Access Arrangement for the South Australian Distribution System

RESPONSE TO ESCOSA ISSUES PAPER BY

ENVESTRA LIMITED

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1. INTRODUCTION

Issue 1

Are there any important issues arising from experience with the current Access Arrangement that are overlooked by the particular issues raised by the Commission throughout the remainder of this Issues Paper?

Envestra does not believe there are important issues arising from experience with the current Access Arrangement that should have been covered in the Paper.

Issue 2

Are there any features of Envestra's approved access arrangements in Victoria and Queensland (or in other access arrangements approved elsewhere) that should be considered for inclusion in Envestra's South Australian Access Arrangement?

Envestra notes that its South Australian Access Arrangement is already very similar to its Queensland Access Arrangement. Envestra does not believe there are material aspects of its Victorian Access Arrangement that require consideration at this stage. However, there may be some minor areas where standardisation may be beneficial, and Envestra will consider those when drafting its Access Arrangement.

Notwithstanding this, Envestra notes that it is not for ESCOSA to decide whether there are features of other access arrangements that should or should not be incorporated into Envestra's Access Arrangement. As stated correctly by ESCOSA[1], ESCOSA cannot require Envestra to include elements additional to those set out in sections 3.1 to 3.20 of the Access Code. Therefore, provided Envestra's Access Arrangement satisfies those elements, ESCOSA cannot reject the Access Arrangement on the basis that it believes the Access Arrangement should contain features of other access arrangements.

2. SERVICES POLICY

Issue 3

Are reference services as defined in the current Access Arrangement comprehensive of the sorts of services required by most network users and potential users? Is there scope to unbundle haulage services into their connection and use-of-system components, especially for demand customers? To what extent should reference services and service obligations be aligned with those applying in other jurisdictions?

Envestra believes the haulage reference services are already generally aligned with those in other jurisdictions, and that they meet the requirements of most users. As users have not requested Envestra

[1] Section 1.3.1 of the Issues Paper

to introduce other reference services, Envestra sees no need to specify additional reference services. Furthermore, as per the current Access Arrangement, Envestra intends to provide for negotiated services in addition to reference services. This will allow users to obtain a separate tariff for any service that is not currently a reference service.

In relation to ancillary reference services, Envestra intends to amend the disconnection and reconnection services so that they are aligned with those supplied by Envestra in Victoria. This is because the current 'disconnection in the street for non-payment' service and associated reconnection service are not commonly used, whereas the 'disconnection at the meter' and 'reconnection at the meter' services (as per Envestra's Victorian Access Arrangement) are commonly required by users.

Issue 4 *Should the Services Policy be approved only if it includes a specification by Envestra, additional to that set out in licences and other regulatory instruments, of the levels of service (e.g. reliability, quality) to be delivered as well of the broad nature (type) of services in question?*

Envestra believes it would be improper for it to set out a specification for the levels of service in the Services Policy, and notes that the Services Policy cannot be rejected on the basis it does not include a specification of service levels. The proper place for any specification of service levels is the terms and conditions of the Access Arrangement and not the Services Policy. The Services Policy is only required to contain a "description" of the Services. Envestra disagrees with ESCOSA that the word "description" can be interpreted to mean "service standards"[2]. The word "description" merely connotes describing the nature of the Service and does not extend to defining the performance standards which must be met in providing the Service. Clause 3.6 of the Access Code states:

> *"An Access Arrangement must include the terms and conditions on which the Service Provider will supply each Reference Service. The terms and conditions included must, in the Relevant Regulator's opinion, be reasonable."*

Terms and conditions are the proper place in which to address service standards as they (ie terms and conditions) outline the basis on which Services are provided. In relation to terms and conditions, ESCOSA's discretion is limited to determining whether they are reasonable.

3. REFERENCE TARIFFS: APPROVAL CRITERIA

Envestra Issue 1 *Limits on the role of the regulator.*

In section 3.2.3 of the Issues Paper, ESCOSA notes the GasNet judgment and the limitations it imposes upon the role of a Regulator and acknowledges the judgment of the Australian Competition Tribunal that: "*The regulator cannot make a decision based on what it thinks is best*."

