RESPONSE TO ESCOSA DRAFT DECISION
Envestra Access Arrangement

PART A

5 May 2006

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INTRODUCTION

Envestra's response to the Draft Decision is set out in two parts:

- **PART A** - addresses the Commission's amendments, or the Commission's comments in the Draft Decision that has led it to recommend amendments in the Draft Decision. (Each of the Commission's amendments/comments are set out in 'box' format, followed by Envestra's response); and
- **PART B** - contains detailed responses to what Envestra considers to be material amendments.

In addition to Parts A and B comprising this submission, Envestra relies on and incorporates into this submission all previous submissions, reports, documents and information provided by Envestra to the Commission in respect of the proposed revisions to the Access Arrangement. These documents have been provided to the Commission over the period commencing 30 September 2005.

Envestra has not commented on amendments relating to the Access Arrangement Information. Envestra accepts that the Access Arrangement Information will need to be updated to reflect the final form of the Access Arrangement. That final form is still being determined as part of the current regulatory process.

Where Envestra does not agree with an amendment in respect of the Access Arrangement, then Envestra also does not agree that it is required to make the corresponding amendment to the Access Arrangement Information set out in the Draft Decision (for example, as Amendment 51 is not accepted, Amendments 52 and 53 are also not accepted).

Envestra rejects the proposition that it is not entitled to include in the Access Arrangement Information, information outlining the interpretation of the Code, summarising the judicial decisions relating to that interpretation or otherwise explaining why the Access Arrangement complies with these principles. Under section 2.6 of the Code, Access Arrangement Information must enable Users and Prospective Users to form an opinion as to the compliance of the Access Arrangement with the provisions of the Code. Under section 2.7 of the Code, Access Arrangement Information may include any relevant information. Information relating to the construction of the Code is clearly relevant to an assessment of the Access Arrangement's compliance with the Code. Envestra therefore does not accept the following amendments proposed by the Commission – Amendments 6, 37, 48, 50, 61, 67, 78, 81 and 90.

1. SERVICES POLICY

Amendment 1

Reference to gas odorisation in Services Policy clause 2.2.4 must be amended to read:

> *"the odorisation of Gas, excepting for Gas from the SEA Gas pipeline which is already odorised".*

Envestra essentially accepts the above recommendation, but notes that is obliged under part 11 of the South Australian Gas Regulations 1997 to ensure that gas is odorized. Envestra cannot therefore, by law, abrogate its responsibility, irrespective of whether gas is odorized by others. If odorisation of gas in the SEAGas pipeline ceased, or if gas was delivered from that pipeline which was not odorised to the standard required by law, Envestra would be obliged to odorize the gas. Envestra will therefore clarify that it will odorise gas where it is not already odorized.

Amendment 2

Services Policy clause 2.5 must be deleted and the following words must be added to clause 2.2.4:

> *"For the avoidance of doubt, Unaccounted for Gas is supplied by Envestra and the cost is incorporated in the Network operating costs, unless an alternative arrangement is provided for which reduces or removes this obligation (and causes it to be assumed by others) and that is allowed by the Relevant Regulator."*

Envestra accepts the above recommendation.

Amendment 3

The words "*less UAFG*" must be removed from the end of the first paragraph of Services Policy clause 2.6 Gas Balancing.

Envestra accepts the above recommendation.

Amendment 4

The second paragraph of Services Policy clause 2.6 Gas Balancing must be deleted and replaced with the following:

> *"The terms and conditions referred to in clause 6 state that gas balancing is regulated through the Retail Market Rules".*

Envestra accepts the above recommendation.

Amendment 7

The following must be deleted from proposed clause 2.4:

> *"and in accordance with any Distribution Licence"*

and replaced with

> *"and in accordance with all other applicable laws as they apply from time to time including the Gas Act, Envestra's Distribution Licence, the Gas Distribution Code, the Gas Metering Code and the Retail Market Rules."*

Envestra accepts the above recommendation. Clause 2.4 of Annexure G has been amended as required by the Draft Decision to refer specifically to the regulatory instruments that surround Envestra's operation of the Network.

The clause has also been amended to impose equivalent obligations on Network Users to comply with the regulatory instruments that surround their use of the Network. It would be unreasonable for the Commission to impose a contractual obligation on Envestra to comply with regulatory instruments without imposing equivalent obligations on the Network Users.

2. TERMS AND CONDITIONS

Note - Accompanying this submission is an amended version of Envestra's proposed terms and conditions (Annexure G to the Access Arrangement). Annexure G has been marked up to show the amendments made as a result of the Draft Decision.

Amendment 8

The following words must be deleted from proposed clause 15.4 of Annexure G:

> *"and risk in" and "The Network User accepts the risk of the loss from the Network of Unaccounted for Gas".*

Envestra accepts the above recommendation.

Amendment 9

The following must be deleted from proposed clauses 5.4(a) and (b) of Annexure G:

> *"(after taking account of UAFG)".*

Envestra accepts the above recommendation.

Amendment 10

The following must be deleted from proposed section 6.3(b) of the Access Arrangement:

> *", after taking account of UAFG".*

Envestra accepts the above recommendation.

Amendment 12

Clause 19 of the Access Arrangement must be revised to have network charges payable one month in arrears, as follows, effective as of 1 July 2007. Envestra must also revise clause 19 to establish transition arrangements to this outcome.

Envestra does not accept this amendment. See section 1 of Part B to this submission.

Amendment 13

Insert the MDQ decrease clause as set out in the Draft Decision.

Envestra has included a new clause 6B which incorporates the MDQ decrease clause, as set out in the Draft Decision, with some minor modifications.

Envestra also proposes to include a new section in its Access Arrangement (as set out below) to set out its policy on the manner in which it will deal with requests for reductions in MDQ. The modifications to the MDQ decrease clause, set out in the Draft Decision, are intended to make the MDQ decrease clause consistent with Envestra's policy.

> *Envestra will consider reasonable written requests from Network Users to decrease the MDQ for a User Demand DP on a case-by-case basis. When considering a request, Envestra will have regard to the following factors:*
>
> *(a) the permanency of any change in the relevant Customer's requirements for Gas;*
>
> *(b) the long-term trend of the Customer's demand for Gas at the relevant User Demand DP, as derived from historical data about the Quantities of Gas delivered through that DP and any reasoned forecasts of the Customer's expected future demand for Gas at that DP;*
>
> *(c) whether, and if so, the extent to which, the proposed reduction will compromise Envestra's ability to recover the capital expenditure Envestra incurred in relation to the relevant User Demand DP, including whether Envestra has any contractual right to recover such expenditure from the Network User or someone else; and*
>
> *(d) any other factors that Envestra considers relevant.*
>
> *In assessing each request, Envestra's objective will be to determine whether the reduced MDQ will accurately reflect the Gas requirements for that DP in the foreseeable future. Accordingly, the factors in paragraphs (a) and (b) will take on different weight depending on the reasons for the Network User's request. Paragraph (a) will be more important in circumstances where the Customer requires less Gas because of a particular event (e.g. the removal of gas fired plant or*

equipment), while paragraph (b) will be relevant in circumstances where the Customer's demand for Gas has steadily declined over a sustained period of time.

Envestra will decide whether to approve a request on the basis of any information provided by the Network User to Envestra and any other information available to Envestra independently of the Network User that Envestra considers relevant. Envestra will not discriminate between Network Users when considering requests and will endeavour to treat requests in a consistent manner, having regard to the circumstances in each case.

Envestra may approve or not approve a request from a Network User in whole or in part. Without limiting the foregoing, Envestra may approve a request on the condition that the relevant MDQ is reduced to a level that is different to that requested by the Network User.

Envestra will determine a request and advise the Network User and the relevant Customer of the outcome of the Network User's request as soon as reasonably practicable. If Envestra agrees to reduce the MDQ for a User Demand DP, the reduced MDQ will take effect on the first day of the month following the month in which the Network User is advised of Envestra's decision.

Envestra reserves the right to disclose details of a reduction or other revision of the MDQ for a User Demand DP to the Customer at that DP and to other Network Users. Envestra will normally make disclosure of changes in the MDQ, to Network Users, where the Customer has gone to tender for gas supplies or is otherwise considering a change in their gas retailer.

Amendment 14

Clause 2.5 of Annexure G must be deleted.

Envestra must also make the required consequential change to Services Policy clause 2.6.

The text of clause 2.5 of Annexure G has been deleted as required by the Draft Decision. In place of the original clause, some new clauses have been added to address the implications of gas balancing:

1. Clause 2.5 now provides for Envestra and the Network User to acknowledge that:

   (a) gas balancing is regulated through the Retail Market Rules; and

   (b) at any given time, the Quantity of Gas delivered into the Network by or for the account of the Network User will not necessarily equal the Quantity of Gas delivered out of the Network to or for the account of the Network User.

   The first acknowledgment is required in consequence of the changes required by the Draft Decision to clause 2.6 of the Access Arrangement (see Amendment 4).

   The second acknowledgment is a bilateral acknowledgment by Envestra and the Network User as to the fact that it is not necessarily possible to achieve physical balance within the Network because it is impossible for Envestra and any given Network User to co-ordinate gas deliveries by that Network User into the Network with gas taken by that Network User's customers out of the Network.

2. Clause 2.6 is a new clause that provides for the Network User and Envestra to confirm to one another that neither of them is liable to pay or compensate the other for any imbalance in gas deliveries into and out of the Network.

3. Clause 2.7 is a new clause which confirms that clause 2.6 does not abrogate the liability of Envestra or the Network User under other agreements, such as the Retail Market Rules. This

clause ensures that clause 2.6 will not prevail over the Retail Market Rules and will remain consistent with the Retail Market Rules in the event they are amended.

4. Clause 24.7 is a new clause which acknowledges that, if there is an imbalance on termination of the Agreement, then title to any excess gas will pass to the persons to whom, or for whose account, the excess gas is delivered. Clause 24.7 also confirms that clauses 2.6 and 2.7 survive termination (and, thus, confirms that neither the Network User nor Envestra will need to pay or compensate one another in respect of any imbalance that might exist as at termination, except as may be provided under other agreements).

   Clause 24.7 follows from the fact that Envestra has not made provision in its Reference Tariffs for the cost of purchasing line pack[1].

Clause 2.2 has been amended to make it clearer that a Network User's gas can be delivered out of the Network to someone other than the Network User or a customer of the Network User. This is because, once it enters the Network, a Network User's gas is commingled with gas owned by other Network Users and may, therefore, be delivered to anyone who takes Gas from the Network.

<u>**Amendment 15**</u>

Clause 5.4(a) of Annexure G must be revised to read:

"unless otherwise agreed by Envestra or if otherwise required by the Retail Market Rules,".

Envestra accepts the above recommendation, but it should be noted that this issue is not covered in any way in the Retail Market Rules. The issue relates to the physical structure of the network and location of injection points, a matter not pertinent to the Retail Market Rules.

<u>**Amendment 16**</u> (in relation to changes to Gas Delivery Zones)

Clause 5.4(e) of Annexure G must be revised to remove *"14 days"* and insert *"20 Business Days".*

Envestra accepts the above recommendation.

