNT:** I'd rather not give you an answer to that just sitting
5 here. But certainly we've seen instances around the world
6 where "regulators" have, if you like, done something that
7 was perceived as changing the regulatory bargain. I think
8 people -- you know -- at the end of the day we're talking
9 about relationships here between consumers and producers
10 with the regulator acting there as somewhat of a kind of a
11 neutral party, and I think there are instances where that
12 bargain has been remade and it's been at the benefit of the
13 consumer in the short-term but potentially to their long-
14 term detriment; and that's really what we're saying here,
15 that it's something that, you know, we all need to avoid I
16 guess, even though we as a consumer may potentially benefit
17 significantly from control in the short-term.

18 **CHAIR:** I just want to follow that up a little bit, because I
19 was interested in some of the comments you made about the
20 ODV, some of the issues around the current application of
21 ODV methodology, and maybe some strong arguments that a
22 regulatory bargain was struck in terms of the Government's
23 approach to disclosure and that that basically was part of a
24 bargain that was struck. We certainly had issues around the
25 same matter when we looked at the electricity lines
26 businesses, and I suspect similar issues are going to come
27 up here, but if I understand your submission, you don't
28 necessarily believe that there is such a regulatory bargain
29 that has been struck, vis-a-vis how ODV is used; you don't
30 think the Commission necessarily should be restrained from
31 looking at possibly changing part of that bargain, if it was

1 one?

2 **MR HUNT:** I think, to give you a specific answer, we'd need to
3 look a bit more closely at what was said at the time. I
4 think the issue here -- and I'll give a personal view here;
5 I would be surprised if one could argue that was an explicit
6 regulatory bargain, because there were earlier bargains that
7 were overturned by that one.

8 **CHAIR:** You would be surprised if? Sorry, I didn't understand.

9 **MR HUNT:** I would be surprised if one could argue that that was
10 a moment in time that defined a bargain that was forever to
11 hold for the next 50 years. But you may well come to the
12 same conclusion from a different test, which is I think the
13 sort of go forward test, if you like. Which is, if at the
14 end of the day the Government as sovereign can change the
15 law, Parliament can do anything, but it doesn't use that
16 power lightly and it, you know, it delegates those powers to
17 certain bodies, including the Commission.

18 I guess the point we're making here is that the --
19 notwithstanding the power exists, how it gets used will not
20 only influence today but the future. And so, if the bargain
21 is reshaped in some form that it is perceived by -- and
22 genuinely perceived by producers as being unfair, then they
23 may not have very much they can do about their sunk
24 investments but they do have a lot they can do about their
25 future investment.

26 **CHAIR:** One of the submissions, I believe it was from Genesis,
27 suggested that they -- if I recall correctly -- they believe
28 the test is met in terms of what's required under Part 4,
29 but they also suggest that the form of control ought to be
30 at least as intrusive as that which applies to the
31 electricity lines businesses, which is -- I don't know,

1 probably falls somewhere in the middle ground in terms of
2 the degree of intervention.

3 You will know, we will have to decide what is the form
4 of control that we will test against and do you share their
5 view on that, that that's the sort of regulatory framework
6 you might want to be considering when you make these
7 comparisons?

8 **MR HUNT:** I think there are probably two issues. One is the, if
9 you like, the form; whether it's what was proposed for
10 airports or what was proposed -- well, not proposed, but
11 being applied for electricity lines businesses. But that,
12 again if I can give a personal view here; to me, that's one
13 part of it, but I think the other part is the, what are the
14 inputs into the analysis. I mean, I would use an example
15 from off-shore. In the United Kingdom there were changes
16 made there in some parts of the -- and I'm thinking
17 particularly electricity transmission -- where it was RPI-X.
18 X was a very large number, and I'm thinking, it's much the
19 X, if you like, as anything else that in the UK at least was
20 perceived as unmaking the bargain.

21 **CHAIR:** All right. Thank you.

22 **MR HUNT:** If we look at the inquiry timetable. From an overall
23 perspective it seems to us that there is sufficient time to
24 come to a proper answer. We would note, though, that there
25 are two quite lengthy periods between now, or the end of
26 cross-submissions and the draft report in March, and then
27 subsequently between the cross-submissions following the
28 Conference next year and the final report to the Minister,
29 where obviously the Commission will be doing a lot of work,
30 but interested parties from both sides will be watching and
31 waiting, and the question that has come to our mind is

Contact Energy

1 whether there isn't potential to get more engagement in
2 those periods, and I guess the flipside of that is whether
3 there is sufficient time for particularly following the
4 draft report, for quality feedback on that report.

5 We just wonder whether that timetable might be able to
6 be adjusted a little to allow more engagement. Particularly
7 parties like Contact who, to be perfectly honest, we don't
8 have people following the detail of some of these issues
9 full-time, and so we will be engaging consultants and they
10 really can't do their work until they know what the draft
11 report is, to allow sufficient internal time for us and then
12 to put in a quality submission. It says April/May, but we
13 don't know whether that's sort of early May, late May; the
14 more time, the better we think we can engage.

15 **CHAIR:** So your suggestion is to allow greater time between when
16 the draft is made available and when parties have to
17 comment?

18 **MR HUNT:** Yes, and if that in turn needs some adjustment
19 somewhere else, it seems to us that there's a bit of time in
20 there that might allow for that.

21 In conclusion then, we are a significant buyer, user and
22 reseller of gas. We welcome this inquiry. As I said
23 before, we are at the point of, if you like, gearing up for
24 this inquiry, so our focus has been on what we think are the
25 larger issues.

26 At this point it seems to us that the Commission has set
27 about its task and is moving in the proper direction, and we
28 look forward to engaging in more detail as the inquiry
29 progresses.

30 **CHAIR:** Thank you for that. I just want to come back to one
31 comment you made about the test, the public benefit test and

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1 it's correct to say when we do a net public benefit test we
2 look at the efficiency effects; that's all it is, there are
3 no distributional effects taken into account. And I
4 understand that you agree with that. However, the Act
5 actually requires us to do a test that looks at the net
6 benefits to acquirers, and in doing that part of the test,
7 that test, we will look at distributional effects.

8 So, I just want to understand your position. In the
9 Airports Inquiry we did both, even though the Act didn't
10 necessarily require us to do the pure net benefit test that
11 the Commission often focuses on in other settings; we did
12 both. In this case the Government has requested
13 specifically that we do a net public benefit test, but the
14 Act does require that we do the test looking at benefits --
15 net benefits to acquirers, and that will pick up
16 distributional effects.

17 Are you arguing that we shouldn't do that bit of the
18 test, or are you -- I want to be clear on your position on
19 this. I mean, you do seem to be concerned about the
20 distributional effects, and I'm not sure that you -- you may
21 not have understood exactly what the approach is.

22 **MR HUNT:** I think you're correct, we didn't understand the
23 approach, and so, just reflecting on what you've said, it
24 seems to me the two tests might well give different answers.

25 **CHAIR:** That's absolutely right, they may well do. They may
26 not, but they may.

27 **MR HUNT:** I suppose the issue as we perceive it is that, to the
28 extent that -- well, to the extent they give different
29 answers, the reason will presumably be in part because the
30 allocation of purely distributional effects, if you like,
31 the allocation of consumer surplus, producer surplus, and I

1 suppose again wearing a kind of strictly kind of economic
2 hat, it seems to us difficult to make judgments about which
3 of different outcomes is better from a national economic
4 perspective, and that's really why we've framed our thinking
5 around a national economic benefit test.

6 Having said that, we are also conscious though that, you
7 know, concepts of marginal pricing are, you know, in effect
8 depend a bit on the time unit and the production and
9 quantity unit and, you know, how one thinks about those
10 might well change the answers that one gets.

11 So, I can't give you a very clear answer I'm afraid.

12 **CHAIR:** Okay, that's fine.

13 **MS BATES QC:** I just, and probably this is in your main
14 submission, I might have forgotten, but what proportion of
15 your business is actually your gas business?

16 **MR HUNT:** About a third of our business is related to gas,
17 either using gas or, you know, buying and selling gas.

18 **MS BATES QC:** And what about if you are looking at just
19 retailing gas?

20 **MR HUNT:** Well, by customer numbers, the gas customers are about
21 20% of the business, and we used to have quite large gas
22 customers, but -- what's our revenue split? Similar? It's
23 probably similar, maybe a bit higher.

24 **MS BATES QC:** 20%?

25 **MR HUNT:** Around that level, but maybe a bit higher. We have
26 some very large gas customers.

27 **CHAIR:** I'll just ask if staff have any questions you'd like to
28 ask of Contact.

29 **MS BEGG:** I just had a question on your comments on the
30 information disclosure regime, and you had a number of
31 proposals of how that could be enhanced. The concerns you

1 have from the point of view of your own business, would they
2 be mainly resolved by enhancing the information disclosure
3 regime, or are your problems such that you would be looking
4 at something beyond that?

5 **MR LOVE:** Yes, I think we've thought in the past with an
6 enhanced information disclosure regime we could largely
7 address the kind of issues that we've seen.

8 **MS BEGG:** Just another question. You supported the building
9 blocks approach that the Commission's proposing, and that
10 asset valuation is obviously an important part of the
11 building blocks. I just wondered if you'd reached a view on
12 whether depreciated historic cost or ODV or ODRC type
13 approaches, which of those you support?

14 **MR HUNT:** I think that's a question we'd prefer to leave till
15 the next stage. It's one of a number of issues we'd be
16 looking to get more expert advice on.

17 **MS BEGG:** There was another issue, on the inter-fuel competition
18 issue, you said that some gas users find it hard to
19 substitute for other fuels because they have large
20 investments in specific assets. Now, obviously the assets
21 you're talking about are sunk so they shouldn't affect their
22 decisions going forward.

23 Is your concern here that if they were to switch they'd
24 need to invest in other sunk assets, or...? Yeah, I just
25 wonder if you could clarify what that --

26 **MR HUNT:** It's really observing that once we've built a gas-
27 fired power station we can't run it on coal, so at that
28 point if someone is supplying us with gas on a non-
29 contracted transmission basis, for example, then we are an
30 obvious target, is really the point that I was making.

31 **MS BEGG:** So you've got the quasi rents that could be

1 appropriated?

2 **MR HUNT:** Yes.

3 **CHAIR:** Any further questions from staff? **[No questions]**.

4 Okay. At this point then, unless you have further comments
5 you'd like to make, I'd like to thank Contact Energy for the
6 submission. We will give careful thought to the timing for
7 the rest of the process. It's very important to the
8 Commission to have the input from major users of gas, so we
9 will give that careful consideration and thank you for your
10 submission.

11 I now propose to break for 15 minutes. I normally would
12 not break at this point but I do have to attend to one other
13 matter, so I propose to reconvene this session at 11.20 at
14 which time Powerco will be presenting. So with that I'll
15 adjourn for now. Thank you.

16

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18 **Adjournment taken from 11.05 am to 11.20 am**

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PRESENTATION BY POWERCO

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CHAIR: We will reconvene the Conference on the Gas Control Inquiry now, and I would like to welcome Powerco and although I welcome you to the Commission, I will ask you to introduce yourselves once more for the record and begin your presentation when you are ready, please.

MS HEINE: Thank you, Madam Chair. My name is Victoria Heine, I'm from Chen Palmer & Partners, I'm going to introduce and commence Powerco's presentation today.

To my left I have Steve Boulton, Powerco's Chief Executive. Next to him, Mr Barry Upson, Powerco's Chair. Then we have Mr Euan Morton who's an expert for Powerco from NECG in Australia, and finally Mr Peter Seed also appearing as an expert.

I thought it would be helpful if I briefly ran through the structure of what we're planning to present to the Commission today. I will briefly introduce what we see as the four -- or some of the four key legal issues which arise from the Commission's framework paper.

Mr Boulton will address current market conditions. The themes of his presentation are threefold. He looks at the current constraints on gas distributors; we say that there are a number of unusual features of the gas industry which act as a constraint on distribution companies; address the impact of underinvestment in infrastructure and look at the behaviour of vertically integrated companies.

Mr Upson looks at investment and investors, focussing on the Chair's perspective, looking at the fixed cost nature of the pipeline industry and the impact on the company in response of investors to regulation.

1 Euan Morton's presentation is under the broad rubric
2 behavioural regulation. He focuses on regulatory
3 developments in Australia, coverage test in Australia to the
4 extent that that's relevant to the Commission's
5 deliberations and proposes an appropriate threshold test for
6 New Zealand.

7 Finally Peter Seed addresses valuation issues, looking
8 at the appropriate valuation approach, valuation date
9 issues, easements and optimisation treatment.

10 In terms of the four issues that I'll be talking about
11 today, and I'll do so relatively briefly, I'll address the
12 counterfactual, issues in relation to workable competition,
13 net benefits and some proposals we have for the way forward.

14 It's apparent from the Commission's paper that it is
15 largely proposing that the counterfactual which will be
16 accepted is the status quo. We say that that -- we contend
17 strongly that that is not an appropriate choice of
18 counterfactual.

19 In support of that proposition we'd like to draw the
20 Commission's attention to the following: We've attached as
21 Schedule B to the submission a number of public statements
22 emanating largely from the Minister which indicate the
23 likely direction of the Government's proposed reforms for
24 the gas industry, and it's apparent from those that the
25 disclosure regulations are likely to be strengthened, and
26 secondly, that the Government is formulating proposals for
27 regulation should the Gas Industry Steering Group fail to
28 produce a statutory outcome.

29 Now, there is one other document that we say is highly
30 relevant to the choice of counterfactual, and that document
31 is a draft consultation paper which the Minister has

1 provided to the Gas Industry Steering Group on a
2 confidential basis. We're unable to disclose to the
3 Commission at this time, but we have initiated discussions
4 with the Minister's office with a view to obtaining
5 permission for that to be disclosed. We haven't at this
6 stage secured that consent, but we say it's relevant to the
7 inquiry because it sets out the Government's proposals in
8 more detail than the public information we've set out in
9 Schedule B.

10 **CHAIR:** I just want to ask you there, if I can: That document
11 that you're trying to get released for our purposes, what is
12 it exactly? Is it a Cabinet paper or is it a...?

13 **MS HEINE:** No, it's termed a Draft Consultation Paper.

14 **MR BOULTON:** I might just answer that one, I'm on the GISG; it's
15 a draft consultation prepared by the MED, as I understand
16 it, which has been shared confidentially with the GISG
17 members at this point in time. It's important from our
18 perspective that the Commission should have some exposure to
19 that when it's released.

20 **CHAIR:** Do you accept that a consultation paper prepared by a
21 Government department is not necessarily a statement of
22 Government policy?

23 **MS HEINE:** It in fact emanates, it was presumably prepared by
24 MED, but in fact emanates under cover of the Minister's
25 office. We accept that it is not a statement of current
26 Government policy, but we believe that it is an indication
27 and an accurate indication of possible Government policy.

28 **CHAIR:** Do you think the Commission can build a counterfactual
29 on possible changes to Government policy that haven't been
30 agreed?

31 **MS HEINE:** In my view Government policy changes to a regulatory

1 environment are as relevant to selecting a counterfactual as
2 any other thing that the Commission takes into account.

3 **CHAIR:** I think changes in Government policy are, but what I'm
4 asking you is whether speculation about possible Government
5 policy changes; it seems to me we have a clear means
6 provided for in the Act for the Government to transmit to
7 this Commission statements of Government policy if it
8 chooses to do so. At this stage it has not chosen to do so
9 and in fact it's putting together a consultation document
10 but it is not a statement of Government policy.

11 So, what I'm asking you is, is it not probably correct
12 to say that the Commission should take account of Government
13 policy as transmitted to it through statements of Government
14 policy as provided for under the Commerce Act?

15 **MR BOULTON:** In a timing issue hopefully that will be resolved
16 for us very quickly if that is promulgated as official
17 policy within the next few months, hopefully that will be
18 recognised as a document that we can have direct reference
19 to, but accept your point in that sense.

20 **MS HEINE:** I think Madam Chair, it really depends on what you
21 mean by "Government policy", and I would accept, for
22 example, that Government policy with respect to
23 environmental issues, for example, would not be something
24 that the Commission could logically build a counterfactual
25 around.

26 But as this slide indicates, if the form of policy
27 change that is being considered is a form of regulation such
28 as provision for open access or terms of access to
29 distribution systems, something that fundamentally alters
30 the nature of the regulatory environment through
31 legislation, then that must be relevant to the choice of

1 counterfactual.

2 **CHAIR:** I'm certainly not questioning whether a change to
3 Government regulation would be relevant and we should take
4 it into account. What I'm questioning is, what is the
5 status of the current consultation document, and I think
6 you've acknowledged that it is not the same as a statement
7 of Government policy, it is one possible scenario that the
8 Government could pursue if it chose to do so.

9 **MS HEINE:** I accept that and perhaps if the Commission could
10 note that we will endeavour to keep the Commission appraised
11 as to what is occurring with respect to policy, and as I
12 think Mr Boulton acknowledges at some point in the timing
13 issue it may well become relevant.

14 **CHAIR:** I understand the point. I just would like to go back
15 to -- if you wouldn't mind going back to your previous slide
16 where the first point was about the gas regulations in terms
17 of information disclosure, or are likely to be strengthened,
18 and I was just trying to see in the appendix whether it
19 indicates in what way and what do you mean by
20 "strengthened"? And where exactly in your submission is
21 that reference to in terms of establishing that the Crown
22 intends to strengthen the information disclosure regs that
23 pertain to gas.

24 **MS HEINE:** Perhaps if I can take you to Schedule B to the
25 second-to-last document from the end, and there may well be
26 other statements within that schedule which I can identify
27 perhaps at the lunch break. But, to deal with the point at
28 present, under ii on page 7, fourth bullet point talks, for
29 example, about requiring multi-utility lines businesses to
30 disclose double-counting of common costs by way of example
31 of what's proposed.

1 **CHAIR:** So this is from a speech that the Minister of Energy
2 gave to a Conference about the -- what he would expect to
3 come out of the industry-led process?

4 **MS HEINE:** Yes.

5 **CHAIR:** Right. And at this stage we, of course, don't know
6 what's going to come out of that industry-led process, do
7 we?

8 **MS HEINE:** And given the timeframe that this inquiry is
9 encompassing, we may well by the time we get to November
10 2004.

11 **MS BATES QC:** Ms Heine, just one thing that occurs to me, and I
12 don't quite know where you're heading with this, but why do
13 you think the Government would set us off on this rather
14 expensive and possibly complex process if what it was going
15 to do is make up its mind on the basis of some other
16 information?

17 **MR BOULTON:** I think the general view that I would have in
18 response to that is that there's been a general dearth of
19 information over a period of time and working through the
20 electricity process, it's only now that companies and the
21 Commission and advisors have had the opportunity to further
22 evaluate the sector and its performance, that new
23 information is becoming available, part of the learning
24 process and the learning cycle to end up with the right
25 outcome at the end.

26 I think on that basis the Government itself, when it
27 relies upon its advisors in the Government circles are
28 picking up more information, hence asking more questions,
29 finding more data information to then perhaps change their
30 view on a number of matters, and that's effectively what's
31 happening in the marketplace.

1 **MS BATES QC:** So, how do you see this inquiry as fitting into
2 that picture, Mr Boulton?

3 **MS HEINE:** Unfortunately for industry, dual inquiries between
4 the Commission and political processes are not uncommon.
5 For example, there is still a Select Committee Inquiry
6 continuing into aspects of the electricity industry which to
7 some extent overlap with the Commission's electricity lines
8 inquiry; and to an extent that is the logical outcome of the
9 separation between the Commission's activities and political
10 deliberations, that's enshrined in s.26. So, as to how --

11 **MS BATES QC:** This is an inquiry that's generated by the
12 Ministry, Ms Heine.

13 **MS HEINE:** It is generated by the Ministry, but I can't
14 speculate, Commissioner Bates, as to why the Government
15 would choose to process this inquiry in tandem with other
16 initiatives.

17 **MS BATES QC:** Well, let me put it to you this way; if you are
18 putting it up to us as the most likely counterfactual that
19 there will be a regulatory scheme put in place prior to this
20 inquiry being completed, an inquiry which actually the
21 purpose of which is to advise Government, I think you might
22 need to come up with some -- a little more convincing
23 reasons.

24 **MS HEINE:** All I can say, Commissioner Bates, is that in terms
25 of the information that we have seen we believe that that is
26 a real possibility and we wish to draw the Commissioner's
27 attention to that, and I accept what Madam Chair has said,
28 that the nature of the evidence at this stage doesn't allow
29 the Commission to build a counterfactual around that
30 information, but nevertheless at this early stage of the
31 inquiry as we set the framework and the parameters for how

1 we proceed, it's an issue that we wish to draw to your
2 attention.

3 **MS BATES QC:** I thought you were making a submission, Ms Heine,
4 that the counterfactual that the Commission was putting
5 forward, i.e. The status quo, was unlikely.

6 **MS HEINE:** We are submitting that the status quo, as the
7 counterfactual, choice of counterfactual is unlikely and
8 believe that as time evolves over the next few months that
9 that will prove to be the case. That's our submission.

10 **MS BATES QC:** So you think that over the next few months there
11 will be for us a proposal or something coming out of
12 Government which bears on our inquiry, telling us what
13 regulatory framework there is going to be? Is that what you
14 are really saying?

15 **MR BOULTON:** Not in the broadest terms as you've just used
16 there, but there may be more information and a position put
17 forward that would be important for the Commission to
18 consider we believe, and hopefully the timeframe that's been
19 espoused at this early stage, we're looking at two or three
20 months away. There's simply more input.

21 **MS BATES QC:** I understand that, I can understand that; but I
22 suppose what I'm challenging you and pushing on this is, I'm
23 trying to ascertain how hard you are really arguing for an
24 alternative counterfactual at this stage.

25 **MR BOULTON:** We would be comfortable in putting forward a
26 stronger position, but we're not able to breach the
27 confidence of the paper that's been given to us, and so we
28 accept your view, but it's another important document, we
29 believe that will have additional information that we think
30 the Commission ought to take on board in terms of the
31 broader framework that might eventually be resolved. So, I

1 think that's in a nutshell what we're submitting in that
2 case.

3 **CHAIR:** I'd just like to follow-up, if I can. It does seem to
4 me that, if the Crown transmitted to us a statement of
5 Government policy that indicated that in some way
6 regulation, whether it's industry-led or Government led, is
7 it right; it seems to me clear that it must also affect the
8 factual as well as the counterfactual, we must then take
9 that, if we can take it and it's appropriate to do so; it
10 then affects both the factual and the counterfactual.

11 **MS HEINE:** Yes, yes, it does. It would have to.

12 **CHAIR:** That's right. I think probably we've taken this one as
13 far as we can at this point so I'd ask you to proceed with
14 your presentation, thank you.

15 **MS HEINE:** We've noted there the two sentences in which workable
16 competition is relevant, both to the s.52(a) requirement for
17 limited competition, and by reference to the fact that the
18 ultimate goal of regulation is to seek to mimic a
19 competitive market.

20 I've noted that the difficulties with the limited
21 competition test were identified by the Ministry of Economic
22 Development, who have indicated that provision is subject to
23 review and their concerns were that the test is too low, and
24 could apply to many markets in New Zealand.

25 The concentrated nature of the gas industry is such that
26 virtually any company could be captured by it. One of the
27 factors that the Commission set out in the Telecom wholesale
28 determination relevant to an assessment of limited
29 competition was the number of market players and the reality
30 is that, in this industry, there are very few.

31 We've noted that workable competition falls on a

1 spectrum between perfect competition and pure monopoly, and
2 obviously what degree of competition is workable competition
3 is a very complex issue.

4 Mr Morton will take the Commission to an Australian
5 case, Epic, which advocated a robust and realistic approach
6 to what constitutes workable competition, bearing in mind
7 the realities of the New Zealand industry, and we've noted
8 there what we consider an apt quotation from that case.

9 **CHAIR:** Can I just clarify. Does this case refer to the test of
10 limited competition?

11 **MS HEINE:** I beg your pardon?

12 **CHAIR:** Does the Australian evidence relate to a test under
13 their Act that is similar to what we call "limited
14 competition" under our legislation?

15 **MS HEINE:** From what I recall of the Australian legislation,
16 there is a difference, whereas our Act specifically defines
17 "limited competition" as workable competition. The
18 Australian legislation simply refers to "limited
19 competition". So the Courts have had to then consider what
20 is meant by limited competition, and this dictum, if you
21 like, comes from a court grappling with an attempt to work
22 out what that means in a regulatory context.

23 **CHAIR:** I just want to come back to the MED statement; I don't
24 know what document that refers to.

25 **MS HEINE:** It's a Cabinet paper arising from the Airports
26 Inquiry.

27 **CHAIR:** You would accept, however, whether the MED accepts the
28 test is too low or not, or indeed whether the Commission
29 thinks the test is too low, it is the test in the Act?

30 **MS HEINE:** Oh, it's irrelevant what the MED think of the test.

31 **CHAIR:** Exactly.

1 **MS HEINE:** And the fact that it's subject to review is, in
2 strict terms, irrelevant to the inquiry you're conducting.
3 Merely, in terms of supporting our submission that the test
4 needs to be approached with caution, we've included that
5 quote.

6 **CHAIR:** Well, I don't necessarily understand why, if they choose
7 to advise the Government, the test is too low and needs to
8 be changed in the Act. It doesn't necessarily tell me that,
9 in the meaning while the Commission should approach the test
10 in the Act with caution.

11 **MS HEINE:** It doesn't -- I agree, I agree with that point, it
12 doesn't; but in terms of the argument we are making, it's
13 simply recording concerns that have arisen from application
14 of the test and then leads into our second slide, which is
15 talking about the concentrated nature of the industry. So,
16 it's reflecting that particular concern.

17 **CHAIR:** Okay. If you want to proceed, thank you.

18 **MS HEINE:** Workable competition 5 noted the somewhat trite point
19 that the purpose of regulation is to mimic competition, and
20 it's submitted that the Commission in terms of its
21 deliberations should not attempt to mimic a theoretical
22 perfectly contestable market, even if such a thing existed,
23 that the costs and risks of doing so are too high, even if
24 it were possible. And that the correct approach is simply
25 to seek to substantially improve on the unregulated market,
26 and request that the Commission bear this in mind when
27 hearing from subsequent presenters about the unusual
28 features of the gas industry.

29 **CHAIR:** I'd just like to stop you on that point. We have a lot
30 of submissions in almost every hearing -- in fact I'm sure
31 every hearing that we have, about what is workable

1 competition.

2 **MS HEINE:** I'm sure.

3 **CHAIR:** And in the last hearing that we had on
4 telecommunications we had this debate and I put it to the
5 parties that, in accepting that the test is workable
6 competition, you're not necessarily accepting that you don't
7 eventually get to efficient prices. There may be -- it may
8 take a bit longer to get there, you may not get efficient
9 prices in every period, but workable competition doesn't
10 sacrifice the basic outcome of efficiency.

11 And I want to ask you if you accept that, because it
12 seems to me your third bullet point which says "the correct
13 approach is simply to seek to substantially improve on the
14 unregulated market" and I wonder if that is correct.

15 **MS HEINE:** I might ask Mr Morton to address that point.

16 **MR MORTON:** I think it is true to say that one of the indicia of
17 a workably competitive market is that we don't have
18 particularly prolonged periods in which prices depart
19 materially from efficient cost. I would say, though, that
20 associated with that is some element of recognition that a
21 regulatory process does not necessarily generate prices,
22 neither do regulatory processes necessarily generate prices
23 that are totally consistent with efficient costs. And that
24 there are elements of imprecision associated with regulatory
25 processes, and perhaps that's something relevant to the
26 Commission's deliberations.

27 **CHAIR:** But you would accept that --

28 **MR MORTON:** Over the long-run? That we don't have prolonged or
29 at least material differences?

30 **CHAIR:** Yes.

31 **MR MORTON:** Between prices and efficient costs?

1 **CHAIR:** Yes, and that that should be the goal, where possible,
2 in terms of improving on the unregulated markets, should
3 there be market power. Would you accept that that should be
4 the goal of regulation, if it's necessary?

5 **MR MORTON:** I'm sorry, the goal to remove market power?

6 **CHAIR:** No, to -- in terms of what you might want to achieve
7 through regulation, should be in the long-run to see
8 efficient prices, not -- to see prices not diverging from
9 what are efficient cost-based prices over long periods?

10 **MR MORTON:** That is a goal of regulation. There is a question
11 of what regulation will actually accomplish relative to the
12 costs that it generates.

13 **CHAIR:** I do understand that point, but my question really is,
14 it seems that bullet point 3 about the correct approach is
15 simply -- and in this I assume this correct approach refers
16 to the purpose of regulation, is simply to seek to
17 substantially improve on the unregulated market, which it
18 seems it doesn't take you very far really. And what I'm
19 asking you is, isn't the objective to ensure that over the
20 long-term, taking account of the costs of regulation, that
21 you move to efficient prices that reflect efficient costs?

22 **MR MORTON:** I think what needs to be I guess borne in mind is
23 that first question you mentioned, about the presence of
24 substantial market power and the capacity of substantial
25 market power to influence outcomes given the totality of the
26 market environment as it presents, and I guess that there
27 are some unusual situations or some unusual circumstances
28 confronting the gas market in New Zealand, such as the gas
29 shortages, all of which need to be contemplated in the
30 concept of what regulation can actually deliver.

31 **CHAIR:** I mean, we'll come back to this issue of substantial,

1 I'm sure, because the Act talks about limited competition,
2 it doesn't talk about substantially limited competition, but
3 I fully understand the point you made and I think we've -- I
4 think I'm clear on what your position is, so we'll proceed
5 if we can, thank you.

6 **MS HEINE:** This part of the presentation addresses the somewhat
7 I think vexed issue of the distinction between the s.52 test
8 of whether control is in the interests of acquirers and the
9 net benefits to the public of control test, which the
10 Commission has requested the Commission to advise on, but as
11 the Commission properly notes in its framework paper it
12 can't actually make that determination itself; that's a
13 matter for the Minister.

14 What's apparent is that in terms of the framework of the
15 decision-making process overall, as set-out in the
16 legislation, that the Minister may take a wider range of
17 factors into account than the Commission.

18 We've noted in the third bullet point some of the things
19 that we thought could be relevant to the net public benefit
20 assessment in this particular case. For example, Government
21 policy on energy efficiency and regulation, Government
22 policy on the encouragement of investment in infrastructure,
23 including foreign direct investment, international treaty
24 obligations, so the Kyoto protocol for example may be
25 something that would be relevant to those sorts of
26 assessments, environmental issues and the Treaty of
27 Waitangi.

28 What we wanted to sound a caution about was the extent
29 to which the Commission can really take those matters into
30 account in conducting the net public benefit assessment. It
31 seemed to us to be constrained by limited access to

1 information and also by the inherently policy based nature
2 of those types of factors.

3 **CHAIR:** I just wonder on this point -- I mean, I understand the
4 difficulty in taking into account some of these things, it's
5 apparent from just looking at the list, but what I also
6 wonder, however, is, to the extent that these matters arise,
7 they arise in the factual and the counterfactual and how
8 much difference are they going to make to the net public
9 benefit test that we have to do, given they will affect both
10 the factual and the counterfactual? Will it make a big
11 difference? Even if we did want to take them into account,
12 or we thought we should, are they likely to matter given any
13 one of them would affect both the factual and the
14 counterfactual?

