PROPOSED REVISIONS TO THE ACCESS ARRANGEMENT FOR THE SOUTH AUSTRALIAN GAS DISTRIBUTION SYSTEM

FURTHER FINAL DECISION

October 2006

The Essential Services Commission of South Australia
Level 8, 50 Pirie Street Adelaide SA 5000
GPO Box 2605 Adelaide SA 5001
Telephone 08 8463 4444 Facsimile 08 8463 4449
E-mail escosa@escosa.sa.gov.au Website www.escosa.sa.gov.au

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GLOSSARY OF TERMS

Definitions

The terms used in this Further Final Decision have the meaning given in the Gas Pipelines Access (South Australia) Act 1997 or the Code, unless otherwise defined below.

TERM	DEFINITION
Capital expenditure	Expenditure on a system of pipelines which is subject to the provisions of the Code and associated regulated assets that may be incorporated into the capital base of that pipeline
Commission	The Essential Services Commission of South Australia established pursuant to the *Essential Services Commission Act 2002*
Depreciation	In any year and on any asset or group of assets, the annual reduction in the service potential of that asset or group of assets calculated according to the depreciation schedule for that year and for that asset or group of assets
Distribution	The transportation of gas over a combination of high pressure and low pressure pipelines from a Gate Station to various customers' usage points
Gas Distribution Code	The industry code of that name made by the Commission under section 28 of the *Essential Services Commission Act 2002*
Gate station	The transition point from high pressure transmission pipelines to a Distribution network; where applicable also referred to as a city gate
Operating Agreement	The contract between Envestra Ltd and Origin Energy Asset Management relating to the operation of Envestra's distribution network
South Australian Gas Distribution System	The natural gas distribution pipeline system in South Australia owned by Envestra which is subject to the provisions of the Code
Unaccounted for gas	The difference between recorded gas inflows at receipt points into the South Australian gas distribution system and reported outflows at delivery points from the South Australian gas distribution system

Abbreviations

The following abbreviations are used in this Further Final Decision:

AA	Access Arrangement	MDQ	Maximum daily quantity
ABS	Australian Bureau of Statistics	MMA	McLennan Magasanik Associates
ACG	Allen Consulting Group	MRP	Market Risk Premium
ACT	Australian Capital Territory	NIEIR	National Institute of Economic and Industry Research
CAPM	Capital asset pricing model	NERA	NERA Economic Consulting
CBD	Central business district	NSW	New South Wales
Code	National Third Party Access Code for Natural Gas Pipeline Systems	OEAM	Origin Energy Asset Management
CPI	Consumer price index	PEG	Pacific Economics Group
DORC	Depreciated optimised replacement cost	PwC	PricewaterhouseCoopers
DP	Delivery Point	SA	South Australia
ECG	Energy Consulting Group	SAIPAR	SA Independent Pricing and Access Regulator
Envestra	Envestra Ltd, ACN 078 551 685	SFG	Strategic Finance Group
EPA	Environmental Protection Authority	TJ	Terajoule
ESC Act	Essential Services Commission Act 2002	UAFG	Unaccounted for gas
GST	Goods and services tax	WA	Western Australia
ICB	Initial Capital Base	WACC	Weighted Average Cost of Capital
IT	Information technology		

1 FURTHER FINAL DECISION

On 30 September 2005, Envestra Ltd (Envestra) submitted proposed revisions to the current Access Arrangement for the South Australian gas distribution system to the Essential Services Commission of South Australia (Commission), in the form of a proposed revised Access Arrangement, for approval under the National Third Party Access Code for Natural Gas Pipeline Systems (Code), and associated Access Arrangement Information. The revisions were intended to apply from 1 July 2006.

In March 2006, the Commission issued a Draft Decision that it was not satisfied that the submitted Access Arrangement Information met the requirements of sections 2.6 and 2.7 of the Code and did not approve the proposed revisions to the Access Arrangement on the basis that they did not satisfy the principles in sections 3.1 to 3.20 of the Code.

The Commission received eight submissions to its Draft Decision, including a submission from Envestra, under section 2.37 of the Code.

On 30 June 2006, the Commission issued a Final Decision that it was not satisfied that the submitted Access Arrangement Information met the requirements of sections 2.6 and 2.7 of the Code and did not approve the proposed revisions to the Access Arrangement on the basis that they did not satisfy the principles in sections 3.1 to 3.20 of the Code.

Envestra submitted amended revisions to the Access Arrangement pursuant to section 2.40 of the Code on 24 July 2006, as stipulated in the Final Decision.[1] Envestra also submitted an amended Access Arrangement Information.

The Commission has now considered the amended revisions to the Access Arrangement (and the amended Access Arrangement Information) as submitted by Envestra.

In accordance with section 2.41 of the Code, the Commission does not approve the amended revisions to the Access Arrangement on the basis that they do not incorporate or substantially incorporate the amendments specified in the Final Decision or otherwise address to the Commission's satisfaction the reasons for the amendments identified in the Final Decision. The detailed reasons for that Further Final Decision are set out in herein.

Consequently, pursuant to section 2.42 of the Code, the Commission has drafted and approved its own amended revisions to the Access Arrangement. The revised Access Arrangement takes effect as of **13 November 2006**.

The Commission is also not satisfied that the amended Access Arrangement Information submitted by Envestra meets the requirements of sections 2.6 and 2.7 of the Code, for the reasons set out in this Further Final Decision. Consequently, the Commission has also drafted and released an explanatory document, the Access Arrangement Explanatory Information (AA Explanatory Information) that provides an explanation of some aspects of the approved revised Access Arrangement. In doing so the Commission has utilised the Envestra Access Arrangement Information, supplemented as necessary. However, the Commission attaches no warranty to the technical content drawn from the Envestra Access Arrangement Information.

[1] On 26 July 2006 Envestra resubmitted its Access Arrangement to correct for some minor errors.

In making this Further Final Decision, and save where expressly stated otherwise in this document, the Commission considered the supporting information provided by Envestra in response to the Final Decision only to the extent that the information was relevant to the Commission's task in making a Further Final Decision. Thus, in most cases, the supporting information was considered in respect of the issue whether the amended revisions substantially incorporated the amendments specified in the Final Decision or otherwise addressed the reasons for the amendments identified in the Final Decision.

As such, to the extent that some or all of the supporting information (and argument therein) provided by Envestra otherwise amounted to a late submission pursuant to section 2.37 of the Code, the Commission has not considered that late submission for the purposes of making its Further Final Decision. In this regard, the Commission notes that submissions subsequent to the Final Decision are not contemplated under the Code – indeed the Code does not contemplate any further consultation with the Service Provider or interested parties after the Final Decision has been issued. Further, to consider such submissions would give rise to issues of procedural fairness for other interested parties who have not had an opportunity to comment on any new material.

Since the making of the Final Decision, the Minister for Energy has increased the amount of the annual licence fee payable by Envestra for its gas distribution licence by $300,000 per annum (in dollars of December 2006) to $1,991,000 per annum. The figures presented in the Final Decision incorporated the previous licence fee (escalated by the Consumer Price Index (CPI) for each year). The Commission, following consultation with Envestra, has decided to include recovery of the additional licence fee amount within the Total Revenue, rather than engaging in a subsequent variation process under section 8.3A of the Code. All relevant figures presented in this Further Final Decision (and the Access Arrangement and AA Explanatory Information) therefore include the incremental $300,000 amount (converted to dollars of December 2005, that is, $291,000) and thus differ to that extent from those presented in the Final Decision.

This Further Final Decision was made by a Commission comprising Dr. P. Walsh, Professor R. Blandy and Mr. J. Hill. In accordance with the requirements of section 19 of the *ESC Act*, Professor S. Richardson took no part in the decision-making process.

2 REASONS

This chapter sets out the Commission's reasons for the Further Final Decision in respect of each amendment as set out in the Final Decision.

2.1 Access Arrangement Information – section 3

2.1.1 Amendment 1.

Amendment 1 required the deletion of section 3 of the submitted Access Arrangement Information as the content did not accord with the requirements for an Access Arrangement Information, as set out in sections 2.6 and 2.7 of the Code.

Final Decision Amendment 1 was as follows:

> *Section 3 of the submitted Access Arrangement Information must be deleted.*

2.1.1.1 Further Final Decision

Envestra amended section 3 of its Access Arrangement Information to remove all the material relevant to the Final Decision, but retained a brief factual statement of the Access Arrangement revision process. The Commission is satisfied that, while Envestra has not strictly incorporated the amendment specified, the revisions otherwise address the reasons for the amendment specified. The Commission therefore approves the amendment to the Access Arrangement Information.

