

Figure 4: Average return on shareholders' funds 1996 and 1997.

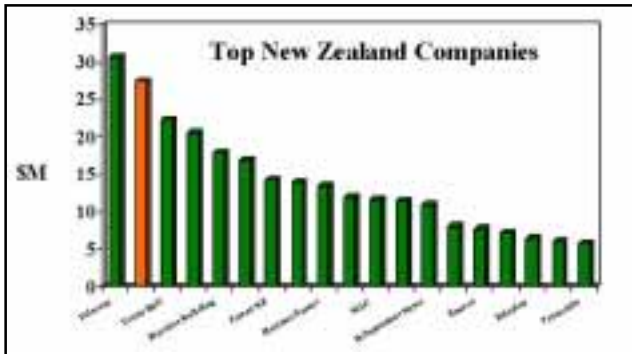


Figure 5: Average return on shareholders' funds 1996 and 1997.

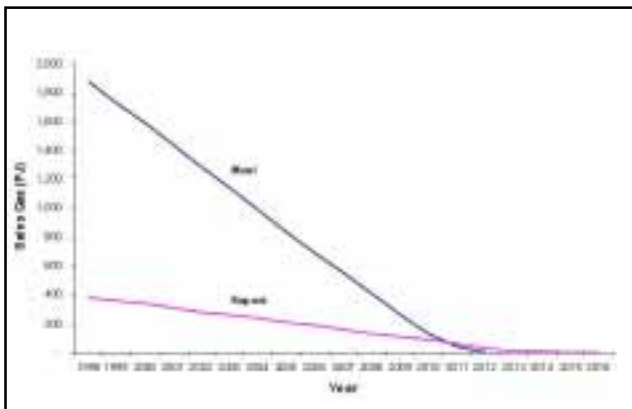


Figure 6: Forecast Maui and Kapuni reserve depletion (100%).

- Condensate 7.1 million barrels
- Oil 0.8 million barrels
- Oil (Maari undeveloped) 10 million barrels
- LPG 100,000 tonnes
- bbls of oil equivalent 60 million BOE
- Coal 50 million tonnes

The importance of gas and electricity to New Zealand competitiveness

- 77% of total exports are from energy intensive industries
- Two major energy inputs are gas and electricity. Gas at 230-250 PJ is nearly twice as large as electricity at 132

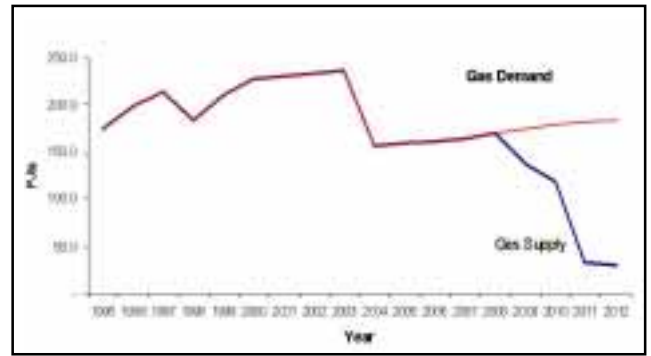


Figure 7: Forecast gas demand and supply in New Zealand - Methanex closes 2003.