15 **MS HEINE:** These are matters, though, that aren't -- that are
16 not part of the Commission's statutory framework under s.52.
17 So, these are -- I mean, we argue that the net benefit to
18 acquirers test should be taking a relatively long-term view,
19 but I don't think we would argue that it should take these
20 type of matters into account.

21 **CHAIR:** I don't see the Commission argue that it should.

22 **MS HEINE:** No.

23 **CHAIR:** And I only see the Commission arguing if it thought that
24 somehow it would play out differently in the factual and the
25 counterfactual, but you're not arguing that it does?

26 **MS HEINE:** I don't think that these types of matters are
27 relevant to the s.52 test, I think they're further down the
28 track. In the Airports Inquiry the MED did all this and now
29 the Minister's decided he wants the Commission to do it.
30 Now I think there are questions as to the appropriateness of
31 that in terms of the administrative law framework of the

1 legislation, but you have been asked to do it.

2 What we wish to sound a caution about is that the
3 Commission, I suppose, should feel free in our view to
4 indicate that it cannot form a view on some of these issues,
5 that its recommendation it's been asked to make is
6 necessarily incomplete or it's not appropriate for it to
7 consider those matters.

8 **CHAIR:** Just leaving that aside, my question to you really is,
9 even if we decided that it was appropriate and we were going
10 to do it, would it be material, if those -- if all of those
11 matters affect the factual and the counterfactual, is it
12 likely to be of any relevance to the outcome of a net public
13 benefit test?

14 **MS HEINE:** I wouldn't like to make a commitment on that. I
15 wouldn't like to concede that it wasn't relevant until I'd
16 had the opportunity to consider it further and I'm happy to
17 do that in the cross-submission if that would be of
18 assistance.

19 **CHAIR:** Okay, thank you.

20 **MS HEINE:** A third matter which I suspect the Commission has
21 already had in the past many submissions on; that control
22 should not be recommended unless the benefits substantially
23 or significantly outweigh the costs of regulation. That's
24 in recognition of regulatory risk. The point again in the
25 second paragraph, that the regulators should not seek
26 outcomes that would be obtained in perfect competitive
27 markets. That's the issue that the Chair had a discussion
28 with Mr Morton about essentially in another guise.

29 Finally, that property rights must be balanced with the
30 need for regulatory oversight. Again, probably a submission
31 with which the Commission is relatively familiar.

1 Finally in terms of a way forward, we note that the
2 present timetable does not provide for the issuing of a
3 final framework paper, we're uncertain as to whether that is
4 implicit in the timetable or whether it's anticipated that
5 no final paper would be provided until the draft report
6 in March. We consider strongly that it would be very
7 beneficial to the industry and parties to see a final
8 framework paper so that we can undertake the type of
9 preparation that will be required for us to meaningfully
10 consult on the draft report.

11 Secondly, I think it's apparent from our submission that
12 one of the key issues that will develop through this inquiry
13 is the issue of substitutability between fuel sources.
14 We've noted the difficulties that we have had in providing
15 the Commission with empirical hard evidence as to what's
16 occurring in the industry, and one of the reasons for that
17 is the nature of the interposed model we have in
18 New Zealand.

19 So, as a distributor Powerco contracts with retailers,
20 it doesn't contract directly with consumers. So when a
21 consumer disconnects with Powerco, they don't know why, and
22 they don't know to which alternative fuel source they are
23 switching.

24 We consider that it would be very useful for the
25 Commission to undertake a study using its statutory powers
26 if necessary, given that it's probably uniquely placed to
27 access this type of information to obtain the empirical
28 evidence that we believe is needed in order for these issues
29 to be meaningfully considered.

30 **CHAIR:** That's an interesting suggestion.

31 **MS HEINE:** It is a key issue, and we are very -- we have

1 anecdotal evidence which we've included in our submission.
2 I doubt that the Commission would want to base its report on
3 anecdotal evidence, we need empirical evidence, and we
4 really can't take matters much further.

5 **CHAIR:** And it's your view that our -- we can use our powers for
6 that purpose, for the purpose of this inquiry?

7 **MS HEINE:** From recollection, the powers are extremely wide,
8 yes. So, unless you have any questions, I'll invite Mr
9 Boulton to continue.

10 **CHAIR:** Just let me check on that before we proceed. [**Pause**].

11 **MS BATES QC:** We're just having some discussion on the
12 suggestion you put forward, about powers that we have.
13 Naturally, you can go away and look, but do you have any
14 submission you want to make about specific provisions in the
15 Act to which you refer or are relying on in support of that
16 submission?

17 **MS HEINE:** It would simply be the normal, and I have the Act
18 here, but obviously won't take the chance to look at it
19 unless you want me to, but I would have thought the normal
20 section, s.98 and s.70E powers would be sufficient, they are
21 very broadly worded. It's simply a matter of collecting
22 information from retailers or other groups as to the reasons
23 for switching and to which alternative fuel sources are
24 being adopted. I mean, one of the points we've made is that
25 we consider LPG to be an increasing constraint because of
26 the non-reticulated nature of it, a constraint on gas.

27 **CHAIR:** I'll just check whether staff have any questions to
28 follow-up. [**No questions**]. Please proceed, thank you.

29 **MR BOULTON:** Thank you. I'd like to take you through a couple
30 of issues, it will all be from a management perspective
31 rather than a theoretical perspective. We have a number of

1 expert witnesses to talk about that and the legal issues,
2 it's really a reflection of what's happening in the
3 marketplace today. Some of the issues that Powerco faces in
4 the industry and in our sector, to be absorbed as key points
5 of current market behaviour to reflect on as we work through
6 this process to develop the final outcomes.

7 I've got a couple of slides on what I call the real
8 commercial issues from a management perspective and some of
9 these perhaps are well-known, but I might just walk through
10 each of them again. One issue that hasn't had much
11 discussion is the fact that New Zealand is still like a
12 greenfield site compared to our international peers in the
13 gas distribution sector.

14 If we compare ourselves to our closest neighbours across
15 the Tasman, in Victoria, they have a 90% penetration rate
16 for gas, which effectively means if we assume that every
17 household has an electricity connection, 90% of those
18 consumers have an option for both electricity and gas. In
19 New Zealand we're looking at a 1 in 8 factor process, so in
20 essence it's still a greenfields site. As you move further
21 north in Australia, so Queensland would have something
22 around a 10 odd percent penetration rate.

23 **CHAIR:** How much does it vary across New Zealand? That's the
24 average for the whole of the country?

25 **MR BOULTON:** That's the whole of the country. Reticulated gas
26 is effectively only in the North Island. There's some small
27 measures of reticulated LPG in the South Island, but there's
28 220,000 connections roughly. Powerco has around 46%, so
29 109,000 odd of those connections.

30 **CHAIR:** Most of those will be in the Auckland region?

31 **MR BOULTON:** In terms of geographic coverage? Sure, Wellington,

1 Hutt Valley all the way up through to Levin, Palmerston
2 North, across to Napier/Hastings, Wanganui, Taranaki, so
3 it's pretty much spread. It's not a great centralised
4 population of gas connections, in fact they're sparsely
5 spread across the country, which adds additional cost
6 because of the length of the sub-transmission, if you like,
7 or the main distribution trunks.

8 **CHAIR:** So when you say 1 in 8, is it 1 in 8 in the regions
9 where the gas is available?

10 **MR BOULTON:** No, 1 in 8 across the country.

11 **CHAIR:** If you look in the areas where gas is an option, how
12 many would be?

13 **MR BOULTON:** It depends on how you define that; if we just look
14 at the North Island, I guess you just separate the
15 electricity connections and break that down. I can't tell
16 you off the top of my head what the breakdown is between
17 North and South Island. Yes, it certainly would be less
18 than that though. The majority of customers are in the
19 North Island obviously, but I can't give you a feel.

20 **CHAIR:** That's fine.

21 **MR BOULTON:** So probably, I'd say probably 70%, 30% split North
22 Island. So it's 70%, then say 1.6 million, 900,000, so 200,
23 you're looking at maybe 20 something percent, just off the
24 top of my head. Sorry?

25 **MS BATES QC:** It's just -- I know that the domestic customers
26 only make up 3 or 4%?

27 **MR BOULTON:** In terms of total consumption, less than 2.5% is
28 what they use, domestic and small industrial commercials.

29 **MS BATES QC:** And is that counting gas used from non-connect --
30 where there are no connections? Just like in barbeques and
31 all that stuff?

1 **MR BOULTON:** Right, no, that's just counting the gas consumed by
2 the residential consumers, excluding LPG and others. So,
3 that's -- actual consumption is around 2.5 odd percent. Oh,
4 barbeques, LPG, yeah, that doesn't include barbeques on LPG.
5 Some restaurants and others in this city here, for example,
6 use natural gas for the big heating units, but don't use it
7 for barbeques normally; LPG. So that 2.5% really is a
8 reflection of the natural gas used, it doesn't count LPG at
9 all.

10 **MS BATES QC:** Okay.

11 **MR BOULTON:** Is that the question?

12 **MS BATES QC:** Yep, thanks.

13 **MR BOULTON:** Another important feature of New Zealand which is
14 very different to the rest of the world is that we do not
15 have a franchise system. Our neighbours across the Tasman
16 have licences that are distributed to them which give them a
17 franchise, which means it's impossible for another third
18 party or even a customer to construct a network even if they
19 have the desire to do so.

20 In that regulatory framework in Australia they are given
21 a geographical area of coverage and have the sole right to
22 install and own the gas pipes, and that's obviously very
23 different to what we have here. In fact I'm not aware of
24 any other country in the world that does not have a
25 franchise system for the likes of gas and electricity
26 distribution.

27 Powerco is not vertically integrated, so we do not have
28 any ownership of gas in an exploration sense, nor do we have
29 any retail business. That, from our perspective, places us
30 in a particular disadvantage given the level of gas that's
31 available in the marketplace and the smaller number of

Powerco

1 players that have that. Powerco has, obviously from a
2 strategic perspective, been looking at the opportunities of
3 perhaps re-entering the retail sector; we sold that as part
4 of our separation process going back to 1999 when the
5 electricity rules changed, we sold off the retail component
6 of our gas business as well. That's an important feature
7 for us given the scarcity of gas.

8 We would suggest there are commercial -- sorry, there
9 are activities that are occurring that disadvantage Powerco
10 to some degree, and I'll talk about that later on.

11 In terms of consumers, and talking on this whole concept
12 of a monopoly, or competitive market, or workable
13 competition, or lessening of competition, consumers
14 obviously are looking for the output which is a source of
15 heat, or cooking, or similar other uses. From that
16 perspective it's not about gas pipes at all, it's about
17 something that affects their lifestyle and what are their
18 options and alternatives for that, and of course gas pipes
19 simply offer one alternative for the delivery of one energy
20 source to a home. Consumers have all of the options open to
21 them.

22 In terms of who has the market power from our
23 perspective, consumers have the market power, they have
24 multiple options and we've heard some of those mentioned
25 before, including LPG, electricity, wood, depending on the
26 type of customer, wood, diesel oil, therefore they choose
27 which of those options are suitable for them. Some of them
28 might make a financial decision in that process, some of
29 them make a lifestyle decision or a combination thereof.

30 **MR STEVENS:** Beyond the ability to switch to alternative fuels,
31 do some consumers have any other countervailing powers?

1 **MR BOULTON:** They have the power to use or not use. For
2 example, if you talk about a monopoly in the broadest
3 possible context, some people would assume that Powerco can
4 simply run a gas pipe down an existing street where there's
5 not a gas pipe and perhaps we're inundated with customers,
6 and we could charge them anything we feel like, given that
7 so-called physical monopoly view of the world. In fact
8 that's not the case at all. We are unable to do that and
9 there's a heck of a lot of work that has to be undertaken
10 from a marketing perspective to even consider that as an
11 option.

12 Just to give you a feel for that, penetration rates are
13 not substantial. We've undertaken a marketing campaign in
14 the last two months called "GetGas" and the objective of
15 that is to try and encourage penetration, particularly where
16 we have low penetration rates and we can try and backfill
17 the connections.

18 By that I mean where a gas pipe goes past a residence
19 but there's no actual gas on the home and to try and
20 encourage new connections; for whatever reason the retail
21 sector is unable to commit to marketing penetration or use
22 of gas, and we'll talk about one of the possible reasons why
23 they might take that particular view later on.

24 **MR STEVENS:** There are many occasions where you have been unable
25 to meet any consumer expectations on price?

26 **MR BOULTON:** They will obviously ask for a price and we can
27 develop a price for the retailers and again we're left out
28 of the loop with this interposed approach. It's very
29 difficult for us to talk to an end consumer about their
30 delivered price.

31 Again to give you a feel of some of Powerco's pricing

1 structures we might have a fixed charge per day of 25 cents.
2 The consumer's option is to go for one that's 75 cents to 1
3 dollar. Now keep in mind it's the distribution part of the
4 sector that has the fixed charges, the fixed cost and
5 ostensibly you could translate that through to a fixed
6 charge. And also keep in mind from a number of Government
7 Policy Statements we're obviously under political pressure
8 as well to meet the Minister's requests for a more variable
9 approach to pricing, and that's a political issue but has a
10 commercial reality for us which places the business at more
11 risk.

12 But just to follow-up on that question, one issue for
13 distribution companies to consider is whether we actually
14 move from an interposed structure to a conveyancing model,
15 where we are able to negotiate directly with consumers and
16 more importantly consumers have the power then to understand
17 the differential in their delivered account; so they can
18 understand what the line charge component is and
19 differentiate that from the energy charge component, but
20 again interpose, we just cannot influence or control the
21 pricing tariffs offered by various retailers.

22 That does have an impact on us, in fact we've lost 400
23 customers recently in Taranaki. The retailer there elected
24 to move the fixed daily charge up substantially. As a
25 consequence are mostly elderly people who would only use the
26 heat outcomes, driven by the gas pipelines for three or four
27 months a year, could not sustain such a high daily fixed
28 charge for the full year, and consequently decided to
29 disconnect.

30 **CHAIR:** Was there no competition at the retail level?

31 **MR BOULTON:** You're completely -- no, is the short -- well,

1 yeah. In our view the answer would be, no. We contacted a
2 number of other retailers to offer them another tariff, we
3 introduced another tariff, a fully variable tariff then to
4 try and overcome that fact problem, but again, we can't
5 force the retailer to pass a fully variable tariff through.

6 The fully variable tariff would suit the disadvantaged
7 people, which is what the Minister's trying to encourage us
8 to focus on in our pricing structure. We did encourage one
9 retailer, so, instead of losing 480 odd, we lost 400. That
10 one retailer has picked up 80 of those customers by offering
11 the fully variable option. So, we would suggest there's not
12 much competition at all in the retail sector.

13 **CHAIR:** I'd like to come back to a comment you made earlier
14 about the situation in Australia and other jurisdictions in
15 terms of franchises. How are prices set in those
16 franchises? Are they regulated prices?

17 **MR BOULTON:** Yes, they are. Powerco was invited to participate
18 in a benchmarking study by one of the Australian regulators
19 as part of their review process. That came at a cost to us,
20 but we were happy to participate as long as we could receive
21 the resultant report identifying us against six unknown
22 peers, if you like, across the Tasman. They take a number
23 of different approaches to regulation from Queensland to New
24 South Wales to Victoria. Some of them around a concept of
25 price control, some I understand could be focused on revenue
26 control.

27 **CHAIR:** Where I wanted to go with the question is, it seems to
28 me you're putting to us that consumers have a great deal of
29 market power because they can switch, either suppliers, or
30 they can, the latter point you were making was that they
31 could just refuse to use gas. That must hold even in a

1 franchise system, and yet, we see regulated prices in those
2 jurisdictions.

3 **MR BOULTON:** Sure, keep in mind that a 90% penetration rate is
4 quite different to a 20% or a 10% penetration rate as well
5 though.

6 **CHAIR:** I would have thought a higher -- I'll think this
7 through, I would have thought a higher penetration rate
8 would have meant possibly greater constraint in those
9 markets.

10 **MR BOULTON:** Yeah, I'm not too sure what the scenarios would be,
11 but we can talk --

12 **CHAIR:** But nevertheless, in those markets they can decline to
13 use gas and they must have significant market power in the
14 way you're suggesting, yet nevertheless in those systems
15 prices are regulated.

16 **MR BOULTON:** Yes, that's right. Keep in mind --

17 **CHAIR:** Do you know of any jurisdiction where the price isn't
18 regulated.

19 **MR BOULTON:** Yes, Tasmania, and I'll talk about that later on,
20 but we've just negotiated a position to enter the market in
21 Tasmania. We've negotiated to provide supply, a natural gas
22 reticulation, to the top 23 customers in that State. The
23 rules there will be quite different and this is part of the
24 changing regulatory environment overseas. There will be no
25 regulation, price profit, or revenue control whatsoever. In
26 fact the Government has agreed to change legislation to
27 remove the capacity to regulate the gas distribution sector
28 and there is no regulation in pricing.

29 **CHAIR:** And there is pricing?

30 **MR BOULTON:** No, there's no regulation at all that covers
31 sector. Not just that, quite different to here, they will

1 be applying and offering a 7 year franchise for our
2 investment, and over and above that, quite different to
3 New Zealand as well, they're offering a contribution to set
4 the business up, a capital contribution of around \$9 million
5 on a total investment of around 38. All of those three
6 areas, and they're quite key to where Powerco will invest
7 our dollar, are fundamentally to where our Government is
8 going at the present time with the request for this inquiry.

9 And yet just north of them, in Victoria, there's a
10 different perspective again, but keep in mind in Victoria as
11 well, with their price control structure the Government's
12 become acutely aware they cannot attract the necessary
13 investment. In fact, the Victorian Government, the Premier
14 Steven Bracks has offered \$70 million to try and attract
15 distribution companies to reticulate gas in the more rural
16 areas of the state. They are having trouble finding
17 companies, given the regulatory structure, to actually put
18 the dollars into the ground.

19 **CHAIR:** I guess it's hard to know what's due to regulation and
20 what's just due to the pure economics of reticulating gas
21 into rural areas.

22 **MR BOULTON:** Sure, and --

23 **CHAIR:** I mean we've not had a lot of regulation here, but we
24 don't see the coverage as extensive as you might suggest if
25 the only issue was regulation.

26 **MR BOULTON:** No, I think what's as important as regulation is
27 the threat of regulation as well, and I think you will have
28 seen a drying up of investment as the market is trying to
29 adjust to understand exactly what these outcomes might be,
30 and the market can only see a few of them at the present
31 time and they can only observe what's happening overseas.

1 So, but I accept your point, there's no absolutes in
2 these issues, there are shades of grey around some of these.
3 But investment community is obviously important from a
4 Powerco investment. They are the people that we would have
5 to tap in terms of equity and debt funding, and convince
6 them about what the business environment might look like.

7 **CHAIR:** I understand that, but I just make the point that we
8 often hear now that -- you see regulation and possible
9 threats of regulation in some areas, that it's somehow going
10 to mean that investments aren't made in places like rural
11 areas, but we also see a lot of under-investment in periods
12 when there was very little, if any, regulation. So, I'm
13 just making the point that there's more at play here than
14 whether there's regulation or not.

15 **MR BOULTON:** Sure, and I think electricity is probably a good
16 point that you are referring to perhaps, that there's been
17 some classic under-investment over time in the electricity
18 distribution sector and I think that's a point that some
19 firms will argue, and again the question of course is, well,
20 what drove that? And one of the drivers for that from a
21 chief executive's perspective working for the trust-owned
22 companies who have no debt funding and who have their
23 owners, if you like, elected on a platform of delivering
24 value to consumers and owners, who are the same people; one
25 of the primary drivers you have is to make sure your
26 delivered price is the lowest it can possibly be, and to do
27 that one option you've got is to sacrifice your maintenance
28 and to sacrifice replacement capital expenditure.

29 So, it's not so much a driver from a regulatory
30 perspective, it's a driver from a social perspective and
31 linked to the rewards that a chief executive might get for

1 having the lowest possible price. But the outcome from
2 either regulation or the social structure of that particular
3 design is the same; under-maintained and under-invested both
4 seem to be delivering the same outcome, which is the dearth
5 of investment over time and the dearth of attracting -- the
6 capacity to attract new investment.

7 **CHAIR:** I just note that in a country that has 90% penetration,
8 it hardly seems to me like people have failed to invest
9 despite regulation of prices, but let's move on with your
10 presentation, thank you.

11 **MR BOULTON:** The last one I probably covered, that natural gas
12 is simply an option, what it produces in terms of heat and
13 cooking to deliver lifestyle or business requirements, and
14 of course it's not an essential service and not many people
15 would see electricity from a social perspective as an
16 essential service, not necessarily from a legal perspective
17 that might exist under some Act, but they would see it as an
18 essential requirement when they purchase a section of land.
19 Gas is not in that same category.

20 The barrier to entry, we do have a barrier to entry. I
21 should explain what I mean here, to extend into the supply
22 chain. One option for us is to look at perhaps purchasing
23 some gas, competing with our peers, and by that I mean, some
24 of our peers who own gas pipes also own gas, and retail gas.
25 We can offer options to consumers but they're very different
26 options. In Powerco's case there's obviously a scarcity of
27 gas, so there's a natural barrier for us to try and enter
28 the marketplace and compete with the parties who have a
29 degree of vertical integration, and that does have a
30 fundamental impact on being in a sole part of the supply
31 chain.

1 I've mentioned this next point, we've had to market the
2 business to grow penetration and throughput, for example
3 Powerco's Get Gas campaign. We've had to try a number of
4 other features. Again this relates back to a management
5 position about the competitive nature of the market and the
6 growth for us.

7 We took a more radical option, probably 2 years ago on a
8 test basis to encourage or incentivise, if I can use that
9 term, retailers to work with us to increase our penetration,
10 obtain new connections. For a fixed period with a cap on it
11 I offered -- Powerco offered the retailers \$1,000 for every
12 new connection. Our hope was that that \$1,000 would be
13 offered, passed through to the consumers to help them with
14 their contribution they might have to make to move from
15 their alternative fuel.

16 As it turns out, we were disappointed, we didn't
17 increase our penetration rate, in fact the consumers in the
18 examples that we found, were offered a financial incentive
19 of \$100 to change over, so \$900 of that was kept by the
20 intermediate party, which would raise the issue about
21 Powerco obviously looking to try to extend into the retail
22 side to compete with other parties in that sense in a
23 broader approach to our business.

24 So that customer capture by retailers, disadvantages gas
25 distribution companies. Again it's an important feature for
26 the Commission to understand that consumers in their
27 accounts including the larger consumers do not get a
28 breakdown from retail to distribution.

29 It's also not constructive for us as a distribution
30 company to try and entertain a conveyancing approach; the
31 retailers have a level of discomfort with distributors when

1 they try and negotiate with customers, and Powerco in
2 essence then is disadvantaged because we cannot offer a full
3 delivered product. Consumers are interested in delivered
4 products. The component of a customer's distribution bill
5 in the larger customers is reasonably low today. In fact in
6 the 10 to 15 to 20% market, it does change for varying
7 customers on their position and so forth.

8 Political pressure does not reflect the economic
9 realities of the distribution sector being largely a fixed
10 cost business, and that's another element of risk that we
11 face with the understandable political pressure placed upon
12 us with various policy statements placed upon us to change.

13 And the last point, perhaps that is a bit controversial
14 in terms of terms, but many people see distribution
15 companies as patsies, soft football to kick around,
16 virtually powerless in the marketplace, and easy targets
17 from a political perspective, because once the "M" word is
18 used, monopoly, people have fundamental beliefs about that
19 type of industry, regardless of which industry it comes
20 from, until we can prove otherwise. And similarly
21 electricity, we suggest the sector has done a poor job of
22 marketing its performance over time to the broader community
23 and hence one of the reasons we're here today.

24 **CHAIR:** I don't think we need to go into that in any great
25 detail, but it does seem to me that if there was an
26 automatic assumption in New Zealand that monopolies were
27 doing something that needed to be controlled, we wouldn't be
28 having this inquiry.

29 **MR BOULTON:** No.

30 **CHAIR:** The Government would simply pass legislation and put you
31 under the same kind of controls that you see in virtually

1 every other jurisdiction around the western world. So, I
2 really wonder if that statement reflects the processes that
3 are underway, which is to first establish whether there is a
4 problem or not regardless of whether we come to a view. You
5 may very well be a monopoly, you may have a monopoly
6 business, but there's not necessarily any presumption that
7 anything needs to be done about it; and so, I just wonder
8 about that last comment.

9 **MR BOULTON:** I think that's pleasant to hear that particular
10 view. I was probably reflecting more the marketplace
11 perspective about the concept of monopolies there and
12 distribution companies being seen as patsies, and even in
13 the paper that the Commission has produced it references
14 earlier input from the Minister and I have to say I still
15 struggle with the Government providing much data,
16 information and evidence to form a view, and perhaps that's
17 why we're going through this process at the present time.

18 The only reference I can see in the Commission's
19 documents thus far is that the Minister is referencing some
20 commentators, some commentators who have made some claims
21 about so-called monopoly profits and, therefore, from his
22 view politically, well, we should kick off a process to have
23 a look at that; that seems to be the only driver to why
24 we're here today.

25 **CHAIR:** I'm not going to comment on what the drivers are, simply
26 to say to you that the Minister has set up an inquiry by a
27 fully independent body.

28 **MR BOULTON:** Sure, I understand.

29 **CHAIR:** And it makes no presumption one way or the other about
30 whether just because something is a monopoly that it needs
31 to be controlled, and I think the process as set down

1 clearly meets that requirement and I don't hear you
2 disagreeing with that.

3 **MR BOULTON:** No, I wasn't suggesting that was the Commission's
4 or the staff's view at all, just a general management
5 marketplace perspective. As I say, it doesn't form any
6 legal or economic analysis at all.

7 **CHAIR:** All right. I just didn't want -- I hoped I wasn't
8 hearing you say that we had come to this with a presumption.

9 **MR BOULTON:** No, no. That's my perspective and I'm reflecting
10 on my perspective there alone.

11 **CHAIR:** Okay, thank you. Please proceed.

12 **MR BOULTON:** Three things I would like to talk to: The current
13 constraints on gas distribution, the impact of under-
14 investment in infrastructure and behaviour of vertically
15 integrated companies in the gas sector.

16 Current constraints we have, we've mentioned these and
17 I'll cover them in detail again, the other possible fuels
18 that are available to be utilised to deliver the end product
19 again, which is the heat or the cooking capacity. And of
20 course the Commission is aware and has made some reference
21 to some other physical pipeline competitors where parallel
22 pipes have been laid.

23 Inter-fuel competition. I just mentioned some of those,
24 again keep in mind this is always on the perspective of them
25 having the capacity to deliver the end product from a
26 consumer perspective. Consumers are less concerned about
27 the type of competitive options more so about whether that
28 competitive option offers the same or a similar delivered
29 outcome for them. And all of these are options available
30 for consumers, including the option of not taking it up at
31 all.

1 I've mentioned this, low volume consumers are
2 disconnecting, around 400 in the Taranaki area, primarily
3 driven by a change to a very high priced daily fixed charge.
4 And we've had some other evidence in other parts of our
5 network where retailers have made some changes and in fact
6 we've lost about 2,000 odd consumers in the Wellington
7 Central regions, most of those low volume consumers, and
8 again the feedback we're getting anecdotally because I can't
9 produce a spreadsheet for you, but just from our discussions
10 in the marketplace, is related to the pricing structures
11 that have been offered in the marketplace from the
12 retailers.

13 We do have some capacity to respond, we have responded
14 in Taranaki by offering the retailers a fully variable
15 option, but again we can't compel them, again try to
16 influence them to try to offer that through to end consumers
17 and keep in mind again, this is an issue with the sunken
18 fixed costs from our perspective, we can't remove those
19 pipes from the ground when those consumers have
20 disconnected.

21 **CHAIR:** So they're disconnecting from you?

22 **MR BOULTON:** Sorry, we're advised by the retailers that there's
23 been a disconnection, and for whatever reason we don't
24 necessarily get reasons from them, just that this customer
25 is no longer wanting to participate in a retail contract
26 with them. So, we effectively disconnect them at the meter.

27 **CHAIR:** Right, and you think they are being picked up by these
28 other generators?

29 **MR BOULTON:** No, sorry, lost them to an alternative.

30 **CHAIR:** Alternative?

31 **MR BOULTON:** Yeah, again I can't --

1 **CHAIR:** You don't know though?

2 **MR BOULTON:** No, I can't provide you with absolute evidence on
3 that; there is some work to be done. But obviously, there
4 are lists of those customers available, and there's some
5 work that could be done to talk to them or identify whatever
6 churn there might be; whether they've gone from one retailer
7 to another.

8 In terms of evidence, the one I do have is the Taranaki
9 one that we can talk about; we've had 400 disconnects.

10 **CHAIR:** So they were disconnecting from gas?

11 **MR BOULTON:** To something else, yeah, going to alternative fuel.

12 **CHAIR:** But what you had up there, if I recall, was that the
13 likes of Genesis were offering new gas pricing plans.

14 **MR BOULTON:** Oh sorry. If we go back a little bit so I can
15 explain this. We have X number of connections. We develop
16 our pricing structures and pass-throughs through to
17 retailers. They reconstruct those in whatever format they
18 think is appropriate; the 400 disconnections, the number of
19 disconnects we've had from the network, so that they're no
20 longer anyone's customer.

21 So, we got some sense of that in the first week or two
22 when Genesis changed their tariff structure, and obviously
23 we picked it up in newspapers and so forth, it becomes a
24 political issue, so we quickly worked through a process of
25 offering a fully variable option.

26 Since we've offered that, another retailer has picked up
27 80, those 80 we believe would have disconnected completely
28 because they're effectively offering the variable option and
29 they are still putting a fixed component on top, but it's
30 smaller than the other party, but we've had 400 absolute
31 disconnects, and 2,000 absolute disconnects, and a number

1 may have changed, but say an 80 to 400 ratio would have
2 been -- to give you some absolute facts on the number of
3 change.

4 **CHAIR:** So you see those disconnects over what sort of period?

5 **MR BOULTON:** That would be, since we've had the assets on board
6 I guess, from November through to now.

7 **CHAIR:** Right and what's happened to prices during that period?

8 **MR BOULTON:** From our perspective, there's been no change. We
9 have to think seriously about a price increase now,
10 obviously just in the backyard here in Wellington, just for
11 asset ratings alone, gone from zero to \$800,000, just like
12 that. So, we can't absorb -- that's just one council. We
13 can't continue to absorb those sort of costs.

14 But sorry, there's been no change to our pricing
15 arrangements. There were changes only to the retail pricing
16 structures which has driven these disconnects, not from
17 ours. We introduced a fully variable option in response to
18 what we saw with some consumers disconnecting, and obviously
19 it's an asset issue, having assets in the ground and not
20 having people connected; it's not a commercial position
21 that's viable long-term.

22 Inter-fuel competition: That does, in our view, provide
23 a constraint on the transmission and distribution charges.
24 I've mentioned before, we simply can't roll out gas pipes
25 and expect consumers to connect. We are in the marketplace
26 trying to draw them from other alternative energy sources or
27 draw them into gas as an energy source in a newer estate for
28 example.

