Summary

Envestra submitted its Access Arrangement revisions and Access Arrangement Information to the Commission on 30 September 2005. The revisions to the Access Arrangement set out Envestra's proposed reference tariffs and associated terms and conditions for the provision of reference services in South Australia for the 5-year period commencing July 2006.

The Commission issued its Draft Decision on 28 March 2006 setting out the amendments it requires Envestra to make to its proposed Access Arrangement in order for it to be accepted as compliant with the Code.

Envestra has accepted many of the amendments put forward by the Commission. However, in a number of cases, Envestra believes that the Commission has erred in making its recommendations by stating its preferred position, rather than objectively assessing Envestra's proposal against the Code. The key concerns raised by Envestra in this submission are summarised below.

Rate of Return

The Commission has proposed that a real pre-tax WACC of 6.16% complies with the Code requirements to approve a rate of return that is consistent with prevailing market conditions in the South Australian energy market.

Envestra disagrees with this recommendation, as the Commissions' allowed rate of return will be insufficient to fund equity and debt obligations in the current market. Specifically, Envestra notes that:

1. the Commission's view on the bounds of the reasonable range for parameter values used to calculate the rate of return are inconsistent with the available evidence. Specifically, the ranges proposed for equity beta, gamma and the market risk premium do not reflect prevailing market conditions. The implication is that the ranges used by the Commission for determining the rate of return need to be revised; and
2. the Commission need to recognise and take into account the impact of uncertainty in selecting WACC parameters.

Envestra has commissioned a report by Professor Stephen Gray, an expert in corporate finance and the intricacies of the Capital Asset Pricing Model. The report demonstrates that some of the assumptions on WACC parameters used by the Commission are inconsistent with the empirical and theoretical evidence. Unless the Commission modifies its assumptions on these key parameters, it will fail to set WACC at a level consistent with prevailing conditions in the market as it is required to do under the Code

On the basis of this advice, Envestra has revised the ranges of some of the WACC parameters and recalculated the WACC. A point estimate has been determined as the mid-point between the 50th and 75th percentiles. This analysis confirms that the appropriate real pre-tax WACC for the South Australian covered network is 7.3%.

Prepayment

The Commission required Envestra to amend the terms and conditions of its Access Arrangement so that network charges are invoiced in arrears rather than in advance, as is currently the case. The Commission stated:

a) the prepayment provision is not required for Envestra to manage credit risk, as this is already addressed by the Access Arrangement's credit policy;

(b) the prepayment clause may act as a barrier to entry;

(c) the complexity of administering the prepayment arrangements is inconsistent with the "economically efficient operation" consideration in section 2.24(d) of the Access Code;

(d) the prepayment provision is not standard practice;

(e) the prepayment provision places a working capital burden on Users which is more appropriately borne by Envestra; and

(f) full retail competition was not in place when the prepayment provision was approved by SAIPAR – therefore despite section 2.46 of the Code, it is now appropriate to require a change to the prepayment provision.

Envestra's submission demonstrates that:

a) Envestra's credit policy is insufficient to manage credit risk. An effective mechanism for managing credit risk is a legitimate business interest which the Commission must provide for in its Final Decision. This is most efficiently done through maintaining the existing prepayment terms;

(b) the fact that churn rates in the South Australian gas market are the highest of any state supports a conclusion that prepayment has not been a barrier to entry;

(c) arrangements for administering prepayment are already in place and are not complex or inefficient, particularly when compared against the requirement for retailers to comply with the retail market rules;

(d) prepayment is a commonly used invoicing technique. A pertinent example is the Commission's own invoicing terms for licence fees, which are prepaid. Other examples include most water authorities, telecommunication charges, property rents, and lease fees;

(e) in the event that prepayment is removed, Envestra would be required to inject about $40m of additional equity into the business to maintain cash flow. The Commission has made no allowance in the Draft Decision for the cost of funding additional equity; and

(f) the argument regarding full retail competition is without basis as the whole purpose of the Access Arrangement is to enable full retail competition. Nothing has changed in this regard since SAIPAR approved the Access Arrangement for the current period.

Envestra's current payment terms were approved by the previous Regulator (SAIPAR) under the Code, and Envestra is not proposing to change those terms, which have formed an integral part of Envestra's capital structure. In addition, the prepayment clause provides appropriate financial protection against user default, which is particularly relevant given users are mostly retailers and there is no retailer of last resort scheme operating in South Australia.