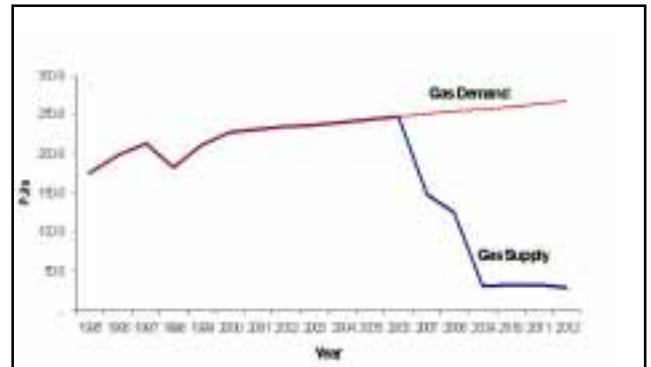


Figure 8: Forecast gas demand and supply in New Zealand - Methanex remains

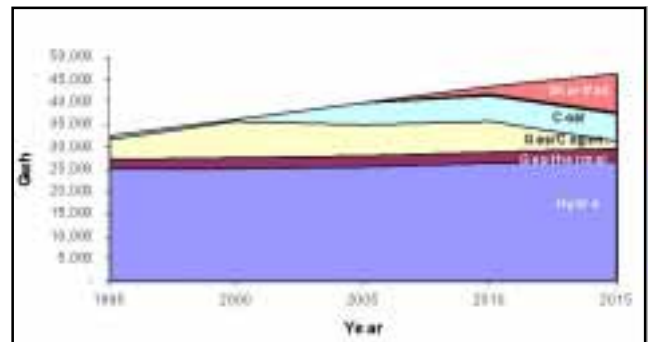


Figure 9: Electricity generation (1995-2015).

- PJ - even without Methanex gas at 150-170 PJ is still larger than electricity.
- Gas is a major source of thermal energy PLUS around one third of electricity is provided from gas.
- Inefficiencies in the gas market increase the retail cost of gas. This acts as a drag on the economy by soaking up capital which could be used for investment and expansion.
- Inefficiencies in the gas market are based around overcharging for distribution and transmission.
- Bundling of competitive and monopoly operations inhibited competition in electricity and was legislated against.
- Yet gas, which is similar to the electricity sector has not been subjected to the same restructuring to facilitate competition.

- Gas and electricity are linked - inefficiencies in the gas industry flow through to the electricity sector.

Successful elements of electricity reform

- Electricity Reform Act 1998 addressed two major issues:
 - separating lines and energy to create transparency; and
 - creating competition in the wholesale electricity market.
- Result
 - the split of lines and energy eliminated the scope for cross subsidy;
 - but, the current information disclosure regime does nothing to drive efficiency in monopoly lines; and
 - there is nothing to prevent ODV producing inflated asset values on which returns can be made.
- Example
 - Central Power and Orion are lines companies who have continued to grow their surpluses - the new

legislation has proved ineffective in requiring them to operate more efficiently or pass on efficiency savings to customers (see Figures 10 and 11).

Value transfer

Monopoly electricity network companies are generating increased revenues and increased surpluses post the 1998 reforms (see Figures 12 to 14).

Gas prices

The same thing has been happening with gas (see Figures 15 and 16).

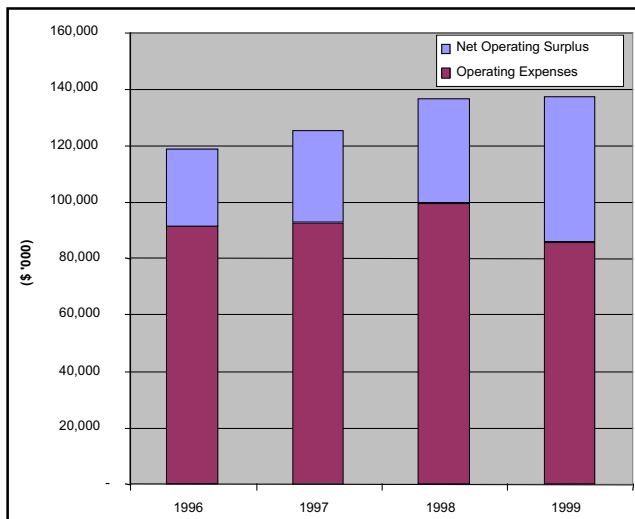


Figure 10: Orion - Expenses and surplus.