<u>**Amendment 17**</u>

The following words must be deleted from proposed clause 5.5 of Annexure G *"Envestra may determine"* and replaced with *"Envestra shall determine".*

Envestra advises that it no longer determines gas deliveries through Receipt Points. This is now done by REMCo. While this clause may therefore be redundant, there remains the possibility that Envestra may be required to determine such deliveries in unusual or rare circumstance. Envestra has therefore changed the the first part of the clause from

"Envestra may determine the Quantity of Gas delivered through each User Receipt Point by or for the account of the Network User: ……:"
to

"If Envestra is required to determine the Quantity of Gas delivered a User Receipt Point by or for the account of the Network User, it shall do so: ……:"

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1 The alternative approach is to make provision in the Reference Tariff for Envestra to purchase line pack.

Amendment 18

Clause 5.5(c) of Annexure G must be amended to replace "on whatever basis Envestra considers reasonable in the circumstances" with "on a reasonable basis".

Envestra accepts the above recommendation.

Amendment 19

The following words must be inserted into proposed clause 5.6 of Annexure G:

"or expand the capacity of an existing DP" after the words "to the Network".

Amendment 20

The following words must be inserted into proposed clause 5.6 of Annexure G:

"or expanding the capacity of an existing DP" after the words "that new DP".

Envestra accepts the above recommendation.

Amendment 21

Clause 7A.3(b) of the proposed Terms and Conditions must be deleted.

Envestra accepts the above recommendation.

Amendment 22

Clause 9.3 of Annexure G must be amended to read:

"Whenever the party that is not responsible for Metering Equipment wishes to request the other party to test that Metering Equipment, the party making the request must give the other party whatever forms, documents and information that other party reasonably requires."

Envestra accepts the above recommendation.

Amendment 23

Clause 9.7(c) of Annexure G must be amended to replace "on whatever basis Envestra considers reasonable in the circumstances" with "on a reasonable basis".

Envestra accepts the above recommendation.

Amendment 24

Clause 16.4 of Annexure G must be amended to add the following sentence:

> *"Envestra will provide, upon the Network User's reasonable request, details of Envestra's determination under this clause."*

Clause 16.4 has been amended in a manner that substantially complies with the Draft Decision.

Amendment 25 (Terms relating to ancillary reference services)

Clauses 17 and 18 of Annexure G must be deleted.

The Draft Decision requires Envestra to delete clauses 17 and 18 because there are inconsistencies between those clauses and the provisions of the Retail Market Rules which provide for disconnection, reconnection and special meter readings.

Envestra is concerned that, if it simply deletes the clauses, then it might not have the right to charge for providing disconnection and reconnection services or for undertaking special meter readings. Rule 362 of the Retail Market Rules permits Envestra to charge for those services but only if Envestra is entitled at law or under an access arrangement or contract to charge for those services.

Clauses 17 and 18 have, therefore, been amended to ensure that they are consistent with the Retail Market Rules and to provide that Envestra is entitled to charge a Network User for services provided in accordance with the clauses.

In the Glossary to the Access Arrangement, the definitions of "Disconnection", Reconnection" and "Special Meter Reading" will be amended to ensure that they are consistent with the definitions used in the Retail Market Rules.

Amendment 26 (regarding "Set-off")

Clause 22.2 of Annexure G must be revised to add to the beginning of the clause the words:

> *"Subject to the Network User's rights under clause 20A,".*

Envestra accepts the above recommendation.

Amendment 27 (regarding Liability)

Clauses 25 of Annexure G must be revised to include a provision that is the same as clause 25.1 in the Terms and Conditions of the current Access Arrangement.

Envestra has revised clause 25 of Annexure G to include a provision that is the same as clause 25.1 of the Terms and Conditions of the current Access Arrangement. However, Envestra has added a new paragraph (at the end of that clause) which states that Envestra's liability under clause 25.1 cannot exceed the liability which Envestra would have at common law in the absence of this clause (unless

Envestra is insured against that liability, in which case, Envestra's liability to the Network User will be commensurate with the extent of Envestra's insurance).

As Envestra has explained in previous submissions to the Commission, clause 25.1 was deleted from the proposed Terms and Conditions because:

(a) Envestra's public liability insurance generally excludes Envestra's insurers from liability in respect of contractual indemnities, except to the extent that the liability would have been implied by law;

(b) consequently, if clause 25.1 were included in the same terms as the current Access Arrangement, Envestra will have an uninsured liability (to the extent that Envestra's liability under the indemnity exceeds the liability implied by law).

Envestra believes it is unreasonable to require the Terms and Conditions to impose liabilities on Envestra for which Envestra is not insured.

Envestra could seek to have its public liability insurance amended so that it provides Envestra with cover for its liability under a contractual indemnity in the terms of clause 25.1 of the Terms and Conditions in the current Access Arrangement. However, it is not clear whether Envestra's insurers would agree to remove the exclusion in the public liability policy and, even if they were to agree, Envestra expects that its insurers would require a premium increase to compensate them for the increased risk under the policy. The Reference Tariff allows for the cost of the public liability insurance which Envestra has effected. It does not make provision for a premium increase which the insurers might require in return for removing the exclusion against contractual liabilities.

In support of these submissions, Envestra has obtained a letter from Willis Australia Limited, the insurance broker that manages Envestra's account. This letter (see Attachment 1) confirms that:

(a) Envestra's public liability insurance does not extend to liability assumed by Envestra under any contract or agreement;

(b) this exclusion is common in public liability insurance policies;

(c) the insurers are unlikely to be willing to delete the exclusion;

(d) if they agree to delete it, they are unlikely to be willing to delete the exclusion without some form of premium penalty.

Envestra submits that, with the new paragraph at the end, clause 25.1 is reasonable having regard to the factors set out in section 2.24 of the National Third Party Access Code.

(a) The factor in clause 2.24(a) of the Code supports the inclusion of the proposed new paragraph. It is a legitimate business interest for Envestra:

    (i) to seek to insure itself under public liability insurance against liabilities that arise in the operation and management of the Network;

    (ii) to recover the costs of that insurance through its charges; and

    (iii) to ensure that it does not agree to incur uninsured liabilities.

(b) The factor in clause 2.24(d) also supports the inclusion of the proposed new paragraph. It is consistent with the economically efficient operation of the Network that Envestra seeks to insure itself under public liability insurance against public liability rather than make provision in its charges for uninsured liabilities.

(c) The factor in clause 2.24(e) also supports the inclusion of the proposed new paragraph. It is in the public interest that Envestra's charges do not make provision for uninsured liabilities.

(d) The factor in clause 2.24(f) also supports the inclusion of the proposed new paragraph. It is in the interests of Users generally that Envestra's charges do not make provision for uninsured liabilities.

If, notwithstanding these submissions, the Commission requires Envestra to delete the new paragraph (at the end of clause 25.1) then Envestra submits that the Commission should increase the Reference Tariff to make provision for the increased cost of public liability insurance which will provide Envestra with cover against its liability under clause 25.1 or to make provision for the uninsured liabilities in the event that Envestra is unable to obtain adequate cover from its insurers. In that event, Envestra requests the opportunity to make submissions to the Commission as to the extent of that cost.

Amendment 28 (regarding Claims)

Clause 30.4 must be amended to require that Envestra be notified only of claims that relate to Envestra.

Envestra accepts the above recommendation.

Amendment 29 (regarding Notice of Entry)

Clauses 31.2 of Annexure G must be revised to add to the end of the clause the words:

", or, if no notice is required by law, it will give reasonable notice."

Envestra accepts the above recommendation.

Amendment 30 (regarding Access to Premises)

Clause 31.7 must be modified to add the word "reasonably" in the first line prior to the word "requested".

Envestra accepts the above recommendation.

Amendment 31 (regarding Confidential Information)

Clauses 32.1 of Annexure G must be revised to add the words "related to or received from Envestra pursuant to the Agreement" between the words "information" and "which".

Envestra accepts the above recommendation.

Amendment 32

Clauses 37.7 of Annexure G must be revised to add to the end of the clause the words:

"The appointment by Envestra of an agent or contractor will not relieve Envestra from any liability in connection with the performance of its obligations under the Agreement."

Envestra accepts the above recommendation.

Amendment 33

Clause 27 of Annexure G must be revised to make the Force Majeure provisions symmetric by altering references to "Envestra" to incorporate, either explicitly or by implication, either party to the agreement. The words in subclause 27.2(b) "to the Network User" should be revised to "to the other party".

Clause 27 of Annexure G has been amended to make the force majeure provision symmetric, as required by the Draft Decision. In view of this requirement of the Draft Decision, Envestra has made some consequential changes to the force majeure clause:

(a) First, a new clause 27.3 has been added to provide that the force majeure clause does not relieve a Party from liability for non-performance of an obligation to pay money. The primary obligation of the Network User is to make payments in accordance with the Terms and Conditions. If clause 27.3 is not included then the Network User could claim relief against payments where it suffers financial difficulties for reasons beyond its control, such as adverse market conditions. Envestra submits that this would be unreasonable in terms of the factors set out in clause 2.24 of the Code. Envestra notes that force majeure clauses in other Access Arrangements commonly exclude relief for non-payment.

(b) Second, a new clause 27.4 has been added to provide that the force majeure clause does not relieve the Network User from liability for non-performance of its obligations:

   (i) to ensure that gas entering the Network meets the required gas specifications (clause 11.1);

   (ii) to ensure that gas entering the Network is within the required range of pressures (clause 12.1); and

   (iii) to ensure that it has title to gas delivered into the Network and has the right to deliver gas into the Network (clause 15.1).

   Envestra submits that it would be unreasonable in terms of the factors set out in clause 2.24 of the Code to provide a Network User with relief for non-performance of these obligations. Specifically:

   (i) It would be contrary to the interests of Envestra, the public and other Network Users (see sections 2.24(a), (e) and (f));

   (ii) it would be inconsistent with Envestra's contractual obligations to deliver on-specification gas to other Network Users (section 2.24(b)); and

   (iii) it would also be inconsistent with the operational and technical requirements for the safe and reliable operation of the Network (see section 2.24(c)).

   Where a Network User cannot meet its obligations under clauses 11.1, 12.1 or 15.1 then the Network User should not deliver gas into the Network and should be liable to compensate Envestra for losses caused to the Network as a result, even where the non-compliance results from factors that are beyond the control of the Network User.

   Envestra notes that its position on this issue is not unusual. AGL's Access Arrangement for AGL's NSW Networks provides that the force majeure clause "… does not apply to a User failing to ensure that gas delivered to a Receipt Point meets the Specifications" (see clause 45(b) of the

Terms and Conditions applicable to all Reference Services in Schedule 2A to that Access Arrangement).

Envestra has also amended clause 27.1 of Annexure G to make it clear that, for the force majeure clause to apply, an event must not only be beyond the control of a Party but also beyond the control of that Party's officers, servants, agents and contractors. This makes it clear that Envestra cannot rely on the force majeure clause where a breach of Envestra's obligations results from acts or omissions within the control of Origin Energy Asset Management Limited and, similarly, that Network Users cannot rely on the force majeure clause where a breach of the Network User's obligations results from acts or omissions within the control of the transmission pipeline operator or a gas supplier.

Amendment 34

Clause 19.5 of Annexure G, or an otherwise amended clause 19 (in relation to prepayment), must be revised to include the words "valid tax invoice".

Envestra accepts the above recommendation.

Amendment 35

Clause 6.2 of the Access Arrangement must be deleted.

Envestra accepts the above recommendation.

Amendment 39

Numbering discrepancies identified in clause 25 must be corrected. The Typographical error in clause 36.2 must be corrected.

Envestra accepts the above recommendation.