ESCOSA then discusses the "propose- accept/reject" model of the Code in the context of section 8.1 of the Access Code, which states:

[2] section 2.3.2 of the Issues Paper

> "*To the extent that any of these objectives conflict in their application to a particular Reference Tariff determination, the Relevant Regulator may determine the manner in which they can best be reconciled or which of them should prevail.*"

On the basis of this section, ESCOSA states:

> "*Hence, where there are conflicts or tensions between any of the section 8.1 criteria in their application to a particular Reference Tariff determination, the regulator may approve an alternate access arrangement over the access arrangement proposed by the service provider on the grounds that the regulator believes the alternate would better achieve the regulator's understanding of the statutory objectives of the law than the access arrangement proposed by the service provider*."

Envestra believes this approach would be incorrect. In Envestra's opinion, the intent of section 8.1 is that if, in the process of assessing the Access Arrangement actually lodged, it becomes apparent that the different factors of section 8.1 lead to a different result, it is ESCOSA's role to reconcile how to give effect to these different factors. Once having reconciled the different tensions between the factors, ESCOSA is to assess the Access Arrangement lodged against the manner in which ESCOSA has reconciled the factors in section 8.1. This process may or may not lead to ESCOSA requiring modifications to the Access Arrangement submitted by Envestra.

Section 8.1 does not, as ESCOSA appears to believe, provide a basis upon which ESCOSA can substitute its own Access Arrangement for that of Envestra's because ESCOSA thinks that its arrangement better meets the manner in which ESCOSA has reconciled the competing objectives of section 8.1. The decision for ESCOSA is whether the Access Arrangement submitted by Envestra meets the competing objectives (as reconciled by ESCOSA). If it does, the Access Arrangement is to be approved. If it does not, that may provide a basis for ESCOSA to require modifications to the Access Arrangement.

We also note that, in addition to reconciling the factors within section 8.1, ESCOSA may also need to reconcile competing objectives in section 8.1 and section 2.24 of the Code. The principles described above apply equally in that respect.

Issue 7

If tariffs – or tariff-determining parameters – proposed by Envestra fall within a range of plausible values, should the Commission give consideration to not approving those tariffs (or parameters) if it believes that the underlying estimate or parameter values expose either the service provider or network users to an asymmetric risk? Are there any circumstances where the midpoint of the plausible range may not necessarily contribute to the avoidance of asymmetric risk?

Choosing the midpoint of a plausible range may not necessarily contribute to the avoidance of asymmetric risk. There will always be an element of uncertainty in determining the mid-point of a range (as well as the high and low values of a range). The fact that there is imprecision and subjectivity was highlighted by the Productivity Commission[3] which also emphasised the need to promote investment:

[3] Finding 7.5, Review of the Gas Access Regime, Productivity Commission 2004

> " *The greatest concern for this inquiry is that the Gas Access Regime's form of cost-based price regulation leads to inefficient investment because of:*
> - *regulatory error — mistakes are made in applying regulation*
> - *regulatory risk — uncertainty about how regulation is applied increases the riskiness of investment* "[4]

In essence, regulators should not attempt to prescribe a level of accuracy that does not exist and recognise that the main cause of asymmetry is regulatory error, which will have extremely serious consequences when it causes underinvestment. Under-compensating service providers is likely to be more costly for the community than over-compensation - under-compensation can lead to non-provision of services. In contrast, over-compensation reduces, but does not eliminate, use of those services. This was recognized by the Productivity Commission in its Review of the National Access Regime:

> "• *Over-compensation may sometimes result in inefficiencies in the timing of new investment in essential infrastructure (with flow-ons to investment in related markets), and occasionally lead to inefficient investment to by-pass parts of a network. However, it will never preclude socially worthwhile investments from proceeding.*
> • *On the other hand, if the truncation of balancing upside profits is expected to be substantial, major investments of considerable benefit to the community could be forgone, again with flow-on effects for investment in related markets. In the Commission's view, the latter is likely to be a worse outcome. Accordingly, it concurs with the argument that access regulators should be circumspect in their attempts to remove monopoly rents perceived to attach to successful infrastructure projects."*[5]

4. REFERENCE TARIFFS: TOTAL REVENUE

Issue 8

To what extent should capital expenditure not forecast or approved as part of the first Access Arrangement be rolled into the capital base at the commencement of the second Access Arrangement Period? How should the Commission go about assessing the (section 8.16(a)(i)) prudency of any variations between actual and forecast/approved capital expenditure?