2.2 Services Policy

2.2.1 Amendment 2.

Acknowledging that SEAGas delivers already odorised Gas, Final Decision Amendment 2 was:

> *Reference to gas odorisation in Services Policy clause 2.2.4 must be amended to read:*
>
> *"the odorisation of Gas, except where Gas is already odorised to the standard required by applicable laws".*

2.2.1.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified in clause 2.2.4 of the Access Arrangement. The Commission therefore approves the amended revision.

2.2.2 Amendment 3.

The Commission's Final Decision on Unaccounted for Gas (UAFG) in the Terms and Conditions required consequential amendments (3 and 4) in the Services Policy.

Final Decision Amendment 3 was as follows:

> *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."

2.2.2.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.2.3 Amendment 4.

Final Decision Amendment 4 was as follows:

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

2.2.3.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.2.4 Amendment 5.

The Commission's Final Decision on Gas Balancing within network in the Terms and Conditions required consequential amendment 5 in the Services Policy.

Final Decision Amendment 5 was as follows:

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

"Gas balancing is regulated through the Retail Market Rules".

2.2.4.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified (noting that clause 2.6 has become clause 2.5). The Commission therefore approves the amended revision.

2.2.5 Amendment 6.

The Commission's Final Decision in respect of Services Policy required consequential amendment to the Access Arrangement Information.

Final Decision Amendment 6 was as follows:

Clause 12 of the submitted Access Arrangement Information must be amended to reflect the changes set out in Amendments 2, 3, 4 and 5.

2.2.5.1 Further Final Decision

The Commission is satisfied that clause 12 of the amended Access Arrangement Information reflects Amendments 2 to 5 inclusive.

2.2.6 Amendment 7.

Consistent with the reasoning for Amendment 1, the Commission's Final Decision in respect of Services Policy also required the deletion of clause 12.5 of the Access Arrangement Information.

Final Decision Amendment 7 was as follows:

> Clause 12.5 of the submitted Access Arrangement Information must be deleted.

2.2.6.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified.

2.2.7 Envestra's further amendments

In addition, Envestra has also amended the Services Policy by adding an explanatory section on Maximum Daily Quantity (MDQ) reductions, provision for which has been included in the Terms and Conditions. As foreshadowed in the Final Decision, inclusion of an explanation is reasonable (aside from the disclosure discussion in the Final Decision) as long as it is consistent with the relevant Terms and Conditions (clause 6B). As was also noted in the Final Decision, the explanation includes provision for Envestra to approve a reduction other than that which was sought. It is not clear that this is consistent with clause 6B. As a result, the Commission cannot approve the amendment. However, to clarify this situation, and any other inconsistencies that may arise, the Commission has included in the Access Arrangement it has drafted and approved, additional words that clarify that, to the extent of any inconsistency between this part of the Services Policy and clause 6B of the Terms and Conditions, clause 6B prevails.

2.3 Terms and Conditions

2.3.1 Amendment 8.

The Commission's Final Decision required an amendment to clause 2.4 of the Terms and Conditions to provide identification of the various obligations applying to Envestra in its operation of the network.

Final Decision Amendment 8 was as follows:

> *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, the Energy Customer Transfer and Consent Code and the Retail Market Rules."*

2.3.1.1 Further Final Decision

Envestra has made the required amendments, with some minor variations and including the additional paragraph foreshadowed in the Final Decision listing the similar obligations upon a Network User. The Commission is satisfied that Envestra

has substantially incorporated the amendment specified. The Commission therefore approves the amended revision to clause 2.4.

2.3.2 Amendment 9.

The Commission's Final Decision required a series of amendments (9, 10, 11 and 12) to reflect its decision to not approve the proposed UAFG revisions – having the effect of UAFG remaining the responsibility of Envestra.

Final Decision Amendment 9 was as follows:

> *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".*

2.3.2.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.3 Amendment 10.

Final Decision Amendment 10 was as follows:

> *The following must be deleted from proposed clauses 5.4(a) and (b) of Annexure G:*
>
> *"(after taking account of UAFG)".*

2.3.3.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.4 Amendment 11.

Final Decision Amendment 11 was as follows:

> *The following must be deleted from proposed section 6.3(b) of the Access Arrangement:*
>
> *", after taking account of UAFG".*

2.3.4.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.5 Amendment 12.

Final Decision Amendment 12 was as follows:

> *Section 9.6 of the submitted Access Arrangement Information must be modified to remove reference to the UAFG proposal and to reflect the Non Capital Cost allowances for UAFG as provided in Chapter 10 of this Final Decision.*

2.3.5.1 Further Final Decision

The Commission is satisfied that clause 9.6 of the amended Access Arrangement Information reflects the various UAFG-related amendments.

2.3.6 Amendment 13.

The Commission's Final Decision required the addition of provisions for MDQ reductions into the Terms and Conditions, as put forward by Envestra during the review process.

Final Decision Amendment 13 was as follows:

> *An included MDQ decrease clause (clause 6B as put forward by Envestra) must include the following sub-clause:*
>
> > *If requested by the Network User, Envestra will provide the Network User with an explanation of Envestra's decision to reject an application under this clause.*

2.3.6.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.7 Amendment 14.

The Commission's Final Decision required the removal of a proposed gas balancing clause, principally because it went well beyond the explanation provided for it and caused conflict with the Retail Market Rules.

Final Decision Amendment 14 was as follows:

> *Clause 2.5 of Annexure G must be deleted.*
>
> > *Envestra must also make the required consequential change to Services Policy clause 2.6.*

2.3.7.1 Further Final Decision

Envestra incorporated the amendment specified. However, it has also added a new clause 2A pursuant to this amendment. The new clause 2A refers to the role of the Retail Market Rules in this area and replicates elements of the Retail Market Rules.

This raises two key concerns. One is the introduction of new clauses at this late stage, where other interested parties will not have the opportunity to comment, and the previously identified question of conflict with the Retail Market Rules.

On the first matter, the Commission notes that, as the clause presents material from the Retail Market Rules, the content is not new to Network Users. On the second matter the Commission is satisfied that the proposed clause 2A provides clear assurance that, in the case of any inconsistency with the Retail Market Rules, the Retail Market Rules will prevail. This addresses the conflict issue in this case.

The Commission is satisfied that the revisions otherwise address the reasons for the amendment specified. The Commission therefore approves the amended revision.

2.3.8 Amendment 15.

The Commission's Final Decision required amendments (15 and 16) in relation to the zonal gas balancing clauses to ensure alignment with the Retail Market Rules.

Final Decision Amendment 15 was as follows:

> *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,".*

2.3.8.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.9 Amendment 16.

Final Decision Amendment 16 was as follows:

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

2.3.9.1 Further Final Decision

Envestra has changed the clause to "20 days", but not to "20 Business Days". The Commission is not satisfied that Envestra has incorporated the amendment specified. The Commission therefore does not approve the amended revision.

2.3.10 Amendment 17.

The Commission's Final Decision required amendments (17 and 18) in relation to the determination of quantities received to clarify that Envestra was required to act as per the proposed clause 5.5 of Annexure G and to apply an objective standard of reasonableness.

Final Decision Amendment 17 was as follows:

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

2.3.10.1 Further Final Decision

Envestra has not made the amendment but has modified the clause to otherwise reflect the amendment specified. The Commission is satisfied that Envestra has substantially incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.11 Amendment 18.

Final Decision Amendment 18 was as follows:

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".

2.3.11.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.12 Amendment 19.

The Commission's Final Decision required amendments (19 and 20) in relation to overselling capacity to make provision for the expansion of existing Delivery Points.

Final Decision Amendment 19 was as follows:

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".

2.3.12.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.13 Amendment 20.

Final Decision Amendment 20 was as follows:

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".

2.3.13.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.14 Amendment 21.

The Commission's Final Decision required the deletion of a redundant MDQ clause.

Final Decision Amendment 21 was as follows:

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

2.3.14.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.15 Amendment 22.

The Commission's Final Decision required amendments (22 and 23) to provide symmetry and to apply an objective standard of reasonableness in relation to meter testing.

Final Decision Amendment 22 was as follows:

> *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."*

2.3.15.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.16 Amendment 23.