3. REFERENCE TARIFF POLICY

<u>Amendment 40</u>

The Commission requires Envestra to include in the proposed revised Access Arrangement a general statement of policy describing the principles (and methods) that are used to determine Reference Tariffs.

<u>Amendment 41</u>

The Commission requires Envestra to include the following elements in the Reference Tariff Policy contained in the proposed revised Access Arrangement :

- a statement describing the method and process for assigning Delivery Points to particular Reference Tariffs;
- a statement describing the process for introducing new Reference Services and/or new Reference Tariff/Reference Tariff component;
- a statement describing the process for withdrawing a Reference Tariff/Reference Tariff component;
- a statement describing the pricing principles to be adopted by the Service Provider in varying, withdrawing or introducing new Reference Tariffs/Reference Tariff components; and
- timeframes and information requirements relating to the process for varying, withdrawing or introducing new Reference Tariffs.

Envestra accepts the above recommendation.

4. GAS DEMAND FORECASTS

<u>Amendment 42</u>

Envestra must amend its proposed revised Access Arrangement to incorporate the domestic forecasts as set out in Table 6.5.

<u>Amendment 44</u>

Envestra must amend its proposed revised Access Arrangement to incorporate the small business forecasts as set out in Table 6.7.

<u>Amendment 46</u>

Envestra must amend its proposed revised Access Arrangement to incorporate the demand market forecasts as set out in Table 6.9.

Envestra does not accept this amendment. See section 3 of Part B of this submission.

5. RATE OF RETURN

Amendment 49

Envestra must modify its proposed revised Access Arrangement and clause 8.1 of its submitted Access Arrangement Information to incorporate the WACC Draft Decision.

Envestra does not accept this amendment. See section 4 of Part B of this submission.

6. CAPITAL BASE AT COMMENCEMENT OF SECOND PERIOD

Amendment 51

Envestra must amend the proposed revised Access Arrangement to base its proposed revised Reference Tariffs upon the value set for the Capital Base at the commencement of the first Access Arrangement Period (1 July 2003) of $796.35 million (in 31 December 2005 dollar terms).

Envestra does not accept this amendment. See section 2 of Part B of this submission.

Amendment 54

For the purposes of rolling forward the Capital Base to the commencement of the second Access Arrangement Period, Envestra must use an updated estimate of capital expenditure for the 2005/06 year based upon actual spending during the first nine months of the year, with provision in the proposed revised Access Arrangement being made that any difference between this estimated level and actual spending for the year being taken into account when the roll-forward occurs at the next review to the commencement of the third Access Arrangement Period.

Envestra accepts the above recommendation.

Amendment 57

Envestra must apply inflation adjustments to arrive at the value of the capital base at the commencement of the second Access Arrangement Period in a manner consistent with those outlined by the Commission in Section 8.5 of this Draft Decision.

Envestra accepts the above recommendation.

7. CAPITAL BASE FOR SECOND PERIOD

Expanded Capital Program

The Commission doubts the deliverability of such an expanded capital expenditure program (notwithstanding the merits of any particular subset of projects). The expansion, combined with the proposed increase in operating expenditures, will require significantly more skilled labour to plan, design and deliver. The Commission notes also that elsewhere in its revisions Envestra has argued that it faces a range of significant workforce challenges. (p115)

Envestra notes that the majority of the work required to complete the expanded capital expenditure program relates to the physical construction/extension of the network. This work is essentially carried out by contractors. The significant workforce challenges mentioned above do not relate to mainlaying contractors, but to the aging workforce of directly employed staff. Aging workforce issues are mainly in the field operations supervision and maintenance areas of Envestra's operations. Envestra is confident that the aging workforce problem will not be an issue because it has a strategy to deal with this (as outlined in the Access Arrangement revision submission).

The other significant workforce challenge relates to retention of staff due to skills shortages. Envestra believes this has been addressed by incorporating appropriate wage increases in the forecast Non Capital Costs, so that wages of staff keep pace with market rates.

In the area of network augmentation, Envestra has acknowledged that additional resources will be required to achieve implementation of the program from a design, planning and project management perspective, and has factored this into its forecasts (see response to "Improve Supply", p17 of this submission).

Mains Renewal

The Commission acknowledges that a CBD area may give rise to a higher unit cost compared to some other areas. However, the Commission also observes that Envestra's unit costs (as presented in ECG's Table 7-23) involve a step increase in 2006/07 and then increase uniformly over the second Access Arrangement Period. This provides little support to the argument over the Adelaide CBD's impact, as that impact should only affect unit rates in one or two years.

The ranking of the Adelaide CBD project, as presented in Envestra's Asset Management Plan (confidential Attachment 8 to its submitted Access Arrangement Information) necessarily places it, or most of it, outside a 500 km program – it would fall into a larger program, which was not proposed. (p117)

There are two issues Envestra wishes to address here – the renewal of the Adelaide CBD and the length of mains to be renewed overall.

1. Adelaide CBD

The Draft Decision is in error in that the cost associated with the renewal of the Adelaide CBD has been excluded. This is despite the fact that:

(a) Envestra clearly included the Adelaide CBD in its forecast mains renewal program (in Envestra's submission to the Commission of 24 February 2006, Envestra set out the breakdown of cost of the mains renewal program, which indicated that a material portion of the program related to the CBD); and

(b) ECG and the Commission have acknowledged the inclusion of the CBD and its cost (as discussed in the Draft Decision)

The Commission appears to have excluded $11.53m of forecast costs because it believes either that

- that renewal of the CBD will not be undertaken during the forecast period; or
- that unit rates applicable to suburbia also apply to the CBD. (The unit rate for work in the CBD is approximately $200/m higher than for outlying suburbs. As the CBD project involves approximately 60km of mains, the resultant additional cost is in the order of $12m.)

Both of the above conclusions are incorrect. It appears that the Commission may have come to one of the conclusions above because:

(a) It has been wrongly assumed that suburbs will be renewed in the exact order of economic priority:

> *"In Envestra's Asset Management Plan, the Adelaide CBD is ranked 42nd in order of priority."*[2]

> *"The ranking of the Adelaide CBD project, as presented in Envestra's Asset Management Plan (confidential Attachment 8 to its submitted Access Arrangement Information) necessarily places it, or most of it, outside a 500 km program – it would fall into a larger program, which was not proposed."*[3]

However, suburbs are not necessarily renewed in order of economic priority, as other factors are also taken into consideration. The Commission and ECG have mistakenly assumed that the proposed renewal schedule is a rigid one that follows the precise order ("1 to 42") set out in Appendix 8 of Envestra's Asset Management Plan dated September 2005.

Appendix 8 of the Asset Management Plan sets out suburbs in order of economic return at that point in time, and that information is taken into consideration when scheduling suburbs to be renewed. However, other factors apart from economic return affect the priority in which suburbs are renewed, e.g. recurring water problems, gas supply issues (eg due to increasing penetration of instantaneous hot water units), practical aspects of developing the high pressure network, council roadworks programs, etc.

Also, Appendix 8 of the Asset Management Plan was compiled in early 2005, and at least two of the suburbs amongst the first 42 listed are expected to be completed before the start of the second Access Arrangement period. Hence the completed suburbs are likely to be replaced by other suburbs further down the list.

(b) ECG wrongly assumed that the CBD will form "only a small proportion of the total renewal program", when in fact it accounts for about 35% of the total cost of the program (as advised in the submission of 24 February 2006). ECG state:

> *"The Plan includes some proportion of the CBD to be renewed in the forecast period. However, given the low priority for the Adelaide CBD renewal, ECG considers that the CBD renewal will form only a small proportion of the total renewal program."*[4]

ECG then erred in its recommended forecast, in that it then allocated the same unit rates for the CBD as for metropolitan suburbs. That forecast was adopted by the Commission despite the

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[2] P84, ECG report
[3] p117, Draft Decision
[4] ibid

Commission acknowledging that "a CBD area may give rise to a higher unit cost compared to some other areas"[5].

Given the confusion in relation to the inclusion of the CBD in Envestra's forecast for the second Access Arrangement period, and the impact this has on Envestra's mains renewal program, it is important that the Commission reassess its decision on this matter.

The Commission has also wrongly assumed that the impact on overall unit rates will only be evident in one or two years:

> *"However, the Commission also observes that Envestra's unit costs (as presented in ECG's Table 7-23) involve a step increase in 2006/07 and then increase uniformly over the second Access Arrangement Period. This provides little support to the argument over the Adelaide CBD's impact, as that impact should only affect unit rates in one or two years."*[6]

In effect, the Commission has assumed that Envestra would allocate significant resources to renewing the CBD over a short period of time, rather than undertaking the renewal over a longer period of time. The Commission is not in a position in make this assertion. The assertion is incorrect.

In relation to the economic return gained by renewing the CBD, it is of no surprise to Envestra that the CBD would not rate highly using this parameter. This is because the cost of undertaking a renewal in the CBD is very high compared to other areas (as reflected by the higher unit rate), and therefore sole reliance upon this parameter would not be prudent. Envestra has taken into consideration the following factors in assessing the need to renew the CBD:

- The existing mains are predominantly cast iron of varying sizes and ages. In the event of unusual ground activity (from seismic activity, weather effects, roadworks, etc) there is an inherent risk of fracture with such pipes;
- Connections and fittings are generally lead yarn and mechanical, prone to failure;
- Mains are often found to have less than currently accepted ground cover;
- Some large diameter pipes (up to 24 inch) is still in use. These would prove very difficult to repair if fractured;
- Due to the underground asset congestion in the area there is often little or no separation between ducts, cables and gas mains, which in the event of leakage can cause the leak to travel some distance from the leak, with a risk of gas entering building basements, with the potential to impact upon the safety to the general public;
- A renewal program and pressure upgrade would ensure that the capacity of the network in the city would adequately cater for the growth in the CBD. At the same time, the use insertion of CI pipes would provide the gas mains with enhanced protection from third party damage;
- Over time, existing meter positions and inlet pipes have been affected due to building alterations and development such that some are now in positions that are considered less than ideal;
- A renewal of the CBD would enable valving to be installed in optimal locations in order for emergency capabilities to be enhanced;
- Leaks in the CBD are much more expensive to repair than in other areas.

The forecasts submitted by Envestra in its Access Arrangement revisions are therefore consistent with those that would be submitted by a prudent Service Provider acting efficiently.

[5] p117, Draft Decision
[6] p117, Draft Decision

2. Length of Mains to be Renewed

Envestra has proposed to replace 500 km of mains over the period. However, the Office of the Technical Regulator has recently expressed concern, based on historical data, in relation to the level of UAFG in the network, and whether the level of proposed mains replacement is sufficient to produce a declining UAFG trend.

Due to the nature of UAFG and the differences between networks, there has always been much conjecture in the gas industry regarding contributing factors to UAFG. Consequently UAFG management relies heavily on the observation of outcomes from programs in place. While it has been clear that the level of mains replacement must be increased to arrest increases in UAFG, it is not clear precisely what that level is, and what level would result in decreasing UAFG.

Envestra began formulating its mains replacement proposal in late 2004. At that time, it was believed that an increase in mains replacement to 100km/yr was prudent. However, given that:

(a) this program will not commence until 2006/07; and

(b) deterioration of the remaining cast iron network may be occurring at a faster rate than previously expected

it is not certain that the higher level of mains replacement will be sufficient to result in a material reduction in UAFG. Depending on observed UAFG levels following the commencement of the higher mains replacement level, it may be necessary for Envestra to accelerate mains replacement even further, perhaps to 200km/yr.