Clause 3.3.3.2 of the Access Arrangement provides:

> "*The Capital Base at the commencement of the next Access Arrangement Period will be adjusted to account for any differences between actual and forecast New Facilities Investment in accordance with section 8.22 of the Code*."

Section 8.22 of the Code provides:

> "*For the purposes of calculating the Capital Base at the commencement of the subsequent Access Arrangement Period, either the Reference Tariff Policy should describe or the Relevant Regulator shall determine when the Relevant Regulator considers revisions to an Access Arrangement submitted by a Service Provider, how the New Facilities Investment is to be determined for the purposes of section 8.9*."

[4] p102, ibid
[5] p83, Review of the National Access Regime, Productivity Commission, 2001

In the case of Envestra's Access Arrangement, the Reference Tariff Policy provides that the Capital Base is to be adjusted to account for differences between actual and forecast New Facilities Investment. Under section 8.22, ESCOSA must give effect to this Reference Tariff Policy.

In any event, Envestra believes that all capital expenditure actually incurred during the first Access Arrangement is prudent and should be rolled into the capital base at the commencement of the second Access Arrangement Period. Whether or not the capital expenditure was forecast or approved in respect of the first Access Arrangement should not be relevant. This is because actual expenditure will always differ from forecast (especially over a five-year period) and because sufficient incentives exist (both under the regulatory regime and under normal commercial operating guidelines for a business) for a regulated business to undertake expenditure in an economically efficient and prudent manner. This has been recognized by the Essential Services Commission of Victoria:

> *"Regarding capital expenditure, the Commission noted that it remained of the view that the most effective means of ensuring that the distributors' capital expenditure meets the requirements of the Gas Code is to provide the distributors with the commercial incentives to achieve this outcome, which existed over the first regulatory period. Accordingly, the Commission concluded that it was appropriate for the distributors to include in their regulatory asset bases their actual capital expenditure*"[6].

It is also noted that the ACCC endorsed the inclusion of actual capital expenditure in the regulatory asset base in its Statement of Principles for the Regulation of Transmission Revenues.

Issue 9

How should assets which may have ceased to contribute in any way to the delivery of network services be identified?

Detailed consideration was given to the issue of redundant assets during the latest review of Envestra's access arrangement in Victoria. It was concluded by the ESCV that "there are likely to be substantial benefits to both customers and distributors from a policy of minimising the risk to distributors associated with recovering the regulatory value of their assets" (p153 Final Decision) and consequently the ESCV undertook not to identify or remove redundant assets.

Envestra supports this approach, especially since the value of any redundant assets in a distribution network is likely to be immaterial. In practice the administrative cost of identifying and valuing each such asset is likely to outweigh the benefits.

It is also noted that the above approach has been supported by the Western Australian Regulator in the recent Draft Decision for Alinta Gas Networks[7].

[6] p133, ESC Final Decision for the Review of Gas Access Arrangements (2002)

[7] paragraph 235, p48, Draft Decision on the Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution Systems, Economic Regulation Authority, 28 February 2005

Issue 10

Should the real versus nominal choice for measuring the WACC (and the pre-tax versus post-tax choice) be left to Envestra to decide?

The Code operates under a propose-accept/reject model, where the Service Provider proposes a method/approach and the Regulator assesses the proposal against the relevant provisions of the Code. The Regulator then either accepts the Service Provider's proposal if it is compliant with the Code, or, if not compliant, requires modifications to the proposal to ensure compliance. It is not within the Regulator's discretion to impose their own view (eg a real or nominal approach) upon a Service Provider.

Issue 11

Should the method used to calculate the WACC – and the parameters used in applying the CAPM approach – be proposed in the first instance by Envestra? If there is no single correct method to determine the WACC, how might the range of plausible estimates consistent with the section 8.1 criteria be determined? Should the Commission detail in advance its analytical framework for assessing the reasonableness of estimates proposed by Envestra?

Issue 11 comprises three issues:

(1) Should the WACC used in the Access Arrangement be proposed by Envestra?
(2) How should Envestra and ESCOSA accommodate for the inherent uncertainty when proposing/assessing the reasonableness of the WACC?
(3) ESCOSA asks the question about whether it should detail its framework for assessing the WACC.

A response to each of the issues is provided below.