Final Decision Amendment 23 was as follows:

> *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".*

2.3.16.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.17 Amendment 24.

The Commission's Final Decision required an amendment to provide for Envestra to give an explanation of its decision in respect of categorisation of delivery points – but not limited to a "brief" explanation.

Final Decision Amendment 24 was as follows:

> *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."*

2.3.17.1 Further Final Decision

Envestra has not made the amendment but has modified the clause to reflect the amendment specified. The Commission is satisfied that Envestra has substantially incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.18 Amendment 25.

The Commission's Final Decision required amendment to the clauses relating to disconnection and reconnection services. These services are dealt with in the Retail Market Rules, but some provision was required in the Terms and Conditions, so long as it did not conflict with the Retail Market Rules and acknowledged other applicable laws.

Final Decision Amendment 25 was as follows:

> *Clauses 17 and 18 of Annexure G must be deleted and replaced with clauses to the following effect:*
>
> *17. DISCONNECTION AND RECONNECTION SERVICES*
>
> *17.1. Disconnection and Reconnection Service*
>
> *Envestra will Disconnect and Reconnect DPs in accordance with the Retail Market Rules and all other applicable laws.*
>
> *17.2. Charges*
>
> *For the purposes of rule 362 of the Retail Mark Rules, Envestra is entitled to charge the Network User for the Disconnection and Reconnection of a DP. The charge will be calculated in accordance with the Agreement and the applicable Reference Tariff.*
>
> *18. SPECIAL METER READING SERVICE*
>
> *18.1. Special Meter Reading Service*
>
> *Envestra will undertake Special Meter Readings in accordance with the Retail Market Rules and all other applicable laws.*
>
> *18.2. Charges*
>
> *For the purposes of rule 362 of the Retail Market Rules, Envestra is entitled to charge the Network User for a Special Meter Reading. The charge will be calculated in accordance with the Agreement and the applicable Reference Tariff.*

2.3.18.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.19 Amendment 26.

The Commission's Final Decision required amendment to the no set-off clause to recognise the dispute provisions.

Final Decision Amendment 26 was as follows:

> *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,".*

2.3.19.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.20 Amendment 27.

The Commission's Final Decision required amendment to retain an indemnity provision from the current Access Arrangement.

Final Decision Amendment 27 was as follows:

> *Clause 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.*

2.3.20.1 Further Final Decision

Envestra has revised clause 25 to include a provision in the nature of clause 25.1 in the terms and conditions of the current Access Arrangement. However, the Commission notes that Envestra's revised clause does not indemnify a Network User from any negligent act or omission on the part of Envestra's contractors. Clause 25.1 in the terms and conditions of the current Access Arrangement includes an indemnity for acts of Envestra's contractors. In the Commission's view, including acts and omissions of contractors as part of the indemnity is an important aspect of the clause. Accordingly, the Commission is not satisfied that Envestra has made the amendment specified. The Commission therefore does not approve the amended revision. The Commission has made the specified amendment in Annexure G which it has drafted and approved.

2.3.21 Amendment 28.

The Commission's Final Decision required amendment to limit notification of claims to those related to Envestra only.

Final Decision Amendment 28 was as follows:

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

2.3.21.1 Further Final Decision

The Commission is not satisfied that Envestra has made the amendment specified. The Commission therefore does not approve the amended revision. The Commission has made the specified amendment in Annexure G which it has drafted and approved.

2.3.22 Amendment 29.

The Commission's Final Decision required amendment to ensure that reasonable notice at least be given of entry to premises.

Final Decision Amendment 29 was as follows:

> *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."*

2.3.22.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.23 Amendment 30.

The Commission's Final Decision required amendment to require "reasonable" requests for further assurances in relation to access to premises.

Final Decision Amendment 30 was as follows:

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

2.3.23.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.24 Amendment 31.

The Commission's Final Decision required amendment to limit confidentiality requirements to information related to the Agreement.

Final Decision Amendment 31 was as follows:

> *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".*

2.3.24.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.25 Amendment 32.

The Commission's Final Decision required amendment to ensure that Envestra's appointment of an agent did not relieve it of certain liabilities.

Final Decision Amendment 32 was as follows:

> *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."*

2.3.25.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.26 Amendment 33.

The Commission's Final Decision required amendment to the Force Majeure clause to make it symmetrical. The Commission also commented on further amendments that Envestra had put forward in its response to the Draft Decision.

Final Decision Amendment 33 was as follows:

> *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".*

2.3.26.1 Further Final Decision

Envestra has included symmetrical language into clause 27 of the Terms and Conditions, which, in general, satisfies the requirements of the amendment specified. As foreshadowed in its response to the Draft Decision, Envestra has also put forward some other changes to clause 27. Some contention arises in respect of clauses 27.3 and 27.4.

In relation to clause 27.4, the Commission's Final Decision indicated that it would accept a clause similar to the proposed clause 27.4 if it were limited so that a party was only able to claim the benefit of Force Majeure where it had taken all reasonable endeavours to prevent or remedy the breach. Envestra has added a clause 27.4 without such limitation, but has added such limitations elsewhere in clause 27 (in clauses 27.2(a) and 27.5). The Commission is satisfied that this approach otherwise addresses the reasons for the Final Decision.

In relation to clause 27.3, the Commission's Final Decision indicated that it was concerned about carving out of the force majeure an obligation to pay that included charges in the nature of penalties such as overrun charges. Thus the Commission indicated that it would require the exemption of such charges to the extent that they are incurred during the Force Majeure event.

Envestra has presented argument seeking to have the Commission reconsider its view expressed in the Final Decision.

Envestra argued that its proposed clause was reasonable on the basis that seven approved Access Arrangements for gas distribution networks owned by companies other than Envestra contained similar provisions. Envestra also argued that a Network User should not be able to avoid paying charges by claiming a change in economic circumstances as a force majeure event. The Commission accepts that the force majeure provisions should not enable a Network User, who has accrued payment obligations under the Agreement, to avoid those obligations on the basis that a change in economic circumstances constitutes a force majeure event. Further, the Commission has considered its reasoning in the Final Decision in light of Envestra's arguments and is of the view that industry and regulatory precedent is relevant to the question of what is a reasonable provision in the Access Arrangement. Having reviewed the relevant comparable provisions and Envestra's proposed clause, the Commission is satisfied that the clause as proposed by Envestra will not allow a penalty to continue to accrue during the occurrence of an event of a force majeure that suspends the obligations under the Agreement. Therefore, in the Commission's view, Envestra's proposal is reasonable and, accordingly, the Commission removes the

requirement for Envestra to modify clause 27.3 of the proposed revised Access Arrangement.

Therefore, the Commission is satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore approves the amended revision.

2.3.27 Amendment 34.

The Commission's Final Decision required amendment to achieve consistency with GST laws.

Final Decision Amendment 34 was as follows:

> *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".*

2.3.27.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.28 Amendment 35.

As the Code does not empower the Commission to make a decision on terms and conditions for Negotiated Services, the Commission's Final Decision required the removal of such material from the Access Arrangement.

Final Decision Amendment 35 was as follows:

> *Clause 6.2 of the proposed revised Access Arrangement must be deleted.*

2.3.28.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.3.29 Amendment 36.

The Commission's Final Decision in respect of Terms and Conditions required consequential amendment to the Access Arrangement Information.

Final Decision Amendment 36 was as follows:

> *Clause 15 of the submitted Access Arrangement Information must be revised to reflect the Commission's Final Decision on Terms and Conditions.*

2.3.29.1 Further Final Decision

The Commission is satisfied that clause 15 of the amended Access Arrangement Information reflects the Final Decision (aside from clause 15.2 addressed below).

2.3.30 Amendment 37.

Consistent with the reasoning for Amendment 1, the Commission's Final Decision in respect of Terms and Conditions also required the deletion of clause 15.2 of the Access Arrangement Information.

Final Decision Amendment 37 was as follows:

> *Clause 15.2 of the submitted Access Arrangement Information must be deleted.*

2.3.30.1 Further Final Decision

Envestra did not delete clause 15.2 from its amended Access Arrangement Information. Therefore the Commission cannot approve the amended Access Arrangement Information.

2.3.31 Amendment 38.

The Commission's Final Decision in respect of Terms and Conditions required consequential amendment (updating) to Attachment 7 of the Access Arrangement Information.