29 They form only part of the delivered price, only 45 odd
30 percent. The cost of converting to LPG is low for
31 consumers, and non-vertically integrated distributors, like

1 Powerco as I mentioned before, will be adversely affected by
2 residential consumers switching to these alternatives.

3 I've mentioned the utility rating, just in Wellington
4 alone there's \$800,000, probably add another half of that
5 again of councils that are closely located. Wellington just
6 happens to have the highest rating structure and other
7 councils seem to be following that particular process, we
8 can't continue to absorb that over time.

9 Liquid natural gas is currently not supplied in New
10 Zealand but some of the generation retail players are
11 suggesting that's a short-to-medium term option, as Maui gas
12 runs down.

13 In terms of the switch to LPG: Very low conversion
14 costs; a connection kit is relatively cheap at \$190.
15 Cylinder rental per quarter, around \$35 to \$40. There's no
16 fixed daily charge, appliance conversion is not major for
17 that, just a case of replacing some jets and manifolds.
18 Compare that 7.64 cents to the cost of natural gas from one
19 of retailers, residential consumers at a range 4.2 to 15.5,
20 plus a daily fixed charge of 50 cents. It's an alternative
21 and a serious alternative for consumers to consider.
22 Compounded now from the fact that unfortunately from our
23 perspective we'll have to pass through an increase from
24 these rates supplied by the local councils.

25 **MS BATES QC:** Just a couple of questions, and they relate to
26 your industrial customers really, because I'm curious about
27 the percentage of customers of yours who are industrial.

28 **MR BOULTON:** In a ratio sense roughly, residential to
29 industrial, commercial?

30 **MS BATES QC:** Yes, both in number and revenue.

31 **MR BOULTON:** Yeah, we haven't provided market information on the

1 revenue split of that, so just have to keep in mind that
2 would be new information for the market, so I'll have to --
3 well, it's confidential from our perspective, as a listed
4 company we would have to release that to the Exchange first.
5 We couldn't release that today, but we would be happy to
6 entertain a closed room discussion for some information if
7 the Commission thinks that is relevant at a later period.

8 **MS BATES QC:** I'll confer on that and come back to you on that
9 particular question. But why I'm asking you, what this is
10 leading up to is this; if I could --

11 **MR BOULTON:** Sorry, we were looking at the total numbers to
12 answer your previous question. That will happen now as
13 you're talking.

14 **MS BATES QC:** Well, is it the far greater proportion's
15 industrial; am I right?

16 **MR BOULTON:** By sheer customer connections, the far greatest
17 proportion is obviously residential commercial.

18 **MS BATES QC:** Yes, but in terms --

19 **MR BOULTON:** No. What we might do, is give you some rough
20 figures, if I can give you a percentage sense, give you a
21 range and feel for the commercial, industrial and
22 residential breakdown. [**Pause**]. We'll just do some more
23 work on that revenue number.

24 **MS BATES QC:** Okay, I might come back to this, and I'll tell you
25 why I'm asking, and that's, the arguments that you are
26 putting forward, or the submissions you're making about the
27 ease of switching in the inter-fuel competition. I might be
28 wrong, but I would have thought that for many industrial
29 customers that will be a lot more difficult than it would be
30 for residential customers, particularly if those industrial
31 customers have processes and machinery which are

1 specifically made for gas. You understand the line I'm
2 pursuing, do you?

3 **MR BOULTON:** Yes, they still have options, though, and to give
4 you an example I'll use Tasmania as a classic example. The
5 businesses in Tasmania don't have natural gas as an option
6 now. The view they take is a very tough view, I understand
7 their commercial position is, we don't have to change
8 Powerco, you guys can come along and lay a gas pipe in the
9 ground but we're not compelled to changes. But now we would
10 know from our analysis that going from natural gas would
11 give them an X percentage, a double figure energy saving,
12 but they're not compelled to spend the dollar. They will
13 negotiate and maintain a position that's quite strong in
14 terms of negotiations going forward.

15 To give you a feel about that, in Tasmania there might
16 be a capital cost that they would have to incur, they place
17 very tough targets on that. They will want to make sure
18 that the energy option of gas given to them will give them a
19 pay back of 1 to 2 years, a simple payback period. We can't
20 get that as an investor in gas pipes. They will take a
21 tough view. They have substantial power in terms of
22 negotiating that. Not just that, they will demand options,
23 everything from timeframe, load factor, utilisation,
24 including them making a capital contribution perhaps.

25 **MS BATES QC:** Let me make sure that I understand what you're
26 saying. Are you talking about people that are already using
27 one type of gas, switching to another type of gas?

28 **MR BOULTON:** One type of energy fuel, whether it be diesel oil,
29 or LPG, or wood, yes, or coal.

30 **MS BATES QC:** Or electricity?

31 **MR BOULTON:** Yeah, they make all -- they use their own external

1 advisors to assess the merits and the risks and the cost of
2 each one of those and obviously use those in negotiations
3 with distributors.

4 **MS BATES QC:** I can understand that, but what I'm asking you is
5 to give me some sort of idea about the difficulty that it is
6 for industrial or some industrial customers to switch from
7 say gas to electricity?

8 **MR BOULTON:** The difficulty they have?

9 **MS BATES QC:** Yes from, say, switching from gas to electricity.

10 **MR BOULTON:** Well, each customer will obviously look at their
11 manufacturing process and make those particular calls.
12 Again, they have many different views on what that call
13 might be. They might have their own capital constraints,
14 you're right. They may not have any capital constraints as
15 well. They might have an economic view that an 8 or 10 year
16 payback period is appropriate for them. They might have a
17 view that gas is running out.

18 **MS BATES QC:** But it's a lot more difficult than a connection
19 kit of \$190 for most of those people, isn't it? I'm trying
20 to get a feel for -- this seems to be basically consumer
21 orientated, your slide 4?

22 **MR BOULTON:** Well, it's very difficult to cover all of our
23 customer types; we're just giving examples in this
24 particular process.

25 **MS BATES QC:** I know, but we are interested in how difficult it
26 is for industrial people to switch, obviously, and I'm just
27 asking if you can give us a bit more information on that
28 from your company.

29 **MR BOULTON:** I can take that away for you and give you some more
30 detailed analysis on that, but I think it's clear to say,
31 they each will use an external advisor --

1 **MS BATES QC:** I appreciate that, I do understand that.

2 **MR BOULTON:** And they will leverage their negotiations with it
3 any which way they can and they do. So from their
4 perspective they do have options. I could probably pick a
5 particular customer type, if you like, and give you a feel
6 for the differential and compare to what they currently have
7 with gas and what their options might be to go to LPG or to
8 diesel oil or electricity, I can pick customer types out for
9 you; not today, but we'd be happy to provide that
10 information to you.

11 **MS BATES QC:** Thank you, I think that would be helpful.

12 **MR STEVENS:** Can I ask a follow-up question, if I may. The
13 large commercial users, do you therefore have long-term
14 transport contracts to provide to those users?

15 **MR BOULTON:** Sure, they vary, and again that's at their request.
16 Some want a one year timeframe because they think they can
17 get a better deal from year to year. Gets back to the issue
18 the other Commissioner has raised about what other capital
19 investments they might be looking at from a board's
20 perspective. In our view, to be factual, we've got a range
21 from 1 year to some with 5.

22 **MR STEVENS:** So, what would be the average then across all of
23 these?

24 **MR BOULTON:** Well, we'll find out. [Pause]. Again, you know, I
25 can't give you -- if you want an absolute I'll have to do
26 some more work on that particular one, but we have a range
27 of 1 to 5. Tasmania will be a little bit different, but
28 you're talking about the New Zealand context here. That's
29 important from the customer's perspective and our
30 perspective as well.

31 Some of the vertically integrated firms are currently

1 offering consumers contracts that might go for 5 years for
2 the distribution component and to draw them into the
3 contract they will offer them obviously a very good deal, 1
4 year deal for gas energy; but the contract would specify
5 they have to stay with them for 5, so we're unable to
6 compete, and that particular firm has a closed network, so
7 other retailers are unable to wheel gas over their network
8 but we open our network up to full and open access, which
9 places us in a difficult position.

10 **MR STEVENS:** Okay.

11 **MR BOULTON:** Just going back to your earlier comment though,
12 Commissioner, I think we might just reflect on a view about
13 that as well. Larger consumers having the option to go to
14 alternatives will see exactly that scenario coming up in
15 Tasmania within 8 months where Powerco will roll out a gas
16 distribution network; let's just pick a number, let's just
17 say we can offer an energy source to them and save them 25
18 or 30% against their current competitive option, which is
19 oil, electricity.

20 We'll draw them all across, draw them into the business,
21 offer a competitive energy option, they make calls about
22 capital contribution or capital expenditure, payback periods
23 themselves. Post that, anyone could argue then that there
24 is no competition, if you like, because we were the lowest
25 cost operator but we had to take some risk to get those
26 businesses to move across to gas.

27 So, there could be an argument some people would run up
28 to say, well, you should be regulated, and we would have to
29 argue, well, why should we be regulated because we've
30 offered the lowest cost alternative to them, which I think
31 is where you're getting to in your question.

1 **MS BATES QC:** Well, I'm probably being a bit more sort of down-
2 home than that, but I'm sort of thinking, you're running a
3 manufacturing business, you're running electricity, you're
4 considering gas as an option, you look at your capital cost
5 and you look at converting and you look at -- obviously you
6 look at the payback and say, how sure can I be that this
7 price is going to stay stable, so you'd want a contract to
8 cover your option.

9 Is that basically what you're saying? I mean, that's
10 what I would do. I'd want to know -- I'd want to be quite -
11 -

12 **MR BOULTON:** Essentially that's what they do. There's
13 variations on the theme as well. In some cases customer
14 says, well, perhaps can the lines company make a capital
15 contribution to the change-over, so it all varies?

16 **MS BATES QC:** If you were a reasonable manufacturer, in terms of
17 size, and you'd want a long-term contract to cover your
18 situation where you've made this capital investment, then
19 once you've done that and you're tied up for 5 years, it
20 would be pretty difficult for you to switch back to
21 electricity. There would have to be a big incentive to do
22 that, wouldn't it?

23 **MR BOULTON:** That's right, but the same reason we'd have to try
24 and attract them from an alternative fuel to gas; it works
25 both ways.

26 **MS BATES QC:** I suppose the point I'm getting at is, in those
27 situations switching, once you've made that investment is
28 not so easy.

29 **MR BOULTON:** No, it's more lumpy than it is going into the
30 corner shop to buy a cake.

31 **MS BATES QC:** A bit more lumpy, even in the cake, but, yeah.

1 **MR BOULTON:** Depends on your view. Is a corner shop competitive
2 but is a gas infrastructure not because it takes a longer
3 timeframe? But again --

4 **MS BATES QC:** I'm not talking about necessarily a corner shop
5 I'm talking about a -- it would usually be, often would be a
6 manufacturing business doing this.

7 **MR BOULTON:** Sure, and they have their own economics and other
8 people to provide them with advice.

9 **MS BATES QC:** And sometimes equipment which is specific to one
10 energy source.

11 **MR BOULTON:** Whether it be electricity or gas or LPG or diesel
12 oil.

13 **MS BATES QC:** And so switching is not as simple, as I say, as
14 change of connection.

15 **MR BOULTON:** No, that's why I've only talked about domestic
16 consumers here in particular.

17 **MS BATES QC:** That's why I've actually wanted to probe a bit on
18 the industrial.

19 **MR BOULTON:** We've taken that on board and we'll do some more
20 work on identifying different customer types if you like
21 from a sector and give you a feel for what some of the
22 issues would be when they consider a possible change-over,
23 from one to the other or reverse back again, so give you
24 both.

25 **MS BATES QC:** And over the break we'll confer on the business of
26 how relevant it is for us to know about the revenue split
27 and come back to you on that.

28 **MR BOULTON:** Yep.

29 **CHAIR:** Okay. Proceed with the presentation thanks.

30 **MR BOULTON:** Just to give you a feel of this break-up again,
31 Powerco's line, gas line charge in terms of competition,

1 fixed charge versus variable. 24.53 cents a day, 2.97 was
2 the variable component, and the retailer then offers the
3 output there of the 87 and 5.7 cents. So, that gives you a
4 feel for some of the differentials that occur between the
5 line side and the retail side.

6 In terms of physical pipe competition. There have been
7 gas pipes laid in parallel with some with Powerco's gas
8 pipes. A couple of drivers for that: People use the term
9 "bypass", and I think there's an assumption that goes with
10 the concept of bypass which people jump to, and the
11 assumption that they jump to is that the alternative was not
12 appropriately priced, so they have bypassed it.

13 In fact what's happened here in Wellington, in
14 particular, although it does exist in other areas, I've
15 mentioned here in this slide -- one particular party was
16 given open access to trenching when another alternative
17 supply, not related to electricity or gas, was being
18 installed, so therefore the costs of them installing their
19 gas pipe were obviously far lower than Powerco's in a real
20 sense and that's obviously what drove the laying of these
21 additional pipes which were then laid in parallel with power
22 costs.

23 The other driver that's occurring at the present time is
24 that there's -- one particular vertically integrated entity
25 has, we believe, would have access to low priced gas which
26 is substantially priced below the competitors in the energy
27 sector, and from discussions with customers we understand
28 that they're offering a bundled product at the end of the
29 day.

30 We can only link up with the competitors that have the
31 high price gas, so we can only assume that one of the

1 drivers for them to lay additional gas pipe is that there
2 may be some form of cross-subsidisation from selling that
3 gas at the market price but obviously paying a low price in
4 the front end for that.

5 **CHAIR:** Can I just ask you; when you say that competition with
6 Nova constrains Powerco's prices, are you charging
7 differently in areas where there is a bypass opportunity?

8 **MR BOULTON:** At some major customers we have negotiations
9 directly, it's very hard to give a uniform answer to that
10 query.

11 **CHAIR:** So when you say they're constraining your prices, are
12 they constraining your prices only in areas where they
13 directly compete with you or more generally?

14 **MR BOULTON:** The areas that they've chosen, some people would
15 argue are cherry picking, they're major connections and not
16 interested in other connections which may not be
17 commercially viable or marginal at best.

18 In terms of constraining prices, it's an artificial
19 constraint in the sense that their cost of construction, if
20 you like, was subsidised by a third party who dug the hole
21 for them so they could lay gas pipes and just cost -- the
22 pipe cost, or alternatively, of course, they're utilising
23 their other vertical integration capabilities to cross-
24 subsidise therefore --

25 **CHAIR:** So they're only constraining your prices in the areas
26 where they're actually competing against you?

27 **MR BOULTON:** We've got a map coming up soon just to take you
28 through that.

29 **CHAIR:** Just, in principle, are they constraining your prices
30 anywhere other than where they directly compete with you?

31 **MR BOULTON:** In principle, I will have to reinforce again, the

1 constraint's an artificial one because they have had other
2 subsidies in place.

3 **CHAIR:** I know, leaving aside whether it's artificial or not, is
4 the constraint on Powerco's prices limited to the areas
5 where they are directly competing with you?

6 **MR BOULTON:** Yeah, only to the extent that the pipe is there,
7 and we've also had a number of scenarios where they have
8 threatened to.

9 **CHAIR:** Sure.

10 **MR BOULTON:** So the threat --

11 **CHAIR:** To extend it.

12 **MR BOULTON:** To extend it and place certain demands on Powerco.

13 **CHAIR:** So they're only constraining your prices where they are
14 either directly competing against you or can credibly
15 threaten to extend their network? Is that a correct
16 statement?

17 **MR BOULTON:** Again I have to reinforce that, if we're just
18 isolating the first pipe competitive component, ignore the
19 inter-fuel competitive component because our prices are
20 constrained, but in other ways, there's a differential
21 there, not just a physical pipe. This one is a double
22 whammy, if you like, for a distribution company over and
23 above the constraints for inter-fuel competition, we have
24 what I call an unfair and unreasonable constraint applied to
25 us because the cross-subsidisation outcomes that they have
26 been able to achieve, fortuitously for them and not for us.

27 **CHAIR:** I just want to get --

28 **MR BOULTON:** For residential consumers we have the same price.

29 **CHAIR:** I just want to get a sense of; you say your prices are
30 constrained everywhere because of inter-fuel competition but
31 they're particularly constrained here because you face head-

1 on competition. Are they constrained further than where you
2 are only constrained by inter-fuel competition?

3 **MR BOULTON:** No, we have the threat of these people also wanting
4 to extend and go elsewhere into the network as well.

5 **CHAIR:** But that does not extend to your entire network.

6 **MR BOULTON:** To broad parts of the network; I've got a map of
7 Auckland --

8 **CHAIR:** Well, let's go outside those two broad parts where you
9 think you face possible entry. Are you constrained also in
10 those areas?

11 **MR BOULTON:** Sure, Hawkes Bay, South Taranaki regions, these
12 people -- this firm hasn't specified any closed area at all
13 where they might be considering their particular expansion,
14 and understandably so if it is true that they have open
15 access to very low price gas in the front end.

16 **CHAIR:** So your prices are constrained in those areas as well in
17 the same way?

18 **MR BOULTON:** Doubly constrained by the pipes being there and the
19 inter-fuel competition. Think about the inter-fuel
20 competition as the first constraint and the second
21 constraint now is an unfair artificial one where we believe
22 there's been some form of cross-subsidy, so we've got a
23 double level of constraint.

24 It's not just that, it's the threat of going to
25 alternative areas as well. Quite frankly when you look at
26 some of these areas we just cannot -- no one can come in to
27 build a gas pipe today for the threats that they apply and
28 the demands they place upon us to reach a pricing agreement
29 with them. It's just not possible to build, if it's not
30 possible to build it, something has to be happening in the
31 marketplace with the vertical integration, and we're not

1 talking marginal here in terms of 1 or 2% not possible to
2 build, we're talking double figures and we've tested that by
3 having third parties, advisors also say, well, are our
4 pricing construction pricing figures so far out here, please
5 give us an external view, and it's substantially different.

6 **CHAIR:** What I'm trying to understand is, is your pricing policy
7 the same across the whole country given you've got
8 constraint in every part of your network?

9 **MR BOULTON:** Well, we have some different pricing structures,
10 obviously we have Taranaki, Hutt Valley, Wellington, Hawkes
11 Bay. There are some variations but generally the price for
12 a residential consumers in each one of those is the same
13 across the whole of the network. The same for the -- the
14 net category's up, general business and so forth, they're
15 generally the same across the whole network.

16 **CHAIR:** And industrials?

17 **MR BOULTON:** They vary on a one by one basis. Again they've got
18 substantial market power to negotiate the best deal, they've
19 got those inter-fuel options.

20 **CHAIR:** Do they tend to be lower in the areas where you face
21 direct competition from the likes of Nova, as opposed to
22 areas where there is no direct competition?

23 **MR BOULTON:** We'd have to do some more work on that to give you
24 the numbers. But again, if they were, that's an artificial
25 constraint, again reinforcing the point that we believe
26 there's been some form of cross-subsidy there. Now, the
27 fairness of that is another issue.

28 **CHAIR:** So, are you not earning a proper return in the areas
29 that Nova competes with you?

30 **MR BOULTON:** Are we getting a?

31 **CHAIR:** Adequate return to meet your cost of capital in those

1 areas?

2 **MR BOULTON:** Again, it gets back to the issue about the
3 valuation, but in short the answer is no.

4 **CHAIR:** And you know what it is for those particular areas?

5 **MR BOULTON:** Well, we don't segment it by breaking it into 100
6 different components, but we could look at it on a broader
7 geographical basis, the Taranaki or the Palmerston North,
8 you know Napier/Hastings, but I haven't got those figures
9 with me and again we haven't revealed those disaggregated
10 figures in the marketplace.

11 **CHAIR:** I'm just trying to get a sense of whether you are in
12 fact more constrained in those areas than others, and if you
13 are earning a lower rate of return I suppose you are saying
14 you are?

15 **MR BOULTON:** Yes, we are earning a lower rate of return, and
16 obviously the economics of that would --

17 **CHAIR:** So, the inter-fuel competition in those areas does not
18 constrain you to the same degree, as what you are
19 constrained where you face head-on competition?

20 **MR BOULTON:** Yep, again I can't give you an absolute outcome
21 there, but the broader -- if you look at the whole of the
22 return, it's constrained by both activities, inter-fuel
23 competition and the -- we simply -- to put it another way,
24 we simply just cannot go out there and raise our prices and
25 look at our asset base, that's irrelevant. The pricing
26 structures that we have are reflective of what the inter-
27 fuel competition and the competitors are doing.

28 Now, we do have a big issue at the moment with
29 Wellington; \$800,000 I've either got to pass through or
30 absorb that as a cost, because we have to try and do some
31 analysis to understand what customers we will lose by

1 passing through a cost imposed from a third party. I'd love
2 to be able to just pass it through and hold my hand up and
3 say, well, we weren't accountable, but we'll have trouble
4 doing that, because it's driven -- the customer potential
5 loss and volume change is driven by that pricing of the
6 competitive players that we're competing against.

7 **CHAIR:** Okay, we'll continue with your -- we would certainly
8 agree with you that there are benefits from competition. At
9 least from our perspective, if not from yours.

10 **MR BOULTON:** Not from my perspective in that sense. From
11 artificial competition, I'd suggest it's unfair and
12 unreasonable.

13 There are benefits to consumers, and they have the
14 benefits now from what you call "normal" competition for
15 want of a better term. Just to give you a feel in the
16 highlighted -- Nova Wellington gas pipe is listed there for
17 you across to Petone and Seaview up through Hutt Valley to
18 Porirua and down through the CBD of this city, Wellington,
19 out to the hospital, so there are two parallel gas pipes
20 running along Lambton Quay and down Featherston Street, but
21 not up The Terrace, and obviously they fan out to major
22 customers, just to give you a bit of a feel for the actual
23 location of this network and these networks have been
24 installed elsewhere as well, partially driven by free access
25 to a trench and partially driven by what we suspect could be
26 some odd behaviour with potential cross-subsidisation.

27 **MR STEVENS:** Just picking up on that free access to the
28 trenching issue; have you ever had any difficulty now or in
29 the past with your RMA consent process in getting access?

30 **MR BOULTON:** I'm just trying to recall. I can't say that we've
31 had any major difficulty. We go through the normal

1 processes with each of the councils, but I can't say to you
2 that, off the top of my head, we've had one major project
3 held up to the extent by some sort of an Act or an
4 application of an Act by a local council.

5 I've probably highlighted most of this just in terms of
6 the discussion. I think the point to reinforce here is,
7 Powerco does have an absolute open access regime on our gas
8 pipe network, and the other party at this stage prevents
9 people trading on the network, they keep that as a closed
10 network for the sole use of their own business to offer a
11 contract to the end consumer.

12 **MR STEVENS:** One other point, if I may pick up on, is that open
13 access point that you mention there. Do you provide the
14 same terms and conditions for all of the users?

15 **MR BOULTON:** Same terms and conditions, common use of system
16 agreement, there's no differentiation from one retailer to
17 another, so they have the same common terms and conditions.
18 So, if we had a new retailer wanting to enter the market,
19 that would be the same arrangement that would apply.

20 **MR STEVENS:** And is that assisted by information disclosures to
21 the various users?

22 **MR BOULTON:** Well, we give them copies freely of use of system
23 agreements, yeah, so the pricing structures, they have full
24 and open access to that. So, if you wanted to start a
25 retail business you would have open access to that and all
26 the pricing structures.

27 **MR STEVENS:** On a level playing field basis?

28 **MR BOULTON:** That's right, yes. So it opens up the
29 opportunities for other players to enter the retail sector,
30 and given the scarcity of gas, it's very difficult at the
31 present time and there seems to be a lack of competitive

1 environment there.

2 I've probably covered this, but using different words I
3 think in terms of the no evidence of misuse of market power
4 for the following reasons. We've had no history of access
5 disputes with any of our retailers. I've highlighted
6 already that Nova is a vertically integrated gas business
7 and seems to have access to an abundant source of cheap gas,
8 and we still struggle to understand the demands placed upon
9 us again from a normal constructive perspective just looking
10 at point A to point B how we could meet that requirement
11 even using modern equipment and today's costs.

12 The impact of under-investment: There's been some
13 experience overseas, in Australia in particular, and that
14 will be covered later by one of our expert witnesses, that
15 it has not been in the best interests from a national
16 economic perspective; in fact there's a situation occurring
17 in Australia at the present time where a number of
18 distribution investment opportunities have been foregone.
19 Investments have not been made because of a concern about
20 the regulatory regime and in fact to avoid being regulated
21 in the overseas environment one of the techniques that firms
22 are using is to size the investment to provide supply to the
23 customer but no extra, and that means if you don't have any
24 spare capacity, there can be nothing that can be negotiated
25 or regulated per se, it's a simple contractual agreement
26 between the customer and the distribution company, and
27 that's what seems to be occurring.

28 A perverse outcome admittedly because some of the gas
29 pipes go past other premises and through other towns, but
30 that's the only approach that can be taken by the investors
31 to deliver a commercial outcome and provide greater

1 certainty, the fact that they can't be regulated because
2 they have no spare capacity.

3 How can it be done better? Well, I've mentioned
4 Powerco's investment in Tasmania. That's a real world
5 scenario in current day about the difficulties of trying to
6 attract investment in a sector that ostensibly has been
7 regulated in a harder format. Some people would call that a
8 heavy-handed or intrusive approach.

9 The Government in Tasmania has decided to place greater
10 emphasise on national economic growth rather than the
11 concept of regulation and by doing so have provided the
12 opportunity in this case, for Powerco, was successful in
13 negotiating the deal to roll out the distribution network to
14 the top 23 customers. We'll cover that in more detail
15 later.

16 Without having a regulatory environment and with the
17 Government making the capital contribution of sorts -- and
18 again, I've already mentioned the recent experience in
19 Victoria where the Government is now looking at contributing
20 around \$70 million odd to encourage distribution companies
21 to invest and provide that alternative option to consumers.

22 To date, the existing light-handed approach has not
23 provided any discouragement or perhaps disincentive. It's
24 been an open approach and has allowed distribution companies
25 opportunities to make those investments, take those risks,
26 and develop an appropriate commercial outcome directly with
27 consumers, and obviously it's important to consider the
28 possible change and the impact of that change on potential
29 investment, both in a maintenance, ongoing maintenance sense
30 and a capital replacement sense as well as new investment
31 going forward. The impact of a different design on the

1 business environment.

2 Overseas, a shorter term focus on consumer saves has led
3 to a backlog of vital investment in that infrastructure.
4 Obviously that comes at a potential cost. The cost of
5 having the opportunities denied to consumers, and we've
6 mentioned in our submission to you one expert's calculation
7 of the cost of that, and the concept of poor quality price
8 control could lead to long-term economic dangers being
9 illustrated by some recent electricity break-outs in the
10 United States, and there's some evidence coming forward that
11 the firms in those regulated environments have under-spent
12 in terms of capital and perhaps even maintenance over a
13 timeframe, and obviously these events have now occurred some
14 10 to 15 years after the regulatory approaches have been
15 introduced to their sector.

16 Well, we're out of time, do you want me to keep going?

17 **CHAIR:** I was going to let you finish the next slide and break
18 for lunch, yes.

19 **MR BOULTON:** So the first bullet point, the Tasmanian
20 Governments and the Victorian Governments have led the way
21 and at taxpayers' expense, they have had to find
22 contributions to attract investment and the argument put
23 forward there is very clear that it provides the regulatory
24 regimes in a heavy-handed sense, provided disincentive and
25 distraction, if you like, from the investment community
26 perspective and it's more difficult to raise necessary
27 capital.

28 One feature we saw in a recent media release from the
29 Auckland Business School was that there may be some more
30 independent analysis being conducted. We think that's a
31 very positive outcome. I mentioned earlier in my

1 presentation, there seems to be a dearth of information is
2 perhaps one of the reasons why the Minister himself has
3 initiated this whole process, that there's been some
4 commentators providing stories and views, but there seems to
5 be insufficient analysis, so hopefully that will occur.

6 I think the important issue is the third one that there
7 should be some initial economic cost/benefit test conducted
8 which looks at the importance of the ongoing investment as
9 well as a couple of tests that the Commission has mentioned
10 in their paper, the public interest test and the net benefit
11 to acquirers.

12 Just in reading the Commission's first paper, in a first
13 pass, there seems to be very little commentary about the
14 importance of investment, both ongoing investment in new
15 infrastructure and maintenance of the existing investment
16 including replacement CapEx, yet that from our perspective
17 is a vital ingredient that hasn't been recognised perhaps,
18 and we'll be happy to provide the Commission with some
19 further input on that as time elapses.

20 **CHAIR:** I think when we come back from the lunch hour there are
21 some questions on that point that I'd like to ask you,
22 Mr Boulton, if you are agreeable with the suggestion that we
23 adjourn now for the lunch hour, we'll return at 2 o'clock
24 and we will carry on through the afternoon with the Powerco
25 submission.

26 I might note, since there are a large number of people
27 from the gas related industries here, you may be interested
28 to know the Commission released the Pohokura Determination
29 at noon today, so if you want to follow that up you might
30 want to check on that in the lunch hour. With that, we'll
31 break for lunch. Thank you very much.

1 Adjournment taken from 1.10 pm to 2.10 pm

2
3 **CHAIR:** Okay, I'd like everyone to be seated please, and we will
4 reconvene today's session on the Gas Inquiry and, as
5 everyone knows, we interrupted the session with Powerco with
6 Mr Boulton, and I will ask you to pick up where we left. In
7 fact, that reminds me, I was going to ask you a question, so
8 the pressure will come on me first. And just so I don't
9 forget, we do need to speak a little more slowly for the
10 transcription in the next session.

11 Before we broke you were talking about the need to have
12 significant focus on issues around investment and I wanted
13 to -- we did want to ask you a number of questions around
14 the issues around dynamic efficiency, which is the language
15 we often put around concerns about investment, and one of
16 the questions we wanted to put to you is to get a sense from
17 you in terms of running this business, how important is
18 innovation in the gas transmission and distribution
19 industry?

20 **MR BOULTON:** Innovation has a couple of contexts. One of those
21 is the technical innovation from a gas pipe owner's
22 perspective and whether there's any technological advances.
23 Related to that, and to the impact of the market, of course,
24 is the technological advances in the consumer's capital
25 equipment that they might use which might drive some
26 potential increased use of gas.

27 And, of course, another focus on the concept of
28 innovation as distinct from technology is how innovative can
29 we be to provide services of a form that's appropriate to
30 the consumers to try and convince them to change from the
31 alternatives that they use at the present time.

1 I think it's probably fair to say just from a gas pipe
2 perspective, ignoring the other technology that's used in
3 terms of metering, you know, gate stations and so forth,
4 there hasn't been a substantial change apart from the move
5 to PE, you know, the plastic pipe as distinct from the steel
6 pipe. So, they're some of the factors that have to be taken
7 into consideration in terms of technology and innovation.

8 But it's probably more aligned to the marketing side,
9 working out what is it that customers are interested in in
10 terms of perhaps some contribution to the cost of the
11 service to connect to their home, whether they'll go to just
12 gas hot water heating, space heating, cook, a combination
13 thereof, trying to work with the equipment manufacturers to
14 bundle up products, that collectively we can work with three
15 or four businesses to overcome the competitive options that
16 they've got. In a nutshell that's --

17 **CHAIR:** It sounds to me like, in terms of things we consider
18 when we look at dynamic efficiency, you're really suggesting
19 that the big effect probably of regulation will be more on
20 incentives to invest at the right time, decisions about when
21 to extend networks, rather than the impact of regulation on
22 innovation.