Envestra acknowledges the difficulty associated with the Commission approving a significant increase in New Facilities Investment at this stage of the review process. Envestra therefore proposes to use a trigger mechanism to recover the costs associated with any additional costs incurred in accelerating the mains replacement program. The trigger mechanism would enable cost recovery of that portion of mains renewal New Facilities Investment that is in addition to the 500km of mains renewal allowed for in the Final Decision.

Envestra proposes that the following trigger mechanism be included in the Reference Tariff Policy:

X.X Trigger Mechanism – Additional Mains Renewal

Envestra has proposed to undertake 500km of mains renewal during the Second Access Arrangement Period. If Envestra intends to renew more than this amount, then Envestra may apply to the Regulator for a pass-through of costs in relation to the additional amount, when the following Specified Event occurs:

- approval by Envestra's Board of Directors of an amount of mains renewal that results in the amount of mains renewed forecast to occur over the Second Access Arrangement Period exceeding 500km.

Changes to Retail Market Rules

In relation to the Retail Market Rules component ($0.26m per year), ECG noted that in the absence of knowledge about Retail Market Rules changes, it could not accept these costs, recommending that they be treated as an impost instead.

The Commission notes that Envestra has considerable input into, but not control of, the Retail Market Rules rule change process. The Commission also observes that the number and scope of Retail Market Rules changes are difficult to predict, and the capital cost effects on Envestra even more so. As such, the Commission cannot conclude that the forecast costs in this area are a best estimate arrived at on a reasonable basis. (p129)

While the Commission has rejected Envestra's forecast, it has not concluded what forecast it considers reasonable. Envestra acknowledges that the number and scope of changes are difficult to predict, and that Envestra has no control over rule changes. However, it is certain that a number of rule changes will occur over the forecast period (REMCo is currently considering a number of changes to retail market rules, and Envestra is also aware of discussions in the industry concerning possible changes to Chapter 5 of the rules). Such changes would impact Envestra and it is inconceivable that Envestra will not need to alter its systems over a five-year period as a consequence.

It is therefore reasonable that Envestra should incorporate an amount in its forecasts that will allow it to implement changes to market rules. These forecasts are provided below and are based on system changes requiring 50 man-days of development. Envestra believes that, given its experience in working with IT systems in a contestable market, its forecast is reasonable.

Resource	Cost Estimate	Comment
Service Provider system changes	$228,000	Based on 50 man days of system development (includes design, development, testing, system change documentation etc)
Internal Technical Support	$18,900	One month full-time support
Total	**$246,900**	

Improve Supply

ECG reviewed these projects and accepted them as being prudent and efficient. However, in its review, ECG discovered an anomaly in respect of the total cost forecast presented in the submitted Access Arrangement Information. ECG provided an adjusted costing to reflect the actual proposed projects presented to it. (p119)

The "anomaly" discovered by ECG is not an anomaly but part of the cost of implementing the augmentation program over the forecast period. As explained further below, the cost relates to project facilities costs. The following tables show how that cost forms part of the overall augmentation program. (It should be noted that during the review process, it was discovered that one of the security of supply projects had been included twice. Consequently Envestra will make the necessary

correction, i.e. remove $670k (nominal) from the 2008/09 Security of Supply forecast New Facilities Investment).

In its report to the Commission, ECG reported the following costs submitted by Envestra for Network Augmentation:

ECG Report Page 88, Table 7-30

$m (31 Dec 2005)	2006/07	2007/08	2008/09	2009/10	2010/11	AA Total
Improve Supply	0.69	0.62	0.11	0.11	0.11	1.64
Nth Central Suburbs	0.00	1.09	1.06	1.07	0.79	4.01
Outer Harbour	0.48	0.48	0.48	0.49	0.49	2.42
Eastern Ring Main	0.00	0.00	0.00	7.51	7.55	15.06
Southern Loop	0.00	3.83	3.84	0.00	0.00	7.67
Gawler	2.08	0.00	0.00	2.85	2.87	7.80
Other	1.39	1.62	0.00	0.68	2.09	5.78
Sub-Total	3.95	7.02	5.38	12.60	13.79	42.74
Network Augmentation Total	**4.64**	**7.64**	**5.49**	**12.71**	**13.90**	**44.38**

Table 1

The Network Augmentation Total set out above reflects the sum total of the 20 projects to be undertaken in the forecast period (as advised to ECG on 10 January 2006). When the project facilities costs are added to the Network Augmentation Total above, it is seen that the total equates to Envestra's Access Arrangement Information submission.

$m (31 Dec 05)	2006/07	2007/08	2008/09	2009/10	2010/11
Sub-Total	4.64	7.63	5.50	12.71	13.90
Project facilities	0.49	0.97	0.43	0.43	0.43
AAI Total - Augmentation	5.13	8.60	5.93	13.14	14.33

Project Facilities Costs

Human resource input into the planning, preparation and execution of each network augmentation project has been estimated and included in the forecast for each network augmentation project. However, the physical facilities (office space, office equipment, IT equipment and set-up) required by the personnel involved has not been included in each project estimate and is forecasted as a separate cost for the total of the network augmentation projects (those requirements cannot be accommodated within existing facilities). These facility costs are included in the capital cost forecasts that have been provided to ECG, and are included in the total network augmentation costs presented in the Access Arrangement Information.

While normal project overheads are sufficient to account for human resource input into the planning, preparation and execution of projects, the physical facilities (office space, office equipment, IT equipment and set-up) required by the personnel involved is a different matter when the number of projects cannot be accommodated within an existing framework.

Envestra notes that "the Commission is concerned about the deliverability of the expanded capital program"[7]. While Envestra believes it can engage contract personnel to assist with the delivery of the expanded program, the provision of physical facilities is an issue which has been addressed by the specific allowance for "project facilities" in its forecasts.

Project facilities costs were derived based on a few key assumptions. A relationship was derived between

(a) the number of office-based project personnel (eg project management, engineering, administration, etc) required for network augmentation projects; and

(b) project costs.

[7] p122, Draft Decision

This was done by using data from one of the larger network augmentation projects, which indicated that

- approximately 10% of project costs were related to such personnel; and
- that each $1m of the above percentage involved the input of the equivalent of 5 FTE project persons, e.g. 10 project persons working 50% of their time. Examples of the various project areas required to be covered are:

Capacity Design Analysis	Route Plans
Preliminary Design	Materials Procurement/M anagement
Prelim Design Review	Drafting/Config uration Management
Business Case	Quality Assurance
Project Plan	Project Manager
Detailed Pipe Design	Con struction Supervisor
Design Risk Assessment	Welding Supervisor
Environment Impact Study	Construction Admin
CP Design & Specification	Project Closure
Valve Specification	Schedule Management
Route Selection	Risk and Issue Management
Detailed Design Review	Project Actions
Route Survey	Project Financials/Accounting

It is estimated that at least 10 different project team members (with the required skills) would be required to fulfill these functions/roles. Following an assumption of the staff-mix required to support the nature and timing of the forecast projects, an estimate was made of the number of work stations and office space requirements.

It is estimated that the number of additional personnel would result in the below project infrastructure costs (where office lease / setup and IT related cost estimates used are based on those incurred on another project requiring a similar number of project-office-based staff size).

$m (31 Dec 05)	2006/07	2007/08	2008/09	2009/10	2010/11	AA Total
Office Lease	0.31	0.31	0.31	0.31	0.31	1.54
On-going IT	0.12	0.12	0.12	0.12	0.12	0.62
Once-off desk setup	0.03	0.29	0.00	0.00	0.00	0.32
Once-off office equipment	0.03	0.00	0.00	0.00	0.00	0.03
Once-off IT costs	0.00	0.25	0.00	0.00	0.00	0.25
Total	0.49	0.97	0.43	0.43	0.43	2.75

Unit rates - IC services and mains, domestic meters

ECG analysed each cost area in turn, for both domestic and industrial and commercial (I&C) customers – noting that mains, meters and services costs differ between customer classes. ECG recommended a number of variations to the cost forecasts in this area, resulting from:

- a reduction in I&C mains unit costs from $148 to $109 per metre;

- a reduction in domestic meter costs from $308 to $280 per customer; and

- a reduction in I&C services costs from $2,531 to $1,305 per customer.

The Commission acknowledges that Envestra has disputed these recommendations, arguing for example that ECG's view on I&C services and mains does not take into account customer differences between jurisdictions – and, hence, raising doubt over the validity of jurisdictional benchmarking.

The Commission acknowledges that there will be variation between costs for particular customers, but has seen no information to suggest that I&C customer types in South Australia should give rise to significantly higher costs than in other jurisdictions (noting that the service unit costs that ECG presents in its Table 7-15 are consistent between those jurisdictions listed). (p120)

I&C Services and Mains

Envestra believes there are a number of factors which the Commission needs to consider in relation to this issue – factors which have not been addressed in the Draft Decision. These are discussed below.

Certainly the Code does not contemplate forecasts being determined as unreasonable on the basis that no information has been seen that explains a difference between benchmarked values. There are often valid reasons why two activities, which appear at face value to be similar activities, differ in cost when performed in different localities. Of importance, however, is the fundamental issue of whether one is comparing "apples with apples". In relation to this "benchmark", some pertinent questions are:

1. are all distributors recording component costs identically, eg is one distributor allocating all costs pertinent to an IC connection to that connection, or are some costs allocated as network upgrade costs?
2. do all distributors lay service pipe up to the meter, or does the customer in some instances partly install their own service pipe where the meter is located some distance from the property boundary?
3. what influence do distributors have in different jurisdictions to influence the location of the meter or other aspects of the installation that may lead to materially lower costs?
4. given the wide variety of types of industrial and commercial installations, has there been particular growth in any specific sector of the market in each locality that may influence the average cost of installations, especially given that a small number of large installations can significantly affect average costs over a given period?

Unless the types of questions above are answered, it is difficult to make any rational conclusion in relation to the efficiency of Envestra's costs.

There are clearly differences in operating environment and other factors that need to be taken into consideration when attempting benchmarking. WorleyParsons took such factors into account when conducting their benchmarking, and their conclusion was that Envestra' costs were reasonable.

The strongest evidence of there being valid differences between jurisdictions lies in the fact that Envestra's forecast costs are based on actual costs incurred to connect I&C customers, not simply forecast costs based upon notional figures. The incentive nature of the regime forces Envestra to reveal efficient costs, so a heavy weighting should be placed on actual costs. In any event, average connection costs for I&C customers will vary materially over time depending on the mix of customers (see point 4 above). This was detailed to the Commission (the ECG Report (p42) acknowledges that Envestra's actual unit rates have fluctuated "between $3650 and $1484 per I&C service in these years"). It is therefore incorrect for ECG to assert that "no specific information has been provided supporting Envestra's position".[8]

The Commission has not acknowledged the above or given sufficient weight to this evidence. Instead it has relied inappropriately on a very limited comparison, which is deficient for benchmarking purposes.

The Commission has also been inconsistent in its use of benchmarking data where Envestra's costs are lower than benchmarked costs. For example, ECG reported mains renewal rates in NSW and Victoria of $79-$96/m and $96-$129/m[9]. However, the Commission concludes that Envestra's mains renewal rate should remain at $65/m. This inconsistency evidences an inappropriate application of methodology.