Final Decision Amendment 38 was as follows:

> *Attachment 7 of the submitted Access Arrangement Information must be revised to reflect the Commission's Final Decision.*

2.3.31.1 Further Final Decision

Envestra deleted Attachment 7 from its amended Access Arrangement Information. The Commission is satisfied that this approach is consistent with the Code requirements for an Access Arrangement Information. The Commission notes that the document it has published entitled AA Explanatory Information does not include Attachment 7.

2.3.32 Amendment 39.

Final Decision Amendment 39 required further minor corrections as follows:

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

2.3.32.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.4 Reference Tariff Policy

2.4.1 Amendment 40.

The Commission's Final Decision required 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. The inclusion of such a statement is required under section 3.5 of the Code.

2.4.1.1 Further Final Decision

Envestra has included a statement in its resubmitted Access Arrangement that describes the methods and principles used to determine annual revenue requirements and Reference Tariffs. The Commission is satisfied that the inclusion of this statement incorporates the required amendment. The Commission notes, however, that in making its own Revised Access Arrangement, it has made two minor amendments to this statement, to address a typographical error and to provide some further clarification. The substance of the statement remains unchanged.

2.4.2 Amendment 41.

The Commission's Final Decision required Envestra to include in the Reference Tariff Policy the following elements:

- 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 a 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.

2.4.2.1 Further Final Decision

Envestra has included in its resubmitted Access Arrangement a statement describing the method and process for assigning Delivery Points to particular Reference Tariffs. This statement relates to Delivery Points that are already being charged a Haulage Reference Tariff. It does not describe how Haulage Reference Tariffs will be assigned to new Delivery Points. The Commission believes that such a statement is an important element of a Reference Tariff Policy and, as a consequence, has concluded that the submitted revisions do not substantially incorporate the Commission's required amendment. The Commission's amendments to the Access Arrangement incorporate such a statement, which mirrors the arrangements under Envestra's current Access Arrangement in Victoria. Under this provision, Envestra will assign a Haulage Reference Tariff to a new Delivery Point, taking into account the User's demand and Connection characteristics, and the Haulage Reference Tariffs assigned to Delivery Points with the same or materially similar demand and connection characteristics.

In relation to the remaining requirements specified in Amendment 41, dealing with the principles and process for varying, withdrawing or introducing new Reference

Tariffs/Reference Tariff components, Envestra has included provisions in its resubmitted Access Arrangement referring to the requirements of section 8.3 of the Code. Section 8.3 of the Code sets out certain processes for these matters.

The Commission accepts that these provisions substantially incorporate the requirements of Amendment 41, although it notes that the Reference Tariff variation process appears to be repeated under clauses 4.9 and 4.11 of the resubmitted Access Arrangement. The Commission has therefore deleted the latter clause in its amended Access Arrangement.

2.5 Gas Demand Forecasts

2.5.1 Amendment 42.

Amendment 42 required Envestra to amend its proposed forecasts for the domestic market to incorporate those specified in Table 6.2 of the Final Decision, as reproduced below. The Commission's Final Decision concluded that the forecasts proposed by Envestra did not meet the requirements of section 8.2(e) of the Code as they did not represent best estimates arrived at on a reasonable basis.

Table 2.1 Commission's Final Decision on Domestic Forecasts 2006/07 – 2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
DOMESTIC CUSTOMERS	361,742	368,843	375,265	382,348	389,618
DOMESTIC CONSUMPTION (TJ)	8,147	8,188	8,210	8,241	8,274

2.5.1.1 Further Final Decision

Envestra has failed to amend its forecasts for the domestic market. Envestra has adopted the demand forecasts presented in its submission to the Draft Decision, arguing that these forecasts best meet the requirements of the Code. Envestra's reasoning is the same as that presented in its submission to the Draft Decision. Based on the information provided by Envestra, the Commission does not approve the domestic forecasts as Envestra has not substantially incorporated or otherwise addressed the Commission's Final Decision.

The Commission notes that Envestra continues to have concerns over the weather normalisation approach underpinning the domestic and small business forecasts developed by McLennan Magasanik Associates (MMA) and endorsed by the Commission. In particular, Envestra refers to a supplementary confidential report developed by the National Institute of Economic and Industry Research (NIEIR), which argues that the MMA forecasts suffer from statistical deficiencies including a low R^2 value. For the same reasons discussed in the Final Decision, the Commission believes that the NIEIR forecasts do not represent best estimates arrived at on a reasonable basis. The Commission rejects NIEIR's argument that the "best" forecasts are those based on an econometric model with the highest R^2 value. The Commission believes that the term "best estimate" as used in the Code is not restricted to mathematical or statistical considerations but rather is a broader concept incorporating

the overall level of rigour involved in proving the methodology. In any event, R^2 cannot be solely relied upon to determine the "best estimate" as it is quite possible for a mis-specified model to produce a high R^2 through collinearity of the explanatory variables. This point was made by NIEIR itself as part of the Envestra submission to the Draft Decision.[2]

2.5.2 Amendment 43.

Amendment 43 required Envestra to make a consequential amendment to clause 17.1 of the Access Arrangement Information to reflect the revised forecasts for the domestic market as set out in Table 6.2 of the Final Decision.

2.5.2.1 Further Final Decision

As discussed in section 2.5.1.1, the Commission is not satisfied that Envestra has substantially incorporated or otherwise addressed the required Amendment 42. The Commission therefore does not approve Envestra's consequential amendment to the Access Arrangement Information and has included in the AA Explanatory Information the required domestic market forecasts as specified in Table 6.2 of the Final Decision.

2.5.3 Amendment 44.

Amendment 44 required Envestra to amend its proposed Access Arrangement to reflect the small business forecasts as set out in Table 6.4 of the Final Decision, as reproduced below.

Table 2.2 Commission Final Decision on Small Business Consumption 2006/07 – 2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
SMALL BUSINESS CONSUMPTION (TJ)	2,903	2,935	2,961	2,995	3,031
SMALL BUSINESS CUSTOMERS	8,724	8,843	8,958	9,091	9,204

2.5.3.1 Further Final Decision

Envestra has amended its forecasts for the small business commercial sector and the Commission is satisfied that Amendment 44 has been incorporated in the resubmitted Access Arrangement.

2.5.4 Amendment 45.

Amendment 45 required Envestra to reflect the revised forecasts set out in Table 6.4 of the Final Decision for small business consumption in the Access Arrangement Information.

[2] National Institute of Economic and Industry Research, (April 2006), *Weather normalisation of Envestra's South Australian gas sales: The NIEIR and MMA approaches*, as submitted as Part B of Envestra's submission to the Draft Decision (5 May 2006)

2.5.4.1 Further Final Decision

Envestra has amended its proposed Access Arrangement Information and the Commission is satisfied that Envestra has complied with Amendment 45.

2.5.5 Amendment 46.

Amendment 46 required Envestra to incorporate the forecasts for the demand market, as set out in Table 6.6 of the Final Decision, reproduced below.

Table 2.3 Commission's Final Decision on Forecasts of Demand MDQ 2006/07 – 2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
MAXIMUM DAILY QUANTITY (TJ)	70.279	70.547	72.248	73.893	74.289
DEMAND CUSTOMERS	149	150	154	157	159

2.5.5.1 Further Final Decision

Envestra has not incorporated the demand market forecasts as required by the Commission in the Final Decision. Consistent with its submission to the Draft Decision, Envestra has maintained the view that the demand market forecasts should not include a forecast expansion of a customer in the Northern Zone from 2008. The Commission stated in its Final Decision that further discussions with this customer have confirmed the forecast expansion, albeit at a slightly later date than originally stated by the customer.

Following the Final Decision, Envestra repeated its concerns that it does not have any evidence as to the identity of this customer and is doubtful that the forecast expansion will occur. Envestra proposed a trigger mechanism given its uncertainty regarding the identity and timing of the expansion. On the basis of the concerns expressed by Envestra, the Commission returned to the relevant customer who has confirmed that its plans have recently changed and that it does not, at this stage, plan to proceed with the forecast expansion. In the circumstances, the Commission has adjusted the demand market forecasts to remove the forecast expansion.

The Commission therefore has approved Envestra's resubmitted demand market forecasts as they otherwise address the Commission's Final Decision. The Commission has incorporated into the Commission's amended Access Arrangement and AA Explanatory Information the demand market forecasts amended to remove the Northern Zone customer's forecast expansion.