(1) Should the WACC used in the Access Arrangement be proposed by Envestra?

The Code operates under a propose-accept/reject model, where the Service Provider proposes a method/approach and the Regulator assesses the proposal against the relevant provisions of the Code. The Regulator then either accepts the Service Provider's proposal if it is compliant with the Code, or rejects it if non-compliant. It is not within the Regulator's discretion to impose their own view. This principle was established in the GasNet Appeal Judgment by the Australian Competition Tribunal on 23 December 2003.

(2) How should Envestra and ESCOSA accommodate inherent uncertainty when proposing/assessing the reasonableness of the WACC?

The requirement of sections 8.30 and 8.31 of the Code is for a forward looking WACC (or rate of return on capital) that is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the Reference Services, not simply the mechanical application of the theoretically pure CAPM. There are three main sources of uncertainty in the WACC:

(a) As the WACC is a forward looking estimate of the required rate of return on capital there is uncertainty about future outcomes;
(b) Uncertainty due to unobservability - point estimates for some of the WACC parameters, like debt margin, equity beta and market risk premium, are unobservable;

(c) Regulatory risk - the CAPM framework does not compensate investors for the asymmetric regulatory risk inherent in the regulatory framework that creates a bias towards consumers.

There are well established and rigorous statistical techniques, such as Monte Carlo simulation, that are used in business to accommodate and quantify such uncertainties. An example is the insurance industry where its required rate of return on capital (via premium income) is calculated with respect to probabilities attached to future states of the environment. These analyses are endorsed by industry regulators (eg. APRA) as they remove the subjectivity and arbitrariness from the process that otherwise has the potential to bias the outcomes. Such analyses can be applied under the Code to accommodate the uncertainties associated with the WACC.

(3) Should the Commission detail its framework for assessing the WACC?

The WACC is the key determinant of investment in gas distribution infrastructure. Infrastructure investment has flow on effects to economic development, employment and business confidence, as demonstrated by recent publicity concerning “infrastructure bottlenecks”. Hence, it is imperative that the outturn WACC reflects the realities of the capital market and is set at a level that allows the business to attract and retain capital to develop infrastructure and facilitate economic development in the State. It would be beneficial for ESCOSA to publish the methodology and analytical framework it intends to use to assess the WACC for compliance with the relevant sections of the Code. In doing so, it is important that ESCOSA recognise the potential for asymmetric risk, and the possible sources of such risk. As pointed out by the Productivity Commission, failure to take into account these risks may lead to regulatory error (regulatory risk) that impedes investment.

The accepted method for determining a Service Provider’s rate of return (WACC) under the Code is to apply the Capital Asset Pricing Model. The standard version of the CAPM, as applied by Regulators, relates the expected return on a stock ($E(R_i)$) to the expected market return ($E(MRP_m)$), a risk-free rate (R_f) and the stock’s beta (β_i). The CAPM is usually presented as follows:

$$E(R_i) = R_f + \beta_i [E(MRP_m)]$$

The CAPM represents a forward-looking model of security pricing (expected return) under conditions of symmetry in outcomes (being based on mean-variance analysis of market portfolios). It thus suggests an expected, but not guaranteed, return appropriate to the level of systematic risk taken on by the well-diversified investor. Alternatively, the cost of capital is the expected rate of return in capital markets on alternative investments of equivalent risk. Thus the level of risk is intimately related to investors’ required rate of return, however not all risks matter equally to investors. The use of CAPM in determining the appropriate return on capital presupposes two important ideas:

i) All risks that are relevant to the investor are incorporated into the market’s estimate of required return; and

ii) Risks are symmetric in their impact (or that asymmetries will cancel out over a large portfolio).

To the extent that risks from economic regulation (i.e. regulatory risks) are not customary in the overall equities market, it may be argued that regulatory risks will not be incorporated into the market’s estimate of the required return. Regulatory risk would thus be a form of non-diversifiable risk that would need to be compensated for in addition to market-determined returns on an asset.

Regulatory risk contributes to asymmetric risk in the following forms:

- Disallowance of capital expenditure to be incorporated into the regulatory asset base;
- Disallowance of certain costs incurred in the operation of the business; or

- An absence of symmetry in the distribution of expected revenues, due to the imposition of price ceilings on the outputs of the regulated firm.