23 **MR BOULTON:** Sure. I can only talk about my experience now.
24 Coming from overseas, it's fair to say the companies
25 overseas have focused on the concept of regulatory
26 innovation, which means an investment in the legal and
27 economic support that's available to debate issues with the
28 regulator over there. That's been an innovation that they
29 focussed on and have to make a call, are my resources more
30 appropriately tuned to debating with the regulator than they
31 are to putting assets in the ground. So, that's an approach

1 that they've taken.

2 In terms of the concept of incentive, I think if the
3 outcome of the design is a neutral one, which means it
4 doesn't provide a disincentive; that's a step in the right
5 direction, as distinct from the concept of incentive.
6 Incentive regulation, a term people use, is really a view of
7 the world. We could have incentive regulation by view if
8 you compare it to a heavy-handed regime.

9 But to move from the current regime we have to a
10 different one, it's more likely to be deemed a disincentive,
11 because it's changing the open environment we have to take
12 the risk at our own discretion, and make the investments and
13 construct the pricing. So, it's a view of the world.

14 Any movement from -- I can't think of any other
15 environment at the moment, a regulatory environment, that
16 would provide a greater incentive in the gas sector, because
17 I'm limited by the competitive market. Unless they could
18 limit my competitors in some way, I'd be happy with that,
19 but I can't see the Commission jumping to that particular
20 conclusion. I just don't know how a design could be
21 constructed better than what we have at the moment.

22 It's different to anything else in the world and it's so
23 different -- in fact, the rest of the world is looking to
24 New Zealand about how we have functioned over time compared
25 to what they've got over there with a strong reference to
26 investment and opportunity, and again, the change we've
27 noticed in Tasmania, which I'll cover in a few slides, is a
28 marked step for the regulatory thinking and the Government
29 thinking in that market.

30 **CHAIR:** Thank you for that. I think -- I'll just check with our
31 staff to see...

1 **MR MELVILLE:** Paul Melville, Commerce Commission. I just had
2 one question relating to the earlier on discussion about the
3 relationship you hold with retailers. It's my understanding
4 you hold an interposed relationship?

5 **MR BOULTON:** That's right.

6 **MR MELVILLE:** And you talked a bit about the costs of that and
7 that you lose the control over billing, there is a lack of
8 information about your end-use consumer. But there's also,
9 I guess, a number of benefits also relating to the
10 interposed agreement where you save on things like billing
11 and call centres and such like, and I just wanted to get an
12 understanding of how that interposed agreement came into
13 place over a conveyance type agreement?

14 **MR BOULTON:** I would have to go back to 99. I'd have to say, I
15 joined Powerco in 2000, so perhaps the Chairman could make a
16 comment on that. But on the electricity side the only
17 company that has a conveyancing agreement at the moment is
18 Vector and the retailers act as their agents. As I
19 understand it, the agency agreement compels the retailer to
20 disclose the line charge component.

21 The upside for Vector, and is similar in gas now, is
22 that they have a relationship with the end-consumer; the
23 consumer's alert and acutely aware of what the charges are
24 and what the differences in charges have been. The cost to
25 Vector for that is that they have to put more people on at
26 the call centres; you're right, there's a greater cost.
27 With that greater cost comes a greater benefit, though, and
28 that is building a rapport, it's a strong one, with the end-
29 consumers. That's something that we have to think about,
30 that would become a greater cost to us, but perhaps the
31 benefit from a company perspective and the consumer

1 perspective is the conveyancing approach is more preferable.

2 **MR UPSON:** Prior to 1999 Taranaki's gas connections were only in
3 the -- sorry, Powerco's gas connections were only in the
4 Taranaki region, and we were a retailer prior to 1999 but
5 sold the retail off, so we ended up being automatically
6 interposed then by the retailer that we sold the business
7 to. The businesses that we've acquired since already had
8 that arrangement in place.

9 **MR MELVILLE:** Thank you.

10 **MS BEGG:** I just had a question following up a little bit on
11 your relationship with retailers. You seem to be suggesting
12 that your interests, and the retailers' interests might be
13 different, and that they weren't marketing gas when you
14 would prefer them to be. And, I just wondered if in the
15 situation where you are a gas distributor as well as an
16 electricity distributor, if you lose a gas customer and you
17 gain that business back into your electricity distribution,
18 is that an offset for you? So that, you're less concerned
19 where you lose business where you've got gas distribution as
20 opposed to in other areas where you're just a gas
21 distributor?

22 **MR BOULTON:** I'd be comfortable in answering that question once
23 the electricity regulatory regime process is resolved
24 because a movement from one to the other, if there's cap
25 structure in place increases our penetration and throughput;
26 what does that do? Well there might be some consequential
27 impact collectively on price over time, so there's a lot of
28 interplays there.

29 At the present time, as we speak today without a
30 regulatory environment on both of those, there's some
31 movement. But again, I can't give you the numbers on what

1 load might have moved across to electricity. Over and above
2 that, Powerco's gas and electricity ownership doesn't always
3 overlap. We don't have electricity in Napier, Hastings and
4 of course Hutt Valley, Wellington which is the biggest chunk
5 of our gas base, we don't have the electricity, so at
6 margins there might be some movement but we couldn't give
7 you an exact number, but we don't have overlaps everywhere,
8 that's for sure.

9 **MS BEGG:** Where you don't have overlaps, is your marketing of
10 gas -- you know, you're talking about this marketing that
11 you were doing, are you more vigorously marketing gas in
12 areas where you don't have overlap as opposed to where you
13 do?

14 **MR BOULTON:** We're marketing in all centres where we can,
15 \$150,000 effectively is the budget for that; it's not a
16 great deal of money for a marketing campaign, but we're
17 marketing across all the gas centres. Part of that is the
18 educational process as well for customers to understand what
19 their options are. Keep in mind that marketing could result
20 in a movement from LPG or from wood, so it's very hard to
21 differentiate in a marketing sense, but it's across all
22 areas.

23 **MS BEGG:** So, a margin on gas transmission distribution is not
24 higher than the -- your margin on electricity distribution,
25 so you don't -- do you have an incentive to prefer one
26 option over the other? Obviously both you and the retailers
27 have no incentives to allow people to switch out of either
28 electricity or gas to something else, but in terms of
29 switching between gas where you are in an overlap situation,
30 do you have a greater margin for one or the other, or are
31 you saying you don't know now given all the regulatory

1 uncertainty?

2 **MR BOULTON:** I mentioned at the start there's a great dearth of
3 information, that's one of the pieces down to a very micro
4 level that's missing. So we'd have to do some more analysis
5 and even then we'd come back and there's a degree of
6 sensitivity around what the responses to that might be.
7 Again, that might -- ideally we could have had or would have
8 had or should have chosen a conveyancing approach that would
9 have been ideal if we had a crystal ball, but we didn't have
10 one; we didn't see that in there, and as a consequence we're
11 missing some information which I think would be more than
12 helpful for the Commission's thinking process to work
13 through.

14 **MS BEGG:** Just a question on Nova, the discussion you had there.
15 Were you trying to make the case that, in discussing Nova
16 and how it was unfairly competing, were you trying to make
17 the case that it had entered the market that didn't mean
18 that Powerco was monopoly pricing, or were you trying to
19 make the case that Nova should also be brought into the
20 regulatory regime, or were you making both those points?

21 **MR BOULTON:** Both those points effectively. The fact that
22 we've -- the word "bypass", you know, again I make the
23 point, some assumptions are made about the concept of
24 bypass. Some people would say "there you go that proves you
25 are monopoly pricing". I'm saying that's an interesting
26 concept but that's not valid at all. They were given a
27 lever up into the marketplace, or have taken one by their
28 approach to being involved in ownership of different parts
29 of the sector to give them an advantage which simply means
30 we've got a double level of constraint. Not only do we have
31 a competitive constraint with LPG and wood and electricity,

1 there's another loaded artificial one applied to us because,
2 in our view, they have some unfair advantages given their
3 vertical aggregation.

4 **MS BEGG:** When you say that -- you said that they get their gas
5 cheap and therefore they can effectively undercut you, do
6 you have any view on why they'd do that? Because, the
7 opportunity cost of gas is the same to them as to you in
8 that it doesn't matter how cheap it is to them, the question
9 is what they can sell it for. Are you suggesting that they
10 have some predatory intent, or that they'll somehow later
11 raise prices or recoup that?

12 **MR BOULTON:** Sure, and maybe if we took that approach it might
13 be for a different part of the Commerce Commission to
14 consider, obviously, apart from today; but our view would be
15 that we assume that they have a very low purchase price of
16 that gas in the front end. One approach they could take is
17 simply to price that to the market and take the upside of
18 the advantage of that particular pricing when their peers
19 can only buy it for, say, double the price or whatever it
20 might be.

21 But I think you will find their tactic is to take the
22 approach, use the excess margin, if I can use that term,
23 that's available to them with the low purchase price, to
24 fund the extension of building of networks, try and lock
25 those customers into a longer term network contract, which
26 compels them to renegotiate year-by-year for the energy
27 component, and the reason for that would be to wait for
28 Pohokura or other gas fields to come on, but they've got a
29 customer tied up contractually. That could be a tactic that
30 they might be employing, which is difficult for us to
31 compete with. We don't have the gas and we cannot offer the

1 end customer as much as they contact, and say what can we do
2 to help them. We obviously work with all of the other
3 retailers to see if we can put together a bundled package.

4 And, I have to say, I don't want to portray that it's
5 difficult for distribution companies who work with all
6 retailers; it's not. There are some features there that
7 make it difficult, but we try and work with a number of
8 other retailers to offer a product, and I can say to you, in
9 doing so we make joint presentations to the customer, and
10 when the customers find out what the line charge component
11 is, it's a real surprise to them. And the surprise being so
12 low compared to what they thought it was, which means
13 they're getting a new view about the price of gas energy.

14 **CHAIR:** Just one further question, Mr Boulton.

15 **MS BATES QC:** All I wanted to explore with you was whether this
16 was a growth area of your business or not?

17 **MR BOULTON:** We're trying to focus on growth with the GetGas
18 campaign, and some of the market analysis THAT we're working
19 on. But if you mean a financial sense...

20 **MS BATES QC:** Yeah, in a financial sense.

21 **MR BOULTON:** I'd say "flat" is a fair term at the moment, but
22 we're trying to work on means to increase penetration.

23 **MS BATES QC:** How long has it been flat for?

24 **MR BOULTON:** Depends on what parameters you utilise, and keep in
25 mind our business is different. It's been different for a
26 period of years, absorbing more gas businesses, which means
27 of course we're trying to have some economies of scale,
28 decrease our expenses, so all of those dynamics are
29 occurring.

30 **MS BATES QC:** I mean growth in terms of getting new customers,
31 getting more revenues.

1 **MR BOULTON:** They're very low, single digit, 1 to 2%, probably
2 less than that in terms of connections. Then you look at
3 growth in terms of volume as well, you know, some different
4 dimensions there. Powerco's gross volume has been growing
5 because we've been growing the business with the purchase of
6 assets and new connections, but the -- which means we don't
7 have some of the historical figures. But it's very low and
8 the business would be relatively flat, hence the focus now
9 on innovation for to us try and lever up against our
10 competitors.

11 **MS BATES QC:** I was just wondering about that.

12 **MR BOULTON:** Just had a quick look, be lucky if it was 1%.

13 **MS BATES QC:** I was wondering about that in terms of, in further
14 capital investment and whether you would; why would you, if
15 you didn't think there was real potential for growth?

16 **MR BOULTON:** Again, that's another issue for us to think about
17 and to try and find a means to grow the business in terms of
18 penetration, with some limits there with the peers at the
19 moment in the competition, and obviously one reason why
20 Powerco would look west, to go to Tasmania where there's
21 abundant source of gas and different opportunities there.

22 **MS BATES QC:** Because the fact that demand exceeds supply, that
23 must factor into your thinking, doesn't it?

24 **MR BOULTON:** In terms of Tasmania.

25 **MS BATES QC:** In terms of New Zealand.

26 **MR BOULTON:** Demand in what way?

27 **MS BATES QC:** Gas, well I mean there's a shortage --

28 **MR BOULTON:** Sorry, yep. Yes, yep, I was thinking of a gas
29 pipe, sorry.

30 **MS BATES QC:** The priority would probably be for the generators?

31 **MR BOULTON:** I think there's still a view in the marketplace at

1 a domestic residential level that has a degree of concern
2 about the gas availability over time, so there might be
3 certainly some additional potential ones we work through
4 some of the processes, so markets are very clear about
5 availability of gas for customers to make some of these
6 investment decisions.

7 **MS BATES QC:** I suppose I was -- I won't pursue this too much,
8 but just thinking in terms of if you wanted to make a
9 capital investment to switch to gas at this time, you'd have
10 to think, well, demand exceeds supply, that means price is
11 going to go up, is this going to be a worthwhile thing to
12 do, and I wonder how that impacts your keenness into
13 developing the gas business?

14 **MR BOULTON:** Sure, means we've got a lot more evaluation work to
15 do as well, because if the price of gas goes up and 40 or 50
16 of the electricity market has that as its primary energy
17 source through generation, we'll see some movement in
18 electricity, what marginal approach to pricing they take and
19 for what market, we don't know what the outcome of that
20 would be. So there's some increased degree of risk about
21 making those calls, yes.

22 **MS BATES QC:** Thank you.

23 **CHAIR:** Okay, I think if we resume your presentation please.

24 **MR BOULTON:** Just to briefly take you through the Australian
25 experience. One of the reasons obviously that we would go
26 there is the abundance of gas. At this stage based on AGA
27 statistics there's more than 100 years of known supply based
28 on anticipated consumption and growth; in fact, 132 years.

29 Powerco went through a process initially competing with
30 a number of larger firms, predominantly based in Australia
31 through the National Competition Code process. That whole

1 process collapsed. We entered negotiations directly with
2 the Tasmanian Government and I've just listed some dates
3 there highlighting when Powerco was selected as the
4 preferred developer and construction owner/operator.

5 I highlight again, it's for the top 23 connections, and
6 we are currently involved in Stage 2 negotiations which
7 could see a roll-out up to an additional 100,000 customers.
8 100,000 connections equates to pretty much 50% of
9 New Zealand's current gas connection market.

10 The Government I've highlighted this before, the
11 fundamental driving approach was more aligned to broad
12 economic growth than it was a concept of regulation. We
13 took them through a process where they determined that a
14 regulatory environment from a State perspective was not
15 supportive of potential infrastructure investment in terms
16 of the risk from the marketplace, and they made a few key
17 decisions, as I mentioned before.

18 The 3 key decisions are that they have removed the
19 capacity to price revenue, or profit regulate or have any
20 rate of return regulation for the distribution company
21 investor, which is Powerco. They've provided capital
22 funding to support the set-up of the business in that
23 period, in fact 9 million of a total of 38, and importantly
24 provided a franchise to get the business up and running
25 before it's open to the full competitive market. The build
26 will take over 18 months.

27 I mentioned some of those key points there. And again,
28 the same approach will see an outcome similar to what we
29 have in New Zealand at the end of the 7 year period, which
30 is further constraining forces over and above the existing
31 power that the customers have in negotiating a transaction

1 with us, so it's really designed to reflect the existing
2 New Zealand gas market post 7 years; and by gas market I
3 mean the distribution market in the regulatory approach.

4 **CHAIR:** I take it, there's no network whatsoever now? Is that
5 the situation?

6 **MR BOULTON:** There's no natural gas network. Transmission gas
7 pipeline has been constructed from Victoria across Bass
8 Strait, runs down in a Y shape through the centre of the
9 island down to Hobart and just past Launceston. So, in
10 terms of total people who live there, about 600,000
11 connections, a likelihood of up to about 100,000
12 connections.

13 The Government had a fundamental decision to make about
14 the form of regulatory approach to provide sufficient
15 incentive for investors to come to the marketplace. I've
16 mentioned earlier the power that the customers have. Even
17 if we're granted a franchise, they still have the choice not
18 to connect. They will utilise and have utilised that power
19 in terms of negotiating with us to achieve an outcome. Some
20 of that network roll-out is conditional; some of it is
21 unconditional.

22 All of that has been revealed in the marketplace. So,
23 they know where Powerco is compelled to make the investment,
24 and obviously would utilise that knowledge in trying to
25 negotiate a deal, and would bring to the table and share
26 with us their particular capital investments that they may
27 have to make, and their particular financial parameters set
28 by their boards.

29 So, I mentioned earlier, have some very tough simple
30 payback periods, given the risk of their business. Again,
31 keep in mind the risks that the distribution entity will

1 carry is that those assets will have a life expectancy of 60
2 odd years. The customers want short payback periods, very
3 low price, and that's what drives the competitive tension.

4 **CHAIR:** Why do you think the regulatory holiday was set at 7
5 years and not indefinitely?

6 **MR BOULTON:** Because that's the best we could negotiate.

7 **CHAIR:** Why is that, given the --

8 **MR BOULTON:** Why didn't we get 15, do you mean?

9 **CHAIR:** No, why did you get any period which it was going to
10 come to an end?

11 **MR BOULTON:** It might be covered by some of our expert
12 presenters later, the gas regulatory environment in
13 Australia is going through another review. The Australian
14 Gas Association and others have made their contribution.
15 What's occurring in the market over there is that there's
16 been some evidence that investment has been withheld because
17 of concerns about the regulatory form, and there are
18 negotiations in place now to provide up to 15 year
19 regulatory free periods to attract the investors to the
20 marketplace in the first instance. We're aware of the 15
21 year, we did raise that, I can say to you openly, in
22 negotiations with the Government. We end up agreeing on
23 7 years.

24 **CHAIR:** What did they tell you was the reason for not going with
25 15?

26 **MR BOULTON:** They didn't have to give a reason. At the end of
27 the day they simply said, we're sitting around the table
28 negotiating a deal, here's what we'll settle on.

29 **CHAIR:** Did you give them any undertakings on how would you go
30 about setting prices?

31 **MR BOULTON:** No, none whatsoever. The ball was completely in

1 our court, they understand that the customers that we're
2 trying to compete for, we have to attract them away from
3 their alternative fuel, we've given no undertakings
4 whatsoever. Nor is there any reference to weighted average
5 cost of capital, there's no issue about what the asset
6 valuation is, and we don't have to reveal any information in
7 terms of disclosure.

8 **CHAIR:** I just wonder if the fact that they put a time limit on
9 this holiday doesn't suggest that they thought this was a
10 problem about de novo entry rather than something that could
11 justify an ongoing treatment in this way?

12 **MR BOULTON:** I think it was just a situation -- there were a
13 number of features of the commercial contract that were
14 there to be negotiated. Obviously, there's another number
15 there which is a contribution of \$9 million. If there was a
16 15 year period, perhaps that number might have changed as
17 well, so it was a bit of argy-bargy, I think, probably can
18 use that term.

19 **CHAIR:** I guess the other point you can take from it is, given
20 the history of regulation in Australia, Powerco must have
21 made the decision that, even if you risk regulation, in
22 7 years time it's still well worth your while to enter?

23 **MR BOULTON:** We have to back ourselves and have done so from a
24 management perspective, put my neck in the noose, so to
25 speak, with the recommendations to the board to now
26 negotiate contracts with those customers. One thing is
27 certain, we have to roll some gas pipe out; that's
28 unconditional. We have to back ourselves now that we can
29 attract those customers away from the alternative fuels.

30 Every negotiation is different from their perspective in
31 terms of, as I say, volume, quantities, load factor,

1 timeframe, they're make -- some of the customers even want
2 options from us about them making an additional capital
3 contribution to Powerco to get that connection up and
4 running. They've got all of the options to work through.

5 **CHAIR:** But you must have also been willing to wear the risk
6 that in 7 years time you would be put under some form of
7 regulatory control?

8 **MR BOULTON:** Yes, there's an element of that, but there's some
9 other contractual structural arrangements that would ensure
10 that Powerco's position is protected.

11 **CHAIR:** What does that mean?

12 **MR BOULTON:** It means -- we'd be comfortable in sharing that
13 with you under different conditions; that's what it means.

14 **CHAIR:** All right, thank you, please proceed.

15 **MR BOULTON:** My words were a bit loose there, but deliberately
16 so.

17 **MS BATES QC:** Can I just clarify something first before we move
18 on; in Tasmania the electricity prices, are they sort of
19 comparable with gas? How do they compare with the gas
20 prices?

21 **MR BOULTON:** Well, the first 23 customers, predominantly the
22 competing fuels are diesel oil, LPG and wood and coal, and
23 some electricity. So, we'll be focusing on those first four
24 rather than the fifth one, it's more difficult, the
25 electricity prices are low, so we'll have a tougher task
26 when it comes to rolling out the next 100,000 connections.

27 Customers generally won't move for a 10% differential
28 from electricity to gas, you need something around the 20%
29 odd mark, and again, many of the customers, you know, live
30 in a week-to-week sense financially; they can't -- they can
31 but don't normally think in terms of 8 year paybacks for

1 perhaps a movement to a full scheme of hobs and gas hot
2 water and gas based heating.

3 **CHAIR:** Is that 20% typical everywhere, or just in Tasmania, the
4 price differential needed to switch?

5 **MR BOULTON:** We don't know. There's some other assumption s
6 that had to be made and have been made during Stage 2
7 negotiations. We've had to base our experience on Victoria,
8 South Australia, New Zealand.

9 **CHAIR:** And that's what you find, you need about a 20% price
10 advantage to get switching?

11 **MR BOULTON:** In a general sense, but then there's some other
12 assumptions about how many people you can move for that sort
13 of differential as well. It's a tough market to get people
14 to move from those alternatives to gas.

15 **CHAIR:** You've come to that view that you need a 20% price
16 advantage in order to get people to switch?

17 **MR BOULTON:** A ballpark figure, yeah.

18 **CHAIR:** Taken from your experience in New Zealand and Australia?

19 **MR BOULTON:** Without saying what that means in terms of
20 penetration rate and time for take-up, because all of those
21 things are linked in the dynamics of getting people to move.

22 **CHAIR:** Just thinking about that in the concept of the
23 Commission's normal test on whether something sits in the
24 same market or not, and 20% is pretty high to argue that
25 they're in one market, you get a 15% price variation, people
26 don't switch, we normally wouldn't put the two sources in
27 the same market, and so I find the 20% a fascinating bit of
28 information.

29 **MR BOULTON:** I guess the quid pro quo is, how can we have a
30 monopoly if that's the case?

31 **CHAIR:** Well, I'm not sure if I'm making myself clear, but I'm

1 going back to the issue about market definition, and are
2 these two fuels in the same market? And usually 20% is well
3 above what we would normally think is acceptable in terms of
4 saying that one adequately constrains the other.

5 So, I'm fascinated by this information, and I think we'd
6 be very interested to see what was behind what Australian
7 and New Zealand evidence supported this 20% differential
8 needed to get people to switch.

9 **MR BOULTON:** Yeah sure, we understand it was in the ACIL report
10 that was provided to the Commission, but over and above that
11 we're happy to provide some more information on that.

12 **CHAIR:** I think it would be very useful, thank you.

13 **MS BATES QC:** Just one more question; are you suggesting to us
14 that the Tasmanian Government has the objective of promoting
15 the use of gas over any other sort of fuel?

16 **MR BOULTON:** I think they have the objective of economic growth
17 and the promotion of other options and opportunities for
18 customers to have a range of energy sources and
19 differentials for their lifestyle in terms of the delivered
20 heat. What the Government's policy is and what drove that,
21 I can't comment on in detail.

22 **MS BATES QC:** It's a matter, you say, of them wanting the people
23 to have a choice rather than driving them in a particular
24 direction for a particular reason?

25 **MR BOULTON:** It's all been presented in terms of rolling out gas
26 for consumers to have an option, an alternative option,
27 another one apart from what they have at the present time.
28 Logically, if I was a Government -- and I won't speak for
29 them -- but if I was in a similar position, you'd like to
30 have as many competitive options for both residential and
31 business customers to try and attract them to the State;

1 it's small State compared to its peers up north, and it's an
2 island State as well, so they're looking at trying to have
3 as many options as they can possibly produce to give
4 consumers additional outcomes.

5 **MS BATES QC:** I was just wondering whether they were trying to
6 attract some business by having a very cheap source of fuel,
7 that's all.

8 **MR BOULTON:** I guess that's probably one of their objectives in
9 how that's presented; I'm not sure. Over and above
10 electricity, which I understand is reasonably low in terms
11 of price compared to their northern neighbours as well.
12 It's pretty much all hydro there. I believe there's a link
13 going across from Tasmania north to export as well, because
14 the costs of production of electricity there are lower than
15 their northern peers.

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

17 **MR BOULTON:** Probably mentioned most of these other points.
18 Distribution becomes exposed to real risks, customers'
19 demand a range of options. In terms of vertically
20 integrated companies, one of the -- when Sue mentioned the
21 question before about the retailers, they do have a decision
22 to make and that is whether gas from their perspective in a
23 commercial value sense is more valuable to them in
24 generating electricity, or is it more valuable to them in
25 load throughput in terms of normal connections; whether it's
26 residential, industrial or commercial.

27 And, I've mentioned already that we've lost a number of
28 customers, so they have some very strong influences on the
29 viability of our distribution business because of the
30 structural approaches that they can have and the tariff
31 options that they offer through to end-consumers. So,

Powerco

1 retailers have significant power in that sense. If we do
2 see a cut in the distribution price, the most likely outcome
3 is, it will simply result in a wealth transfer to those
4 retailers. Sorry, there's a typo there.

5 This is this whole cross-subsidisation issue. Again,
6 Nova has that capacity with their exploration front end, or
7 ownership of gas to cross-subsidise and negotiate contracts
8 with customers, which places an additional level of
9 constraint on Powerco's line charges over and above the
10 already existing constraints we have with competitive
11 marketplace.

12 And, of course, the approach that they've been taking
13 tactically is to use Powerco's network because we have an
14 open access network. We don't deny any retailers access to
15 our network, build those retail relationships with those
16 consumers and then work on a cherrypick basis to then
17 construct their own networks which they deny access to third
18 party retailers on.

19 **CHAIR:** Why would they go to the expense of building their own
20 networks if you were providing them access at a competitive
21 price?

22 **MR BOULTON:** Well, that's a good question. We can't understand
23 the logic of it in many ways with some of the prices that
24 we've offered. You can't construct the network, in our
25 view, for the prices that they demand from us. Our only
26 understanding would be that on a closed network with
27 relatively cheap gas they can lock the customer up for
28 longer periods, and the customer might want to come to
29 Powerco, but if we can't offer the full bundled package the
30 competitive option to them is denied, so --

31 **CHAIR:** Do you deny them long-term contracts -- is their access

1 to your network somehow limited in a way that prevents them
2 from signing long-term contracts?

3 **MR BOULTON:** By Nova signing a long-term contract or customers?

4 **CHAIR:** No, for the likes of Vector and --

5 **MR BOULTON:** No, we have no constraints in terms of the length
6 of timeframe that could be negotiated. We would only
7 negotiate a timeframe contract outside the use of system
8 agreement for the major customers; again, they're the ones
9 who feel they can lever a stronger position by negotiating
10 separately for gas and distribution.

11 **CHAIR:** I just don't see what the incentive is to build your own
12 pipeline if you have access to somebody else's at a
13 competitive price.

14 **MR BOULTON:** Long-term locking up of the customer.

15 **CHAIR:** Why can they not do that without that if they have
16 access to a back-to-back contract with you for long periods?

17 **MR BOULTON:** That's a question perhaps that Nova might be able
18 to respond to. We struggle with their commercial logic in
19 that sense.

20 **MR STEVENS:** Could I just possibly follow-up on that, because
21 likewise I'm having a little bit of a difficulty
22 understanding. So, from your perspective, the rationale for
23 them possibly building their own networks is because they
24 can lock up the customer for a longer period, yet over your
25 network they could likewise deliver the same gas under a
26 long-term contract to the same customer.

27 So, I'm sort of still missing the point as to why they
28 would want to build their own network.

29 **MR BOULTON:** Again, if it's cross-subsidised, if that's the
30 case, and we have to -- we can only assume that's the case;
31 they also then try and lever up into other customers between

1 the ones that have been cherrypicked obviously using the
2 leverage that they have from having that gas pipe invested.
3 So, it provides them with additional opportunity further
4 down the track, but subsidised again by the low priced gas,
5 and consequently subsidised then in series, if you like, to
6 give them access to additional customers. Then you'd have
7 to think about the sort of contract that they might have
8 with those customers.

9 **MR STEVENS:** In terms of cross-subsidise, you mean in two
10 different aspects I presume; one cross-subsidised in terms
11 of the low priced gas, and cross-subsidise in terms of the
12 network being rolled out simultaneously with another type of
13 infrastructural network?

14 **MR BOULTON:** That's right, and subsidised to the extent that
15 it's rolled out and goes past a series of other customers
16 who they could just try and backfill over time, so three
17 elements to that. We have met what they would call a bypass
18 price but again, some cases we've had them -- I shouldn't
19 use the word "threat" -- had demands placed upon us for a
20 certain price, and again we couldn't quite understand how
21 they would achieve that, so we had to test it.

22 One test was; well, if that's what you think it costs to
23 construct, please go ahead and proceed, build this thing
24 yourself and the result is, it's not constructed. So, it's
25 part of the process of try on, if you like, to try and force
26 and squeeze from us a better deal than what they might of in
27 reality, if they'd shared more information with us, have
28 actually constructed themselves. That's just what happens
29 in the competitive business that we're in.

30 **MR STEVENS:** Likewise, could you cooperate with another
31 infrastructural roll-out at the same time as a new roll-out

1 for yourself to be able to meet the same cross-
2 subsidisation?

3 **MR BOULTON:** If we haven't got a gas pipe in an area and a
4 telecommunications firm wants to run out a trench, obviously
5 we could try and put a gas pipe in that trench. We haven't
6 had that occur in recent times, but obviously we're alert to
7 the fact that that's an opportunity to us. That reduces our
8 construction cost for that particular phase.

9 Some of the big assumptions that we saw there; there was
10 not a list of assumptions added to the Commission's paper,
11 but again I've probably reiterated on these through the
12 discussion thus far. But it seems to be an assumption in
13 there that distribution companies will continue to invest in
14 the development and construction of gas pipelines. And, I
15 think there's question mark about whether firms will
16 continue to do that over time.

17 Another assumption about infrastructure, maintenance and
18 asset renewal that seems to be an assumption that's made;
19 that firms under regulatory pressure, depending upon the
20 form of the regulatory environment developed potentially,
21 that they would continue to do so, and we found that hasn't
22 been the case thus far from early information based on
23 overseas failures.

24 That the capital investors can be readily attracted to
25 continue investment in the sector following restoration, and
26 Mr Upson will talk about that in a moment; that gas
27 distribution entities are monopolies except where physical
28 proximity of pipes can be proven. When the paper talks
29 about the potential competitive component for the
30 transmission gas pipelines but only where it's contiguous,
31 so there's a physical view of the world that seems to be an

1 assumption in the framework.

2 That asymmetric risks are fair and reasonable for the
3 sector, which gets back to this concept about potential
4 regulatory design which might have a WACC which is treated
5 as a cap, but the firm might perhaps carry the downside of
6 that but not have any potential upside. Sharing of benefits
7 means guarantees for consumers but companies must carry all
8 risk. There was a reference in the paper to the
9 comparability of the electricity regime being developed thus
10 far which would see, depending on how the X factor is
11 applied, a potential guarantee benefit to consumers but
12 companies perhaps carrying the downside risk.