2.5.6 Amendment 47.

Amendment 47 required Envestra to reflect Table 6.6 in clause 17.1 of the submitted Access Arrangement Information. By reason of the customer's changed circumstances referred to in section 2.5.5.1, the Commission accepts that Amendment 47 is not now required and the Commission accepts that clause 17.1 of the submitted Access Arrangement Information otherwise addresses the Commission's reasons for decision.

2.5.6.1 Further Final Decision

As discussed, Envestra has incorporated the required demand market forecasts and, in light of the changed circumstances referred to in section 2.5.5.1, the Commission does not require compliance with Amendment 47. The Commission's Further Final Decision in relation to the demand market forecasts is set out in Table 2.4.

Table 2.4 Commission's Further Final Decision on Forecasts of Demand MDQ 2006/07 – 2010/11

	2006/07	2007/08	2008/09	2009/10	2010/11
MAXIMUM DAILY QUANTITY (TJ)	70.279	70.547	72.248	72.643	71.789
DEMAND CUSTOMERS	149	150	154	157	160

2.5.7 Amendment 48.

Amendment 48 required Envestra to delete clause 17.2 and Attachment 8 of the Access Arrangement Information, which contained some general discussion relating to the development of its originally proposed demand forecasts. These forecasts have been superseded and the discussion is not relevant.

2.5.7.1 Further Final Decision

Envestra has deleted clause 17.2 and Attachment 8 of the Access Arrangement Information and the Commission is satisfied that this amendment has been complied with.

2.6 Capital Base at commencement of second period

2.6.1 Amendment 49.

In its Final Decision, the Commission required Envestra to amend the value of the Capital Base at the commencement of the first Access Arrangement Period to $796.35 million (in dollar values of 31 December 2005).

The Final Decision Amendment 49 was as follows:

> *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 dollar values of 31 December 2005).*

2.6.1.1 Further Final Decision

The asset value as at the commencement of the Access Arrangement Period is critical in the determination of the Haulage Reference Tariffs because it forms the basis for the asset roll forward for each of the years in the forecast period. A return on this rolled–forward asset value is then included in the required revenue calculation. Tariffs are then determined to achieve the calculated required revenue.

In its proposed revised Access Arrangement submitted on 30 September 2005, Envestra incorrectly assumed that the first Access Arrangement period commenced on 1 July 2001. Subsequent to the Commission's release of the Draft Decision, Envestra accepted the Commission's decision that the commencement of the first Access Arrangement was in fact May 2003 and not July 2001. It did not accept the Commission's decision that the value as at the commencement of the first Access Arrangement period is the value derived from Table 15 of the approved Access Arrangement Information for the first Access Arrangement period.

However, Envestra only amended the capital value at the commencement of the first Access Arrangement to $810.21 million to reflect the fact that the commencement of the first Access Arrangement was not July 2001 but July 2003, and did not make the other required changes.

In submissions made after the Final Decision, Envestra argued that section 5.9 of the South Australian Independent Pricing and Access Regulator's (SAIPAR) Final Decision required the final value for the Initial Capital Base (ICB) as at the commencement of the Access Arrangement to be the depreciated optimised replacement cost (DORC) valuation as at 30 June 1998 adjusted to take into account, amongst other things, actual inflation.

Envestra supported its argument by noting clause 3.3.3.2 of the Access Arrangement, which states:

> *The Capital Base, when reviewed, shall be adjusted to reflect the following factors, which will be calculated on an annual basis:*
>
> - *New Facilities Investment that is to be added to the Capital Base in accordance with the Extensions/Expansions Policy and section 8 of the Code;*
> - *depreciation calculated in accordance with section 3.3.5 of this Access Arrangement;*
> - *Redundant Capital determined in accordance with section 3.3.4 of this Access Arrangement; and*
> - *the actual percentage change in the CPI (or if not available, estimates of the CPI).*
>
> *The Capital Base at the commencement of the next Access Arrangement Period will be adjusted to account for any difference between actual and forecast New Facilities Investment in accordance with section 8.22 of the Code.*

Envestra argued that there is no "economic logic" to the Commission's required amendment that calculates the ICB using, amongst other things, forecast inflation, as it will create a windfall gain or loss either for Users or the Service Provider. Finally, Envestra submitted that the Commission's position is inconsistent with section 8.1(a) of the Code because it does not allow Envestra to recover all of its efficient costs.

The Commission notes that clause 3.3.3.2 concerns the treatment of the ICB during the Access Arrangement Period. That is, clause 3.3.3.2 mandates that the ICB be adjusted with actual figures during the Access Arrangement Period but does not affect the calculation of the Capital Base before the commencement of the Access Arrangement.

The Commission does not accept that its position is inconsistent with "economic logic" or section 8.1(a) of the Code as, pursuant to section 8.9(a) of the Code, the

Commission is required to establish the Capital Base for the revised Access Arrangement by taking the Capital Base at the start of the immediately preceding Access Arrangement Period and then adjusting that value in accordance with sub-sections 8.9(b) to (d) of the Code. Further, the Commission notes that section 8.1(a) is only one consideration that the Regulator is required to take into account. As noted in the Final Decision, section 8.1(d) of the Code (not distorting investment decisions by re-opening prior decisions) as well as the public interest in regulatory certainty (section 2.24(e)) support the Commission's calculation of the ICB.

In its Final Decision, the Commission noted that, although section 5.9 of SAIPAR's Final Decision required the ICB to be adjusted using actual figures, in the Final Approval SAIPAR accepted that the figures put forward by Envestra (which included actual and forecast figures) complied with the requirement of section 5.9 of the Final Decision.

The Commission notes that Envestra has reiterated its earlier submission and has not provided any further reasons. The Commission's consideration of Envestra's earlier submission and its reasons are provided in the Final Decision.

The Commission notes that there is ambiguity in the Final Decision (and consequently the Final Approval) concerning the methodology SAIPAR used to calculate the ICB.

In its Final Decision, SAIPAR determined:

- *DORC is considered to be the most appropriate methodology to be used in determining the ICB, and will be adopted in preference to alternative methodologies.*
- *In respect to the appropriate valuation, it is expected that the ICB will reflect the value as at the commencement of the Access Arrangement period.*
- *It is proposed that this will be arrived at by first determining an amended DORC valuation as at 30 June 1998. This amended figure will be initially based on the amount submitted by Envestra ($766m), and then adjusted for specific amendments required by the Final Decision.*
- *The amended 30 June 1998 valuation will then be adjusted to take into account appropriate inflation rates*[3] *and movements in depreciation, redundant capital and actual capital expenditure between 30 June 1998 and the date on which the Access Arrangement comes into effect.*
- *The adjustments for inflation is to utilise the CPI (All Groups – Average Eight State Capitals) published by the Australian Bureau of Statistics.*[4]

This aspect of SAIPAR's Final Decision appeared to require that the DORC valuation as at 30 June 1998 be adjusted to the beginning of the Access Arrangement Period using, amongst other things, actual values of inflation.

However, the Final Decision also contained a table that set out the average Asset Base forecast for the period 2001/2002 to 2005/2006 that Envestra was required to

[3] The footnote in the Final Decision stated "SAIPAR has revised inflation rates based on ABS actual and forecast data. This data is to be incorporated in Envestra's DORC valuation modeling".

[4] SA Independent Pricing and Access Regulator (September 2001), *Final Decision*, page 70.

include in its Access Arrangement.[5] The figures in 2001/2002 were based on values calculated using inflation data which did not reflect actual inflation. In particular, the 2000/2001 inflation figure used to calculate the 2001/2002 values was 3.09% and not the actual value of 5.99%.

To resolve this tension in SAIPAR's Final Decision, the Commission has examined relevant correspondence between SAIPAR and Envestra on this issue. The correspondence discloses that, after the Final Decision, Envestra wrote to SAIPAR amending its ICB using, among other things, an inflation figure for the 2000/2001 year of 5.99%. Envestra argued that this was in response to, and complied with, SAIPAR's Final Decision. SAIPAR wrote back to Envestra expressly rejecting the use of 5.99% for inflation for the 2000/2001 year and stated that, in order to comply with SAIPAR's Final Decision, a value of 3.09% was the appropriate value for the 2000/2001 year. Envestra then submitted an Access Arrangement that, among other things, contained an ICB calculated on the basis of a value of inflation of 3.09% for the 2000/2001 year and in the Final Approval SAIPAR accepted that this complied with the Final Decision.