Abolition of prepayment would result in a cash flow deficit for Envestra of approximately $40m in the first year of the second access arrangement period. Envestra would be unable to fund the shortfall in revenue through working capital as it is prevented from doing so by its financial covenants. Envestra believes that the Commission has not adequately taken into account Envestra's legitimate business interests, as it is required to do under section 2.24(a) of the Code, in considering this matter. Implementation of the Commission's recommendation without providing appropriate compensation to Envestra to replace this cash flow deficit will have significant financial implications for Envestra's business including a likely downgrade of its credit rating. Standard and Poors, who have placed Envestra on negative credit watch, have already recognized the potential impact of the Draft Decision on cash flow.

Operating and Capital Cost Forecasts

The Commission has proposed to reduce Envestra's operating and capital costs by about 17% and 22% respectively from that proposed by Envestra in its Access Arrangement revision. Envestra disagrees with the non-capital cost and capital cost reductions proposed by the Commission in its Draft Decision, aside from reductions stemming from the proposed trigger mechanism and the correction of minor errors. Further information is provided in Envestra's submission to assist the Commission examine these matters further.

Network Management Fee

The Commission has removed from the benchmark non capital costs an amount reflecting the network management fee paid by Envestra to OEAM under its O&M Agreement. The Commission has noted that the fee, which represents 3% of network revenue, does not relate to a particular service provided by OEAM to Envestra.

Envestra believes that the Commission has erred in its construction of section 8.37 of the Code in that the Commission has sought to determine the lowest sustainable costs of OEAM providing Reference Services rather than the costs that could be achieved by a Service Provider. In Envestra's case, the lowest sustainable cost is achieved by engaging a contractor and paying the requisite costs necessary to engage such a contractor.

In applying section 8.37 of the Code, an assessment needs to be made as to whether the Service Provider has acted efficiently, prudently, in accordance with accepted and good industry practice and with the intent of achieving the lowest sustainable cost. Envestra has demonstrated, through an assessment undertaken by PricewaterhouseCoopers (among other things), that the prudent and efficient course is to outsource the management of its network.

The Commission has also failed to take into account section 2.46 of the Code, which requires the Regulator to take into account the provisions of the current Access Arrangement. The network management fee is currently reflected in Envestra's non-capital costs, which indicates that the fee has previously been assessed as consistent with the requirements of section 8.37 of the Code (as is also the case in Envestra's Victorian and Queensland Access Arrangements).

Section 2.24(a) of the Code requires the Regulator to take into account the Service Provider's legitimate business interests. However, there is no evidence to suggest that the Commission has considered the fact that it is placing Envestra in a position where it will be required to incur a cost (the payment of the network management fee, which has the effect of reducing overall non-capital costs) which it can no longer recover through its Reference Tariffs.

Moreover, section 2.24(b) of the Code requires the Regulator to take into account firm and binding obligations of the Service Provider. Again there is no evidence that the Commission has taken this factor into account – that is, the fact that Envestra is party to a contract with OEAM requiring Envestra to pay the network management fee.

The Commission has wrongly considered that Envestra and OEAM are related parties, which has in turn caused the Commission to raise concerns about non arms length transactions and the lack of market testing. These issues are irrelevant as OEAM is not a related party to Envestra and there is transparency about the direct costs involved. That is, Envestra has no financial interest in OEAM and therefore no incentive to inflate any cost related to the O&M Agreement, which would be against the best interests of shareholders (particularly that of CKI, whom are Envestra's largest shareholder).

The contract was negotiated at arms length, with each party represented by separate negotiating teams reporting to two separate boards. Included in the contract are incentive arrangements and strict contract management provisions, both of which have significantly contributed to a 15% reduction in operating costs per end user over the current regulatory period. Such cost savings stemming from the contract have been passed through by Envestra to consumers.

There have been many reviews into Envestra's non-capital costs and capital costs as part of this process, including that undertaken for Envestra by WorleyParsons and Benchmark Economics, and for the Commission by the ECG. These reviews have generally concluded that Envestra's non-capital costs, inclusive of the network management fee, are reasonable and consistent with that of an efficient operator.

The network management fee provides for the full recovery of the economic cost to OEAM of meeting its obligations under the O&M Agreement, and relates to services provided by OEAM by other areas of the Origin Energy group. There are a broad range of services that are included in the Network Management Fee, including Origin Energy management time and advice on technical and corporate matters, the provision of IT infrastructure, working capital and corporate governance costs. The quantum of the fee is at the lower end of the scale of margins generally paid to contractors.

In summary, the network management fee is a legitimate cost paid by Envestra to OEAM to ensure that Envestra operates the network in an efficient and prudent manner, consistent with achieving the lowest sustainable cost of providing reference services.

Site Monitoring and Remediation

The Commission has determined that site monitoring and remediation costs should not be allowed, but Envestra believes that the Commission has not properly considered the requirements of the Code in its determination.