Each of these examples is asymmetric in that the regulated firm only faces a downside risk from the application of regulation (i.e. its returns will be reduced).

Regulatory Risk and its Impact on Returns

To appreciate the impact of asymmetric regulatory risk on the expected return to equity, one begins with the premise that investors in the regulated firm assume that the return on capital expenditures is initially set to be in line with the CAPM determined required return ($E(R_j)^{CAPM}$).

In the absence of any disallowance of capital expenditure incurred by the firm, investors would expect to receive the regulated return $E(R_j)^{regulation}$ equal to $E(R_j)^{CAPM}$ in the future. However, if there is a non-zero probability that any component of capital is disallowed in the regulatory capital base, and under the assumption that funds invested are recovered, the expected return to equity investors become as follows:

$$E(r_i)^{regualtion} = \left(\frac{K^{REG}}{K^{INVESTED}}\right) \times E(r_i)^{CAPM} + \left(\frac{K^{DIS}}{K^{INVESTED}}\right) \times 0\%$$

Conversely, where there is no recovery of funds invested, the return on investment will equate to:

$$E(r_i)^{regualtion} = \left(\frac{K^{REG}}{K^{INVESTED}}\right) \times E(r_i)^{CAPM} + \left(\frac{K^{DIS}}{K^{INVESTED}}\right) \times -100\%$$

Partial recovery of funds invested would see an expected return between these two extremes. Here K^{DIS} represents disallowed investment, $K^{INVESTED}$ the total funds invested and K^{REG} the regulatory capital base. In each case the disallowance of capital invested by the firm reduces the return on equity below the rate implied by the CAPM ($E(R_j)^{regulation} < E(R_j)^{CAPM}$). On any new investment, the risk of disallowance is asymmetric and an assessment of the size of K^{DIS} will be made according to the likely probability of disallowance of the planned capital expenditure.

Moreover, if Non-Capital Costs that satisfy the prudency test in section 8.37 of the Access Code are not allowed to be passed through into Reference Tariffs, then CAPM ($E(R_j)^{regulation}$ will be less than $E(R_j)^{CAPM}$. As contractors, employees, debt providers, etc, all receive their payments before equity holders, any adverse (net) Non-Capital Cost outcomes are borne entirely by equity holders, thus reducing their returns below the Regulator-determined returns.

Regulatory risk is a special class of asymmetric risk that must be recognised when setting the cost of capital. The presence of regulatory risk thus requires the setting of a target return under regulation that is higher than the required return implied by CAPM to compensate investors for the risk of losses due to the regulatory framework. Inadequate regulatory rates of return will produce sub-optimal investment outcomes whereby regulated businesses will only invest when there is no material downside risk, this being to the long-term detriment of consumers, business confidence and economic development.

Issue 12

Should the Commission provide guidance on the circumstances in which alternatives to straight-line depreciation may satisfy the requirements of the Code?

It would be beneficial if ESCOSA were to publish in advance what alternatives to straight-line depreciation it believes may satisfy the requirements of the Code.

Issue 13

Should the Commission provide guidance on the extent to which Envestra's marketing costs will be allowed for the purpose of calculating Total Revenue?

It would be beneficial if ESCOSA were to publish in advance what ESCOSA defines as 'marketing costs' and how it considers it is entitled to assess Envestra's proposed "marketing" costs against the relevant provisions of the Code.

Issue 14

Should the Commission provide guidance as to the basis upon which it will assess the prudency and reasonableness of (forward-looking) non-capital costs? To what extent should such an assessment rely upon the benchmarking of Envestra's unit costs in the SA gas distribution system relative to unit costs observed in other systems?

It would be useful if ESCOSA were to publish in advance how it considers it is entitled to assess Envestra's proposed non-capital costs against the relevant provisions of the Code.

Issue 15

To what extent should the Commission provide guidance as to the desired features of a regulatory framework for assessing New Facilities Investment that provides clear incentives for economic efficiency and reduces regulatory uncertainty?

It would be beneficial if ESCOSA were to publish in advance how it considers it is entitled to assess Envestra's proposed New Facilities Investment against the relevant provisions of the Code.

Issue 16

Should the Commission give advance consideration as to what additional assessments and consultation may be necessary to assess the prudency and reasonableness of the FRC capital expenditure actually incurred by Envestra to 1 July 2006 and forecast to be incurred from 1 July 2006?