The correspondence between SAIPAR and Envestra that occurred between SAIPAR's Final Decision and SAIPAR's Final Approval demonstrate SAIPAR's clear intent that, notwithstanding the statement in the Final Decision that "*adjustments for inflation is to utilise the CPI (All Groups – Average Eight State Capitals) published by the Australian Bureau of Statistics*"[6], the value of 3.09% was expressly required to be adopted by Envestra (and was adopted by Envestra) in rolling forward the capital base for the 2000/2001 regulatory year.

The Commission provided the relevant correspondence referred to above to Envestra for its comment. In its response, Envestra argued that the correspondence between SAIPAR and Envestra supported Envestra's position, and that the Commission's position is inconsistent with its approach in its 2005 - 2010 Electricity Price Determination for ETSA Utilities.

Envestra argued, firstly, that the table as set out in section 5.9 of the Final Decision is only for the purpose of determining Total Revenue within the Access Arrangement Period. That is, the ICB is notionally inflated (using forecast figures) to determine the Total Revenue for the Access Arrangement Period in order to derive a Reference Tariff.

Envestra distinguished this from the roll forward of the ICB which, as stipulated by clause 3.3.3.2 of the Access Arrangement, must be based on actual values of inflation in order to determine the correct Capital Base for the next Access Arrangement Period.

The Commission notes that clause 3.3.3.2 concerns the treatment of the ICB *during* the Access Arrangement Period. That is, clause 3.3.3.2 mandates that the ICB be adjusted with actual figures during the Access Arrangement Period but does not affect the calculation of the Capital Base *before* the commencement of the Access Arrangement.

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5 SA Independent Pricing and Access Regulator (September 2001), *Final Decision*, Table 5.8.11.1, page 73.

6 SA Independent Pricing and Access Regulator (September 2001), *Final Decision*, page 70.

The confusion appears to result from the method used by SAIPAR to set the ICB. In the Final Decision, SAIPAR set the ICB as at 30 June 1998 and then required that it be adjusted when the Access Arrangement Period commenced by inflation, depreciation, etc. to arrive at an ICB which reflected the value of the network as at the commencement of the Access Arrangement (rather than 30 June 1998).

Envestra appears to interpret this as meaning that the Access Arrangement Period commenced on 30 June 1998 and, as a result, the ICB must be adjusted in accordance with clause 3.3.3.2 of the Access Arrangement which requires that, when the Access Arrangement is revised, the Capital Base is adjusted to take into account actual inflation.

The Commission's position is that the Access Arrangement commenced 14 days after the Final Approval (2 May 2003) and, accordingly, the value of the ICB at that time should be adjusted in accordance with the Access Arrangement. The value before the commencement of the Access Arrangement was set by SAIPAR in the Final Decision and Final Approval by Table 5.9 (with the relevant ICB being the value in the table as at the date the Access Arrangement commenced).

Secondly, Envestra referred to the Commission's Final Decision on the 2005 - 2010 Electricity Price Determination for ETSA Utilities in order to argue that the Commission's treatment of the ICB is incorrect. However, the clause used to make such an argument, clause 7.2(e)(i) of the Electricity Pricing Order, is in similar terms to clause 3.3.3.2 of the Access Arrangement and, similarly, relates to the approach to be taken to adjust for actual inflation *since* the Commencement Date. Accordingly, there is no inconsistency with the Commission's approach to the treatment of inflation *prior to* the commencement date.

Further, the Commission notes that, to the extent there is any inconsistency in the treatment of inflation between SAIPAR's Final Decision and the Final Approval, it is stated on page 9 of SAIPAR's Final Approval that:

> *"Within the Approved Access Arrangement submitted by Envestra, there are examples of departures from the Final Decision. These departures were arrived at in consultation with, and have the approval of the Regulator, and are contained in their complete form within the document. SAIPAR is satisfied that these "approved departures" do not constitute a material revision to the determinations of the Final Decision and is further satisfied that, having regard to both the amendments are required by the Final Decision and the "approved departures", the Envestra Access Arrangement documentation complies with the provisions of the Code."*

In the circumstances, the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision. The Commission has based its reference tariffs upon the value set for the Capital Base at the commencement of the first Access Arrangement Period of $796.35 million (in dollar values of 31 December 2005).

2.6.2 Amendment 50.

This amendment to the Access Arrangement Information is consequential to the previous amendment to the Access Arrangement.

It states that:

> *Envestra must amend the submitted Access Arrangement Information to correct the description, under the Reference Tariff Policy, of the principles by which the value of the Capital Base at the commencement of the previous (i.e., first) Access Arrangement Period has been determined.*

2.6.2.1 Further Final Decision

Envestra has not amended the Access Arrangement Information in accordance with the Final Decision and the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision and will make the necessary changes in the AA Explanatory Information.

2.6.3 Amendment 51.

Similar to the previous amendment, this amendment to the Access Arrangement Information is also consequential to the Amendment 49.

It states that:

> *The submitted Access Arrangement Information must be amended consequentially to reflect these changes in respect of descriptions of the other elements of the Capital Base at the commencement of the second Access Arrangement Period.*

2.6.3.1 Further Final Decision

Envestra has not amended the Access Arrangement Information in accordance with the Final Decision and the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision and will make the necessary changes in the AA Explanatory Information.

2.6.4 Amendment 52.

The Commission's Final Decision required Envestra to use $25.97 million as its estimate for the capital expenditure for the financial year 2005/2006. This estimate was based on the latest information provided by Envestra to the Commission.

The Final Decision Amendment was as follows:

> *For the purposes of rolling forward the Capital Base to the commencement of the second Access Arrangement Period, Envestra must use the updated estimate of capital expenditure for the 2005/06 year (total of $25.97m as provided), with provision in the proposed revised Access Arrangement being made that any difference between this estimated level and actual spending for the year be taken into account when the roll-forward occurs at the next review to the commencement of the third Access Arrangement Period.*

2.6.4.1 Further Final Decision

Envestra has not amended the capital expenditure for 2005/2006 in accordance with the Final Decision. Instead, Envestra has used $25.69 million as updated capital expenditure for that period.

With regard to the inclusion of a provision in the Access Arrangement to allow for adjustment of any difference between the estimated and actual capital expenditure for 2005/2006, Envestra has not included any such provision in the Access Arrangement. Instead, it has included a statement in the Access Arrangement Information.

Based on further discussions with Envestra, the Commission understands that this was an oversight by Envestra. Consequently, the Commission has made the correction in determining the required revenue.

Also, the requirement to have the provision for adjustment of any difference between the actual and estimated capital expenditure in the Access Arrangement was to ensure that this requirement is ”locked-in” regardless of the outcome. The Commission does not consider that, by including the provision in the Access Arrangement Information, Envestra has complied with the Final Decision as the Access Arrangement Information has a different purpose under the Code.

As such, the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision. The Commission has included $25.97 million as the basis for the calculation of the Capital Base as at the commencement of the second Access Arrangement Period. The Commission has also included a provision under the Access Arrangement that will ensure that any difference between the actual and estimated capital expenditure for 2005/2006 is taken into account when the roll-forward occurs at the next review.

2.6.5 Amendment 53.

This amendment to the Access Arrangement Information is consequential to the previous amendment required to the Access Arrangement.

It states that:

> *Envestra must amend the submitted Access Arrangement Information to reflect this revision.*

2.6.5.1 Further Final Decision

As mentioned above, Envestra has included $25.69 million rather than the $25.97 million in the Final Decision. This is presented in Table 2 of the Access Arrangement Information and forms the basis of the Capital Base at the commencement of the second Access Arrangement Period as shown in Table 5 of the Access Arrangement Information.

As this is not consistent with the Final Decision, and no reasons are provided, the Commission is not satisfied that the revisions incorporate or substantially incorporate

the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision.

2.6.6 Amendment 54.

This amendment requires Envestra to use depreciation values identified in Table 8.8 of the Final Decision.

Amendment 54 states that:

> *The depreciation values presented in the submitted Access Arrangement Information must be changed to reflect the values in Table 8.8.*

2.6.6.1 Further Final Decision

This amendment relates to depreciation for the period between 1998/1999 and 2005/2006. The Commission's calculation and reasons were outlined in the Final Decision.

Envestra has not made the amendments in accordance with the Final Decision. It has made its depreciation calculation using actual inflation for each of the years prior to the commencement of the first Access Arrangement and for the three-year period of the first Access Arrangement Period. This is contrary to the Commission's Final Decision, which required Envestra to use the depreciation figures as decided by the previous regulator, SAIPAR, without making any adjustments for actual inflation. This issue has been discussed under Amendment 49 (section 2.6.1.1).