Finally, it is clear that some of the data on which the Commission has relied is incorrect. The Commission has relied upon ECG's recommendation that an appropriate unit rate for I&C services is $1305. ECG has recommended that unit rate based upon Table 6-16 (and similarly, Table 7-15) in their report. That table shows unit rates for AGLN and Envestra Qld as $1305 and $1300 respectively. Envestra advises that:

(a) the Envestra Qld number quoted by ECG is incorrect – it should be $2588[10]

(b) the AGLN unit rate of $1305 cannot be relied upon, as it is the same unit rate as shown in that table for a AGLN domestic service. This clearly cannot be the case, as the cost of laying an average industrial and commercial service exceeds that for the average domestic service.

Envestra therefore submits that the Commission's estimates of I&C unit rates are incorrect and not reasonable, and that Envestra's estimates of I&C unit rates are best estimates on a reasonable basis and compliant with section 8.2(e) of the Code.

Domestic Meters

The data on which the Commission has relied to make its decision is incorrect. The Commission has relied upon ECG's recommendation that an appropriate unit rate for domestic meters is $280. ECG has recommended this unit rate based upon Table 7-14 in their report. That table shows the unit rate for Envestra Qld as $180. ECG go on to say that "as shown in Table 7-14, the unit cost of a meter installation is within the range of $140 to $180"[11]. Envestra advises that:

(a) the Envestra Qld number quoted by ECG is incorrect – it should be $336[12]. Hence the range is not as stated by ECG.

(b) the AGLN unit rate of $180 is not correct. According to ECG's Report for IPART[13], AGLN's actual average unit rate was $195 in 2004.

(c) Even if the unit rate of $180 were correct, and it was correct to apply this figure to the SA network, the Commission has not adjusted this cost for inflation, as the report for IPART is dated August 2004, which implies that the unit rate quoted is possibly in 2003/04 dollars.

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[8] p42, ECG Report
[9] p47, ECG report
[10] p63, QCA Draft Decision in relation to Envestra's Queensland Network, Dec 2005
[11] p74,ECG Report
[12] p63, QCA Draft Decision in relation to Envestra's Queensland Network, Dec 2005
[13] p41, Review of AGLN Gas Access Arrangement for Independent Pricing and Regulatory Tribunal, 30 August 2004

If the AGLN unit rate of $195 is adjusted for inflation and the cost of the meter box and fitting line check (costs unique to SA), this equates to approximately $310, compared to Envestra's unit rate of $308.

Envestra therefore submits that Envestra's estimate of the domestic meter unit rate is reasonable.

> **Security of supply**
>
> ECG ….proposed some variations….These variations involve project staging, with some aspects of some projects deferred beyond the second Access Arrangement Period. The affected projects are:
>
> 1. The Gawler Transmission System Augmentation Project (but does not affect the new supply point);
>
> 2. The Grand Junction Road Project - Stages 2 and 3; and
>
> 3. A further project at Magill
>
> (p122)

Envestra accepts that it may be possible to delay that part of the Gawler project referred to in "1" above, as well as the Magill project and Stage 3 of the Grand Junction Road project. However, as advised by Envestra in its submission to the Commission on 28 February 2006 (p14), Envestra disagrees that Stage 2 of the project should be deferred, for safety reasons:

> *"Envestra acknowledges that Stages 2 and 3 were based on replacement criteria that took into account that the level of risk associated with safety were low. However, based on a recent event involving a trunk cast iron main just off Grand Junction Road, Envestra believes that it would be prudent for safety reasons to ensure that Stage 2 is completed in the next Access Arrangement period. The cast iron main in question had very little history of leaks, but a section of the main "fell out" while under repair. It is clear that the aggressive nature of the soils in this area has led to graphitization of the mains, and the completion of Stage 2 would enable the remaining sections of large diameter cast iron mains in Grand Junction Road to be replaced, significantly reducing the risk from brittle failures."*

The Commission's recommendation to defer Stage 2 is based on ECG's advice:

> *"In its response to ECG's draft report, Envestra advises that a section of the cast iron main in question experienced brittle fracture and the exclusion of stage 2 from the forecast period would increase risks to an unacceptable level. In the absence of a formal risk assessment and evidence that the condition of the remaining Stage 2 cast iron mains has deteriorated and warrants replacement within five years, ECG considers that its recommendation is appropriate."*[14]

Envestra submits that it is inappropriate for

(a) Envestra to undertake formal risk assessments in relation to every project it expects to undertake in the forecast period; and

(b) Envestra to be required to provide evidence of the condition of mains in order to support its forecast of New Facilities Investment;

Both of the above expectations are not only unreasonable but impractical. The Code requires forecasts to be best estimates on a reasonable basis. It would be a mammoth task for service providers to prepare formal risk assessments in relation to five years of forecast expenditure. Apart from the cost of undertaking such an exercise for regulatory review purposes, a cost that would be ultimately borne by users, the need

[14] p93, ECG Report

for such data is limited. Network operators will conduct formal risk assessments when necessary – such assessments are not required in many situations.

Envestra's operational staff has advocated, based on field evidence and experience, that it would be prudent to undertake Stage 2 of the project within the forecast period. Envestra submits that it is reasonable to include Stage 2 in its New Facilities Investment forecast.

Trigger Mechanism

The potential for the Eastern Ring Main and Southern Loops is provided for through a reopening-type trigger mechanism. (p124)

Envestra is unclear on why the Commission believes that the need to obtain planning approvals raises doubt regarding the timing of these projects, or their deliverability. Envestra has demonstrated, and ECG has confirmed, that on the basis of available information, investment in the Southern Loop and Eastern Ring Main is likely to be required over the next five years, and the forecast represents prudent expenditure. This should be sufficient for the Commission to approve the proposed expenditure.

Nevertheless, Envestra is prepared to accept the Commission's trigger mechanism recommendation on the basis that it will not adversely impact Envestra's ability to invest in increasing security of supply in the network during the next access arrangement period.

Envestra therefore proposes that the following trigger mechanism be included in the Reference Tariff Policy:

X.X Trigger Mechanism – Major Augmentation Project

Envestra is proposing to augment the network during the Second Access Arrangement Period by carrying out two projects known as the Eastern Ring Main and the Southern Loop. In the context of this clause, these projects refer, both in nature and in cost ($15.06m and $7.67m respectively in real $ 2005/06), to the proposed projects as submitted to the Regulator as part of Envestra's Access Arrangement review.

Envestra will notify the Regulator when the following Specified Event occurs:
- approval by Envestra's Board of Directors of the Eastern Ring Main and the Southern Loop projects.

Envestra will then apply to the Regulator for an increase in Reference Tariffs that reflects a pass-through of the above costs in relation to these projects.

Amendment 59

The forecast (gross) New Facilities Investment for each year of the second Access Arrangement Period must be changed to reflect the revised values determined by the Commission.

Envestra submits that the revised values determined by the Commission in the Draft Decision must be modified to reflect the matters discussed by Envestra above.

Envestra will revise the New Facilities Investment accordingly when calculating the Reference Tariffs. In addition, Envestra advises that it has become evident over the last 12 months that the price of oil will have a sustained and detrimental impact on various costs, notably those heavily reliant on oil as a feedstock. The consequent impact on the cost of PE pipe is a factor that Envestra can no longer dismiss as short-term or immaterial. This cost increase therefore must be taken into consideration if New Facilities

Investment forecasts are to be best estimates on a reasonable basis. Envestra has calculated below the cost impact resulting from the increase in cost of PE pipe.

The following table sets out

(a) the nominal percentage increase in cost of PE pipe, noting that actual increases have been significant, but with the assumption that similar large increases will not occur in the forecast period
(b) the average incremental cost per metre of PE pipe – this has been calculated by estimating the usage of various sizes of pipe and taking a weighted average of the cost increase per metre of PE pipe used
(c) the forecast length of PE pipe
(d) the resultant additional cost, i.e. (b) times (c) above.

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
nominal % increase	18.7%	15.0%	10.0%	10.0%	2.5%	2.5%	2.5%
incremental ave $/m	$1.50	$0.44	$0.78	$1.15	$1.25	$1.36	$1.47
metres of PE pipe		259500	314000	311000	288000	302000	319000
Additional cost		$114,180	$244,920	$357,650	$360,000	$410,720	$468,930

Envestra proposes to include the above additional cost as a separate line item in its forecast of New Facilities Investment.

Amendment 62

The revised Access Arrangement should remove any provisions relating to the treatment of redundant capital at the time of the next review.

Envestra accepts the above recommendation.

8. NON CAPITAL COSTS

ESCOSA benchmarking

Unlike the WorleyParsons analysis, the Commission has included marketing costs in its analysis as it considers these costs to be largely within the control of each business. While the need for marketing may be different in each jurisdiction, the Commission considers it appropriate to retain these costs in the benchmarks rather than ignoring them. (p147)

The Commission's benchmarking is

(a) incomplete in that it has only compared two indicators and not undertaken any analysis or discussion in order to allow for an informed opinion on the meaning of the data. For example, no information is presented in relation to percentage/length of cast iron mains and the impact that would have on maintenance costs for each network or any other factors that affect the operating environment in the jurisdictions benchmarked; and

(b) flawed in that it has included marketing costs - this is clearly inappropriate.

It is well known that benchmarking of data has limited application if that data is not normalized as far as possible by taking into account known differences that are peculiar to each set of data (as discussed by WorleyParsons). This fact has also been acknowledged by the Commission in that it has excluded UAFG costs from its benchmarking data, presumably on the correct basis that UAFG is a parameter that is influenced significantly by the specific network history and characteristics. However, marketing costs are also influenced significantly by specific network characteristics, ie the market in which the reference services are provided.

It is well known that, due to the difference in climate, gas penetration is far easier to achieve in Victoria than it is in South Australia, and hence that far greater marketing effort is required in South Australia to entice customers to connect. This factor is network specific and an exogenous factor, not one over which Envestra has control. To conclude that this factor is largely within the control of Envestra is essentially concluding that Envestra is largely in control of the climate, clearly a false premise.

Similarly, decisions by governments in relation to energy efficiency or greenhouse policy, and decisions by developers or consumers in relation to alternative energy appliances are market factors over which Envestra has no control. While Envestra acknowledges that it is responsible for determining its marketing program, the impetus for the program are the exogenous factors specific to its network. The inclusion of marketing costs in the Commission's distributor comparison is therefore inappropriate and indicates a possible bias in the Commission's process that provides a misleading representation on which flawed judgements may be made.

Envestra also notes the Commission's comment that "Envestra has presented its own benchmarking of costs as part of the WorleyParsons report. However, the WorleyParsons benchmarking only focuses on costs in one year (2004)"[15]. The rationale for the WorleyParsons approach (of benchmarking 2004 costs only) is that those costs formed the baseline cost from which forecast changes were assessed. This is also the approach on which the Draft Decision was based (and on which Envestra understood the Draft Decision would be based). The WorleyParsons review was therefore focused on providing assurance that the 2004 starting point was efficient. WorleyParsons did not look at:

- costs prior to 2004 because the rationale of the WorleyParsons review was to confirm that the 2004 costs are an efficient starting point (which was subject to review by the ACG in the incentives project); and

- costs following 2004 because they were subject to the detailed assessment by the ECG.

[15] p146, Draft Decision

Network Management Fee

To the extent that the 3 percent management fee represents a profit margin, the Commission's view is that the inclusion of the fee will not reflect the "lowest sustainable cost" for providing the Reference Service, particularly since the contract between OEAM and Envestra has not ever been market tested, and is not at arms length. Even if the 'lowest sustainable cost' is the cost incurred by OEAM, unless it can be shown that the 3 percent management fee reflects a true cost (to OEAM) of providing the service, such as overhead costs, the management fee relates to a margin over and above the 'lowest sustainable cost' of delivering the service. (p151)

Envestra does not accept this amendment. Envestra has addressed this issue in section 5 of Part B of this submission.