In relation to whether additional consideration should be given to the assessment of Envestra's FRC costs up to 1 July 2006, it is noted that Envestra's FRC costs were subjected to an extensive assessment that culminated in the "Price Determination – Envestra Limited FRC Maximum Prices" in June 2004. The process used for the recovery of FRC costs up to 1 July 2006 is outside of the Access Arrangement process. Therefore the issue of FRC costs up to 1 July 2006 is not pertinent to the Access Arrangement review process.

In relation to the assessment of Envestra's FRC costs from 1 July 2006, it is noted that the Code makes no distinction between FRC and other expenditure. That is, FRC expenditure must meet the requirements of the Code like any other expenditure and ESCOSA is not able to discriminate Non-Capital Costs on the grounds that it is or is not FRC-related.

Issue 17

In the absence of any relevant Ministerial notice or direction, should the Commission provide guidance as to how the benefit of the ex-gratia FRC payment that is not required by Envestra in the first two years of FRC is to be allocated to consumers in future years?

The South Australian Government provided an ex-gratia payment in lieu of a tariff increase to cover the cost of implementing FRC in South Australia. If a tariff increase had been granted, the Commission would not be assessing whether or not the revenue obtained from the tariff increase was sufficient to meet the FRC costs. That is a risk that is borne by Envestra. Similarly it is not appropriate for the Commission to review how the ex-gratia payment was used by Envestra in the first two years of FRC.

In relation to that part of the ex-gratia payment that relates to the third, fourth and fifth year following the implementation of FRC, Envestra believes no guidance from ESCOSA is necessary. Envestra will be developing its non-capital forecasts on a prudent basis, as if no ex-gratia payment existed, and then account for the ex-gratia payment on a transparent basis. Envestra believes it is in the best position to determine how it should structure its non-capital cost forecast. Under the Access Code, it is for Envestra to develop its non-capital cost forecasts.

5. REFERENCE TARIFFS: PRICE STRUCTURE ISSUES

Issue 18

Are there aspects of Envestra's existing tariff structure that warrant – or do relevant features of likely changes to the Code's pricing principle warrant – the Commission clarifying its intended approach to assessing Envestra's Reference Tariff and Reference Tariff Policy for compliance with the Code's requirements for allocating costs between difference reference services and between (classes of) users of a reference service?

It would be beneficial if ESCOSA were to publish in advance how it considers it is entitled to assess Envestra's proposed Reference Tariffs and Reference Tariff Policy against the relevant provisions of the Code.

Issue 19

Should the Commission encourage Envestra to base its proposed price path on the weighted average of reference tariffs, and so rely on such an approach to provide the incentives necessary for Envestra to adopt efficient price structures?

The Code operates under a propose-accept/reject model, where the Service Provider proposes a method/approach and the Regulator assesses the proposal against the relevant provisions of the Code. The Regulator then either accepts the Service Provider's proposal if it is compliant with the Code, or , if not compliant, requires modifications to the proposal to ensure compliance.

6. REFERENCE TARIFFS: ANNUAL VARIATION METHOD

Issue 21

Should the Commission provide guidance as to the requirements to be met by any off-ramps proposed by Envestra to ensure that trigger event adjustments are symmetrical in nature?

It would be beneficial if ESCOSA were to publish in advance how it considers it is entitled to assess whether any trigger events proposed by Envestra complied with the relevant provisions of the Code.

7. REFERENCE TARIFFS: INCENTIVE MECHANISM

> *Issue 22*
>
> *Should the Commission consider giving some broad guidance as to how it intends to go about assessing whether forecasts made by Envestra of unit sales and input prices, either for the current Access Arrangement or for the next Access Arrangement, are best estimates arrived at on a reasonable basis? Or should such matters be addressed only if it is apparent that any actual decreases in input prices during the first Access Arrangement Period relative to levels forecast by Envestra seem 'significant' or any under-estimations of sales during the first Access Arrangement Period relative to levels forecast seem 'excessive'. If so, should the Commission provide some advance indication as to how it intends to assess the 'significant' and 'excessive' characteristics?*

It is not open to ESCOSA to assess whether the forecasts approved by SAIPAR were, in effect, incorrect. The forecasts were approved by SAIPAR, ie they were deemed to be reasonable and best estimates at the time the Access Arrangement was approved. It is not permissible to revisit forecasts in hindsight except as expressly provided in section 3.3.7 of the Access Arrangement. Such an approach is inconsistent with the Code and would effectively allow the Regulator to assess forecasts twice, once when they are submitted and then again at the next review (with the benefit of hindsight).