For the reasons discussed earlier, the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision.

2.6.7 Amendment 55.

This amendment requires Envestra to apply inflation adjustments in a manner that is consistent with section 8.5 of the Draft Decision.

The amendment states that:

> *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 the Draft Decision.*

2.6.7.1 Further Final Decision

Envestra has not applied the inflation adjustment to arrive at the value of the Capital Base at the commencement of the second Access Arrangement Period. The reasons for this, and the Commission's consideration of these reasons have been previously discussed, particularly under Amendment 49.

The Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended

revision. The Commission has based its Reference Tariffs upon the value set for the Capital Base at the commencement of the first Access Arrangement Period of $796.35 million (in dollar values of 31 December 2005).

2.6.8 Amendment 56.

This was a consequential amendment to the previous amendment.

It states that:

> *Envestra must amend the submitted Access Arrangement Information to reflect this revision.*

2.6.8.1 Further Final Decision

The Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision.

2.7 Capital Base for each year of second period

2.7.1 Amendment 57.

The Commission's Final Decision required that the forecast New Facilities Investment be amended to reflect Table 9.8 of the Final Decision.

Final Decision Amendment 57 was as follows:

> *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.*

2.7.1.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.7.2 Amendment 58.

The Commission's Final Decision required consequential amendment to the Access Arrangement Information.

Final Decision Amendment 58 was as follows:

> *The Access Arrangement Information must be amended to reflect the Commission's revised forecasts as set out in Table 9.8 of this Final Decision.*

2.7.2.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.7.3 Amendment 59.

The Commission's Final Decision required clauses 7.4 and 7.5 and Attachments 1, 2 and 3 of the submitted Access Arrangement Information to be deleted.

2.7.3.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.7.4 Amendment 59A[7]

The Final Decision required Envestra to:

- *calculate Envestra's Total Revenue using the same method that the Commission used in its Draft Decision (with the error in the working capital calculation rectified); and*
- *deduct the Commission's estimate of the benefit that Envestra would receive from charging for Reference Services in advance relative to charging in arrears in the manner that was the Commission's Draft Decision.*

The effect of the Commission's approach is to reduce the Total Revenue by approximately $1.8 million each year.

2.7.4.1 Further Final Decision

Envestra has not complied with the Final Decision. In the models provided by Envestra, together with its revised Access Arrangement and Access Arrangement Information, it is evident that Envestra has included a return on working capital despite retaining the prepayment terms.

Envestra submitted a report produced by NERA Economic Consulting (NERA), which argued that the Commission was wrong in reducing the revenue due to Envestra's prepayment terms.[8] In this report, NERA's principal contention was that "there is no ongoing advantage from prepayment" and, hence, Envestra should not be required to reduce its Total Revenue.

Envestra argued that the effect of the Commission's decision was to purport to penalize Envestra for an additional cash flow (as compared with a notional firm issuing invoices monthly in arrears) received 10 years previously, the benefit of which additional cash flow is long since exhausted (and would have been exhausted long before 2003 when Envestra's current Access Arrangement came into effect). Envestra noted that one of the original purposes of the prepayment was to provide Envestra with working capital to assist during the initial months of its establishment and that this could have been provided by other means such as a registration fee. Envestra argued that such an alternative would not justify a reduction to Total

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7 This amendment is required at section 9.2.5 of the Final Decision but was not allocated an amendment number and, as a result, was inadvertently left out of the list of amendments in Chapter 17 of the Final Decision.

8 NERA Economic Consulting Group (July 2006), *Envestra Payment Terms in SA: A Report for Envestra*

Revenue in 2006, invoicing in advance (which has the same cash flow impact) should be treated in the same way.

Envestra also argued that the effect of the Commission's reduction to Total Revenue was to deny Envestra the ability to earn a stream of revenue that recovered the efficient costs of delivering the Reference Service over the life of the assets, contrary to section 8.1(a) of the Code.

Alternatively, Envestra argued that even if Envestra received a benefit from the prepayment terms (which it denies), the period which should be used to account for that benefit is 27 days (being the period from the time Envestra receives a payment to the time when Envestra begins incurring the costs of providing the services to which that payment relates), not 60 days (being the time from when Envestra receives a payment and the time payment would be received by a notional entity invoicing in arrears).

Finally, Envestra argued that the Commission's decision did not take into account section 2.46(b) nor section 2.24(a) of the Code.

The Commission sought further advice on the issue from the Allen Consulting Group (ACG) and specifically required ACG to review and respond to the NERA report. ACG provided a note to the Commission entitled "Analysis of the NERA paper on prepayment". In that note, ACG refuted the arguments put forward by NERA and concluded that:

- If Envestra commences charging earlier than otherwise for providing services over the new Access Arrangement Period (and indeed commences charging before that period has started) its costs will be lower by an amount equal to the savings in financing costs associated with the earlier receipt of money;
- The revenue that the Commission determined before the adjustment to working capital would overstate Envestra's costs of providing the Reference Services over the Access Arrangement Period by the amount of the savings in financing costs referred to above;
- The adjustment to working capital required by the Final Decision would be required to set Reference Tariffs that are expected to recover the cost of providing Reference Services over the Access Arrangement Period; and
- The adjustment to working capital is solely concerned with revenue and expenses associated with the sale of services over the forthcoming regulatory period and does not amount to retrospectively penalizing Envestra for cashflow received 10 years previously.

The Commission has reviewed the material supplied by Envestra (including the NERA report), and ACG's note in response to the NERA report. It accepts the advice provided by ACG that the arguments put forward by NERA are flawed for the reasons set out in the ACG note.

The Commission has also given consideration to the factors in section 2.24(a) and 2.46(b) of the Code. The Commission does not agree with Envestra that the effect of section 2.46(b) of the Code is that the Regulator should not unilaterally impose a change in the Access Arrangement unless there has been a variation in

circumstances requiring such a change. While, as required by section 2.24(a), the Commission has taken into account the fact that the pre-payment term is in the existing Access Arrangement and is in Envestra's legitimate business interests, the Commission has weighed this against the fact that the effect of Envestra's prepayment term is that new entrant retailers (and any existing retailer attempting to serve new customers) will pay distribution charges two months earlier and this represents a cost that increases the cost structure of retailers which is likely to result in higher retail prices. In the circumstances, the Commission is of the view that the existing prepayment term is inconsistent with sections 2.24(d), (e) and (f) and sections 8.1(b), (d) and (f) of the Code.

Accordingly, the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision. The Commission has made the amendment in its revisions to the Access Arrangement and to the AA Explanatory Information.

2.7.5 Amendment 60.

This Amendment requires that:

> *The proposed revised Access Arrangement must remove any provisions relating to the treatment of Redundant Capital at the time of the next review.*

2.7.5.1 Further Final Decision

The Commission is satisfied that Envestra has incorporated the amendment specified. The Commission therefore approves the amended revision.

2.7.6 Amendment 61.

This amendment requires Envestra to use the depreciation values for the next Access Arrangement period, as determined by the Commission in the Final Decision.

It stated that:

> *The minor discrepancies in the depreciation forecasts must be corrected in the proposed revised Access Arrangement and in the submitted Access Arrangement Information to accommodate the variations set out in Table 9.12*

2.7.6.1 Further Final Decision

Envestra has not complied with this requirement of the Final Decision. The difference relates to the determination of depreciation for "mains and inlets". The Commission maintained a methodology applied for the 2002/2003 to 2005/2006 Access Arrangement period, and one that was initially submitted by Envestra in its revised Access Arrangement to the Commission on 30 September 2005, whereby the mains and inlets included in the initial capital value were assumed to have a 12% "residual value" (i.e. depreciation allowances are calculated by straight-line depreciation of 88% of the asset value). However, Envestra has changed its revision to the Access Arrangement and determined depreciation allowances without any residual value (i.e.

depreciation allowances are calculated by straight-line depreciation of 100% of the asset values).

The Commission does not consider the change as being appropriate, particularly since no reasons were outlined for the change either in its submission to the Draft Decision or in its response to the Final Decision.

The Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision. The Commission has therefore amended the Access Arrangement and the AA Explanatory Information to reflect the value of the depreciation as determined in Table 9.12 of the Final Decision.