The Draft Decision highlights that Envestra does not own the sites in question. Envestra's submission makes it clear that ownership of sites is not a consideration under the Code. Where a service provider uses land, buildings, plant or equipment in the delivery of reference services to users, the ownership of such items is not an issue in determining whether the associated costs should or should not be allowed.

The Code requires environmental management costs to be considered. These costs are sought by Envestra as being reasonable and prudent, and as such, they should be recoverable as non-capital costs for the following reasons:

(a) Firstly, if gas pipeline distribution was provided in an unregulated and competitive market, all distributors would have to pass their environmental management costs (including investigation, monitoring and remediation costs) onto their customers. Envestra's costs have all been determined by the ECG to be reasonable and prudent.

(b) Secondly, section 2.24 of the Code requires the regulator to take into account the public interest when assessing a proposed Access Arrangement. Clearly, it is in the public interest to monitor and remediate these sites if required.

(c) Thirdly, section 8.30 of the Code provides that a reference tariff should provide a return which is commensurate with prevailing conditions in the market for funds and the risk involved in delivering the reference service. If the Environment Protection Authority were to direct Envestra to incur monitoring, investigation and/or remediation costs, Envestra would be required to comply with such lawful directions and incur the costs lawfully imposed on its business. The fact that the costs related to historical activities, and not current activities, does not change their character as a business expense.

[confidential]

Initial Capital Base

The Commission has stated that Envestra must amend its revised Access Arrangement to base its proposed reference tariffs upon a capital base of $748.52 (or $796.35 million in $2005). This is because the Commission has formed the view that this represents the value of the initial capital base set by SAIPAR as at 1 July 2003, being the commencement of the first Access Arrangement Period. The Commission considers that the initial capital base set by SAIPAR is that set out in Table 15 of the existing Access Arrangement Information.

The figure selected by the Commission is incorrect. That figure is taken from a table in the Access Arrangement Information that does not purport to set out the calculation of the initial capital base. That table sets out a roll forward based on forecast information used for the purposes of calculating total revenue during the first Access Arrangement. The table was never intended to, and indeed does not provide a basis for calculating the initial capital base.

While the Access Arrangement did not set out the actual figure which results from performing the above calculation, it did set out how the relevant figure was to be calculated. When this calculation is performed, the initial capital base as a 1 July 2003 is $810.21 million, which is around $14 million higher than the Commission's figure. Its derivation is set out in Envestra's submission. This is the figure that, under clause 8.9(a) of the Access Code, must be used as the initial capital base.

Gas Demand Forecasts

The Commission required Envestra in its Draft Decision to modify gas demand forecasts to align with those developed by its consultant, MMA.

After reviewing the decision, Envestra believes that the MMA forecasts for the Volume market cannot be considered best estimates arrived at on a reasonable basis. This is primarily because the models underpinning the consultant's demand forecasts are affected by statistical errors and are not a suitable basis for addressing weather normalisation. Because the Commission would not provide Envestra with copies of the models used by its consultant to prepare the demand forecasts, Envestra was unable to adapt the MMA methodology to correct for this error. Rather, Envestra has submitted as its own the forecasts prepared by NIEIR for the volume market, which are based on superior statistical models relative to those relied upon by the Commission.

Envestra has accepted the Commission's approach to deriving forecasts for the demand haulage market, except for in one respect. That is MMA's conclusion that there will be an increase in demand in the northern zone of 2.5 TJs of MDQ due to the expansion of an existing plant. Envestra has no knowledge of any such proposed expansion. Because MMA has not disclosed to Envestra the data upon which it has based its conclusion, Envestra has had no opportunity to assess, or comment on, the appropriateness of the data relied upon by MMA. Moreover, our intelligence suggests that MMA's purported expansion may be supplied directly from the transmission system rather than Envestra's distribution network.

Commercial Impact of the Draft Decision

The Commission is required by section 2.24 of the Code to take into account the Service Provider's legitimate business interests and investment in the covered pipeline. The Draft Decision refers in a number of instances where the Commission has considered Envestra's interests. However, at no point in the Draft Decision has the Commission assessed the combined impact of its recommendations on Envestra's business interests in the South Australian network.

Despite this omission, other experts in the field, namely Standard & Poors credit ratings agency have examined the commercial implications of the Draft Decision. They issued a statement immediately following the release of the Draft Decision cautioning investors against the negative cash flow implications arising from the Draft Decision (eg. low rate of return). They suggested that the Commission's decision, when viewed as a whole, was below expectations relative to other similar companies operating in different regulatory jurisdictions.

Regulatory determinations that affect credit ratings clearly impact the legitimate business interests of the regulated entity. In accordance with the Code, the Commission must give further consideration to these issues that are fundamental to the Code, investors and consumers of natural gas in South Australia.