To undertake a general revision of previously approved forecasts is not compatible with the Code or with effective incentive regulation.

Section 8.44 of the Code provides:

> "*The Reference Tariff Policy should, wherever the Relevant Regulator considers appropriate, contain a mechanism that permits the Service Provider to retain all, or a share of, any returns to the Service Provider from the sale of a Reference Service during an Access Arrangement Period that exceeds the level of returns expected at the beginning of the Access Arrangement Period (an* ***Incentive Mechanism****), particularly where the additional returns are attributable (at least in part) to the efforts of the Service Provider. Such additional returns may result, amongst other things, from lower Non Capital Costs or greater sales of Services than forecast*."

Section 8.44 refers expressly to the level of returns expected at the beginning of the Access Arrangement – that is, the incentive mechanism is to be based on the level of returns expected at the beginning of the Access Arrangement and not on any subsequent revision of those expected returns.

It is noted that the gas demand forecast which SAIPAR required to be increased in the final decision was not achieved and that in fact actual gas demand has been significantly below that determined by SAIPAR. This regulatory error has resulted in a correspondingly significant loss of revenue for Envestra.

> *Issue 23*
>
> *To what extent should benefit sharing be based on realised rather than forecast levels of return and efficiencies?*

Section 3.3.7 of Envestra's Access Arrangement provides that the full value of any efficiency gains will be retained by Envestra, and that this principle will apply for the first and second Access Arrangement periods. In relation to determining the quantum of the efficiency gain, Envestra believes that a "year on year" comparison should be made to determine actual realised efficiency gains, rather than assuming a level of efficiency in the forecasts and then only rewarding the Service Provider if additional efficiencies are achieved.

Incorporating an assumed level of efficiency in the forecasts is prone to regulatory error and asymmetric risk. There is no risk to users as they receive the benefits of an assumed efficiency gain, regardless of whether it is achieved, but there is a risk to the Service Provider in that the efficiency gain may not be achieved.

Issue 24

Does the Commission need to provide guidance regarding its views on the relative incentive merits of alternative gain-sharing ratios and periods?

It would be beneficial if ESCOSA were to provide the above guidance.

Issue 25

Is it appropriate for the Commission to provide guidance regarding the sharing of downside as well as upside returns?

Section 8.44 of the Code states:

> *"The Reference Tariff Policy should, wherever the Relevant Regulator considers appropriate, contain a mechanism that permits the Service Provider to retain all, or a share of, any returns to the Service Provider from the sale of a Reference Service during an Access Arrangement that <u>exceeds</u> the level of returns expected at the beginning of the Access Arrangement." [underlining added]*

Given that section 8.44 only refers to sharing of upside return, it is clear that the Access Code does not allow sharing of downside returns.

8. REFERENCE TARIFFS: INFORMATION DISCLOSURE

Issue 26

Should the Commission state clearly its information requirements prior to Envestra finalising its proposed Access Arrangement Revisions? To what extent may these requirements need to differ from the Access Arrangement Information documentation approved by SAIPAR?

Envestra will be providing Access Arrangement Information that enables users to understand the derivation of elements in the proposed Access Arrangement revision, in accordance with section 2.6 of the Code. Envestra therefore sees no need for ESCOSA to publish information requirements in anticipation of Envestra's submission.

9. TERMS AND CONDITIONS

Issue 27

Should the Commission provide guidance as to its general tests for the reasonableness of terms and conditions? In particular, does Envestra's current Credit Policy meet the Code's reasonableness requirement? Is this a matter on which the Commission should provide further guidance?

It would be beneficial if ESCOSA were to publish in advance how it considers it is entitled to assess the reasonableness of terms and conditions against the relevant provisions of the Code.