IT Non Capital Costs

Envestra has assumed that the forecast IT capital and Non Capital Costs will be incurred in the same year as each other. The Commission believes that it is appropriate to accommodate a 12-month lag in the Non Capital Costs, such that the relevant Non Capital Costs are incurred from years following the project implementation. (P156)

Envestra does not accept this amendment. Envestra acknowledges that it may be appropriate to allow for a nominal lag between the capital and operating costs of an IT project, but submits that a 12-month lag is unreasonable and does not take into account experience nor the reality in relation to the projects that are forecast. As it is expected that the majority of projects would be completed and be operational within a 12-month period, it is unreasonable for the Commission to predict that all projects would not be operational in the same financial year as they are set up. Envestra therefore believes that forecasts derived on the latter basis would not be compliant with the Code.

On balance, Envestra submits that it is reasonable to assume that for 50% of the projects, Non-Capital Costs may be incurred in the following financial year, and that forecasts bases on this assumption would be compliant with the Code. Envestra has amended its forecasts accordingly.

Ageing Workforce

ECG has reviewed these forecast costs and has recommended that the Commission reject them on the basis that Envestra has been unable to demonstrate any other strategic options (e.g. outsourcing) that may have been evaluated by Envestra in attempting to accommodate this situation. ECG has recommended the inclusion of costs associated with the recruitment of graduate engineers on the basis that these positions relate to network planning and design functions for which there are limitations in outsourcing. Without any assurance that Envestra's proposed approach is the most efficient, ECG has been unable to recommend that the remaining expenditure is prudent and efficient.

Taking a general view of the forecast Non Capital Costs, the Commission believes that there is sufficient scope within other Non Capital Costs to accommodate this issue. (p156)

Envestra does not accept the above amendment. The Commission has adopted ECG's recommendation, which has been based upon the belief that Envestra has been unable to demonstrate any other strategic options such as outsourcing.

Envestra provides the following comments:

(a) in relation to "any other strategic options" - outsourcing is the only other option, ie a task can either be performed in-house or not in-house.

(b) Envestra has considered outsourcing. In its response to certain questions (reply to ECG and the Commission of 20 December 2005), Envestra stated:

> *"The contracting out of activities is not considered to be a strategy for dealing with an aging workforce, i.e. a decision to contract an activity would be made on a cost-benefit basis, not on the basis of age of employees. For example, if a pipeline welder is an employee because that is the most cost-effective means of carrying out the work, one would not contract the activity merely because the welder is becoming old. Envestra has determined that its best strategy is to rely upon natural attrition and replace staff with younger persons as opportunities become available. Envestra would only contract out activities if it is clearly cost effective. Given issues such as skills shortages and the need to make redundant or redeploy persons displaced by contractors, outsourcing is not always a cost effective solution, notwithstanding the increasing costs associated with an ageing workforce."*

In its submission to the Commission of 24 February 2006, Envestra also reiterated, on the same issue:

> *"In relation to options in dealing with the aging workforce issue, ECG has indicated that Envestra may not have examined the option of outsourcing. Envestra advises that it has examined this issue. Management considers outsourcing on an on-going basis, and where there are benefits, undertakes outsourcing. This is evidenced by the considerable amount of work that is already outsourced.*
>
> *Furthermore, many of the positions for which "age" is an issue are in areas where outsourcing is not possible, eg network planning, contract supervision, etc. Outsourcing is therefore not a solution to the ageing workforce issue that Envestra faces."*

(c) the Commission has in essence implied that outsourcing is a more cost effective or efficient option than utilizing direct labour. This is not always the case, and each case must be examined on its merits, as discussed in part (b) above.

In summary, the Commission has rejected Envestra's forecast on the basis that outsourcing has not been considered. Envestra advises the Commission again that outsourcing has been considered. In its Draft Decision, the Commission has not concluded that Envestra's estimates are not reasonable under the Code. In relation to the forecast costs that have not been allowed, the Commission has not put forward what estimates it believes would be reasonable estimates. It has only made the statement that it "believes that there is sufficient scope within other Non Capital Costs to accommodate this issue". However, no other Non Capital Costs make specific allowance for recruitment and training of persons to address the ageing workforce issue.

Envestra therefore submits that is forecast costs in relation to Ageing Workforce, and the associated office/equipment costs, should be included in the Non Capital Cost forecast.

Australian Standard AS2558

The Commission has rejected Envestra's forecast costs associated with changes in Australian Standards and increased regulatory compliance costs as there is no firm basis to support such cost increases at this point. The Commission believes it is speculative to forecast such cost increases. (p157)

Envestra advises that in relation to

(a) the revised Australian Standard – the revisions to the standard are currently being finalised and latest advice from the Chair of the relevant Australian Standard committee is that the standard will come into force in July 2006. Therefore there is no speculation in this regard. Its content is known and hence the impact on Envestra's operations can be forecast with a high degree of certainty, eg it is a fact that the standard will require:

- more frequent patrolling of transmission pressure sections of the network than is currently required;
- more frequent markers on the pipeline network, and upgrades to some existing markers. Marker signs are currently required at 500m intervals for a T1 location class, whereas the revised standard will require marker signs at 100m intervals. In total approximately 1,700 new marker signs will need to be installed at a cost of $100 each;
- greater levels of documentation and record keeping, including producing, processing, checking and filing records, in order to demonstrate compliance with the Australian Standard; and
- increased costs associated with welding procedures.

The above costs must be allowed for in order to enable Envestra to recover the costs that would be incurred by a prudent Service Provider acting efficiently and in accordance with good industry practice and in accordance with its regulatory obligations (since it is required to comply with AS2885).

(b) Increased regulatory compliance costs – Envestra advised the Commission in its submission of 28 February 2006 that it had already recently employed an additional person in this area (a cost which is not in the base costs). Therefore there is no speculation in this regard.

Notification of Periodical Meter Changes

Envestra's forecast increase in Non Capital Costs relating to the provision of five business days notice of a supply interruption associated with a periodic meter change is also not accepted by the Commission on the grounds that the five business day requirement has existed under the Gas Distribution Code since March 2004 and compliance costs associated with it should be incorporated into the baseline expenditure. (p157)

The Commission has erred in arriving at its conclusion in that the provision of five days notice does not apply to periodic meter changes and is therefore not included in the baseline expenditure. The requirement to provide five business days notice applies to planned interruptions only. Periodic meter change work is not of a planned nature, ie it is not planned to be undertaken in any particular week or on any particular day or at any particular time – periodic meter changes are used as "fill-in" jobs (when higher priority work such as leak repairs are not available, in order to maximise efficiency in operating the network). As previously advised to the Commission:

"While clause 6.2.1 does not apply to periodic meter changeovers as such work is essentially not of a planned nature, a recent investigation by the SA Ombudsman caused Envestra to investigate whether it is feasible to implement a means of notification to consumers of an impending meter change (there are approximately 35,000 meter changes per year)."[16]

While Envestra is not required to give advance notice of meter changes, Envestra believes improved service to consumers will result if affected consumers received written notice of an impending meter change.

Responding to External Enquiries

Envestra has also been unable to provide any tangible evidence to support its increased expenditure relating to "increased service response" and " responding to external enquiries". Anecdotal evidence of increased activity in these areas is insufficient for the Commission to approve increased expenditure. The Commission concludes that these forecast costs are not prudent and efficient. (p157)

Envestra is concerned that the Commission's approach is not consistent with the Code. The Commission appears to be of the view that "tangible evidence" is required to support estimates of forecasts of costs that are to be incurred up to 6 years from the time that the forecasts are developed.

Notwithstanding the above, Envestra has provided tangible evidence to the Commission in relation to the recent increase in external enquiries to which Envestra is subjected. This tangible evidence is set out in Table 8-55 of the ECG Report (see following table).

Item	% Increase 2004/05 to 2005/06
Ombudsman enquiries	91%
Retailer requests for assistance/enquiries to operations	17%
OTR requests for assistance, information	38%
Retailer and customer enquiries to Envestra	1,500%
Retailer reinstatement enquiries	21%

It appears that the Commission has not taken account of the above tangible evidence as set out in the ECG Report.

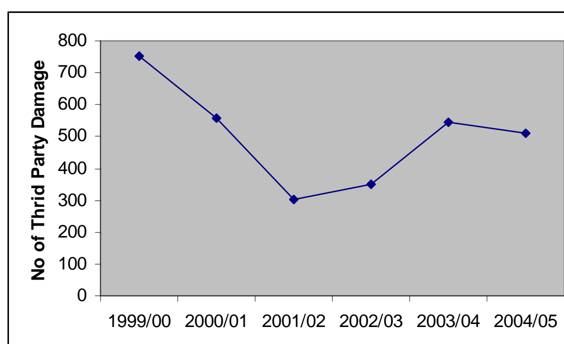
Envestra notes ECG's comment[17] that it would expect the bulk of external enquiries, ie from retailers, customers, the Commission, the Ombudsman and the Office of the Technical Regulator, to be handled under a "fee for service" basis. If the Commission endorses the recommendation of its consultant, Envestra will consider this alternative, but Envestra does not consider such an option to be practical.

Envestra submits that the evidence shows that significant increases in workload, and hence costs, is occurring in this area and that Envestra's Non-Capital Cost forecast must make adequate provision of resources to perform the functions outlined above. Envestra believes that its forecast is a best estimate of the respective Non-Capital Cost to be incurred.

[16] submission to Commission by email, 26 October 2005
[17] p169, ECG Report

Dial Before You Dig
Envestra has forecast increased expenditure to promote the dial before you dig (DBYD) service in light of historical third-party damage incidents and a recent near-fatal incident. The Commission recognises DBYD as an important service in promoting safety, but supports ECG's conclusion that current resources are sufficient for Envestra to ensure the ongoing success of the scheme. (p158)

In its submissions to ECG and the Commission, Envestra has conveyed the background to the need for increased resources in this area. In its submission to the Commission on 24 February 2006, Envestra included the following graph that shows an increasing trend of third party damages over recent years:



The trend is of concern to Envestra and has been noted by the Office of the Technical Regulator. As Envestra is conscious of the need to be pro-active in seeking to minimise the number of incidents, it has been working, in conjunction with other authorities, to increase the awareness of the DBYD service, albeit much further work remains to be done (as evidenced by the above trend). Envestra is therefore perplexed by the Commission's comment that the scheme portrays "on-going success" and that it believes that current resources devoted to this area is sufficient.

If Envestra were to accept this position, it would not be able to comply with undertakings given to the Office of the Technical Regulator, whereby Envestra undertook to become more proactive in the promotion of DBYD by undertaking activities such as the provision of gas awareness information sessions and material to councils, excavation contractors and major utility contractors. It does not appear that the Commission has consulted with the Office of the Technical Regulator on this matter, in order to ensure that Envestra has sufficient resources to ensure the safe operation of the network.

Envestra therefore submits that its forecast is not only reasonable, but also necessary in order for it to meet its regulatory obligations.