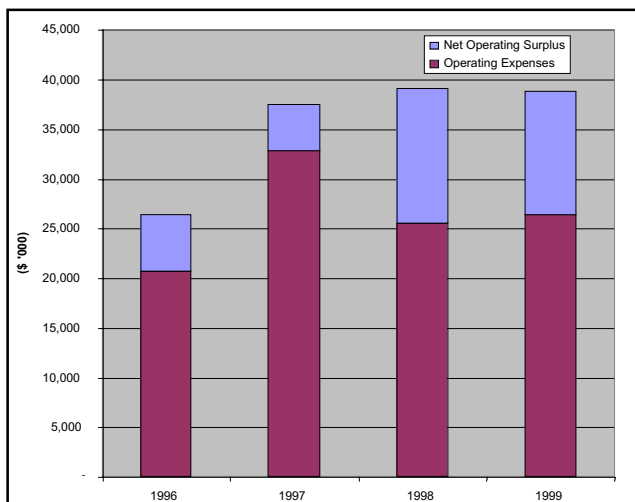


Figure 11: Central Power - Expenses and surplus.

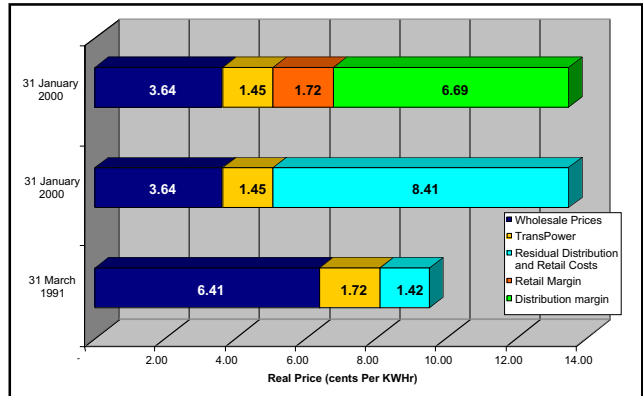


Figure 12: Real residential electricity prices (2000 base).

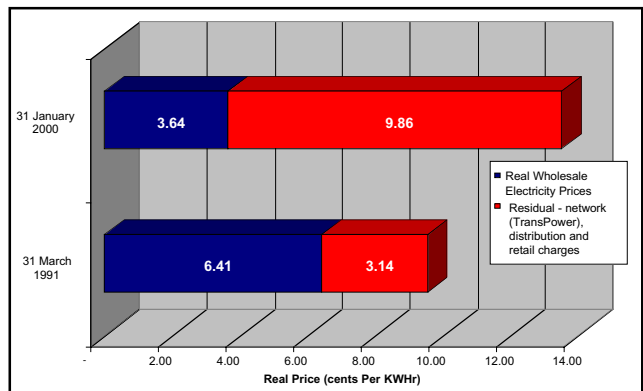


Figure 13: Real residential electricity prices (2000 base).

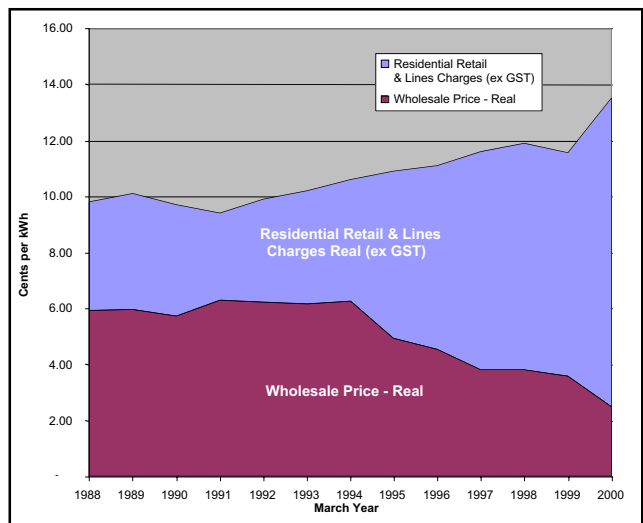


Figure 14: Real New Zealand electricity prices.