13 And perhaps there has been some -- a number of
14 assumptions made about what companies might do, almost the
15 worst-case view in terms of what might be an appropriate
16 regulatory design, and that gas distribution companies could
17 readily perhaps extract so-called excessive returns.

18 So the assumptions have not been specified, but there is
19 some assumptions that could underpin some of the possible
20 regulatory discussion thus far, and of course obviously
21 Powerco would be happy to make some contribution to those
22 and will do so through this process.

23 So, in conclusion, gas distribution companies' already
24 constrained in a number of ways in terms of the interfuel
25 competition to provide heat and source for cooking. From
26 our perspective consumers do have market power, but don't
27 carry any capital risk, apart from what they might make some
28 independent decisions about in a changeover from one fuel to
29 another, which is one of the Commissioner's points before.

30 It's crucial that asset replacement investment and new
31 investment not be prejudiced for short-term consumer gain,

1 and that we're still confident that, as time elapses, more
2 information will become available so that we'll end up with
3 a fair and reasonable outcome at the conclusion of the
4 process.

5 **MS BATES QC:** Just -- I don't think that the capital risks
6 necessarily are confined to changeover, because when you're
7 putting in new plant you might have to make a decision as to
8 which way you're going to go; that's a risk too, I suppose
9 it's a risk of -- maybe it is the same thing. Do you think
10 it is?

11 **MR BOULTON:** They've got to make a call, I think you're right,
12 maybe we're saying things but using different words perhaps.
13 They have to make a decision about the movement from, say,
14 electricity to gas, what the capital costs of that
15 changeover would be, the dead period while they get the new
16 process up and running and any other risks that might be
17 associated with that changeover from people training,
18 development, you know, technology, legislation, all those
19 perspectives -- all of those issues have to be considered.

20 I think we're saying -- I don't disagree with your
21 comment. I think we're saying the same thing but just
22 different words. Thank you.

23 **CHAIR:** I'd just like to pick up on one of the comments you made
24 about the sharing of benefits. Leaving aside whether that's
25 a guarantee for consumers, I'm not sure if it is, but
26 usually when you have a CPI-X sort of regime, if you use
27 that as your comparator the benefits aren't instantaneously
28 shared, and in fact if you set a long regulatory period any
29 efficiency gains usually are retained for the company during
30 that period, and that period can be quite long, and I think
31 the electricity line side is a case in point where the

1 Commission has previously indicated it would set a
2 reasonably long regulatory period, and during that period
3 any gains could be retained by the companies beyond, you
4 know, whatever is set.

5 So, I wonder if this is really a fair representation
6 that it's all downside risk for the company, and I'd just
7 like your comment on that?

8 **MR BOULTON:** Yeah. I think if something goes awry, if I can use
9 that term, during that reasonably long timeframe that you're
10 talking about, whether it be a cyclone Bola or a number of
11 events, an earthquake, dozens of events that could occur,
12 changing Government policy. The company would be bearing
13 all of the downside risk associated with that whilst the
14 consumer is still on a good plane and is flat, it doesn't
15 peak and move up and down as the company would have exposed
16 you to in terms of the risk profile.

17 **CHAIR:** I suspect most markets work that way though, don't they?

18 **MR BOULTON:** Sure. Again, it gets back to the concept of
19 sharing. Is that post the result or is it developed in such
20 a way that there's an outcome that could be anticipated from
21 the performance over time frame, but in the meantime whilst
22 the five years, say, if that's an example, goes forward, the
23 consumers carry minimal risk; in fact, you know, no risk in
24 that sense. They don't have any capital tied up in the
25 businesses. The businesses carry all of that. Again,
26 depends how it works in parallel with your asset valuation,
27 the WACC, the ROI, all of those things have to be thrown
28 into the boiling pot.

29 That was my point there, I think, but accept your view
30 if -- the word "all" was perhaps marginally too
31 encompassing.

1 **CHAIR:** Right, just marginally. Okay. I was just going to say,
2 if it doesn't really help you out much, we could always just
3 not bother with it on the electricity lines side.

4 **MR BOULTON:** What's that, no X factor?

5 **CHAIR:** Let me see if there are further questions, Mr Boulton.
6 [No comments]. Thank you for that presentation. We'll move
7 on to, is it Mr Upson? Are you going to present next?

8 **MR UPSON:** Yes.

9 **CHAIR:** Thank you.

10 **MR UPSON:** Good afternoon Commissioners. My name is Barry
11 Upson. I'm going to be talking, I guess, mainly from a
12 governance and investors' viewpoint. So, some of the
13 material has been partially covered already, and so, it's
14 just a slightly different viewpoint in some aspects.

15 As you know, Powerco owns and operates a number of --
16 they're actually small localised gas networks. People have
17 a sort of concept that we operate a big gas network; we
18 don't. We actually operate a lot of small localised
19 networks that are teed off from various gate stations up and
20 down the main transmission trunk line, so you're really
21 talking about a whole host of small networks here. The
22 industrial is largely a fixed cost industry.

23 I think the point -- the comment's already been made in
24 the past, it's a sunk cost, so the cost is there and the
25 best opportunities for growth now is through backfilling,
26 and I think that point has also been made, if the pipe
27 already goes down the street and half the houses aren't
28 connected, obviously there is an opportunity to try and grow
29 the business that way.

30 We've also had a strategy in the past to increase our
31 economies of scale through acquisition. When we separated

1 the retail side of the business in 1999 we were but a very
2 small player operating only in the Taranaki -- in fact, it
3 was only in the north Taranaki area, and in the south
4 Taranaki, Hawera area. In 1999 we actually acquired from
5 NGC their distribution pipes in the Taranaki region, and
6 since then the other acquisitions have been made
7 progressively over the last three or four years to actually
8 give us a far better base to operate from in terms of
9 economies of scale, particularly in the fixed cost area.

10 Of course, as a fixed cost industry, the pricing in fact
11 should also be done on a fixed cost basis on a fixed daily
12 charge basis; that would be typical of how to recover this
13 cost, because regardless of whether any gas is transported
14 or not the cost is still there.

15 Attracting and retaining capital investors is key to the
16 funding of future growth. Any growth in the infrastructure
17 industry requires investors, not only new investors, but
18 also retaining the existing ones.

19 Powerco only plays a very small part in the gas
20 distribution chain. In fact, just before when the questions
21 were asked about our retail market, it's interesting to note
22 that in the last -- latest year's disclosure our average
23 revenue per residential ICP is \$289 per annum; \$24 a month
24 is what we're talking about in terms of the revenue in the
25 gas sector.

26 Powerco has no influence over the supply and the price
27 of gas from the well head, no influence over the cost of
28 transmission to the various gate stations that we tee off
29 from, and also no influence over the retailers' motivation,
30 including whether they use gas for this purpose or whether
31 they use gas for electricity generation. We have no control

Powerco

1 over that; no control over their marketing, as you've just
2 heard. We've offered marketing incentives for new
3 connections and couldn't even control that process, and nor
4 do we have any control over the final pricing of gas to
5 consumers.

6 And, you've just heard that in some major residential
7 areas we also compete with another distributor, and gas also
8 competes with other forms of alternative forms of energy.
9 One other interesting alternative form of energy that hasn't
10 been mentioned, of course, particularly in the vehicle
11 industry was CNG. Huge investment made in CNG around the
12 country. The returns weren't there and gradually that
13 investment is coming out of the ground. And, most garages
14 have actually now pulled out of CNG as an alternative fuel,
15 and that's what happens in this type of alternative fuel
16 competition.

17 And so, the question I certainly raise is, why do we
18 need regulation? Market strategy; for a majority of
19 customers Powerco does have a large proportion of its
20 customers on a variable price basis. The split is roughly
21 about 60/40, so we have a large proportion of our revenue on
22 a variable basis. And so, that means that -- and we've done
23 that of course as a strategy to increase our penetration, so
24 if you don't use you don't pay, but the connection's still
25 there.

26 What that means is that we've taken on board a huge
27 volume risk, significant volume risk, and you've heard the
28 comment about the number of connections already that have
29 dropped off; now, that's a volume risk that we've now got on
30 board.

31 I've mentioned that we work with retailers to promote

1 services, offering special incentives. The net result is
2 that we have little or no control over the gas distribution
3 market, as retailers actually determine the final market
4 strategy, including the price and the supply availability.
5 And again, we get to the conclusion, why do we need
6 regulation?

7 Just moving on to the investor issues. Typically
8 regulatory regimes are asymmetrical regimes and typically
9 cap returns to a WACC at some level, but with no floor.
10 Investors get very nervous about the regulatory approach.
11 They regard these businesses as yield stock, not as a growth
12 stock for that reason, because they expect a maximum return
13 from the cashflows that are generated, and that's the way
14 they just happen to work.

15 Any reduction, of course, in the level of dividend will
16 affect the yield from the equity investors' viewpoint. And
17 the approach to regulation usually means that over time the
18 free funds from operation, which is essentially EBITDA minus
19 a cash tax, is the term used by the credit rating agencies,
20 any reduction will mean that the FFO will in fact have no
21 upside, you will even struggle to make -- unless the
22 industry had no floor, you would struggle to make a constant
23 return year-by-year, and usually because of these other
24 risks that have just been mentioned, the returns are
25 normally less than a WACC return. If you've got a WACC cap.

26 **CHAIR:** So, this is a rate of return type regulation that you're
27 talking about?

28 **MR UPSON:** Yes, we understand that that's a question still to be
29 determined, if there is a control regime. But again, the
30 effect usually comes to a similar thing; FFO suffers, it
31 suffers because it operates to a ceiling all the time, it

1 doesn't operate in a range. And if FFO suffers, of course
2 that's the cash to pay investors, and it's also the cash
3 required for reinvesting in the assets. That's what the
4 free cashflow is all about.

5 Just quickly on Powerco's capital structure, just to get
6 this comparison. Powerco of course has a triple B plus
7 credit rating, that's just been recently re-affirmed; that's
8 a credit rating that's pretty much in line with our
9 international peers in the industry, both electricity and
10 gas. So, it's not a credit rating that's out of line. It's
11 a rating that has allowed us to be highly leveraged; 60% in
12 our case. And at that level of leverage we have been able
13 to maintain a credit rating.

14 Any reduction in market value that will arise through
15 lower dividends; of course, if we reduce our dividend, our
16 share price will drop, our market value will drop, and that
17 will impinge on our credit rating. It could also impinge on
18 our banking covenants. It puts the balancing structure
19 under stress. And the down -- any downgrade in credit
20 rating also affects the cost of capital, both debt and
21 equity, the cost will go up if the triple B credit rating
22 goes down.

23 We will have demands from investors to create cash from
24 other sources and that could be through reduction in
25 asset -- increase in asset sales or reduction in re-
26 investment to maintain the -- just so we can maintain
27 investor returns and confidence in the market. And the
28 reduction in FFO will ultimately result in reduced
29 investment in the asset base.

30 That's really what it means. If we reduce the dividend,
31 it's a bit circular, it forces the market value down, puts

1 the balance sheet under stress; the net result is that we'll
2 be put under pressure ultimately to reduce the investment in
3 the asset base, so we're back to where we should have
4 started in the first place; reduce the investment in the
5 asset.

6 **MS BATES QC:** Can I just ask you this, Mr Upson. What
7 percentage of revenue, of it's revenue does Powerco get from
8 its gas business?

9 **MR UPSON:** [Pause]. About 25%, I think it is. We can get that
10 figure checked out later on.

11 **MS BATES QC:** Thank you.

12 **MR UPSON:** So, for infrastructure investment, the only safety
13 valve for cashflow reductions is to reduce investment in the
14 assets by a similar amount. And, of course, we've heard the
15 investment is needed to maintain and upgrade the asset,
16 upgrade the network. It is needed to expand the network in
17 response to increased demand or to service new consumers.
18 That increased demand mainly comes from new subdivisions.
19 By-in-large most new subdivisions still put gas pipelines in
20 at the same time as the subdivision's being developed. The
21 investment ensures that services are provided safely and
22 reliably, that they provided efficiently and also we're able
23 to respond to consumer demands.

24 One of the problems in growing the business, of course,
25 is that you always have to make the investment before you
26 know whether you're going to get customers on the end of the
27 investment. So, there's always a timing issue here as well,
28 which is another risk the company has to take. If the
29 investment is slowed down, in the long-term customers will
30 suffer of course through non-availability.

31 One of the questions asked earlier on, just as a note in

1 this area as well is, how do we deal with low population
2 density areas compared with electricity? Well, of course,
3 the two had different histories. Electricity in the 1920s
4 and 30s, I believe, were mainly controlled by --
5 reticulation was controlled by local authorities, Electric
6 Power Boards, who had sort of a community of interest to
7 develop a network in their own area regardless of how remote
8 they happened to be from the rest of the country, and that
9 was the model that was used to get reticulation in the first
10 place.

11 In gas that didn't happen. You had localised sort of
12 coal, gas reticulation in most, or the bigger cities, but
13 that was about it. When natural gas came on there was a
14 gradual conversion of those areas before it eventually came
15 out into some of the countryside. So, you only get natural
16 gas reticulation, or distribution, in areas which are close
17 to the main transmission pipelines.

18 **MS BATES QC:** Can I just ask you just a quick question about
19 subdivisions; I mean greenfields ones where -- big ones,
20 say; how does that work with the developer? Who actually
21 pays for the gas network?

22 **MR BOULTON:** In electricity Powerco subsidises the investment,
23 so for example we might -- our current policy is to pay
24 about \$600 odd per connection for electricity, and that
25 varies from distribution company to company. Some are down
26 as low as zero, 25%, or up to where Powerco is.

27 The gas side is negotiated with each of the developers,
28 and obviously the unknown factor is, what will the take-up
29 rate be? What's the behaviour of the customer base in that
30 immediate proximity in terms of gas? What is the market in
31 terms of the competitors for LPG? So that's why it's

1 negotiated. It all varies across different --

2 **MS BATES QC:** So the developer is paying for some of it?

3 **MR BOULTON:** That would normally be the case.

4 **MS BATES QC:** Is it ever a requirement of the subdivisional
5 consent that that gas be made available in the subdivision?

6 **MR BOULTON:** No, not normally, no. Again, that varies as well;
7 depends on the local council, and we've got 16 odd different
8 councils that we have.

9 **MS BATES QC:** So the developer picks up some of the risk?

10 **MR BOULTON:** Depends on what you mean by "some of the risk".

11 **MS BATES QC:** If they're actually paying some of the cost of
12 putting in the lines.

13 **MR BOULTON:** That's right, but they don't carry the ongoing risk
14 associated with maintenance and so forth, it's an upfront --
15 an amount that obviously from their perspective they might
16 try to recover through the sale of the section.

17 **MS BATES QC:** Thank you.

18 **MR BOULTON:** That's the issue that we talk about in terms of
19 investment in the future. Why would Powerco perhaps want to
20 own that network? Maybe that's best left in the hands of
21 other potential owners. Again, it depends on what the
22 regulatory environment evolves into through this particular
23 process. We might go through a competitive opportunity and
24 suggest to them we could construct it for them, but here are
25 five other companies who could construct the network again,
26 and at the end of that process we don't want to own it
27 either but we're happy to give them a price in a competitive
28 process to maintain that asset for them over time. But the
29 outcome of that is in the hands of the Commission in terms
30 of the decision that you make.

31 **MR UPSON:** Probably as an afterthought the councils probably

1 will insist that gas pipelines have to go into new
2 subdivisions just so they can charge us rates on them.

3 **MR BOULTON:** For the same trench.

4 **MS BATES QC:** Perhaps you should suggest it to them.

5 **MR UPSON:** The gas investment returns, the most recent ROIs for
6 Powerco have been poor. That's the last three years, and so
7 this has been a concern from a board point of view, and
8 hence the internal debates that we do have about how to
9 improve the return on the gas investment, and it is a major
10 concern, and hence the concern over any sort of regulatory
11 imposed as well from an investors' point of view.

12 **CHAIR:** How are these rates -- how are these returns calculated
13 that you have here?

14 **MR UPSON:** That's the standard disclosure for the Gas
15 Regulations, as per the Gas Regulations.

16 **CHAIR:** Do they take account of revaluation gains and all this?

17 **MR UPSON:** Which there haven't been any.

18 **CHAIR:** There haven't been any?

19 **MR UPSON:** No.

20 **CHAIR:** These returns have been quite a bit lower in your
21 business, haven't they?

22 **MR UPSON:** Yes.

23 **CHAIR:** But you've continued to invest in your gas business?

24 **MR UPSON:** Yes, we have, and we're still working on the basis
25 that the increased economies of scale will improve those
26 returns, but we've still got a long way to go, we've still
27 got a long way to go.

28 **CHAIR:** So, you've low returns but you're continuing to invest.

29 **MR UPSON:** Those investments -- when you say "continuing to
30 invest", the past investments of course have mainly been
31 acquisitions. The investment in terms of what we call

1 "organic growth" is very low, it's -- I think the comment
2 made before, it was about 1% is about the growth factor.
3 So, you're not talking a lot of -- and that's the net
4 growth, we're losing customers and at the same time we're
5 trying to add new ones on. So, it's a pretty low growth
6 rate.

7 **CHAIR:** What's happened to your spend over this period on
8 maintenance and renewal?

9 **MR UPSON:** We'd have to dig that out. They'd be in the
10 disclosure accounts.

11 **MR BOULTON:** Just keep in mind it's very difficult to compare
12 year to year; the businesses change from year to year as
13 well, so it's been done in some proportion, if you like, of
14 the revenue or whatever it might be, not just an absolute
15 number. Because of different customer bases, different
16 total revenue, different cost structures.

17 I'd have to say, from a management perspective, we take
18 the sort of opposite view of what you're talking about, not
19 about being a disappointing business but what can management
20 do now to influence the outcome, to improve that over time,
21 part of that is the innovation and approach to --

22 **CHAIR:** Sometimes to improve your return you do have to invest,
23 don't you?

24 **MR BOULTON:** Sometimes, mmmhmm, that's again another risk call
25 and again why this process that we're going through at the
26 moment, making contribution to the Commission for the
27 recommendation in the end is so critical to absorbing all of
28 the relevancy about potential future investment. Because
29 the opposite is also true, is that it could, depending on
30 the design, actually deter investment.

31 **MR STEVENS:** Do you believe that the fall-off in the ROI has

1 been a result of poor organic growth? In other words,
2 purchasing businesses that perhaps didn't have the higher
3 rate of return as you had previously?

4 **MR BOULTON:** That's a possibility. It could also mean there's
5 more aggressive competitive behaviour with the entities, and
6 the competitive fuels that we're focused on; could also
7 reflect some concern in the marketplace about gas running
8 out. The mum and dad average consumer see the big market
9 ploys and plays and stances being taken with the big guys
10 which grab the headlines and from their perspective it is a
11 question mark for them, how much gas will there be. The
12 market is saying at the moment not much for the big players,
13 but the mum and dads forget it's only 2.5% of the total gas
14 consumed by them is very small, and there are a number of
15 other options and sources for them as well.

16 **MR STEVENS:** So obviously you have an issue with getting some
17 key messages out there to some of the smaller consumers?

18 **MR BOULTON:** The sector has not done a good job, I would
19 suggest, in getting the right messages out. One is about
20 the opportunities for customers, and one is about the
21 performance of the sector over time. So, two parts I think,
22 you know, probably a score of 5 out of 10 would be
23 appropriate for that; hasn't done a good job.

24 **MS BATES QC:** I want to follow that up because I don't know if I
25 understood it right. You know that \$150,000 figure you
26 mentioned for marketing?

27 **MR BOULTON:** Mmmhmm.

28 **MS BATES QC:** Is that just on one particular campaign? What is
29 your annual spend?

30 **MR BOULTON:** We haven't released that information in the
31 marketplace either.

1 **MS BATES QC:** Okay, you might consider -- it's just that if
2 you're getting such poor rates of return, I thought you
3 might put a bit more effort into marketing.

4 **MR BOULTON:** Well, a couple of points there, it's good point, I
5 accept that. We don't control the market in the first
6 instance; it could mean the competitors are doing a better
7 job than we are at marketing their particular fuel. Of
8 course, the point that the Chair raised, and that was,
9 sometimes you have to invest in marketing and so forth to
10 grow, and that's what we're trying to do. Short form
11 timeframe thus far as we work through the process to see
12 what the results will be of that particular campaign, and
13 keep in mind in a real sense what it also means is the
14 people -- the firms that do the work for us are
15 subcontracted out and we've got to work through some of the
16 firm to firm to firm --

17 **MS BATES QC:** You mean, you get your --

18 **MR BOULTON:** Construction firms who dig the trenches and put the
19 gas pipes in, we contract almost all of that out to third
20 parties, and then there's another party involved which is
21 the provider of the equipment itself. So, there's the
22 provider of the hot water units, the entity ourselves that
23 lay the gas pipe, the retailer, and the firm that does the
24 work; you've got to co-ordinate all of those.

25 **MS BATES QC:** Just explain -- I'm sorry I'm being a bit slow,
26 but how does that actually influence what you as a company
27 spend on marketing?

28 **MR BOULTON:** Well, whatever we spend on marketing in GetGas with
29 the promises that we make to the market to perhaps get
30 supply on very quickly, which is one of the factors that
31 they would consider in making a decision, is a function of

1 whether we can get all four of those units working together
2 cohesively. We might be able to get a gas pipeline in there
3 in 10 days but is the gas equipment available in 10 days as
4 well? That's the stuff we have to work through.

5 **MS BATES QC:** But that doesn't just apply to the GetGas
6 campaign, does it?

7 **MR BOULTON:** Yes, the GetGas campaign specifies some target
8 timeframes that we would have a connection for them.

9 **MS BATES QC:** Yeah, but that's not your whole marketing spend
10 surely.

11 **MR BOULTON:** No, it's a component of it though.

12 **MS BATES QC:** Yeah, but I'm talking sort of in a bigger picture.

13 **MR BOULTON:** Yeah, we spend more than \$150,000 on marketing.

14 **MS BATES QC:** I'm sure you would. I know you've got the
15 retailer that you have to deal with, and the retailer's got
16 to do its marketing, but what do you do to actually
17 influence the retailer to -- I mean, you can have some
18 influence, it's another way of marketing, isn't it?

19 **MR BOULTON:** Yes, but it depends upon the commercial view of the
20 retailer, the options that they've got as well. One is the
21 scarcity of gas, one of them is which part of the market are
22 they best selling gas in? Is it the commercial, industrial
23 or residential? And we're focusing GetGas predominantly on
24 residential, predominantly on backfill where there's
25 existing pipe. With the scarcity of gas, though, they've
26 got to make a call about whether they want gas for that
27 purpose or some other purpose, including possible sale to
28 generation. So, convincing them to go with this is not that
29 simple, because they have a number of options themselves.

30 **MS BATES QC:** Yeah, I do understand what you're saying, but from
31 your company's point of view, your interest is in persuading

1 them; from your gas business's point of view, your interest
2 is persuading them to do a particular thing?

3 **MR BOULTON:** Yes, that's right, and we work on that as well with
4 each and every one of them where we can, and they would be
5 happy if we -- if we put more money into marketing, which is
6 an interesting concept given we're portrayed as a monopoly,
7 why is it that we're out there marketing the energy option
8 when they're in a competitive market, and it's almost
9 flippant. That's the way it is.

10 The logic that sits behind that, they have options,
11 scarcity of gas, they can listen to us, but if -- put
12 yourself in their shoes; perhaps if other contributions are
13 made to them they might try and market gas themselves.
14 We're at a disadvantage in a competitive sense not having
15 opportunity in the retailing sector.

16 **MS BATES QC:** When did you make your last significant
17 acquisition of a gas business?

18 **MR BOULTON:** In November of last year.

19 **MS BATES QC:** What made you do that when the returns seem so
20 appalling?

21 **MR BOULTON:** Again, it gets back to the economies of scale,
22 putting the larger business units together, having a
23 management view on what we can do to reduce our total
24 operating costs, having some view about the potential of
25 that growth, but again none of that's guaranteed; it's like
26 any competitive market. It's all that risk, and again other
27 factors include weather; is the winter cold or warm or
28 whatever the case may be. The windchill factor has an
29 effect on people staying inside and choosing to use gas.
30 That's the risk --

31 **MS BATES QC:** Yes, I do understand, I won't go into the --

1 belabour the point, but it just seems, with declining
2 returns are you locked into a situation where you've got to
3 try and do what you can to make it a bit better?

4 **MR BOULTON:** Essentially we've got to work on all of those
5 factors that you've raised and subsets of those to improve
6 the financial outcome where we can in the limitations driven
7 by the competitive players.

8 **MR UPSON:** To make matters even worse, cost of equity as
9 demonstrated in the recent equity raising is some 1 to 2%
10 above the actual cost of equity used in the WACC
11 calculation. So, while we're trying to compare ROIs to
12 WACC, the actual cost of capital is even higher again.

13 **CHAIR:** This was for your United purchases?

14 **MR UPSON:** Yes, that was the 150 million equity raising that we
15 did last November, and so the cost of that equity has been
16 calculated at 10.3%, which is inclusive of the issuance cost
17 involved in raising equity.

18 **CHAIR:** Seems rather high compared to what companies are
19 achieving in the market. Why do you think that would be?

20 **MR UPSON:** Well, in terms of raising cost of equity, that's the
21 total cost of -- ongoing cost of servicing the equity. The
22 dividend yield at the time of that equity raising was 10%,
23 as per the forecasts that were in the market at that time,
24 and the issuance costs add another 30 basis points to it; 34
25 I think it calculated.

26 Powerco's ability actually just to retain and attract
27 investors is becoming more difficult and investors are
28 becoming more influenced by international events. Most of
29 the investors that we see do invest offshore and as do
30 offshore investors invest around the world, so it's very
31 much an international market, and of course local and world

1 events have made investors, particularly in energy
2 infrastructure more jittery, starting from the Californian
3 issues some years ago to the more recent issues; investors
4 in infrastructure used to think it was a safe bet but
5 they've certainly become more jittery.

6 Since 1993 reforms a number of large investors have
7 left, and others have reduced holdings in the New Zealand
8 energy sector, so we need to attract more overseas investors
9 into the sector, just to be able to maintain what we've got.

10 Today's investors are more astute because of more
11 choice; they're certainly more mobile, they seek to maximise
12 the return for the perceived risks that they see and, of
13 course, the comment's been made about the nervousness about
14 just the threat of regulatory approach; that always sends
15 investors in a spin.

16 Not interested in regulated industry where WACC is seen
17 as a cap rather than a mid-point in a range, and they also
18 ask themselves why invest in a sector where there's little
19 chance of achieving EVA zero, let alone positive; because
20 obviously if your cap returns to somewhere in the WACC
21 range, then these sort of companies will never get to an EVA
22 positive. In fact in the gas side here, as you've just
23 seen, we would be very much an EVA negative.

24 **CHAIR:** Just looking at these disclosures, and Powerco seems to
25 be the exception rather than the rule in terms of fairly low
26 returns and --

27 **MR BOULTON:** Is that the PricewaterhouseCoopers? I think that's
28 2002 or 1.

29 **CHAIR:** It's the 2002 one, yes, and I just -- I'm just curious
30 about the relativities between you and say NGC and Wanganui
31 Gas and wonder if you have any comments on that?

1 **MR UPSON:** Probably not off-hand without doing a bit more
2 research, but I would suspect that our customer densities
3 are very low compared with some of the others, because in
4 2002 we wouldn't have had a lot of high density areas, a lot
5 of rural areas and small networks spaced out all over the
6 place, and that certainly is a factor in --

7 **MR BOULTON:** In location you have to go for a 15 minute drive,
8 nice dairy farming community to drive through before you
9 come across a batch or a group of homes, which might have
10 500 homes, and the gas network is in those sort of areas.
11 That's very different to having Wellington City, Hutt Valley
12 to a degree.

13 **MR UPSON:** Or a Hamilton.

14 **MS BATES QC:** So, the latest acquisition what sort of densities
15 are you dealing with there?

16 **MR BOULTON:** It's a little better, you've got obviously
17 Wellington City, and Hutt Valley's quite different to
18 Oakura, where you're not 10 minutes out of town from New
19 Plymouth. Hawkes Bay, I couldn't give you an absolute
20 number, but certainly it's a reasonable difference.

21 **MS BATES QC:** So, you're hoping for a better return from the
22 higher density?

23 **MR BOULTON:** That would be a conclusion you could draw.

24 **MR UPSON:** Then you bring in the Nova factor.

25 **MS BATES QC:** Okay, but you chose to do this, knowing the Nova
26 factor; but I'm just trying to work out; you said you were
27 trying to improve your returns by cutting costs.

28 **MR BOULTON:** Sure, in any merger acquisition you look at a
29 number of factors and one of those would be the potential
30 you have to try and reduce your total operating costs over
31 time, doesn't happen in --

1 **MS BATES QC:** Just looking at this one that you've just got, how
2 does that work? What costs are you looking at chopping out
3 through that one?

4 **MR BOULTON:** Asset management costs, some of the contracting
5 costs in terms of negotiations, some of the backroom costs,
6 trying to spread the broader investment of larger size
7 across one cheap executive rather than two; all those
8 factors that you would normally consider in a business case.

9 **MS BATES QC:** I understand that, but are you going to get more
10 payback from that or just having increased density?

11 **MR BOULTON:** We're looking at every avenue we've got in terms of
12 revenue and better positioning ourselves against our market
13 as well as costs, so all of those features will be something
14 that, from a management perspective, we'll focus on to
15 improve the financial outcome. It's a no stone unturned
16 scenario. Every one of those factors you've mentioned is
17 something we have a tactic and strategy on to work forward
18 through from a management perspective. That would be a
19 logical conclusion to draw from a commercial approach.

20 **MS BATES QC:** Yeah, but the logical conclusion to draw though
21 also if you're spending \$150 million is that you think
22 you're going to get significant return from that.

23 **MR BOULTON:** Well, no return's guaranteed, these are some of the
24 risks that you face when you try and grow the business and
25 that process that we're going through now is another risk
26 until the decision is determined to factor into that
27 particular total equation. Will just keep in mind, the
28 process started after we made the acquisition as well, not
29 before this gas process.

30 **CHAIR:** I think we realise that, but we also realise the
31 electricity changes were made before you made the

1 acquisition, and it was primarily about electricity, wasn't
2 it, the acquisition?

3 **MR BOULTON:** The acquisition of -- the assets was exactly the
4 same as the ratio we had on board in terms of electricity to
5 gas. So we've grown the total business and the ratio has
6 stayed the same. So a reasonable chunk of gas assets were
7 purchased. In fact the only gas assets we didn't purchase
8 were the Auckland based assets that were purchased by
9 Vector.

10 **CHAIR:** Right. Might have you go ahead and finish the
11 presentation and then we'll take some more questions,
12 thanks.

13 **MR UPSON:** It's my view that New Zealand desperately needs
14 greater investment in the gas sector and, of course, a lot
15 of that is in the up-front exploration area. Regulation is
16 seen as a deterrent by investors who have better investment
17 alternatives to consider. The lack of investors could be a
18 deterrent to the long-term benefit to the consumers and the
19 economy.

20 I think one point that should be made is that by-in-
21 large, just putting price aside, it must be more economical
22 to use gas and water heating than to use gas to generate
23 electricity to put into water heating. And I think that's
24 the real fact that is missing here from an economy point of
25 view. But there is a whole lot of pricing factors that
26 actually cause that not to happen.