Envestra notes the following comment made by ESCOSA (p62 of the Issues Paper):

> *"The Commission's own legislative framework is different to that which faced SAIPAR, and with it comes different perspectives and approaches."*

This statement appears to be referring to the fact that ESCOSA is separately constituted under the *Essential Services Commission of South Australia Act 2002* ("ESC Act"). However the statement ignores the fact that section 6 of the ESC Act does not apply to ESCOSA when acting as local Regulator under the Access Code. Nor do the provisions of Part 3 of the ESC Act (dealing with pricing determinations) apply, as those provisions apply only where ESCOSA is making a determination under a "relevant industry regulation act" and the Access Code is not such an Act.

Given these factors, the legislative framework regulating ESCOSA in relation to the Access Code is the same as that applying to SAIPAR.

10. CAPACITY MANAGEMENT AND TRADING POLICIES

Issue 28

Should the Commission give consideration to approving use-it-or-lose-it rules for contracted capacity? For the SA gas distribution system, might the benefits of introducing use-it-or-lose-it rules be outweighed by the costs?

Envestra does not believe this issue to be relevant to distribution networks, since unlike transmission pipelines, retailers do not have contracted capacity. Envestra contracts with retailers to deliver gas to their customers, and that capacity stays with the customer when or if it transfers to a different retailer.

11. QUEUING POLICY

Issue 29

Does the currently-approved Queuing Policy require any reconsideration by the Commission, particularly in view of experience with that policy during the first Access Arrangement Period?

The Queuing Policy in Envestra's Access Arrangement has not been used. This is because, unlike transmission pipelines, capacity in a network is not allocated to specific retailers.

Following wide discussion through the Code change committee (NGPAC), all jurisdictions agreed to remove this requirement in relation to networks, and the Code was subsequently amended in February 2003.

Envestra seeks ESCOSA's confirmation that, in accordance with section 3.12 of the Code, a Queuing Policy is not required for the network.

12. EXTENSTIONS/EXPANSIONS POLICY

Issue 30

Should any distinction be made between the coverage of 'extensions' versus 'expansions' to the network? Should an access arrangement be approved if it involves the coverage of an 'extension' being at Envestra's discretion?

Expansion of a pipeline is commonly understood to refer to increasing the flow capacity of the relevant section of pipeline, whereas an extension is understood to relate to a physical increase in the length of pipeline.

The concept of separating that part of a pipeline that is "expanded" from that part which is not "expanded" presents difficulties, which the Productivity Commission discussed in its review of the gas access regime[8]. In relation to coverage, Envestra acknowledges the recommendation of the Productivity Commission that "section 3.16 of the Code should be amended so that it unambiguously clarifies that any expansion of a covered pipeline will also be covered"[9]. Envestra intends to reflect this recommendation in its Access Arrangement.

ESCOSA asks whether an access arrangement should be approved if it involves the coverage of an extension being at Envestra's discretion. While noting that no issues have arisen from the application of Envestra's current extensions policy, it should be noted that ESCOSA cannot reject an access arrangement on the grounds that coverage of an extension is at Envestra's discretion. ESCOSA can only reject an extensions policy if it does not meet the requirements of the Code, and the Code allows a Service Provider to elect how it will treat extensions to the covered pipeline.

[8] section 7.8, Review of the Gas Access Regime, Productivity Commission Inquiry Report, June 2004
[9] ibid, recommendation 7.15, p328

Issue 31

To what extent does the Commission need to give consideration to ensuring that customers receive gas distribution services where such customers are prepared to meet the net incremental costs of receiving those services?

Envestra has always pursued opportunities for customers to connect to the network and is not aware of any instances where a customer has not been connected where they were prepared to meet any shortfall resulting from application of the economic feasibility test.

13. DURATION OF ACCESS ARRANGEMENT

Issue 32

Should the Commission give advance consideration to the extended (longer-than-five-years) access arrangement period? What weight should be given to leaving maximum discretion to ESCOSA's successor (the AER)?

As Envestra intends to have an Access Arrangement period of five years, there is no need for ESCOSA to give consideration to approval of a longer term.

In relation to the AER, this should have little bearing on the decision to be made by ESCOSA, since ESCOSA must apply the Code in a manner that does not discriminate between which Regulator carries out the next review of the Access Arrangement.

Issue 33

Should the Commission provide guidance regarding the requirements to be met by any proposals made by Envestra for Fixed Principles?

It may be beneficial if ESCOSA were to publish in advance how ESCOSA considers it is entitled to assess whether any proposed fixed principles meet the requirements of the Code.