Cost of servicing new customers
In addition, the Commission agrees with ECG's recommendation that the "cost of servicing new customers" component proposed by Envestra is not efficient and has accepted ECG's revised costs. (p159)

The Commission has accepted ECG's recommended costs. ECG's costs have been incorrectly calculated, in that ECG has not taken into account the accumulated number of new customers, e.g. if there are say, 1000 additional customers in year one, then those 1000 customers will still be there in subsequent years.

Instead, ECG has only taken into account the number of new customers added in any particular year, and not the cumulative number over time. Also:

- ECG has not included the small number of new customers in new towns; or
- Allowed for the additional consumers in 2005/06, which are not in the base costs.

Below is a summary showing the derivation of the correct figures.

Increased Cost $nom	05/06	06/07	07/08	08/09	09/10	10/11
New consumers each yr		6,972	7,080	6,426	6,977	7,286
Addn'l consumers new townships		0	218	178	274	207
Cumulative addn'l consumers	6,240	13,212	20,510	27,114	34,365	41,858
Cost of additional consumers		$161,509	$256,991	$348,233	$452,393	$564,810
Total		**$161,509**	**$256,991**	**$348,233**	**$452,393**	**$564,810**

Consequently, when the cumulative costs are taken into consideration, it can be seen that Envestra's forecasts are appropriate.

Environmental management

The Commission's Draft Decision removes the forecast $8m of monitoring, investigation and remediation Non Capital Costs from the environmental management category under Material Changes. (p159)

Envestra does not accept this amendment. Envestra has addressed this issue in section 6 Part B of this submission.

Amendment 64

The forecast Non Capital Costs for each year of the second Access Arrangement period must be changed to reflect the revised values determined by the Commission, as set out in Table 10.19.

As part of this amendment, Envestra is required to remove the 3% network management fee from its forecast Non Capital Cost unless it can demonstrate to the satisfaction of the Commission that the inclusion of the management fee is consistent with the Code requirement that the forecast Non Capital Costs achieve the lowest sustainable cost of delivering the Reference Services.

Envestra does not accept the revised values determined by the Commission, as set out in this submission. In relation to the network management fee, Envestra will address this issue separately.

Amendment 65

Envestra must remove its proposed increase in insurance costs unless it can substantiate its forecast of rising insurance premium relative to 2004/05 amounts.

Envestra does not accept this amendment. The Commission has erred in that it has based its decision on the assumption that Envestra is seeking increases in insurance costs relative to 2004/05. This is incorrect.

This issue has arisen because ECG queried why administration costs had shown a step increase from 2003/04 to 2004/05. A substantial portion of the increase related to insurance costs. Envestra is not forecasting any real increase in insurance costs from 2004/05. The step increase is related to historical actual costs which should therefore be allowed by the Commission.

Amendment 66

Envestra must amend clauses 9.1 to 9.8 of its submitted Access Arrangement Information to reflect the approved Non Capital Costs, including the incorporation of UAFG into approved Non Capital Costs...

Envestra accepts this amendment but, as advised to the Commission, is undertaking a tender process to establish a firm price for UAFG gas for the forecast period. It is expected that this price will be finalized in time to be reflected in the approved Reference Tariffs.

9. TOTAL REVENUE

Envestra will recalculate the total revenue requirement taking into consideration the Final Decision.

10. REFERENCE TARIFFS

Amendment 71

Envestra is required to apply an allocation of Total Revenue to the demand haulage Reference Service that is demonstrably no greater than the efficient stand-alone cost of providing this service during the second Access Arrangement Period.

Envestra accepts this amendment.

Amendment 72

Envestra must amend its proposed Reference Tariff schedules to accommodate other Amendments to the Access Arrangement and Access Arrangement Information.

Envestra accepts this recommendation. However, there are a number of matters that need to be taken into account when finalising the tariff schedules in addition to those mentioned by the Commission in the Draft Decision.

Tariff Steps for Volume Tariffs

The current South Australian Volume tariffs have tariff steps or components that include fractions of a GJ specified to several decimal points. For example the first step of the Domestic Tariff applies to the first 0.0493 GJ of gas delivered per day. This arose because the tariffs were originally presented as steps to apply per quarter, but prior to the final approval were converted to equivalent daily values.

Envestra proposes to simplify the tariffs by "rounding" the current tariff steps to the nearest whole number of GJs as set out below:

Existing Step	Proposed Step
0.0493	0.05
0.9863	1.0
4.274	4.0
11.178	11.0

These changes will be made in a way that is revenue neutral, but provides a simpler tariff structure for the future.

Transition from Tariff V to Tariff D

The current tariffs in South Australia do not provide for a sensible transition for Tariff V consumers transferring to Tariff D.

A volume consumer using 10,000 GJ per annum on the 2005/06 Volume tariff in South Australia will pay an annual network charge of $19,524 (excluding GST).

Consumers using 10,000 GJ per annum or more are eligible for the Demand tariff, and a consumer at this level would have a Maximum Daily Quantity of about 50 GJ. The annual charge (at 2005/06 tariffs) for a MDQ of 50 GJ is $24,816. It is illogical that a consumer should receive such a large increase in tariff for consuming slightly more gas as it moves above the 10,000 GJ threshold. The cost of supplying the consumers will be almost the same, except a tariff D consumer will require demand metering and telemetry.

The structure of the V and D tariffs could be amended to address this problem by:

- Increasing some steps of the Commercial tariff;
- Decreasing the first step of the Demand tariff, or
- A combination of both the above

The actual tariff changes required will depend on the final price path required to achieve the target revenue specified in the Final Decision. Envestra will take account of this issue when preparing the tariffs to apply following the Final Decision.

Negotiated Tariffs

There are three Demand consumers in the Network for which a tariff other than the Reference Tariff applies. Two are consumers supplied under long-term contracts that were entered into before the first Access Arrangement was finalised. The other, also supplied under a long-term contract, is a special case where it was necessary to negotiate a tariff less than the Reference Tariff in order to secure the load. In these cases, Envestra considered that it was necessary to offer prudent discounts, as all consumers are better off relative to the alternative of the loss of these consumers.

Further information about these special cases can be provided to the Commission on a confidential basis upon request.

Envestra has not yet amended its tariff schedules as the total revenue requirements in the Final Decision are likely to differ from those set out in the Draft Decision. Envestra will ensure that its tariff schedules

included in its approved Access Arrangement are consistent with the revenue requirements of the Commission's Final Decision.

<u>Other Minor Amendments</u>

There are a number of other minor corrections required to the model that calculates the Reference Tariffs. These amendments will be included in the revised model to be provided to the Commission.

Amendment 73

Envestra's tariff basket approach must be amended to apply separately to each haulage Reference Service.

Envestra does not agree with the Commission's amendment on the application of the tariff basket, noting that the Commission's proposed approach would represent the most prescriptive application of this regulatory control currently applying (or proposed to apply) to Envestra's gas distribution tariffs. The Commission has opted for three separate "tariff baskets" for the following two reasons:

- the potential for a single tariff basket to breach the ceiling represented by stand alone costs for demand customers given that the reference tariffs may be close to stand alone cost; and
- a greater capacity for Envestra to ratchet its total revenue above the level of regulated revenue under a single tariff basket.

With regard to the first issue, Envestra has undertaken an assessment that shows the demand haulage reference tariffs recover no more than the efficient stand alone cost of providing services to these customers. This analysis will be provided to the Commission as indicated under amendment 71.

In support of this, Envestra has also provided to the Commission an assessment of the cost reflectivity of all its proposed distribution tariffs, which shows that all tariffs lie within the band set by incremental and stand alone cost.

With regard to the second concern, the Commission has focused its attention entirely on the ability for Envestra to earn total revenue 'above the level of regulated revenue'. Envestra notes that the Commission has not discussed the issue from the perspective of the business, namely to provide a mechanism that assists it to achieve the regulated revenue. That is, no consideration has been given to the requirement under clause 8.1(a) of the Code to provide the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service.

Over the past regulatory period, and consistent with experience in most jurisdictions, Envestra has not earned the regulated revenue that has been set. Envestra would have therefore considered it appropriate, if anything, to implement proposals aimed more at facilitating revenue recovery rather than limiting it. This is particularly a concern if the demand forecasts in the Final Decision remain similar to those in the Draft Decision.

In addition, inherent in any form of tariff basket (including that proposed by the Commission in its Draft Decision) is the incentive for the business to outperform the revenue benchmarks. Regulatory regimes based on some form of price or average revenue form of regulation provide an incentive for the business to increase sales where it is efficient to do so (for example, by increasing network utilisation to the benefit of consumers). The Commission's desire to limit Envestra's ability to recover revenue appears more akin to a control placed on total revenue.

Whether or not actual revenue exceeds or falls below the regulated revenue determined by the Commission will be determined by the volume of gas actually delivered. Whether the price control mechanism applies to the "tariff basket" of all three tariffs or to each tariff individually (as proposed by the Commission) will **not** affect Envestra's ability to increase its total revenue.

The Commission's decision to adopt three separate "tariff baskets" has not adequately taken into consideration Envestra's legitimate business interests (as required by section 2.24(a) of the Code). Envestra proposes that the tariff basket methodology proposed by Envestra in its original submission be approved by the Commission.

Amendment 74

The side constraint formula must be corrected to provide that the side-constraint factor applies relative to the relevant CPI-X price path.

Amendment 75

The side constraint factor applying in any one year must be set at 2.5 percent.

Envestra accepts the above recommendations.

X factor

Amendment 76

The X factor proposed by Envestra in Box 1, Annexure E of the revised Access Arrangement must be amended to -0.003.

Amendment 77

The X factor in clauses 2.3 and 13.2 of the submitted Access Arrangement Information must be amended to –0.003.

Envestra will recalculate the X factor taking into consideration the Final Decision.

Impost Pass-through

<u>**Amendment 79**</u>

In order for Envestra's proposed revised Access Arrangement to be approved, Envestra must:

- modify its definitions with the effect that any imposts or statutory charges imposed by any local government or statutory authority or any other body authorised by law to impose such imposts or statutory charges are unexpected and beyond Envestra's control and not as a result of Envestra's actions;
- include a materiality threshold for cost pass-through events of 1 percent of (forecast) annual revenue per event based on the forecast revenue in the year in which the event occurred; and
- clarify that the resultant Reference Tariff variation is subject to Commission's approval in accordance with the Code.

Envestra accepts the amendments in relation to the first and third points above.

In relation to the materiality threshold, Envestra does not accept a materiality threshold for cost pass-through events of 1% of forecast annual revenue, especially since imposts usually result in additional costs, meaning that impost pass-through events cannot be considered as symmetrical in nature.

Envestra notes that the Commission has provided no evidence or analysis of the Code to support its requirement for the materiality threshold. The Commission has simply asserted: "*Relatively minor events should not be considered for pass-through. Only substantive changes in costs should be covered by the mechanism*."

The Commission has then proceeded to adopt a 1% threshold because AEMC has done so in its February 2006 rule proposal report. That report relates to a different regulatory environment and has no relevance to the application of the Code. The Commission must apply the principles set out in the Code. It is not a valid exercise of the Commission's power to impose a materiality threshold because that has been recommended by another regulator or another regulator administering a different industry subject to a different regulatory environment.

Further if the Commission's recommendation were implemented and only one event per year eventuated, it would be possible for Envestra to lose up to $7.5m of revenue over the second Access Arrangement period (this representing 1% of Envestra's proposed revenue forecast). Such an amount cannot be considered by any reasonable person to constitute an immaterial amount.