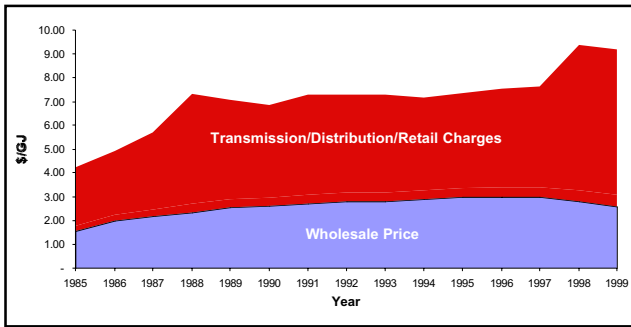


Figure 15: New Zealand industrial gas prices per GJ delivered (1985-1999) nominal \$. Source: Ministry of Commerce/NGC.

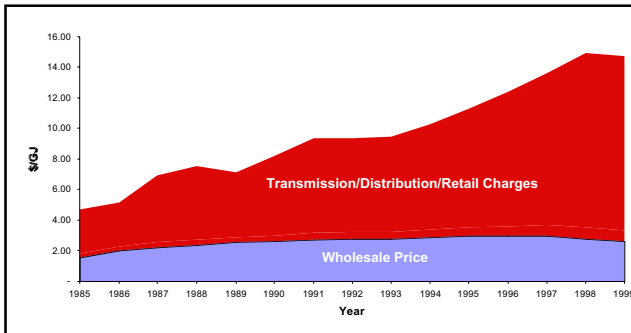


Figure 16: New Zealand residential gas prices per GJ delivered (1985-1999) nominal \$. Source: Ministry of Commerce/NGC.

- Wholesale price of gas have reduced;
- Yet delivered prices have risen;
- Cause - rapidly escalating pipeline charges.
- Lighted handed regime has allowed network companies to manipulate ODV and pricing methodology to justify repeated ODV increases, and in turn network price increases.
- Bypass is the sign of an inefficient regime - and it has been rampant in gas.
- There is no regional information disclosure on segments of transmission and distribution networks.
- There is open price discrimination on line charges to gain energy business.

Key obligations of the new proposals for the UK market

- non-discriminatory pricing and access to the distribution network;
- legal obligation to accept and distribute electricity;
- legal obligation to operate an enquiry and customer service function;
- an obligation to publish both network performance and customer satisfaction statistics; and
- a prohibition on activities which distort competition.

These obligations are substantially the same for gas suppliers who in most cases are also electricity suppliers.

The key lessons for a New Zealand regulatory regime are:

- Gas and electricity retail markets are likely to converge over time with the same operators retailing both fuels.
- Gas will increasingly determine the cost of electricity generation.
- To ensure that the structure of the gas and electricity sectors are similar with similar costs structures and similar levels of competition, the gas sector will have to be split along the same lines as electricity. To do otherwise will create permanent structural distortions in the economy.

A common regulatory model is both appropriate and efficient to apply to both electricity and gas. However a common model requires a similar structure in both industries. Regulating a split industry and a non-split industry are very different. A non-split industry requires a very detailed focus upon all the different businesses in which the monopoly is involved to control cross subsidies and price discrimination. In contrast regulating a split industry limits the regulatory focus to only the monopoly network segment.

The output of the Government inquiry is likely to be some form of more formal regulation of the electricity sector. Given the convergence of the gas and electricity markets and the similar cost and physical structure of the market participants it would be both appropriate and efficient to impose similar cross ownership restrictions and regulatory requirements to both sectors.

Elements of a desirable regulatory regime

- common regulatory regime for network energy (gas and electricity) delivery;
- prevent cross subsidy – transparency of costs;
- non-discriminatory access to all parties – at cost equal for all;
- drive efficiency in monopoly businesses – transmission and distribution;
- pass through efficiency to consumers;
- allow fair rate of return but not monopoly rent on new capital expenditure;
- change the current flexible system to one that prevents monopoly overpricing; and
- regulate monopoly asset pricing to allow consumer demand price signals to flow through to producers of the energy.