27 Powerco only plays a small part in the gas sector, a
28 very small part as you can see, and we're being squeezed
29 both from the supply side and the demand-side and any
30 regulatory controls will further add unnecessary burden to
31 us struggling in a competitive sector. So, PowerCo will

1 have to consider whether it actually continues to reinvest
2 in this sector in New Zealand. We're making the investment
3 in Australia as a Greenfield operation in Australia, but
4 here in New Zealand we really have to make better returns
5 and so some hard decisions will be made over the course of
6 the next few months.

7 **CHAIR:** Are you suggesting you're revisiting your participation
8 in this market prior to this inquiry being completed?

9 **MR UPSON:** We're not suggesting we will pull out, but we are
10 suggesting that the investment -- re-investment in the
11 sector has now been closely scrutinised. Obviously, if we
12 have growth potential on backfilling that must, or should
13 happen because it's illogical for it not to happen but when
14 you get into new subdivision -- and the point that was made
15 before, it does become debatable as to whether you want
16 pipes in the ground that don't actually have any gas going
17 through for some considerable period before the subdivision
18 takes place. So, those are the sort of questions that have
19 to be answered. We've got to make use of what we have got
20 in the ground, but to put more in the ground does raise some
21 question marks.

22 **CHAIR:** I'll just see if there are any further questions.

23 **MS BEGG:** I just had one question. You note there that Powerco
24 owns and operates a number of small localised gas networks,
25 and it's apparent from what you've said in the presentations
26 that the competition that's faced in these different
27 networks could well be different. And I just wondered, it's
28 conceivable I suppose that the Commission could find that
29 competition is sufficient in some of those networks, that
30 we're not worried about it, but in others that may find that
31 PowerCo has market power and therefore could be considering

1 regulation, just wonder whether it's possible, or whether
2 you collect information at this sort of network level that
3 would make it possible for the Commission to consider
4 regulating, whether it's through enhanced disclosure or more
5 heavy-hand regulation parts of your distribution network as
6 opposed to the whole --

7 **MR UPSON:** I don't believe it's collected down to the level that
8 I'm referring to here, which is a whole lot of little
9 subnetworks, but it's something we can check on in terms of
10 a regional basis, regional -- mainly because their networks
11 have been built up. The recent acquisition that we've just
12 been talking about, of course, the Wellington City is a
13 whole area made up of a whole lot of subnetworks but it's a
14 region, and so, that might be possible.

15 **MR BOULTON:** Another concern would be the absolute cost of the
16 regulatory approach for that, how would we -- you or we or
17 the -- whoever it is, deal with the issue about new growth
18 if it's connected to the unregulated network, is that okay;
19 the regulated stuff is not okay, sizing issues, one big
20 customer comes along, does that make a difference, what
21 about an area that doesn't have gas at all, how is that one
22 treated?

23 We would just express a concern, if I can put it that
24 way, that for 220,000 connections in the country is quite a
25 small business compared to our peers; is that form of design
26 appropriate, that's all. Just another factor to keep in, or
27 develop in terms of the unintended consequences of taking a
28 look at existing sunk capital versus what might happen for
29 the future and important issues for future investment.

30 **MS BEGG:** It's just a question of trade-offs, I suppose, as to
31 whether you'd be better to regulate the whole entity which

1 would include regulating bits that didn't need it versus
2 trying to separate out those bits that might need it, or not
3 regulating at all, I suppose on the other hand if the
4 balance of costs was in that direction.

5 **MR BOULTON:** We're still talking about a sector that
6 collectively uses the 2.5% of the total gas consumed; it's
7 pretty small, totally it's small.

8 **CHAIR:** Any other questions from staff? [**No comments**]. I think
9 Commissioner Bates has one further question.

10 **MS BATES QC:** I just wanted to follow-up on something you said
11 Mr Upson. I think you're putting forward the argument that
12 public interests would be served by promoting the use of gas
13 directly by consumers rather than electricity generation, is
14 that right?

15 **MR UPSON:** Yes.

16 **MS BATES QC:** Could I ask you to elaborate on that a bit more,
17 just to explain a bit more?

18 **MR UPSON:** Obviously again, putting price aside, putting gas
19 through a turbine to generate electricity and transmit over
20 lines to get to the consumer as against putting gas straight
21 into the pipe to get to the consumer, has got a different
22 cost factor, and so it's really that comparison.

23 **MR BOULTON:** It's an efficiency issue, and ECA have produced a
24 number of reports, as have other parties, about the
25 efficiency analysis as using gas as the primary fuel source
26 to cook and hot water and compare that to the losses
27 associated with using gas through generation through
28 transmission through distribution to get to the home as
29 delivered electricity, and the electricity generation
30 component is far less efficient.

31 So, we're suggesting that a more abundant use of gas

1 from a consumer's perspective which will require gas
2 pipeline investment will be better nationally for news an
3 efficiency sense, particularly given the scarcity of gas
4 that we have.

5 **MR UPSON:** Maybe the Tasmanian Government see that, I don't
6 know. It's an interesting point.

7 **MS BATES QC:** Is the argument equally applicable to your
8 industrial sector, or is it just a more domestic --

9 **MR UPSON:** The industrial sector already make that choice. If
10 you are an industry that believe that gas is far more
11 efficient to use than electricity, then you will locate
12 yourself somewhere near the gas pipeline. So therefore,
13 you'll give yourself that choice, so that's already there.
14 Those industries -- I think the point was made before, as
15 their plant comes up for replacement they always go through
16 that cost benefit analysis. Is it best to stick to gas? Is
17 it best to use electricity or vice versa every time they
18 come up with a replacement decision? So, the major users
19 have got, you know, they've got ability to make those
20 decisions. The domestic user doesn't because quite often
21 the price differentials, by the time it gets to their door,
22 is quite different to the source.

23 **MS BATES QC:** Thank you.

24 **CHAIR:** Unless you have further comments Mr Upson, I propose to
25 break for afternoon tea, and then we'll resume I think with
26 NECG after the break. So, if everyone could be back please
27 at 5 minutes to 4.

28

29 **Adjournment taken from 3.40 pm to 4.05 pm**

30

31 **CHAIR:** I'd just like to reconvene this session, and I do

1 apologise for being a few minutes late. And I believe NECG
2 is going to present next. If you could, for the record,
3 please introduce yourself and begin when you're ready.

4 **MR MORTON:** Thank you, Madam Chair. My name's Euan Morton, I'm
5 a principal and executive director at NECG. Chen & Palmer
6 asked me to provide some input or some observations from the
7 Australian experience to the extent that that assists the
8 Commission in their deliberations, and in so doing I wanted
9 to outline some of the regulatory developments in Australia,
10 talk about the coverage tests that's applied currently in
11 Australian regulation, talk about some of the frameworks
12 that have been developed by businesses involved in the gas
13 industry, in particular in response to that regulatory
14 environment, provide one case study in some detail which is
15 the most significant coverage issue which has been arisen or
16 has been applied in Australia and finally offer some
17 comments about the status of investment in Australia.

18 In terms of regulatory developments, I think it's fair
19 to say that we're seeing over the course of the last four or
20 five years some evidence of some rising tensions. What
21 we've seen is -- when I say that, some tension between the
22 regulatory bodies themselves and some of the Government
23 policy bodies and also the courts, and I'll turn to this in
24 more detail further on in the presentation. But what we
25 have seen over the last couple of years is three significant
26 developments in the policy and judicial spheres.

27 The first one is that the Productivity Commission, which
28 is an independent Government body charged with the task
29 providing independent advice to the Government pursuant to
30 terms of reference, has conducted a very extensive review of
31 several of the regulatory regimes, and the most significant

1 of which is Part IIIA of the Trade Practices Act, which is
2 the generic legislation applying access to essential
3 infrastructure in Australia.

4 We've also had a judicial review in relation to a
5 regulator's decision in Western Australia which is related
6 to a pipeline Dampier to Bunberry, natural gas pipeline
7 owned by Epic. I'd like to draw very briefly on that. In
8 relation to your comments earlier this morning, Madam Chair,
9 I thought we could cover that off fairly quickly. But one
10 that is worth exploring in some detail I believe, is the
11 Australian Competition Tribunal and Duke, which is the EGP
12 case which we'll be turning to as well.

13 In relation to the Productivity Commission's approach to
14 regulation, what we've seen in recent times in Australia is
15 the Productivity Commission which, as I mentioned, is an
16 independent policy advisor to Government, review much of the
17 economic regulation that has been established in response to
18 the Hilmer report that concluded about 10 years ago in
19 Australia.

20 Some of the findings that perhaps are of relevance to
21 the Commission's own determinations or deliberations during
22 the course of this process is that perhaps Australia may
23 have gone overboard in its willingness to embrace regulatory
24 solutions.

25 Some of the key findings were that there was a need for
26 a better diagnosis of the problem and the need for
27 regulation; that greater focus on the objects and principles
28 of regulation could reduce regulatory discretion, which in
29 turn could reduce regulatory risk; that perhaps a greater
30 account could be taken of the impact of regulatory error in
31 regulatory decision-making; and that that sort of particular

1 reference to building blocks type approaches for the reasons
2 I'll outline later; and in particular it was felt that
3 allowing a right of merits appeal from regulatory decisions
4 could increase regulatory accountability and also reduce
5 regulatory risk.

6 I think out of that report, out of that 600 page report,
7 if there was one sentence that summed up the Productivity
8 Commission's concerns about the application of regulation in
9 Australia better than any other, it was that the object of
10 regulatory processes should be to improve on unregulated
11 outcomes but recognise that precision is not possible with
12 the information and instruments available. And I emphasise
13 that in the context of potentially applying a building
14 blocks process to assess the merits or otherwise of applying
15 regulation to a monopoly or what might seem to be a
16 monopoly.

17 There is inevitably much debate, much concern about what
18 is the precise levels of price that should be applied, and
19 so Madam Chair your question this morning was very apt in
20 relation to the position you put about price reflecting
21 efficient costs in the long run under workable competition,
22 and I fully agree with that statement.

23 What I also would suggest respectfully to the Commission
24 though is that, in applying that test, one also needs to be
25 aware of the limitations of the factual as well as the
26 counterfactual. That is, the building blocks processes are
27 by no means guaranteed to also deliver an approach where
28 prices equate with efficient cost, particularly when regard
29 is had to the fact that regulatory processes invariably and
30 inevitably must rely on snapshots in time in terms of the
31 life cycle of an asset.

1 The other, I guess, key result coming from the
2 Productivity Commission processes was that perhaps at least
3 in the context of the first round of regulatory reviews in
4 Australia that there was perhaps not a tendency for
5 regulatory bodies to fully appreciate the risk of regulatory
6 error. This is a point that the Chair of Powerco, I think,
7 made quite effectively in his presentation; but again to
8 relate to workable competition and to the consequence of
9 regulatory decision-making in reflecting workably
10 competitive outcomes; one point that we need to, I think,
11 bear in mind very carefully, or I would urge upon the
12 Commission to consider at least, is that if access prices
13 are too high there is no question that there is a harm
14 caused to consumers, because that harm is that there may be
15 some allocative efficiency loss and there may be a transfer.

16 But also, and in particular having regard to the
17 consequences of regulatory error and the fact that it's an
18 imprecise process, if access prices are set too low, there
19 is -- the entire social surplus associated with the
20 provision of the services is effectively imperiled in the
21 longer run; that is, the prices are set too low, we run the
22 risk that the entire surplus associated with the activity
23 that has been provided will be lost.

24 And so, can I suggest that one issue that perhaps can be
25 borne in mind through the processes that the Commission is
26 considering and has before it is that the efficiency loss
27 from some customers not using the service, and others paying
28 too much is much smaller than the efficiency loss from not
29 having a facility or service provided at all. That's a
30 drastic statement, but one that is the ultimate corollary of
31 prices being below levels that would remunerate new

1 investment in the industry.

2 I would like to turn very briefly --

3 **CHAIR:** Can I just, before you go on; these reviews were of
4 airports and telecommunications. Do you know whether the
5 Productivity Commission has looked at the gas --

6 **MR MORTON:** The Productivity Commission is currently looking at
7 the gas regime. The Productivity Commission issued an
8 issues paper about a month ago. Submissions are currently
9 coming in and some are on the website. There are still some
10 very significant submissions to come, I believe, Madam
11 Chair.

12 **CHAIR:** When they looked at airports and telecommunications, did
13 they actually come to a view on whether ongoing regulation
14 was necessary in those areas?

15 **MR MORTON:** I'm afraid I'm not fully across the
16 telecommunications report. In relation to airports it was
17 the price monitoring regime that they established, which was
18 I guess materially less invasive than the building blocks
19 type approach that had been applied in relation -- or has
20 been applied in some of the regulated industries such as
21 electricity and gas to date.

22 **CHAIR:** In terms of the Government's acceptance of the
23 Productivity Commission's views, how many of these views
24 have been accepted by the Government of Australia, in terms
25 of setting the regulatory framework?

26 **MR MORTON:** Substantially accepted, I think, would be a fair
27 comment, Madam Chair, but I'd certainly welcome the
28 opportunity to put that in detail. For example, merits
29 review's been accepted. The question of increasing the
30 threshold test has been accepted but not in identical terms
31 to that suggested by the Commission. So, I think it's fair

1 to say that substantial, but not complete, acceptance would
2 be a summary term and I'd welcome the opportunity to set
3 that out in more detail.

4 **CHAIR:** Sometimes I think when we look at these matters a lot of
5 what they've written about was the actual way these
6 industries have been regulated in Australia, and even the
7 first point under your key findings about a better diagnosis
8 for the need for regulation, I'd suggest to you, that
9 perhaps as I've commented earlier, that that in fact is what
10 this process is about; it's not for deciding to necessarily
11 regulate and if so what form of regulation -- what form
12 regulation would take, but it is simply to consider and
13 advise the Minister on whether regulation would be in the
14 best long-term interests of acquirers, and it seems to me we
15 are in the first instance starting with the first key
16 finding of this Productivity Commission.

17 **MR MORTON:** I'd agree with that, Madam Chair. I've got no
18 problem with that. I'm simply drawing to your attention the
19 results that the Productivity Commission found and I also
20 agree with the fact that as I mentioned earlier, Australia
21 perhaps embraces regulatory outcomes with an enthusiasm that
22 perhaps has subsequently been rethought, and that would only
23 serve to endorse the approach that the New Zealand
24 Government's taken in instigating this review.

25 **CHAIR:** Okay, thank you. I have to say, I did find the quote on
26 how you weigh up the two -- the risks of having access
27 prices too high and too low interesting, because it is a
28 constant debate about whether there's an asymmetric risk
29 there, and if so which way does it go. And I've heard it
30 argued every way it could be argued, from no asymmetry to
31 asymmetry moving in either direction, but if I recall right

1 this access pricing bit here was specifically from the
2 review of telecommunications. Is that right?

3 **MR MORTON:** Part IIIA, Madam Chair.

4 **CHAIR:** All right, thank you.

5 **MR MORTON:** I'd like to very briefly discuss Epic but only very
6 briefly, Madam Chair, partly on account of the comments you
7 made this morning, that Epic did not concern issues of
8 limited competition. I think what it did concern was a
9 preparedness by the Court to look beyond the narrow building
10 blocks approach provided by the regulator in that instance,
11 although I would certainly point out to the Commission that
12 the facts of Epic were a little bit unusual in the context
13 of regulatory processes.

14 There, there was an express requirement provided by the
15 Gas Code that the investment in the pipeline be considered.
16 That investment was the purchase price for the pipeline.
17 That purchase price was materially above the DORC valuation
18 that was adopted by the regulator. The regulator did not
19 consider the wider social, political and public interest
20 considerations associated with long-term certainty in
21 investment, and I guess the point that emerges from that
22 from an economists perspective was that, perhaps the Court
23 wasn't recognising it at the time.

24 But really what the Court was emphasising was that there
25 was a very strong public interest in having sufficient
26 certainty in investment outcomes to engender public
27 confidence for investment to occur, and that the regulatory
28 risks associated with that must be weighed in that context.
29 And so, despite it being clothed in terms of social,
30 political and public interest considerations, my view as an
31 economist interpreting the Epic decision was that there was

1 a very strong concern with continuing to provide incentives
2 to invest in networks.

3 In terms of the coverage test, clearly the coverage test
4 over the Gas Code in Australia, and it's broadly mirrored in
5 Part IIIA, is different to the test that's before you to be
6 applied in this instance. In the context of the Gas Code,
7 though, there are some similar concerns in the context of
8 promoting competition. And that is an issue that has been
9 subject to the review of the Australian Competition Tribunal
10 in the EGP case and so I thought in the context of what was
11 requested of me it was relevant to bring before you.

12 The fall in test is, essentially the bolded words are
13 the most significant; that access would promote competition
14 in at least one market other than the market for the
15 service, that it's uneconomic for anyone to develop another
16 pipeline, that access can essentially be provided safely and
17 not be contrary to the public interest.

18 That test is quite similar to the test in Part IIIA of
19 the Trade Practices Act, and perhaps the most important
20 consideration is the promotion of competition, which I
21 acknowledge is different to the test that's before you
22 today. But in saying that, the interpretation of that test
23 by the Australian Competition Tribunal was that, whilst it
24 was abundantly clear that the abuse of market power would
25 not be tolerated under the test, the Competition Tribunal in
26 that case expressed some skepticism and reservation about
27 the precision and accuracy of regulatory processes and
28 deliberately avoided application of a cost-based test,
29 partly for that reason. And so, what we saw in the case of
30 the EGP decision was not reliance on a building blocks type
31 approach; admittedly under the guise of a different test.

1 **CHAIR:** But this is -- if I just, I want to make sure I
2 understand this. This is to determine the coverage
3 criterias to determine whether or not you are to be subject
4 to control.

5 **MR MORTON:** Sorry, yes, a similar process to what is going
6 before you today. What was -- and I'll come to it in more
7 detail in the presentation in the case study. But I guess
8 the point I wanted to emphasise at this point in the
9 presentation was, a cost-based test was not applied in that
10 instance and if I could come back to that subs -- or, I
11 could move straight to it if you prefer?

12 **CHAIR:** No, do it in the order that you planned, thanks.

13 **MR MORTON:** In terms of behaviour regulation, in the context of
14 the EGP case what was committed to by the owner of the
15 pipeline was a commitment to sell capacity. What the
16 pipeline company was able to do was to show in a very
17 transparent and credible way that their incentives were
18 reliant with maximising sales to promote competition.

19 Since then as part of that commitment Duke Energy
20 developed a code of practice that it applied and committed
21 to, bearing in mind there always remains the threat of
22 regulation to the extent that that Code is not adhered to in
23 the future. APIA, or the Australian Pipeline Industry
24 Association, is developing its own Code of practice that's
25 built loosely on Duke's framework.

26 And out of that I think is the important consideration
27 that it is open and perhaps desirable for self-imposed
28 commitments to play some role in alleviating any perceived
29 effects from market power that provide an incentive for
30 businesses to avoid regulation, to the extent that
31 behavioural type commitments can reduce the scope for

1 regulatory imposition.

2 So, the key principles that underpin Duke's framework is
3 a commitment to develop market responsive pipeline services,
4 and in that respect I think it's fair to say that when we
5 look at workably competitive markets, whilst I fully
6 acknowledge the point you made earlier today, Madam Chair,
7 about the correspondence over the long run between price and
8 efficient cost, that is only one of many factors that is
9 exhibited by workably competitive markets, and in fact what
10 limited empirical evidence there is suggests that the most
11 important consideration is likely to be the dynamic
12 considerations; that is, services tailored to customer's
13 needs and that there are incentives for that to happen.

14 So, one of the key principles underpinning the Duke
15 behavioural regulatory regime is developing market
16 responsive pipeline services; the use of non-discriminatory
17 tariffs; that there is public disclosure of dealings with
18 affiliates, now that's less of a concern in the Powerco
19 situation at least as it's currently structured; but clearly
20 the issue of preferential self-dealing is something that
21 undermines confidence in a market and will undermine
22 regulatory outcomes, or at least provides a very good case
23 for regulation to apply, if it cannot -- if self-dealing
24 cannot be adequately addressed.

25 As part of that process, in Duke's example there's
26 public disclosure of key contract details so that all
27 participants in the market can avail themselves of
28 opportunities that are presented because those arrangements
29 are open to the market that is there; that there's
30 protection of confidential information; capacity trading is
31 facilitated; and there's an independent audit to ensure that

1 there's compliance with these principles over time; and
2 finally, there's binding independent dispute resolution as
3 part of the key principles, as part of the behaviour of
4 regulation framework.

5 I simply present that, Madam Chair, as one example of
6 one behavioural regulatory framework that has been applied
7 and has been applied in a credible way in Australia.

8 And to put that into context, there's at least a dozen
9 services that are now on offer on Duke's pipeline on the EGP
10 pipeline that reflects that market responsiveness and that
11 critical element of workably competitive markets where there
12 is an incentive and desire to be responsive to customer
13 needs.

14 **CHAIR:** When you -- the first part of that last sentence, when
15 you said there were -- what did you say, 12 different?

16 **MR MORTON:** 12 different services offered as part of the range
17 of services.

18 **CHAIR:** What is it that's being offered? I'm trying to
19 understand how...

20 **MR MORTON:** Various options, various swaps, those types of
21 services. Again, I'd be happy to provide more detail.

22 **CHAIR:** I'd just like to ask you, in terms of what's currently
23 available in terms of tailoring customers' needs, how do we
24 see -- in this business how much variation do we see, for
25 instance in Powerco's terms and conditions, to meet
26 customer's needs?

27 **MR BOULTON:** Standard use of system agreements which covers the
28 majority of the customers connected and --

29 **CHAIR:** So, do you vary it for your customers' needs?

30 **MR BOULTON:** Our customers are the retailers in essence for most
31 of those, and once we vary it for one in terms of open

1 access, we have to vary it for them all to maintain a level
2 playing field and not have claims of discrimination made
3 against us. So, generally it's a standard approach during
4 renegotiations, ideas are put forward by both parties, we
5 receive those, but have to test them with the other
6 retailers then so, it's a -- four or five different
7 perspectives, it's not that easy to get agreement.

8 **CHAIR:** I'm just trying to understand how important this -- I
9 mean, normally I'd find it not difficult to accept that you
10 want to see terms and conditions and various services
11 tailored to customers needs, but what would we be seeing if
12 that held here? In the Australian case you said you found
13 12 different variations or 12 different services.

14 **MR MORTON:** That is a transmission as opposed to a distribution
15 system. I guess one issue is what I think is fair to say in
16 the context of the regulated systems, is that, there is a
17 gravitation towards the reference tariff and the reference
18 service, and that that can actually inhibit some of the
19 negotiations that might otherwise occur.

20 **CHAIR:** Gravitating towards one?

21 **MR MORTON:** The regulated service. Certainly, that's the
22 experience of the pipelines.

23 **CHAIR:** I want to pursue this for other reasons besides Powerco,
24 but in terms of the services, the 12 services that you
25 mentioned, what would they relate to --

26 **MR MORTON:** Backhaul, storage, swap options, other options
27 associated with the provision of the service, and so on.
28 So, it's a range of factors. The take or pay elements, the
29 commitments, the length of the commitments; there's a range
30 of factors that can be applied.

31 **CHAIR:** So, in a case where you think that the pipeline services

1 are more market responsive, you'd expect to see a greater
2 rather than a fewer number of these services being offered?

3 **MR MORTON:** Quite possibly. There are a range of issues that
4 can apply in a transmission pipeline that only apply to
5 varying degrees in a distribution pipeline. I'd defer
6 obviously to the experts in the business to outline the
7 range of possibilities in relation to a distribution system.
8 The point I was trying to impress was, irrespective of
9 whether it's distribution or transmission, I believe that
10 the framework that has been established in the context of
11 the EGP has at least been conducive to satisfying customer
12 needs in a market responsive way in relation to that
13 particular sector of the industry which is a behavioral
14 regulation framework.

15 **CHAIR:** I guess we'd want to know what we'd expect to see then
16 in the distribution business if we thought it was being
17 responsive, and I don't normally associate that with
18 standard terms and conditions that you take or leave
19 basically if you want to acquire services. But we can come
20 back to that. I do think the list is interesting though,
21 and it would be useful when we look at transmission.

22 **MR MORTON:** I'd like to turn now, if it's appropriate, to the
23 EGP case study. Now, there's lots of lines on the map. The
24 two I'd like you to focus on are the pipelines between
25 Melbourne and Sydney and between Moomba and Sydney, and the
26 EGP pipeline is the pipeline between Melbourne and Sydney.

27 By way of background, in the case of the EGP, Duke
28 Energy built the EGP bringing -- at the Eastern Gas Pipeline
29 which brought in a base of competition to Sydney because for
30 the first time Sydney consumers could choose between gas
31 sourced from the Moomba fields, central Australian fields,

1 with those from the Gippsiland and Bass Strait.

2 The Minister in that decision -- the Minister under a
3 different framework where an independent body was charged
4 with the responsibility for assessing compliance with the
5 criteria that I mentioned before, who was then charged with
6 making a recommendation to the Minister, in the context of
7 the Gas Code and in fact Part IIIA of the Trade Practices
8 Act, the Minister's decision is appealable to an Australian
9 Competition Tribunal which is an appellant body which is
10 subject to full merits review.

11 In the instance of the EGP, the Competition Tribunal
12 overturned the Minister's decision, finding that the
13 criteria under the Gas Code would not satisfy.

14 **CHAIR:** This is a second pipeline coming in to the --

15 **MR MORTON:** Yes, that's right.

16 **CHAIR:** So, they were competing head-to-head basically?

17 **MR MORTON:** That's right. The regulation of the Eastern Gas
18 Pipeline or the regulation generally can be a second best
19 option to competition, but perhaps most importantly, bearing
20 in mind the building blocks approach that's being considered
21 by the Commission, that the price set by regulation is not
22 necessarily the price that would result from competition. I
23 simply make that point to emphasise again that in the
24 context of workable competition we need to be aware of the
25 limitations of the factual as well as the counterfactual.

26 **CHAIR:** I just wonder how much of this result in the Australian
27 case was because it wasn't. I mean, in a market -- I know
28 that in Australia they approach things differently than we
29 do, but if you had two competitors going head-to-head, that
30 might have been fairly critical to overturning the view on
31 coverage.

1 **MR MORTON:** I think it's certainly a factor, but I think
2 abstracting from that there will always be a range of issues
3 surrounding market power. And I believe in the current
4 context one of the important issues, or the important issues
5 that have been discussed today about market power and the
6 constraints on market power that are all factors that may be
7 relevant, and perhaps one that hasn't been discussed in
8 great detail are the second best considerations in relation
9 to this market with gas shortages and the integration
10 horizontally at the retail level; and so the issues
11 associated with the market power by distributors in the gas
12 industry is a -- and the constraints that are on that market
13 power certainly are still relevant, albeit not from
14 necessarily in all instances competing pipelines, although
15 clearly with Nova we've seen that to some extent in
16 Wellington. But also the second-guess considerations that
17 are relevant in the case here, where reductions in
18 distribution prices, if they were to occur, may very well
19 not end up in the customers' pockets because of the nature
20 and the structure of the industry that are also relevant
21 considerations. So, whilst certainly acknowledging that
22 point you make, Madam Chair, I'd also suggest there are a
23 range of other considerations that provide alternative
24 constraints here.

25 **CHAIR:** That may very well be the case, but I'm sure you would
26 agree the existence of two competitors as opposed to one
27 supplier is a pretty pivotal difference in the fact
28 situation we're looking at?

29 **MR MORTON:** I accept that, that's why I was at pains to
30 highlight it to you.

31 **CHAIR:** No, I appreciate that. Thank you.

1 **MR MORTON:** In the context -- although in saying that, Madam
2 Chair, it's interesting that the NCC in relation to the
3 other pipeline which has had a revocation application, the
4 National Competition Council, which is the body first
5 charged with making a recommendation at that time, the
6 Minister was still of the view that despite the EGP that the
7 Moomba to Sydney pipeline ought to be covered.

8 So, in that instance that recommendation is before the
9 Minister. I'm quite sure that if that decision to revoke is
10 not made, that it will also be appealed to the Competition
11 Tribunal. And I agree with you, that it's fairly compelling
12 a priori case that two pipelines will exert countervailing
13 force on one another. But what is also significant, and the
14 issue that I wanted to impress upon you in the context of
15 the EGP case and the Tribunal's decision-making, and it's
16 referred to in the submission at paragraph 110 of that
17 decision, and it's referred to in page 8 of Powerco's
18 submission, is that the price setting process from a
19 regulatory body applying the building blocks approach is not
20 necessarily determinative of efficient price in the context
21 of the factual that's been presented, and I think that the
22 EGP case is more significant from that perspective than
23 looking purely at competing pipelines.

24 So, putting that into context, in the context of some of
25 the submissions that Powerco has made to the Commission,
26 it's important to recognise that there are a number of
27 regional markets that were also serviced by the EGP, that
28 didn't have the benefit of the competing pipeline and the
29 Commission, at least the Tribunal was satisfied in those
30 instances that market power wasn't sufficient, or wasn't a
31 sufficient concern for that pipeline to be covered.

1 So, whilst in relation to the Sydney market there was
2 clearly head-on-head competition, that wasn't the case
3 throughout the course of the pipelines coverage, if you
4 like, or the pipeline did serve regional markets that were
5 monopolies, at least for gas, and it was found that that
6 wasn't a concern in relation to coverage.

7 The Tribunal also was very conscious of the possibility
8 of future coverage, that the threat of regulation imposed a
9 very substantial constraint itself on Duke's activities, and
10 that that perhaps is an issue that the Commission may wish
11 to consider in relation to its own test for coverage, or --
12 and so in essence, in terms of the findings, the Tribunal
13 found that the Eastern Gas pipeline did not have and would
14 not have, over reasonable future periods, sufficient market
15 power to enter into competition, and again that judgment was
16 made without direct reference to pricing outcomes or cost
17 outcomes.

18 And so, without wanting to labour the point, in the case
19 of the EGP, the key concern for the Tribunal was the manner
20 in which the asset owner was providing access such that
21 regulated access would or would not promote upstream or
22 downstream competition; not whether or not regulation would
23 deliver lower prices. And in that instance the commitment
24 by the asset owner to a behavioural regulatory framework was
25 a material consideration in providing comfort to the
26 Tribunal that regulation or coverage would not promote
27 competition in that instance, recognising of course that it
28 was a slightly different set of factual circumstances to
29 what's before you now.

30 So, translating that in relation to the framework
31 document that has been prepared, and I think covered the

1 issue of regulatory risk, and coming back to the issues that
2 we were discussing before, Madam Chair, about the
3 consequences of error and the asymmetric consequences of
4 prices being too high or too low, once we acknowledge, as
5 has been acknowledged in the framework paper, that
6 regulatory decision-making comes with it a risk of
7 regulatory error, and that the cost of that error can be too
8 rapid or too willing intervention or in fact too reluctant
9 intervention, that is the problem of a Type I or a Type II
10 error.

11 And that, in the context of the issues before the
12 Commission, one consideration may be that the design of the
13 regulatory regime might wish to take account of balancing
14 those errors on account of the inefficiencies that occur
15 from those errors. So, weighing the social costs of Type I
16 versus Type II error.