Presumably the Commission's proposal of instituting a materiality threshold is aimed at avoiding frivolous requests for impost pass-through. As Envestra has not made any such requests, Envestra is perplexed at the need for the Commission to consider a materiality threshold.

In any event:

(a) materiality needs to be considered in the context of costs and benefits of the situation concerned. In this situation, the relevant costs are those of the service provider in preparing a request, the

costs of the Regulator in assessing a request and the costs of users in adjusting their tariffs if required. It is considered that the total of such costs, depending on the nature of the impost, would be less than $20,000.

(b) The Commission's proposal is not consistent with its own philosophy on materiality, since the 1% threshold is considered as a threshold "per event" rather than an annual threshold. This means that two events in one year, each equivalent to 0.9% of the threshold, could occur with no pass-through. This implies that the Commission considers, for example, that an impost equivalent to 1.8% of revenue is also not material.

(c) A materiality threshold is not consistent with the Commission's intention to allow the service provider to earn the regulated rate of return. To deny Envestra the opportunity to earn 1% of the required revenue equates to the Commission approving a lower rate of return than that recommended in the Draft Decision.

In any event the Commission's recommendation is inconsistent with, and not permitted by, the Code. The imposition of a materiality threshold is not consistent with any of the objectives set out in section 8.1 of the Code. The six objectives to which the Commission must have regard in determining a Reference Tariff and Reference Tariff Policy are set out in the following table:

Objective	Application to materiality threshold
8.1(a) – Providing the Service Provider with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service.	The materiality threshold is inconsistent with this objective. The threshold will prevent Envestra recovering all efficient costs incurred in delivering the Reference Service. As imposts are, by the Commission's definition, beyond Envestra's control there can be no argument they are not efficient.
8.1(b) – replicating the outcome of a competitive market.	In a competitive market imposts will generally be passed through to the ultimate consumer. There is nothing in this objective which justifies a materiality threshold.
8.1(c) – ensuring the safe and reliable operation of the Pipeline.	Arguably this objective is not relevant to this issue. However Envestra notes that requiring Envestra to incur costs (to pay imposts) without providing it with the revenue to recoup those costs reduces the funds otherwise available to Envestra to operate and maintain its network.
8.1(d) - not distorting investment decisions in Pipeline transportation systems or in upstream and downstream industries	Requiring Envestra to incur costs (to pay imposts) without providing it with the revenue to recoup those costs reduces the funds otherwise available to Envestra to invest in development of its network.
8.1(e) – efficiency in the level and structure of the Reference Tariff.	The imposition of a materiality threshold does not increase the efficiency of the Reference Tariff.
8.1(f) – providing an incentive to the Service Provider to reduce costs and to develop the market for Reference and other Services.	As imposts are beyond Envestra's control (under the Commission's definition) they cannot be avoided. There is therefore no way for Envestra to eliminate this cost. Requiring Envestra to bear a certain portion of impost costs will not provide any incentive to Envestra to reduce those imposts costs (as this cannot, by definition, be achieved). Further as noted above, requiring Envestra to incur costs it cannot recoup reduces the funds available to Envestra for activities such as developing the market for Services.

No objective in section 8.1 supports the materiality threshold. Rather the objectives either support removal of the threshold or are not relevant to this issue.

Further section 8.3 of the Code provides:

> "*Subject to section 8.3A[18] and to the Relevant Regulator being satisfied that it is consistent with the objectives contained in section 8.1, the manner in which a Reference Tariff may vary within an Access Arrangement Period through the implementation of a Reference Tariff Policy is within the discretion of the Service Provider.*"

That is, it is for Envestra to propose the triggers for variation of a Reference Tariff. The Relevant Regulator can only reject the variation methodology proposed by Envestra if it is inconsistent with section 8.1 (section 8.3A being a procedural section). Envestra does not propose the use of a materiality threshold. Rather Envestra's position is that a materiality threshold should not be included as that would mean Envestra is not able to recover all its efficient costs of delivering services. There is nothing in section 8.1 which requires inclusion of such a threshold – therefore the Commission must approve Envestra's proposal without constraining it by including a materiality threshold.

One of the principles underpinning Chapter 8 is (essentially) that the Service Provider must be able to recover costs which would be incurred by a prudent Service Provider acting efficiently – expressions of this concept are contained in section 8.1(a) and section 8.37. For the Commission to refuse to allow Envestra to recoup imposts (a cost which Envestra cannot mitigate) places Envestra in a position where it cannot recover a cost which will inevitably be incurred by a prudent Service Provider acting efficiently

11. FIXED PRINCIPLES AND INCENTIVE MECHANISM

<u>Amendment 80</u>

Envestra must delete the references to the proposed Fixed Principles 1, 2 and 3 from the proposed revised Access Arrangement.

Envestra accepts the above recommendation.

<u>Amendment 82</u>

Envestra must amend its proposed Incentive Mechanism to clarify the intent of the "no claw back" provision under clause 5.5.2(2) of the proposed revised Access Arrangement to ensure that it does not constrain the efficiency carryover mechanism from allowing customers to share in the benefits of the business' efficiency gains.

<u>Amendment 83</u>

Envestra must amend its proposed Incentive Mechanism to clarify in clauses 5.5.2(3) and 5.5.2(4) of the proposed revised Access Arrangement that these provisions are subject to the provisions set out in clauses 5.5.3(1) and 5.5.3(2) of the proposed revised Access Arrangement.

[18] Which section sets out various procedural matters.

Envestra will amend its Access Arrangement to give effect to amendments 82 and 83.

Amendment 84

Envestra must amend its proposed Incentive Mechanism by deleting reference to the ten-year carryover period and inserting reference to a five-year carryover period.

Envestra's primary concern with the Commission's Draft Decision on the efficiency carryover mechanism concerns the period over which efficiency gains can be retained by the business. In its Draft Decision (p. 207), the Commission set out the following reasons for its five-year carryover period:

> "The Commission considers that a sharing ratio of 30:70 between the Service Provider and consumers is consistent with the requirement of the Code as it provides a sufficient incentive for the Service Provider to seek out efficiencies, and ensures that customers receive sufficient gains from any efficiencies achieved. This sharing ratio is achieved under a five year carryover period."

The Commission prefaced its decision by a similar decision made by the then Office of the Regulator-General in Victoria in relation to electricity distribution prices for the 2001-05 period.

Envestra is unsure of the basis of the assertions made by the Commission regarding the appropriate power of the incentive mechanism that would comply with the Code and be sufficient to drive efficiencies. The five-year sharing ratio is driven primarily by mechanisms adopted elsewhere rather than any consideration of Envestra's views and the requirements of the Code.

In particular, Envestra is of the view that it operates at a level that is consistent with industry best practice. This is due in large part to its prudent business decision of engaging OEAM to operate and maintain its distribution network. In doing so, Envestra achieves significant benefits not just through economies of scale and increased purchasing power, but through economies of scope and specialisation.

These benefits are generally reflected in the various assessments undertaken into Envestra's current and forecast expenditure as part of this Access Arrangement review, including that undertaken by both Envestra's consultant (Worley Parsons) and the Commission's consultant (ECG).

Envestra is of the view that a five-year sharing ratio, to the extent that this might have provided an appropriate incentive in the past, will not provide a sufficient incentive going forward. This is because efficiency gains become harder, or more risky to achieve, the longer a business has been exposed to commercial and regulatory pressure aimed at driving costs towards industry best practice.

Achieving efficiency gains under this scenario requires the business to devote increasingly more resources to seek out ways of improving the way the business operates. This investment required, and hence the risk taken on by the business, therefore increases over time.

Envestra therefore believes that it is appropriate that the Commission consider the change in the environment under which Envestra operates rather than just adopt decisions made in other jurisdictions. Envestra is also unsure why the Commission considers its approach better meets the requirements of the Code and how section 2.24 of the Code has been considered in making this decision.

Envestra proposes that efficiency benefits should be shared 50:50 between customers and Envestra. This is necessary to take into account the additional costs and risks associated with obtaining improvements in efficiency, greater than the considerable improvements already embedded in Envestra's forecasts. The Commission should also note that the productivity improvements embedded in Envestra forecasts over the next five years will be passed through totally to customers without any benefit accruing to Envestra.

Furthermore, there is no evidence provided by the Commission that the existing 10-year carryover mechanism is inappropriate. Hence, given it currently applies, Envestra contends that there is no reason to amend it.

<u>**Amendment 85**</u>

Envestra must delete the following sentences from clause 5.5.3(1) of the proposed revised Access Arrangement:

> *The operating expenditure benchmark for the third Access Arrangement Period will then be higher than otherwise for the third Access Arrangement Period by the amount of the efficiency gain. This will provide Envestra with precisely the same reward had the expenditure level in the last year been known.*

<u>**Amendment 86**</u>

Envestra must amend clause 5.5.3(3) of the proposed revised Access Arrangement to allow for an adjustment to expenditure benchmarks to reflect exogenously determined changes in the scope of activities which impose material additional costs to the Service Provider.

<u>**Amendment 87**</u>

Envestra must amend the proposed Incentive Mechanism by removing the ability to adjust the expenditure benchmarks for the purposes of calculating efficiencies to reflect differences in forecast and actual output.

Envestra accepts these amendments.

<u>**Amendment 88**</u>

Envestra must amend clause 5.5.3(4) of the proposed revised Access Arrangement to allow for the treatment of any net negative carryover amounts determined at the end of the second Access Arrangement Period to be considered by the Relevant Regulator at the time of the next Access Arrangement review.

Envestra does not accept this amendment. The Code does not permit negative carryovers from one regulatory period to the next. Section 8.44 of the Code refers to the efficiency carryover mechanism in "positive" terms only, i.e. the Code provision only relates to efficiency gains, not efficiency losses. The section refers to the Service Provider retaining a share of returns which exceed the level of returns for an Access Arrangement Period and refers to such additional returns resulting "*amongst other things, from lower Non Capital Costs or greater sales of Services than forecast*." Similarly clauses 8.45 and 8.46 all refer only to positive concepts –exceeding a revenue target, minimising overall costs and developing new Services. There is simply no mention in section 8.44 of a negative carry-over mechanism.

The Commission states that "*it is of the view that section 8.44 discusses efficiencies in the positive sense, but it is of the view that the Code does not preclude negative amounts from being carried forward from one period to the next*." However the Commission has provided no analysis of the Code to support this view – that is, it has not indicated where in the Code it obtains the power to direct Envestra to utilise a negative carryover mechanism.

The Code does not permit the Commission to direct Envestra to use a negative carryover mechanism. If Envestra's Reference Tariff Policy is to include an incentive mechanism, the Code only allows the carrying-over of positive amounts.

12. CAPACITY MANAGEMENT, TRADING AND QUEUING POLICIES

Envestra agrees with the Commission's conclusions on these policies.

13. EXTENSION POLICY

Amendment 91

The proposed revised Access Arrangement must be amended to reinstate the provision that Envestra must obtain written agreement from the Commission prior to excluding a significant extension from the Covered Pipeline by the inclusion of words with the following effect:

> An extension which is directly connected to an existing Covered Pipeline will not be treated as part of the Covered Pipeline through the operation of the extensions/expansion policy if:
>
> (a) the extension is a significant extension (or where Envestra can demonstrate the extension represents a special case); and
>
> (b) Envestra obtains the Commission's written approval to exclude the extension from the Covered Pipeline.

Envestra accepts the above recommendation.

ATTACHMENT 1

Letter from Willis Australia Ltd

[confidential attachment]