17 And by Type I error, I mean regulating too readily, that
18 is that a regulator wrongly identifies a case for market
19 failure requiring intervention, where for whatever reasons
20 the benefits are outweighed by the costs of that
21 intervention; or alternatively a Type II error which is not
22 regulating when perhaps the case for it -- when the market
23 failure exists, and that the benefits of regulation were to
24 outweigh the costs.

25 So in the context of the building blocks approach that
26 has been presented, perhaps that increases the risks of
27 Type I errors being committed in the context of the
28 regulatory design and that perhaps it is worth considering
29 in the context of that regulatory design greater recognition
30 of Type I versus Type II errors.

31 When we look at some of the costs of regulatory error,

1 we've already seen presented by Powerco's Chairman
2 diminishing incentives for firms to invest in
3 infrastructure. I don't want to dwell on that. It's quite
4 clear that that's one risk that can occur. I think what we
5 can also see is a number of other risks and other social
6 costs that are imposed. For example, one natural response
7 to the imposition of regulation is that regulated businesses
8 will engage in socially undesirable risks for minimisation,
9 and by that I mean an unwillingness to invest to attract new
10 customers to the infrastructure and insisting instead that
11 the customers make that investment themselves, and that will
12 be a socially undesirable allocation of risk.

13 Obviously the administrative costs which full
14 pipelines -- with distribution systems with relatively low
15 penetration can assume some significance; there are the
16 risks associated with regulatory gaming and wasteful
17 strategic behaviour. I think that's really important
18 because, as soon as a regulatory regime is imposed the
19 experience from Australia has been that attention has been
20 directed from both parties towards the regulator instead of
21 from the imposition of the regulator between the two parties
22 negotiating and that rather than them negotiating, so it
23 stifles -- it can stifle commercial negotiation.

24 Whereas, the increasing cost of capital from the impact
25 of regulatory risk, and of course in acknowledging
26 regulatory risk one of the factors would be the fact that
27 the Government is prepared to go through quite a transparent
28 process to assess the merits or otherwise of coverage, but
29 simply put, any imposition of regulation almost invariably
30 will introduce regulatory risk and thereby increase the cost
31 of capital, which is a significant issue in and of itself,

1 because it can result in the very opposite of your desire to
2 seek to advance the interests of acquirers to the extent
3 that regulatory risk actually increases the cost of
4 attracting capital, increases the cost of capital and that
5 capital in terms of businesses, obviously has an impact on
6 efficient prices.

7 Ultimately, and I make the point again, and recognising
8 that this is a distribution rather than a transmission
9 system we're talking about, but the imposition of regulation
10 tends to constrain the scope for infrastructure providers to
11 deliver and price their services efficiently.

12 With that in mind, turning to Powerco's submission, and
13 some of the issues relevant to Powerco's submission, and
14 recognising that there will be issues with market definition
15 associated with the small but significant increase in price,
16 that non-transitory increase in price that may be relevant
17 to the definition of the market and that those are all
18 issues that the Commission will need to consider throughout
19 its investigation and deliberation.

20 It is perhaps important to recognise the entirety of the
21 factual matrix that has the full Powerco's interests in
22 relation to the distribution and the fact that there are a
23 range of considerations, be it the potential competition
24 from either competing distribution providers or alternative
25 fuels, the fact that reductions in distribution charges will
26 not be mirrored fully in the retail price, and in fact may
27 not be mirrored at all to the extent that second best
28 considerations take or determine outcomes given the
29 existence of gas shortages and the structure of the retail
30 market, and potentially the high costs associated with
31 regulation.

1 So, having regard to the totality of circumstances, or
2 all of the indicia of workably competitive markets, Powerco
3 suggested a three-pronged approach that may be relevant for
4 the Commission's deliberation. The first one is to ask the
5 question, is there evidence of inappropriate behaviour? By
6 that it is meant that, is there evidence of an open access
7 environment? Is there full information about the nature of
8 services that are provided? Is there transparency
9 associated with the provision of access? Is there any
10 evidence of disputes about the provision of access?
11 Because, if there hasn't been evidence of disputes about the
12 provision of access in the past, it suggests that there
13 hasn't been abuses in monopoly purpose or market power, or
14 in fact there may not even be market power in existence, and
15 finally, is there evidence of sustained price
16 discrimination.

17 So, if we look at some of the other factors that are
18 relevant to the existence of workably competitive markets,
19 if the Commission is satisfied that the types of harms, if
20 you like, associated with monopoly pricing or monopoly
21 activity are not in effect, or are not seen in practise,
22 perhaps that's one indicator to the Commission to suggest
23 that regulation is not required.

24 The second step is --

25 **CHAIR:** I just want to stop you there for a second. This
26 evidence of inappropriate behaviour; the test here requires
27 us to answer the first question, which is, is competition
28 limited, and I'm not sure if this evidence of inappropriate
29 behaviour really deals directly with that.

30 **MR MORTON:** I would accept there is a question of, is there
31 market power or limited competition in the first instance, I

1 would certainly endorse that view.

2 **CHAIR:** So, I assume then you would accept that we must answer
3 that question in the first instance?

4 **MR MORTON:** Yes, I would agree with that.

5 **CHAIR:** And then this three-pronged approach, you're suggesting,
6 comes as the second step?

7 **MR MORTON:** Yes, if in fact you were satisfied about the limited
8 competition. Although I would also suggest, Madam Chair,
9 that the absence of any evidence of inappropriate
10 competition itself might provide you with a guide to the
11 absence of market power in the first instance.

12 **CHAIR:** I just wonder about this inappropriate behaviour thing,
13 because when I look at the list that's on page 10 of the
14 submission, I don't really see anything that gets at whether
15 prices are generally above what you would expect and if they
16 were set based on efficient costs and, you know, whether you
17 have access disputes or not, I'm not sure really, in an
18 environment where no-one had any recourse other than to pay
19 what was being charged, I don't know why you'd expect to see
20 anybody having disputes over it if they know they have no
21 recourse.

22 **MR MORTON:** I'd certainly suggest that, if a regulatory
23 environment was designed in such a way that customers who
24 were dissatisfied had an avenue for disputation, and that
25 disputation assumed some significance in the potential
26 regulatory outcomes in the future, then that certainly would
27 encourage those disputes if they were in fact present.

28 **CHAIR:** Presumably the users of -- that are seeking access, most
29 of them in this country generally don't favour greater
30 degrees of control because they think it might spread to
31 their sectors, and we see in this case quite a few users

1 saying unequivocally that these markets -- there is limited
2 competition and there's a strong case for regulation. They
3 may not be having open disputes, but nevertheless perhaps
4 they've exercised their voice in the only way they can in
5 the current regulatory environment.

6 So, how much weight do you put on what the people at the
7 other end of these access arrangements are saying when you
8 come to a view about the -- this behavioural assessment?

9 **MR MORTON:** Certainly, I'd acknowledge your point that customers
10 have -- or at least some users have indicated a level of
11 discomfort with at least some distributors' charging. But
12 I'd also suggest that that's quite a broadbrush response to
13 a general process, and that what might be the case in
14 general may not be the case specifically.

15 So, I think it's quite dangerous to tar an industry with
16 one brush.

17 **CHAIR:** Sure, so you look at each one.

18 **MR MORTON:** I think it's very important on a case-by-case basis.
19 And that leads in turn to the second part of the test, which
20 is to ask, before embarking on a very significant process,
21 to look at the available information, to assess whether or
22 not -- to put your own words, Madam Chair, which I thought
23 were extremely well put this morning.

24 **CHAIR:** It always worries me when people quote me back.

25 **MR MORTON:** Well, to establish whether or not there's a problem.
26 That's precisely -- that seems to me to be an eminently
27 sensible question to ask before embarking on a major
28 process, so the idea is the partial building block analysis,
29 which is a high level test.

30 I've recently been engaged or provided advice to a
31 Government Department in Queensland on a partial building

1 blocks test; I'm not at liberty to disclose details today,
2 but I'm very happy to seek any -- to provide a confidential
3 submission on that if it helps the Commission on the way
4 that that test has been conducted, to indicate a way of a
5 partial building block analysis and how it could work, and
6 most importantly how it could mitigate or minimise
7 regulatory cost where there's a question mark over whether
8 or not there's a problem, to use that phrase.

9 Then, depending on the results of that second test, that
10 regulatory filter, if you like, from the partial building
11 blocks test only embark on the major process, then
12 recognising again the imprecision with the process, and the
13 fact that the factual has its own limitations in terms of
14 reflecting, or prices reflecting efficient cost.

15 **MR BOULTON:** Can I just go back to a comment you made earlier.
16 From my perspective it seems logical that a user would argue
17 that perhaps there might be excessive market power.
18 Logically if they can utilise a third party to apply some
19 additional pressure it reduces their input cost, they would
20 argue that. Of course the real test from my perspective is
21 to say, that's fine, you put the gas pipe in yourself and
22 you own it, and if they take that option up then obviously
23 there's a problem. If they say no, I don't want to do that,
24 you have to question whether there's actually pressure in
25 the first instance.

26 **CHAIR:** I'd like to explore that, because if you were pricing
27 efficiently and offering innovation and service
28 responsiveness that they want, if we impose costs on you to
29 regulate you, those costs get passed on I'm afraid; they
30 would be passed on to the people that you provide services
31 to, they would have to wear those costs eventually.

1 So, I don't think that if -- if this is a cost less --
2 it didn't cost less to anyone who purchases services to seek
3 regulation, there is -- if you take a dynamic view of things
4 there's a risk over time that the costs to them eventually
5 rise. And I take that point from the submissions that your
6 company has put in, that over time it raises costs and it
7 raises costs to everyone, and especially the acquirer, so
8 I'm not sure that there is strong incentives on market
9 participants downstream from you to argue for regulation if
10 they don't really believe there's an issue there.

11 **MR BOULTON:** I'm not sure they would have the same perspective,
12 that's all. Again there's some assumptions that have to be
13 made that they would have that same view that you've just
14 espoused.

15 **CHAIR:** I'm asking you if it's rational to assume that at some
16 point in time those costs don't get borne by end-users?

17 **MR MORTON:** Could I suggest, Madam Chair, that that's actually
18 quite a rational position to put in the general, but not
19 perhaps in the specific; and I refer again to the
20 characteristics of the market that confront us and the
21 realities of gas shortages, because I'm not sure that the
22 capacity to pass those costs on is there to the same extent
23 that would occur in other markets for example. For example
24 in the case of electricity, and so that's perhaps another
25 factor that needs to be considered in this context.

26 I would also add that there can be a free-rider problem
27 associated with the objection because those costs might be
28 spread across the industry generally, rather than being
29 borne exclusively by the complainant.

30 It's very interesting, in the case of the EGP, the
31 complainant, Duke, in the EGP had never said no to an access

1 request, and in fact the application for access came from
2 the competing pipeline's affiliated retailer, someone who
3 had never been exposed to any adverse consequences from the
4 application of regulation, and in fact were the ones that
5 would be expected, at least in appearance, sense to lose the
6 most from the successful coverage. What was accomplished
7 there was the imposition of about \$3 million on a competitor
8 from the abuse of regulatory processes.

9 So, can I suggest that in general that's true, but not
10 necessarily in the specific, and that there are some
11 characteristics of this market that would cause one to
12 question whether or not it was automatically the case.

13 Could I just close by looking at some of the investment
14 issues that have emerged in Australia, and I'd like to make
15 it very clear that when we talk about the risk to
16 investment, two things: The first one is where projects
17 have been shelved, I don't believe they've been shelved
18 exclusively because of the threat of regulation.

19 But the point I would make is that the threat of
20 regulation and the threat of adverse consequences from
21 regulation become a very material commercial consideration
22 for the boards of directors when making these decisions.

23 The second point I would like to make about regulation
24 and investment is that the implications and the impacts
25 perhaps are less transparent than first thought. Because,
26 what we tend to see in the first instance is a willingness
27 to let infrastructure run down, and that the protection
28 against low probability catastrophic events decreases over
29 time as investment on maintenance declines from an
30 unfavorable regulatory environment, and so some of the
31 consequences of -- or some of the adverse consequences of

1 regulation are not immediately apparent.

2 At least in the Australian situation we've seen four
3 very significant expansions occur since the application of
4 regulation, which in the Eastern Gas pipeline which I
5 mentioned or discussed before that hasn't been covered,
6 we've got the pipeline that's servicing the Tasmanian
7 customers. My view is, in relation to that pipeline -- and
8 I have provided advice to Duke Energy on this issue -- that
9 the Tasmanian Gas pipeline is unlikely to have market power
10 of a degree that would cause it to be regulated or covered
11 under the National Gas Code.

12 The next pipeline that's being developed is the SEAGas
13 pipeline which is from the Otway Basin, and I can refer you
14 to the map and move back to the map if that assists, but the
15 fundamental point about that pipeline is that it's a
16 producer pipeline, that it's essentially a customer pipeline
17 that's been built to -- that's been fundamentally built to a
18 capacity to service existing customers, and finally the APT
19 pipeline, Australian Pipeline Trust pipeline between Roma
20 and Brisbane; that has been significantly expanded since the
21 advent of regulation, but a key point to recognise in
22 relation to those expansions is, they've all been
23 commercially negotiated outside of the regulatory framework.

24 So, I think that in the context of substantial
25 investment occurring in pipeline infrastructure in Australia
26 since the advent of the Code, all of those investments have
27 been made in the context where investors have taken a
28 realistic position that there's a high probability that
29 regulation won't be applied. The EGP was ruled not to be
30 covered, it's highly unlikely that the TGP will be found to
31 have any market power, and that again is the pipeline

1 servicing Powerco's distribution network.

2 The SEAGas Pipeline has been deliberately sized to
3 contract and the Roma to Brisbane pipeline has had
4 unregulated contractual expansions and so none of those
5 pipelines are likely to be significantly affected by
6 regulation.

7 In the case of distribution, these examples have already
8 been given in the other presentations, and it's clear that
9 at least in relation to the Tasmanian and the Victorian
10 situations, governments have felt impelled, or the market
11 has in fact impelled substantial subsidy to underpin
12 investment in those distribution systems, of course
13 acknowledging the point that was made I think by the
14 Commissioners that rural expansions often need subsidies to
15 assist them to make them commercial propositions. But all
16 in the context where there's a recognition that there is
17 some form of regulatory holiday will assist and promote that
18 investment.

19 In the case of --

20 **CHAIR:** I just -- you know this business about -- used to
21 hearing people tell us there's no case for regulation, but
22 when I hear there's a strong case for subsidies I really
23 suffer from some despair, but I just want to make the
24 comment that some of that seems to me likely to be driven in
25 Australia by quite different market circumstances where
26 arguably maybe you have quite considerable excess supply of
27 gas, I don't know, but we're just simply not in that
28 situation here where this issue about -- it seems to me this
29 desire to encourage this investment to the extent to which
30 governments are offering subsidies is driven by particular
31 market circumstances just doesn't apply in New Zealand.

1 **MR BOULTON:** Tasmania's almost an identical market to what we
2 have here. It's geographically, when you look at it, a
3 large number of small townships.

4 **CHAIR:** I understand that. I mean in terms of the relative
5 supply of cheap gas, and I just wonder how much of that
6 investment environment in Australia, where they want to
7 encourage people to invest in gas infrastructure, is because
8 there's a vast availability of cheap gas.

9 **MR MORTON:** There's an even more vast availability of cheap coal
10 in Australia that has been used. It is mixed around
11 Australia, the availability of gas. Certainly in Tasmania
12 there is a proximity to Bass Strait where there's an
13 abundance of gas, but most of the gas in Australia is
14 actually at the absolute extremity of a very big nature at
15 the northwest shelf, and whether or not that comes to serve
16 the eastern states, which is where the demand is greatest,
17 is yet to be determined.

18 I can't comment on the decisions by governments to
19 encourage gas. I suspect that something -- it may have
20 something to do with the cleanness of the fuel. But, I'm
21 not sure it's related directly to the abundance. I wouldn't
22 have thought that that was actually a primary consideration,
23 but.

24 **MR BOULTON:** Yeah, I'd -- the circumstances may change depending
25 on what the Commission comes up with, but if we move to more
26 regulations from what we've currently got, from an
27 investor's perspective, our perspective, it increases the
28 risk profile, so we're less reluctant to invest.

29 **CHAIR:** I understand that point, I'm just questioning the
30 relevance of the Tasmanian and Victorian examples for what
31 we're considering here. I understand the point you're

1 making about investment risk, but it just seems to mean
2 what's happening with some of these subsidies with
3 Government support is driven by something quite different in
4 Australia.

5 **MR MORTON:** I think there's an element of truth to that, I can
6 understand your point. I was simply wanting to make the
7 point, Madam Chair, that in terms of expansions of the
8 Australian network they tend to be in marginal cases, and in
9 fact rather than -- or at least the regulatory environment
10 has contributed to a situation where subsidies have been
11 seen as necessary to promote that investment.

12 **MR BOULTON:** There are a number of reference documents that we
13 will provide to the Commission which provide some additional
14 commentary on the very points you've raised as part of the
15 Productivity Commission process, so we're happy to provide
16 that.

17 **MS BATES QC:** Can I just clarify something: Are you saying that
18 the Government is providing subsidies and that is necessary
19 because of the regulatory environment?

20 **MR MORTON:** I've said that the regulatory environment has
21 contributed to -- has contributed to regulatory risk and
22 that that can only increase the cost of capital for anyone
23 looking to invest, and that ultimately that means for a
24 marginal investment -- can cause it to be submarginal which
25 can require a subsidy then for it to occur in the
26 marketplace.

27 **MS BATES QC:** I think the Government would rather subsidise than
28 fix a perceived problem with the regulatory environment.

29 **MR MORTON:** Well, the regulatory environment is currently under
30 review. The regulatory environment in gas -- in the gas
31 industry is currently being reviewed and from the

1 submissions a number of very strong views have already been
2 put about the invasiveness of the regulatory environment.
3 What we didn't have before the application with the Gas Code
4 was a process such as this where the issues were looked at
5 very thoroughly before the application of regulation.

6 What happened in Australia was, there was a one in all
7 in approach, where every piece of gas pipeline
8 infrastructure in the company was presumed to be -- it was
9 presumed that it was subject to regulation or ought to be
10 subject to regulation, which is a different approach to
11 what's been applied here; and what the opportunity I believe
12 that that presents to the Commerce Commission and to the
13 decision-making process in New Zealand is a far more
14 rigorous assessment about the intrinsic merits of applying
15 regulation before it's applied rather than the reverse
16 that's applied in Australia, and that was the point I was
17 wanting to make from that process.

18 **MR BOULTON:** That's the primary argument that's occurring at the
19 moment over there in the gas sector, the impact of
20 regulation on the cost of capital and the impact of that on
21 the marketplace and the capacity to find the necessary
22 funding to provide the infrastructure that the Government is
23 keen on, and at this stage the Governments -- a number of
24 them have made the call to utilise tax payers' funds to
25 ensure the investment proceeds.

26 **MR MORTON:** I would be happy to comment that I believe that the
27 regulatory environment has contributed to regulatory risk
28 that has increased the cost of capital for attracting
29 investment to sectors of the infrastructure industries in
30 Australia; I would be happy to make that comment, on my view
31 as an economist.

1 **MS BATES QC:** I'm sorry, I just was a little puzzled by the
2 Government's response to subsidise rather than to.

3 **MR MORTON:** Fix the problem.

4 **MS BATES QC:** Fix the problem, doesn't seem to be particularly
5 rational.

6 **MR MORTON:** Or to ask more fundamentally, is there a problem in
7 the first place, which is the question that the Chairman put
8 this morning, which I agree and endorse.

9 In closing, and without wanting to labour the point, I
10 simply wanted to make the point that there has been a number
11 of projects, distribution projects in Australia that have at
12 least been shelved or delayed sense the advent of the Code.
13 These are all projects that in the first instance would be
14 subject to the possibility of regulation.

15 I don't want to ascribe the shelving of these projects
16 to the imposition of the regulatory framework in Australia.
17 I simply wanted to make the point that I made a second ago,
18 that I believe the regulatory framework in Australia has
19 increased the cost of capital because of regulatory risk,
20 and that that's a material consideration when considering
21 the benefits to consumers of applying regulation. That
22 concludes my presentation, thank you.

23 **CHAIR:** Can I just follow-up a question on the partial building
24 blocks approach, and I think you've indicated that it's been
25 used, I think you said in Australia, and I just wonder if
26 there was a direct comparison done of the results from using
27 a partial building block approach to using a full building
28 block approach?

29 **MR MORTON:** No, there are some -- I'm simply reflecting my
30 experience as a consultant and being engaged by Queensland
31 Treasury to investigate whether or not a water business, in

1 that instance, should be referred for prices oversight, in
2 which case a high level test was suggested and applied.

3 I guess, in applying that test we saw the issues of
4 Type I/Type II error with some significance. What that
5 opportunity, though, presented was to look at the publicly
6 available information and apply a range of tests to it. So,
7 for example, we looked at the application of depreciation in
8 a range of contexts; straight line depreciation, annuity
9 based depreciation, the implications of renewals annuities
10 in that instance, and were able to form a view, that was
11 there a substantial likelihood or a likelihood of there
12 being monopoly pricing being applied in that instance. I'd
13 prefer not to mention the conclusions without reference back
14 to -- the document's still in draft form.

15 But, simply put, the review of publically available
16 information did present an opportunity to have quite a high
17 level test, where it was seen whether or not there was a
18 problem there, essentially, to see whether or not there was
19 an issue.

20 **CHAIR:** What can you tell us about the likely biases? And I
21 don't mean that in a negative sense, just in a purely
22 economic sense, what sort of biases would result from using
23 that approach? In other words, what information do you not
24 get and what do you think the impact of not having it is on
25 the outcome?

26 **MR MORTON:** I think that's fundamentally a question of asking
27 about the Commission's, to use your words, bias towards
28 Type I and Type II error, and that that's an issue for the
29 Commissioners to decide as to where that balance best lies
30 in the context of the application of the test in the
31 legislation.

1 So, one option is to simply apply standard industry-wide
2 tests in terms of asset valuations, for example, and the
3 cost of capital; various approaches to depreciation, and
4 then depending on the outcomes of that analysis, to look at
5 the appetite, if you like, for Type I verses Type II errors,
6 and that's really an issue for the Commission to determine
7 in the application of the test.

8 **CHAIR:** What I was trying to get at is, I would have thought
9 when you use a partial building blocks approach, if there is
10 anything unusual about the company that you're looking at,
11 you risk not picking it up; something unusual in their costs
12 or -- and it's not clear to me that it -- there's not equal
13 chance of you sort of disadvantaging the company by using
14 that approach as opposed to advantaging it.

15 **MR MORTON:** I would accept that, but bear in mind you're not
16 setting prices on the basis of that test, you're simply
17 saying, is there a problem here.

18 **CHAIR:** I understand that, I do understand that point, but it
19 seems to me that having gone through long debates in
20 electricity about how to target, a targeting regime that is
21 just meant to find the companies you want to have a closer
22 look at, it's not even to control them, but to decide
23 whether to fully investigate them; the simpler we made it,
24 the more we got into suggestions from individual lines
25 companies, yes, but our circumstance is slightly different,
26 if you'd looked at this additional factor it would explain
27 everything about what the results you're getting for our
28 company, and it seems to me these partial building block
29 approaches run that risk, that each company will come back
30 to you and say yeah, but you've missed out on a key factor
31 for our company that you just don't pick up taking these

1 partial approaches.

2 **MR MORTON:** I don't think there's any doubt that there's a risk
3 of that occurring. I would also suggest, however, that to
4 the extent that issues can be standardised across a
5 network -- when I look at an electricity network I think
6 about climatic issues that assume some significance and
7 correcting for them that perhaps don't apply to quite the
8 same extent in gas distribution networks. The first issue
9 is to work out just the sensible tolerance around
10 standardised tests and the margin for error in the context
11 of Type I/Type II.

12 In my experience, and I have been involved in several
13 regulatory processes involving rail and electricity. My
14 view is, there's a tolerance of 10 to 15% around a price
15 that might be determined by a building blocks approach, that
16 the range of error is quite easily 10 to 15% when you look
17 at all of the parameters. I think that's the critical issue
18 when we look at a partial building blocks test to find out
19 whether or not there's enough of an issue to go further.

20 If I was to look at an ROI of 3 or 4%, and I was to
21 accept that number, obviously I'm scrutinising the number as
22 a regulator; and without wanting to suggest any answers to
23 the Commission, perhaps that might give me some comfort that
24 that was far enough to go without embarking on a full-blown
25 process.

26 **CHAIR:** Can I just check and see if there are further questions.
27 [No comments].

28 Thank you very much for that. We've saved the best for
29 last; I always like having these discussions. I will be
30 most disappointed if we don't speak on WACC for at least an
31 hour. [Pause]

1 **MR SEED:** Thank you, Madam Chair. By way of introduction, my
2 name's Peter Seed, I am an independent financial and
3 economic consultant based in Christchurch and I specialise
4 in advising utility companies primarily in the airports,
5 electricity and gas fields on pricing and valuation issues,
6 and today I'm here to make some comments about valuation
7 issues as they pertain to the Commission's Gas Control
8 Inquiry.

9 And, what I'd like to do is to cover off four topics
10 that we dealt with in the submission, and we'd just like to
11 go into a little bit more detail here. First one being the
12 appropriate valuation approach for gas pipeline business
13 assets. The second one being just some brief comments on
14 valuation date issues and the consistency surrounding them.

15 The first one being the valuation of easements, which
16 was raised in the framework paper, and I have some examples
17 there that the Commission may find interesting, and lastly
18 I'd just like to comment on some of the optimisation issues
19 that arose as well.

20 So firstly, just in terms of the preferred valuation
21 approach: I guess where we're starting from is really from
22 the basis of saying, okay, one of the key inputs in the
23 building block approach that's been put forward by the
24 Commission, or suggested by the Commission, is the valuation
25 of the asset base. And what I'd like to do is just spend a
26 few minutes just talking very briefly about that.

27 The issue of the appropriate valuation approach has been
28 pretty well traversed, not just in electricity but also in
29 airports, and I dare say in telecommunications but I haven't
30 had anything much to do with that, but we certainly spent a
31 lot of time talking about it with regard to the airports.

1 I'd have to say that the approach that I think is most
2 appropriate for the valuation of the asset base is ODRC or
3 optimised depreciated replacement cost and with the proviso
4 that the asset base reflects a number of things to do with
5 the identification of the appropriate assets for inclusion
6 in that asset base.

7 And, if you like to think about a valuation approach as,
8 or any valuation process as including a number of discrete
9 steps, the first one is really identifying the assets that
10 should go into the rate base, and the second one is moving
11 through the valuation process. And, within the rate base
12 for gas we would be looking at, not just network fixed
13 assets, in other words pipes and pumping stations and all
14 that kind of stuff, but also including the easements which
15 are associated with those pipelines. Also, we'd be looking
16 at network related working capital, and lastly the
17 intangibles that are associated with the gas pipeline
18 business.

19 Just talking about the intangibles, or just expanding
20 that for a second, they're not insignificant because they
21 include a lot of information about, for example, the
22 customer base, asset condition, remaining economic lives and
23 so on that are all quite important for the management of the
24 network.

25 It's important to note that the Draft Gas ODV Manual
26 that was distributed, I think it was in June 2000 by the
27 MED -- and it's been in draft, it's not in their website or
28 anything like that, but it is possible to get hold of
29 copies -- doesn't actually specify the asset base in that
30 way, it specifies it in a way which is much closer to the
31 specification in the ODV Handbook for Electricity Lines

1 Businesses. In other words, it includes a subset of the
2 easements, it includes the fixed assets, but it doesn't
3 include the intangibles.

4 **CHAIR:** Can I just ask, in terms of the approach Powerco takes
5 now with its own accounts, what valuation methodology do you
6 use?

7 **MR BOULTON:** In which account, sorry?

8 **CHAIR:** In your own financial reporting.

9 **MR BOULTON:** The purchase historical cost is the approach we
10 use, what we purchased the assets for, which is the real
11 cost to us.

12 **CHAIR:** So, in terms of the -- but the information you gave us
13 earlier about your return on equity, I think it was.

14 **MR BOULTON:** Return on investment.

15 **CHAIR:** Return on investment; was that done based on the ODV
16 Manual draft or was it done on historic costs?

17 **MR BOULTON:** It's done on the ODV Manual draft for the year
18 2001/2002, I think it is.

19 **CHAIR:** Okay, thank you.

20 **MR SEED:** Just to pick up a couple of points about the ODRC
21 method. ODRC is effectively a proxy for the cost of a new
22 entrant, replicating the service potential of those fixed
23 assets, and it mimics the process that's gone through, not
24 just in the likes of the pipeline valuation, but also when
25 you're looking at some downstream industries, the same type
26 of thinking goes on as to saying, okay, what is the cost to
27 a new entrant, and what is the value or the costs that they
28 would face in replicating that capacity.

29 It's important to note there just a point about service
30 potential of the fixed assets. We're saying here that ODRC
31 would replicate the service potential of a group of fixed

1 assets that say had an average remaining life of 20 years or
2 something like that, whereas new assets may have a remaining
3 life or a total life of something of say 40 years. So,
4 we're just looking at replicating the available service
5 potential of the fixed assets being valued.

6 Now, that's actually a little bit different than what a
7 new entrant will actually face, because a new entrant would
8 face the optimised replacement cost, not necessarily the
9 ODRC, and this brings us to this issue of how would we
10 actually reconcile these two. And, it really comes down to
11 making sure that any depreciation approach that's put
12 forward is consistent, and for example there is a number of
13 depreciation approaches or methods that could be used; one
14 being an example of an annuity approach where the value of
15 the asset is amortised over its economic life.

16 Secondly you could have a straight line approach where
17 the value of the asset is simply divided by its remaining
18 life; and you could also have a diminishing value approach
19 where you just take a constant percentage of the outstanding
20 asset value at beginning of each year and just march on
21 forward with that.

22 Now, if you're going to use any kind of annuity based
23 approach, it would make sense that if, for example, you were
24 starting from ORC, optimised replacement cost being the cost
25 faced by a new entrant, that you would say, well, that's
26 fine, we will amortise that over the full, say, 40 years of
27 that asset's life. Whereas, if you're looking at ODRC, if
28 you're looking at ODRC, you would, say, amortise it, say,
29 over whatever the remaining life was of that asset base; it
30 could be say 20 years as opposed to the original 40, so it's
31 just a consistency issue.

1 **MR STEVENS:** What methodology do you use for determining the
2 remaining economic life of the asset?

3 **MR SEED:** I'm not an engineer, but my understanding is, there
4 are a number of approaches that can be used. For example,
5 condition assessments; that's quite a common one.

6 **MR BOULTON:** Just generally the approach taken, there's a
7 manufacturer's view on the life of the asset, then obviously
8 the way that asset management has been progressing is driven
9 by condition based monitoring.

10 **MR STEVENS:** Including the maintenance programme that has been
11 undertaken in respect of that asset?

12 **MR BOULTON:** That's right.

13 **CHAIR:** Is it such a vexed issue with the gas pipeline business
14 as it is with the electricity lines businesses?

15 **MR BOULTON:** There's a reduced degree of difficulty, I'd
16 suggest, and reduced number of assets in sheer quantum to
17 conduct a condition based monitoring assessment on. In
18 electricity, one component of a pole could break and has an
19 impact on the performance of the whole of the pole.

20 **MR SEED:** I'd now just like to make a couple of comments about
21 the appropriate valuation date.

22 **CHAIR:** Can I -- just before you go on I want to come back to
23 this issue about intangibles. I want to ask you if you are
24 aware of any regulator taking account of intangibles in the
25 asset base, for regulatory purposes?

26 **MR SEED:** Madam Chair, no, I'm not, but certainly in terms of a
27 cross-submission we'd like to look at that in a little bit
28 more detail.

29 **CHAIR:** I just want to try to understand what the arguments are
30 for and against including intangibles in the asset base for
31 regulatory purposes, and I wonder if you could tell me what

1 they are, the arguments for and against. It seems to me a
2 ripe area for catching just about anything you want to wrap
3 up in there between what the ODV actually is and what you
4 actually paid, and it may be a fairly cynical approach to
5 it, but it does seem to me that in a way that's virtually
6 what it comes to, if I understand it right; it's what we
7 might think of as goodwill or just the value above a sort of
8 cost-based approach and what you actually paid.

9 So, I just want you to help me out a little bit and tell
10 me what you think the arguments are for and against taking
11 account of intangibles in the asset base for regulatory
12 purposes.

13 **MR SEED:** In terms of the arguments against, obviously if you
14 are looking at just including a globo classification called
15 "goodwill", that is obviously open to abuse. In terms of
16 the arguments for, there's a number of significant items of
17 intellectual property that are associated, once again, for
18 example, things like the customer base and asset conditions
19 records and basically the asset database that goes with the
20 assets that we're actually talking about there, not goodwill
21 as such.

22 So, those are all -- they have value to somebody that
23 would actually be buying that particular network, and in my
24 view they would contribute to the value of the total asset
25 base.

26 **MR BOULTON:** Another way to look at that, of course, is just
27 look at hard descriptions in the ODV Handbook itself and
28 then look to see whether you can run those assets, run a
29 business just by isolating those assets if you couldn't put
30 them in a room. What's missing from that to effectively run
31 the full business, that's the other way to look at that.

1 There's a number of factors that are missing, including the
2 historical evidence, the data, the information, the
3 condition based monitoring, load profiling, a whole pile of
4 other additional features which are inextricably linked to
5 the assets which are not effectively called goodwill in an
6 accounting sense, they've just simply never been described.

7 And again, I can only think that some assumptions have
8 been made, unspecified again, about those factors; and
9 perhaps going back in time we're going back some time now to
10 those handbooks when they were first developed, the maturity
11 of thinking, the maturity of data information and knowledge
12 was not available.

13 So, to suggest that something that's effectively
14 10 years old is valid today is a difficult concept over and
15 above the issue about standard costs which are not up to
16 date either for the electricity sector given, of course --
17 the difference here is we're talking about gas which doesn't
18 have an official handbook anyway.

19 **CHAIR:** That's why I ask whether you know of any regulator that
20 takes account of intangibles in the asset base for pricing
21 purposes? If you do, we would certainly be interested in
22 hearing about it.

23 **MR STEVENS:** Just a follow-up question on that, Mr Morton, I
24 presume you'd agree that valuation is an art and not a
25 science, particularly in the areas of intangibles. And the
26 problem that may arise really is how to actually value those
27 intangibles, given that even in the areas such in an IP way
28 there are a number of experts who are capable of valuing
29 that; the range of valuations can sometimes be quite
30 enormous, and how would we be able to sensibly bring that
31 into an ODV type model?

1 **MR SEED:** That's something I'd prefer to cover in more detail in
2 some form of cross-submission, but certainly it would be
3 something that we'd like to give a more detailed response
4 on.

5 **MR BOULTON:** Keep in mind, we've responded in this way with some
6 detail about ODRC and asset valuation, because a large
7 component of the paper developed by the Commission asked
8 questions about that, and of course it goes back to our --
9 my big assumptions before, and we're not suggesting that --
10 and Tasmania's a classic case, it's irrelevant, ODV, ODRC,
11 WACC, they're irrelevant issues from a regulatory
12 perspective. The market, the market from our perspective
13 doesn't require this in the first instance, but we've
14 responded, as we have done historically, to the requests of
15 the Commission with the design of your Discussion Paper.

16 **MR SEED:** Okay, just in terms of the valuation date, it seems to
17 me that if the Commission is going to do any form of ex-post
18 or ex-ante analysis, it makes sense to have a valuation date
19 that corresponds to the start of the period, and the
20 difficulty is being able to -- it's not so much the
21 valuation date, and the question was which is the -- I think
22 the question that was in the framework paper was something
23 along the lines of, what is the appropriate valuation date?
24 It's more of a question of, at which date can we have some
25 consistent data so we can actually undertake some analysis.
26 That's my sort of reading between the lines of what the
27 Commission appears to be after.

28 To that end, if the Commission is going to do any form
29 of ex-post analysis, it really needs to make sure that, when
30 it has chosen a date, that the valuation approach that it
31 uses at that date is consistent across companies so it has

1 some form of meaningful comparison.

2 Now, turning to the valuation of easements. In the
3 framework paper easements were in one question included with
4 intangibles as an asset class, but what I'd really like to
5 raise here is that easements themselves are effectively an
6 interest in land -- I forget the exact legal term, I think
7 it's a hereditament or something along those lines. They
8 are similar conceptually to leases, licences and other
9 partial interests in land and, therefore, they're not, as
10 such, an intangible.

11 So, think about how you go about valuing them. Easement
12 values are based on an allocation of a bundle of property
13 rights because when you own land you own a bundle of
14 property rights and all that an easement agreement does is
15 just allocate those property rights between the person that
16 actually owns the land, between the grantor, and the grantee
17 being the person who's had the easement granted to them.

18 So, in terms of types of easements, we've really got two
19 broad types, and these are the statutory easements and
20 acquired easements, and statutory easements as the name
21 suggests, they are granted by statute and certainly -- I'm
22 just trying to think of the ones that are granted in the
23 Electricity Act, they include generally the rights to
24 inspect, operate and maintain assets that may pass across
25 another landowner's property.

26 Acquired easements, on the other hand, are created by
27 contract and they result from negotiation between the two
28 parties, and they don't always, but usually they contain
29 more rights than the statutory easements, so they won't just
30 have the rights to inspect, operate and maintain, they may
31 also include the rights to upgrade assets, increase the

1 capacity of a particular, for example electricity line, or
2 alternatively to put another pipe through. So, they tend to
3 grant more rights.

4 They both have value, but if you're going to be looking
5 at them properly the acquired easements would have more
6 value than the statutory easements.

7 Usually the acquired easements also are registered
8 against the title, but the important take-home message I
9 guess is that both types of easements have value.

10 **MS BATES QC:** I wouldn't know about the value of statutory
11 easements; that's a right granted by a statute, how does
12 that have a value?

13 **MR SEED:** I guess it comes down to the cost of replacement. In
14 other words, if you were actually going to have the right to
15 put that particular line -- say, for example, you inherited
16 the statutory right.

17 **MS BATES QC:** You get the right granted to you by virtue of
18 statute, so as was the case in electricity.

19 **MR SEED:** Yes, but today if you had to turn around and actually
20 put that line across that property, it would cost you
21 considerably more than -- sorry, it still would cost you
22 money, just in terms of negotiating with the landowner
23 because you wouldn't acquire it that way.

24 **MS BATES QC:** In electricity there's still statutory easements.

25 **MR SEED:** Yes.

26 **MS BATES QC:** You know that.

27 **MR SEED:** Yes.

28 **MS BATES QC:** I don't see how they actually have a value;
29 they're a statutory right you either have or you don't.

30 [Pause]

31 **MR SEED:** They still have -- you are still granted rights to

1 inspect, operate and maintain.

2 **MS BATES QC:** Yes you are, but you don't have to pay for them;
3 it's a right you have under statute. I don't quite see how
4 they have a value.

5 **MR SEED:** Well --

6 **MS BATES QC:** How would you value them?

7 **MR SEED:** They are a right of access.

8 **MS BATES QC:** I know what they are, I've had a fairly major case
9 involving them, so I know what they are, I'm just pushing
10 how -- how do they have a value in statutory easement?

11 **MR SEED:** Well, when you were valuing them, you would basically
12 treat them exactly the same way as an acquired easement.
13 It's irrelevant what you actually paid for them. You would
14 still be valuing the right of access; in other words, the
15 right to go across somebody else's property, because that
16 landowner has actually lost some rights by the granting of
17 that particular right of access.

18 **MS BATES QC:** The landowner doesn't have any choice in the
19 matter because the Government imposed that particular
20 condition; the landowners were never compensated.

21 **MR SEED:** Sorry, there's two things going on here; you're
22 looking at it historically and I'm looking at it now. In
23 other words, if we were going to assess for example the
24 replacement cost of the statutory easements versus the
25 acquired easements, all that we'd be looking at from a
26 valuation perspective is a difference in the bundle of
27 rights that have actually been granted to the two parties,
28 and the allocation of rights between those two parties.

29 **MR STEVENS:** Are you suggesting that the statutory easement
30 option is no longer available and that if -- and that anyone
31 who wants to have something similar has to go through a

1 different process now?

2 **MR SEED:** Yes.

3 **MS BATES QC:** Is that -- there's still a statutory right to
4 maintain under electricity; I don't know, what's the
5 position for gas? [Pause]

6 **MR SEED:** I'm sorry, could you please repeat your question?

7 **MS BATES QC:** Well, with electricity easements there's a regime,
8 and there's a statutory right to enter and maintain; if you
9 need to do more than that, and maintenance is defined fairly
10 narrowly for electricity, if you need to upgrade the line
11 from a so and so voltage, you actually have to go and
12 negotiate, and I know in some of those there's been quite
13 significant sums of money paid for the easements.

14 Very different situation to where you don't have to pay
15 anything. You have the right given to you by statute, no-
16 one's ever compensated for it; I mean, I just can't see the
17 monetary value coming in. And I don't -- the second thing
18 is, what -- and Ms Heine might be able to help us -- what
19 legislation actually regulates easements for gas?

20 **MS HEINE:** It's very complex, there are certain provisions in
21 the Gas Act which then translate back into the previous Gas
22 Act, which mirror the Electricity Act. It is something I
23 need to undertake quite a lot more work on, but I'm
24 confident that we can give you something that could clarify
25 the position.

26 And in that context I think it's worth exploring this
27 valuation of statutory easement point from a legal point of
28 view in more detail. The mere fact that something is a
29 statutory right doesn't necessarily mean it has no value.
30 For example, some statutory rights are tradable, but
31 obviously this is a different situation here.

1 **MS BATES QC:** The one under the Electricity Act, I don't see how
2 it does have any value, but maybe you can come back to that
3 and I don't want to delay it unnecessarily but...

4 **MS HEINE:** I think we can, it's very complicated.

5 **MS BATES QC:** Well the electricity position is not very
6 complicated, the gas position may be more complicated.

7 **MS HEINE:** The gas position is, as I understand it, because
8 there is no directly applicable statutory provision.

9 **MS BATES QC:** Perhaps could you come back to us with some
10 information on that.

11 **MR SEED:** Sure. I think the take-home message irrespective of
12 how the two parties received the easements, whether they
13 were statutory or acquired, is that there is an allocation
14 of property rights here between the landowner who is granted
15 them, or had them taken off them, and the person who has
16 received them or been given them and paid for them. It's an
17 allocation of rights issue that we're really talking about.

18 So, to that end, if we're just talking about acquired
19 easements, the two key issues that dictate value of the
20 easement are firstly the value of the land within the
21 easement area, or what's known as the corridor, and that's
22 fairly easily derived from market benchmarks from comparable
23 sales of land.

24 The second issue is the allocation of the rights to use
25 the land, and they're generally going to be derived from
26 market benchmarks. It is possible to build those up, so you
27 can actually look at what is the value of each of the
28 components to each of the parties.

29 There are additional costs involved here, and these are
30 additional to the cost of replacement, and they may include
31 legal RMA valuation expenses, costs of negotiation and so

1 on. In general the thing that drives the allocation of the
2 rights to the use of the land is an issue known as injurious
3 affection, and that's where, once again, you're carving up
4 the whole issue or the whole bundle of rights.

5 So, just going into a little bit more detail here about
6 the corridor value, that's going to depend largely on the
7 value of the underlying land and the easement area, and when
8 we say "the easement area" we just mean the width of the
9 effective corridor between each of the network nodes, and
10 the allocation of property rights is going to depend on,
11 once again, impacts on the land use, any restrictions on
12 what the easement holder can do, and any access and other
13 rights that are conferred.

14 For example, for an underground pipe you might be
15 looking at a percentage allocation between the easement
16 holder and the easement grantor where the easement is worth
17 say 60% of the value of the underlying land. It's as simple
18 as that.

19 Just as an example of how that works, and just to show
20 you how relatively straightforward it is to operationalise
21 this between nodes: Say for example you were looking at a
22 length of pipe that ran through a semi-rural area with an
23 average land value of about \$10,000 a hectare. The gas
24 underground pipeline may require a 20 meter wide corridor,
25 so over -- for each kilometre it's going to take up roughly
26 about 2 hectares of land; given that the land value is about
27 \$10,000 a hectare in that area -- this is just an example --
28 it implies that the total corridor value is about \$20,000
29 per kilometre.

30 If you work on the allocation principle that you've got
31 to be allocating 60% of the corridor value to the easement

1 holder, it implies that the easement value is around about
2 \$12,000 per kilometre. So, they're not insignificant, or
3 the value of the easements isn't insignificant, and
4 depending upon the type of asset that's actually going
5 through the corridor, you could be in a situation where the
6 corridor is much wider than that, where the degree of
7 injurious affection is much much higher as you often find
8 with transmission lines.

9 Just finishing up on easement valuation and just to
10 cover off the main topics, easement replacement cost is
11 reasonably straightforward. The issue was raised, I think,
12 in the framework paper as to how you could go about
13 assessing it. Well, it's as simple as actually assessing
14 the value of the land that the line goes through, and given
15 that the allocation of rights is going to stay relatively
16 constant, it just means that you're applying the same
17 allocation of rights to different values of land.

18 The question was also raised about whether easements
19 depreciate. Well, as easements are an interest in land they
20 don't depreciate, if anything they'll just -- given a
21 consonant allocation of rights they'll change in value at
22 much the same rate as the underlying land value.

23 And lastly, there was the issue of easement
24 optimisation, and the most usual case of optimisation
25 applied to pipelines is where a pipeline becomes surplus due
26 to, say, something like bypass, and in that instance the
27 easement has its value in its next best use, it may be able
28 to be sold to another, or transferred to another user;
29 alternatively it may lie idle. So, that is how easements
30 would be treated for the purpose of optimisation.

31 **MR STEVENS:** Have you had any other valuation methodologies used

1 in respect of easements? For example, when certain
2 easements are of strategic value, clearly if it's a
3 commercial negotiation between the landowner and the access
4 seeker, there obviously may well be a different valuation
5 methodology applied, and I wondered if, in your experience,
6 whether you had come across different types of valuation
7 methodologies for easements?

8 **MR SEED:** The corridor method is the most usual. The --

9 **MR STEVENS:** For example in the electricity sector when they are
10 looking at bypass easements for penstocks, there has been
11 completely different valuation methodologies used in those
12 instances, and they've tended to base that on the additional
13 generation capacity from a better easement.

14 **MR SEED:** You're valuing effectively the value that the easement
15 brings to the rest of the business, isn't it, so it's an
16 incremental approach.

17 **MR STEVENS:** Yes.

18 **MR SEED:** Yes, there are other approaches that can be used.

19 **MR STEVENS:** Have you come across that in the gas industry at
20 all?

21 **MR SEED:** No, I haven't. But that's not to say it may not be
22 used. But I was giving you an example here covering off at
23 a relatively higher level as to how you would operationalise
24 some form of easement valuation approach on sort of like a
25 mass appraisal -- from a mass appraisal perspective. For
26 example, I think Powerco has about 4,000 kilometres of line,
27 of pipeline, and NGC probably certainly has a lot more.

28 **MR STEVENS:** I don't want to labour the point because I know
29 you're coming back to us on that statutory easement, but
30 when you do come back to us, I wondered if you could also
31 advise us whether it is possible to get a similar statutory

1 easement now, or if you are saying now that you're unable to
2 get statutory easements in the future and having to go to
3 commercial negotiation with landowners, and if you could
4 perhaps advise --

5 **MR SEED:** That's my understanding of what you have to do at the
6 moment.

7 **MR STEVENS:** So, now you can no longer request statutory
8 easements?

9 **MR SEED:** I don't believe so.

10 **MR BOULTON:** That's as we understand it, but we'll come back to
11 you on that issue.

12 **MS BATES QC:** Have any of you actually negotiated any?

13 **MR BOULTON:** In terms of -- no, our Powerco staff have. So, I
14 can't say that I've been through the process, I'm spending a
15 lot of time on regulatory matters at the moment.

16 **MS BATES QC:** Did you pay for them, did you? You've paid for
17 your easements?

18 **MR BOULTON:** There have been negotiations. **[Pause]**

19 I've just been advised we sign about five a week, one or
20 two for gas and the remainder for electricity on average.
21 They're negotiated by this chap behind me, Mr Barber.

22 **MS BATES QC:** Are they always done on the basis of the value of
23 land?

24 **MR BARBER:** Often it's part of in effect our subsidy for the
25 construction of the work. If we're building what is in
26 effect -- take a situation in the developer wanting a
27 subdivision reticulated, they will come to us and say is
28 it -- you know, is it on present line charges economically
29 to build it? We'll advise them and in most cases it isn't
30 economic to be built, so we say we require a contribution of
31 X dollars and as part of your contribution, in effect we

1 discount the contribution if they give us the private
2 property rights via an easement to build own and operate a
3 gas and/or electricity network on it. So, we get it via
4 that.

5 **MS BATES QC:** I can understand -- well understand that
6 situation, because it's a greenfields.

7 **MR BARBER:** Yeah.

8 **MS BATES QC:** What about where you haven't got that situation,
9 where you're having to actually pay a landowner rather than
10 a developer?

11 **MR BARBER:** We tried to start off on some principle basis like
12 a corridor valuation methodology. It does not always end up
13 being resolved on a principle basis such as that. Often it
14 is effectively some sort of almost dispute resolution thing
15 where we work out how much more we lose if we dragged it
16 through the courts or -- and often end up paying something.

17 **MS BATES QC:** It's exactly consistent with my experience of it.

18 **MR SEED:** Commissioner, if I could just add a couple of
19 comments. My previous firm used to act for quite a number
20 of firms in the valuation of easements, and what we always
21 tried to do was to start off in a principle basis, and
22 generally if you are negotiating something like 20 or 30
23 kilometres of line you can -- it's a case of trying to make
24 sure that everybody is treated equally along the line,
25 because there will be people that do not wish to be part of
26 it or will decide to hold out and hold the whole project to
27 ransom. That does tend to happen and there will always be
28 outliers.

29 But in terms of assessing the replacement cost of an
30 easement, you would fall back to a method like this, and we
31 are saying you would base it on land value and the observed

1 out-turn of, you know, the allocation of property rights in
2 some form of average, and that's what you'd fall back to,
3 because you'd say, okay, there are observable allocations
4 out there, and we've seen them, and there are also
5 observable land values out there, and we've seen those too;
6 this is our offer of what we think, you know -- sorry, this
7 is our estimate, rather, of what we think that that
8 particular easement's worth. But certainly it does come
9 down to negotiation, and that's the price.

10 Just moving on to the last topic to do with
11 optimisation. There were a number of questions in the
12 framework paper regarding this, and just as a general
13 observation, optimisation occurs at a number of levels, and
14 there is a little bar chart that I think a number of us are
15 familiar with, where you're basically setting the value of
16 an asset or of a network or of some infrastructural asset as
17 a function of the degree of optimisation.

18 In general the greater the degree of optimisation, the
19 lower the value of the asset. As successive hair cuts are
20 taken off for a range of things such as surplus assets,
21 changes in technology, identification of obsolescence and so
22 on and so forth, all the way down to a complete greenfields
23 approach to the determination of what that asset's worth.

24 Just as a general observation, bypass in the case of a
25 gas pipeline is a subset of the overall optimisation
26 question, and the point was raised as to how optimisation
27 should be reflected and whether it should be reflected in
28 cashflows and taken account of in required revenue that way,
29 or whether it should be reflected in the discount rate. At
30 the moment our view is, in either case it needs to be, or
31 the risk of optimisation, or optimisation risk rather, needs

1 to be reflected somehow in higher required revenues, in
2 other words if you had two situations one where there was
3 optimisation risk and one where there wasn't, it's got to
4 come through somewhere.

5 Now, in terms of how that would be dealt with, if
6 optimisation is going to be reflected in cashflows, my view
7 is that it should be smoothed. I think it's impractical, as
8 somebody that's been involved in pricing, to adjust prices
9 from year to year for them to bounce around as one asset's
10 dropped out and there's an instantaneous adjustment. It
11 would actually make more sense to somehow reflect the
12 optimisation risk -- I believe anyway -- in the way that --
13 the way that economic lives are assessed, so that for
14 example, where you have a higher risk of optimisation, it's
15 going to be reflected in a shorter economic life, and
16 therefore some sort of higher amount of amortised asset
17 value and therefore higher required revenue.

18 It is possible that you could -- well, I mean it's
19 logical, if you could reflect it in the discount rate you
20 would end up with exactly the same kind of -- not discounted
21 rate, the required rate of return rather, you would end up
22 with exactly the same answer. But there is an issue to get
23 over here, and that's that the WACC, as we're currently
24 defining it, uses the capital asset pricing model, and the
25 capital asset pricing model only records systematic risk, it
26 doesn't record what is called unsystematic risk.

27 My understanding is that optimisation is -- it falls
28 into the gambit of being a non-systematic risk and,
29 therefore, it would be dropped out and therefore wouldn't be
30 reflected, so there would have to be some explicit margin
31 over the cost of capital to take account of that. But, we

1 look forward to talking about that a little bit further in
2 the cross-submissions.

3 Just to summarise then, just on those four points, we're
4 of the view that we should look at a replacement cost
5 approach, which is correctly specified in so far as the
6 asset base includes easements as well as a tightly defined
7 group of intangible assets. The take-home message I think
8 with easements is that they're relatively easily valued and
9 they're as easily valued and optimised as land, and that we
10 will come back to you also on the issue of the statutory --

11 **MS BATES QC:** Just one thing. Do you think they have any use to
12 anybody else other than somebody who owns a gas pipeline?

13 **MR SEED:** They may have to use another person that wants that
14 corridor, yes. They may have use another utility.

15 The last point is --

16 **MS BATES QC:** Have you ever heard of a situation where it's
17 been -- easements have been transferred to another utility?
18 Are you sure there'd be the right in these easements for
19 them to be transferred to another utility?

20 **MR SEED:** We can go back and check on that, but certainly if
21 you're looking at the replacement cost, and that's almost --
22 well, what you seem to be raising is a sunk cost argument
23 here, we're looking at the value of this particular asset to
24 a new entrant, and that's the approach that we've taken when
25 we're looking at ODRG. So, we're just being consistent with
26 how we're treating easements as well, and we're looking at
27 the value of that easement to the pipeline operator.

28 **MR BOULTON:** I think the Commission in your own paper talk about
29 the entry barriers and the cost of negotiating easements for
30 obtaining all of those consents, so it has an assumed value
31 in there if it's specified as a potential barrier to entry

1 for other participants.

2 **CHAIR:** I'm not sure that applies to the statutory easements,
3 but we can look at that.

4 **MR BOULTON:** I'm not sure what's referenced in 5.64, but
5 anyway...

6 **MS BATES QC:** I think there might be a distinction, but we can
7 come back to that, this is exploratory, isn't it.

8 **MR SEED:** And lastly optimisation risk, we believe that it
9 should be reflected somewhere along the line in higher
10 required revenues, either by an adjustment to the economic
11 lives, which is a way of smoothing out the potential risks
12 of optimisation, or alternatively through some margin over
13 the WACC, and that brings me to the end of my presentation,
14 Madam Chair.

15 **CHAIR:** Thank you.

16 **MS BATES QC:** I'm just -- this might not be a question four, but
17 just something I'm curious about; the rates of return you
18 gave us, you said, were based on the draft ODV Handbook.
19 What are the rates based on what you paid?

20 **MR BOULTON:** I did specify for year 2001/2002. 2003 is based on
21 historical cost, so I did answer that question.

22 **MS BATES QC:** Sorry, I missed it, sorry. So, the other two you
23 don't know what they were based on --

24 **MR BOULTON:** ODV was utilised for the best of my recollection
25 for the year 2001/2002, the date that was shown to you, and
26 for the year 2003 the reference asset base is historical
27 cost.

28 **MS BATES QC:** Do you have the other historical cost references
29 for the other two years?

30 **MR BOULTON:** We can build those.

31 **MS BATES QC:** I think that might be helpful for the sake of

1 completeness.

2 **MR BOULTON:** And the converse as well applies for the reference
3 point of the ODV.

4 **MS BATES QC:** Yeah, so we have...

5 **MR BOULTON:** Yeah, two columns, I think we can build that. That
6 historical cost data's in our historical accounts, but we
7 can build that.

8 **MS BEGG:** I presume most of Powerco's pipelines are under the
9 road reserve. Would you please attribute any value to the
10 rights to that? They wouldn't require easements, I guess,
11 for that do they? That's one question. The other is, I
12 think in passing you mentioned the kilometres of easement
13 that PowerCo have; I just wonder whether you'd mind
14 repeating that element?

15 **MR BOULTON:** I don't have that data with me, we'll get back to
16 you and break it down in that sense. There are costs
17 associated with the roading corridor of course, and they're
18 becoming more complex and more costly over time. The
19 approach by councils and others in terms of access times,
20 frequency, reinstatement costs, it's just compounding and
21 seemingly never ending.

22 **MS BEGG:** So, if you were doing a replacement cost, you'd want
23 to put that in.

24 Another possible thought on the easements is, in the
25 past the Commission has valued land on an opportunity cost
26 basis, and I wondered if you're saying -- if, as you say,
27 easements are a part of land, which is fair enough, could
28 that same approach be applied to easements; an opportunity
29 cost type approach?

30 **MR SEED:** In so far as it's reflecting the market value of the
31 land that the easement's passing through, yes. Because --

1 **MS BEGG:** I suppose you could use the opportunity cost of the
2 easement being returned to the owner, or the opportunity
3 cost would be as Denese was asking, you know, someone else,
4 you selling the easement to someone else.

5 **MR SEED:** Well yes, the -- by its very nature an easement is
6 following along a particular pipeline, and a path that's
7 been chosen between two nodes. It is passing across land
8 that has an easily observed market value; for example, it's
9 dairy farmland or it's commercial industrial land or
10 something like that. So, I'm just wondering as to why you
11 would even need to go down that track?

12 **MS BEGG:** I guess you're saying that the value there is the
13 opportunity costs, because you're taking the value of the
14 land in the alternative use, which is where it's come from,
15 so you're automatically picking that up.

16 **MR SEED:** It's like, for example, saying what is the opportunity
17 cost of this office building.

18 **MS BEGG:** Is it true to say that the NGC, the transmission line
19 would have a lot more easements, the easements would be a
20 much more significant part of their operation than for you,
21 is that --

22 **MR BOULTON:** Just in terms of the sheer number of properties
23 that the pipeline goes across, in sheer numbers?

24 **MS BEGG:** When you reticulate around a city there's plenty of
25 road, you're going through the road reserve because that's
26 where the houses front, but with transmission, I presume
27 it's going from A to B?

28 **MR BOULTON:** Across private property.

29 **MS BEGG:** Across private property to a great extent; is that
30 true?

31 **MR BOULTON:** That's largely true, I think maybe NGC could answer

1 that question, they would know the property numbers.

2 **CHAIR:** I'd like to now ask Powerco if you have any comments or
3 submissions?

4 **MR BOULTON:** I don't think so, just one reference point earlier
5 where we talked about the percentage price reduction, I was
6 making reference to a larger customer base there rather than
7 the smaller residential consumer.

8 Perhaps Commissioner Bates and I were talking about two
9 different customer bases there, so I just wanted to clarify,
10 that was the larger customers who have to look at the
11 commerciality of that changeover, and keep in mind the
12 negotiations there often involve an option for them to
13 consider a reduced cost for a particular timeframe which,
14 from their perspective, gives them the payback period from
15 which the price can increase.

16 In most cases it doesn't end up like that because it
17 becomes too chunky from the budgeting perspective for the
18 prospective customer and for them to take information to the
19 board, so they'll say let's spread this out over 5 years or
20 7 years, even though they know that they have a stronger
21 capital policy approach, they might specify a 2 or 3 year
22 period. So the residential and the major customers are a
23 little bit different perhaps.

24 You may have been thinking about the residential
25 consumer; I was talking about the larger consumer, reference
26 to the earlier discussion about Tasmania; just to clarify
27 that one point following the break that I didn't -- my
28 fault, I didn't pick that up in your question perhaps.

29 **MS BATES QC:** Yes, I think you might not of, yeah. Just about
30 this easement, I know I'm still worrying it a bit, but when
31 you pay for them, when you've acquired -- you've had quite a

1 few acquisitions, on what basis did you pay for them?

2 **MR BOULTON:** Again, the approach -- sorry, in terms of --

3 **MS BATES QC:** When you paid for them, how were they valued when
4 you paid for them?

5 **MR BOULTON:** Again, I have to rely on my legal man; he tried to
6 explain that before, the approach that the --

7 **MS BATES QC:** I mean when you actually acquired the companies
8 that had them, were they separately valued?

9 **MR BOULTON:** No, we purchased assets and all of that other
10 related components to the assets were valued in one block.

11 **MS BATES QC:** Including the easements?

12 **MR BOULTON:** All of that was collectively assessed, yes, we
13 didn't have a separate individual value to attribute data
14 and information, or a contract, or an easement to that. In
15 most cases the only thing they sort of separated was the
16 physical properties, you know, blocks of land, substation
17 sites, is the general process that's followed through a
18 sale. So, it's the collective value of the asset. Sorry if
19 I misinterpreted your question again there at the start.

20 **MS BATES QC:** No, I don't think you did.

21 **CHAIR:** Any further comments that you'd like to make?

22 **MR BOULTON:** No, I think we've got some work to do to take on
23 some of the comments that we've picked up from the
24 Commission and some direct questions, so we'll --

25 **MS BATES QC:** It's easier to ask the questions than to know the
26 answers. We ask the questions so that we can get some
27 helpful information back, so I just want to make that point
28 if I seem to --

29 **MR BOULTON:** No, we don't mind, I'm just suggesting we'll now
30 follow that up and pour some resources into that and provide
31 feedback.

1 **MS BATES QC:** They're not easy questions a lot of them.

2 **MR BOULTON:** No, and I don't think anyone has an easy job here
3 either quite frankly, but anyway. So our apologies for
4 taking you over time, I hope there's no disincentive to us
5 in that sense. Thank you very much for your time and we
6 will provide you with the information requested.

7 **CHAIR:** I also now would like to thank you, Powerco, for its
8 submission, and in particular it's been beneficial to the
9 Commission to have access to both the CEO and Chairman. It
10 is important for us to get to hear people who have direct
11 industry experience, so we're grateful to you for that, and
12 also for being able to have access to your legal economic
13 and financial advisors, so thank you very much for your
14 submissions, and with that I will just remind people that at
15 8.30 in the morning we will start with PEANZ and until then
16 I will adjourn the meeting for the day.

17

18 **Hearing adjourned at 6.05 pm**

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Resuming Tuesday, 2 September 2003 at 8.30 am

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