2.8 Non Capital Costs

2.8.1 Amendment 62.

Amendment 62 of the Final Decision required Envestra to incorporate into the revised Access Arrangement the forecast Non Capital Costs determined by the Commission, as set out in Table 10.9 of the Final Decision.

2.8.1.1 Further Final Decision

Envestra has not complied with the Commission's required amendment. Envestra's resubmitted Access Arrangement does not incorporate the Commission's forecast Non Capital Costs in relation to the following items:

(a) Network Management Fee;

(b) Environmental Management Costs;

(c) IT Non Capital Costs; and

(d) Compliance costs, including AS2885 costs.

(A) Network Management Fee Costs

The Commission's Final Decision required Envestra to remove the network management fee from its forecast Non Capital Costs.

The network management fee, set at 3% of Envestra's distribution revenue, is paid by Envestra to its network operator, Origin Energy Asset Management (OEAM), in addition to the costs incurred by OEAM in operating Envestra's network.

In its resubmitted Access Arrangement, Envestra has included the network management fee in its forecast Non Capital Costs, arguing that the Commission's Final Decision to exclude the fee is in error.

As Envestra has not substantially incorporated or otherwise addressed the Commission's requirement to exclude the network management fee, the Commission does not approve the inclusion of the network management fee in the resubmitted

Access Arrangement and the Commission has drafted its amended Access Arrangement such that the fee is excluded.

The Commission notes that Envestra has presented a confidential submission to the Commission setting out the reasons as to why it believes the Commission is in error in requiring the exclusion of the network management fee. These reasons include:

- Pursuant to section 8.37 of the Code, the network management fee should be recoverable unless it can be shown that it would not be incurred by a prudent Service Provider acting efficiently, in accordance with accepted and good industry practice, and seeking to achieve the lowest sustainable cost of delivering the Reference Service.
- Section 8.37 of the Code does not contemplate that there is a single manner in which a Service Provider must structure its business, as is assumed by the Commission. Outsourcing of operations is one means by which the Service Provider may achieve the lowest sustainable cost of delivering Reference Services.
- The motive for the original introduction of the network management fee is irrelevant.
- The Commission's analysis of the motive for introducing the network management fee is incorrect. The assumptions regarding Boral's behaviour are not supported by any evidence.
- The Commission's criticisms of the PricewaterhouseCoopers (PwC) report[9] are not sustainable as the PwC benchmarking data is used extensively by private business to assess their performance. In addition, a PwC supplementary report[10] demonstrates that the contract between OEAM and Envestra (Operating Agreement) provides a lower cost alternative compared to a standalone hypothetical Service Provider operating in South Australia, Queensland and Victoria.
- It is not necessary to link the network management fee to specific costs incurred by Envestra or OEAM.
- The network management fee represents reimbursement of various indirect costs as previously advised by Envestra. These costs are not recovered under clause 10.2 of the Operating Agreement. The Commission's construction of clause 10.2 is not correct, and is not how Envestra and OEAM construe and administer this clause.
- There is no evidence that the network management fee is inflated. Envestra believes that the Commission's view is not consistent with the views presented in the WorleyParsons report on forecast non capital costs, the PwC report, Mr Holdaway's expert witness statement and the benchmarking analysis conducted by Envestra and Energy Consulting Group (ECG).

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9 PricewaterhouseCoopers, (March 2006), *Determination of a Standalone Model of OEAM's Shared Services Procurement, Finance, Information Technology, and Human Resources for Envestra's South Australian Natural Gas Network* (Confidential).

10 PricewaterhouseCoopers, (20 July 2006), *letter to Envestra titled South Australian Gas Distribution Review* (Confidential).

(A.1) Section 8.37 of the Code

The Commission's consideration of section 8.37 of the Code and, in particular, its consistency with the requirements of section 8.1 of the Code, was discussed in the Commission's Final Decision. The Final Decision set out at length the reasons why the Commission believes that the inclusion of the network management fee in forecast Non Capital Costs in this case would be inconsistent with the section 8.37 requirement for Non Capital Costs to represent costs incurred by a prudent Service Provider, acting efficiently, in accordance with accepted and good industry practice, and to achieve the lowest sustainable cost of delivering the Reference Service.

(A.2) Outsourcing of operations

In material provided to the Commission after the Final Decision, Envestra suggested that the Commission had an in-principle objection to the outsourcing of network operations and that the Commission did not accept the potential efficiencies that can be achieved through outsourcing. It argued that the Code does not contemplate that there is a single manner in which a Service Provider must structure its business.

The Commission notes that these arguments were presented by Envestra as part of its submission to the Commission's Draft Decision. As explained in both the Draft Decision[11] and the Final Decision[12], the Commission does not have any in-principle concerns with the outsourcing of network operations and accepts that in some circumstances outsourcing can lead to cost savings relative to conducting operations in-house. The Commission's concerns with the network management fee arose from the particular circumstances surrounding the creation of the Operating Agreement, where the agreement was entered into between related parties. As a result of these circumstances, the Commission did not simply accept the contract price relating to the operating agreement (which includes the network management fee) but rather undertook an examination of the costs associated with the network management fee in order to assess whether the inclusion of the network management fee in forecast Non Capital Costs is compliant with the "lowest sustainable cost" test under section 8.37 of the Code.

A detailed explanation of the circumstances under which the outsourcing arrangement between Envestra and OEAM was entered into, and the Commission's concerns arising from these circumstances, was set out in the Commission's Final Decision.

(A.3) Motive for introducing the network management fee

The Commission agrees with Envestra's contention that the motive for the introduction of the network management fee is irrelevant if it otherwise satisfies the

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[11] Essential Services Commission of South Australia, (March 2006), *Proposed Revisions to the Access Arrangement for the South Australian Gas Distribution System: Draft Decision*, p154.

[12] Essential Services Commission of South Australia, (June 2006), *Proposed Revisions to the Access Arrangement for the South Australian Gas Distribution System: Final Decision*, p141.

test in section 8.37 of the Code. Although it is correct that the Commission found in its Final Decision that there existed a financial incentive for an inflated price to be set for the fee at the time the operating agreement was entered into, the Commission did not then conclude that therefore the fee must be irrecoverable. Rather, the Commission indicated that it could not *assume* the contract price was prudent and that it would need to examine the costs that were covered by the fee.

The Commission notes that Envestra has included, as part of its response to the Final Decision, "expert witness statements" from Mr. Graham Holdaway (KPMG) responding to the Commission's concerns regarding the motives of Boral Limited at the time the agreement was entered into. The Commission has sought advice from ACG[13] on the arguments presented by Mr. Holdaway.

Many of the comments raised by Mr. Holdaway seek to demonstrate that the outsourcing of network operations can lead to efficiencies relative to conducting operations in-house. As discussed previously, the Commission does not dispute this contention, but it is not relevant to the matters considered by the Commission.

(A.4) PwC Report

In response to the Commission's concerns regarding the benchmarking analysis conducted by PwC, Envestra has argued that the analysis is of value as competitive firms use the PwC benchmarking data to assess their own performance.

The Commission does not dispute that firms use PwC benchmarking for this purpose. However, the Commission's objective is to determine whether Envestra's forecast Non Capital Costs, inclusive of the network management fee, are consistent with the requirements of the Code. As discussed in the Final Decision, it is possible for benchmarking to provide assurances regarding the efficiency of Non Capital Costs. However, to the extent that there are deficiencies in a benchmarking approach as identified in the Final Decision, the Commission is of the view that the most reliable measure of the Non Capital Costs involves separately reviewing each of the Non Capital Cost categories, having regard to costs incurred in respect of each item during the first Access Arrangement Period.

In order to assess the forecast Non Capital Costs against the requirements of the Code, the Commission decided that this approach would provide for a more robust method compared to relying on the benchmarking analysis presented by Envestra, including that contained in the PwC report. The Commission's specific concerns with this benchmarking analysis were set out in the Final Decision, and there is no new information presented by Envestra in its response to the Final Decision that alleviates these concerns.

The Commission notes that the PwC supplementary report analysed any savings resulting from economies of scale which would be available if the standalone Envestra business incorporated its Queensland and Victorian networks. This analysis was provided in response to the Commission's concerns that the PwC

[13] The Allen Consulting Group, (August 2006), *KPMG Second Statement on the Network Management Fee*.

model only considered efficiencies relative to a standalone South Australian business in circumstances where Envestra also operates large distribution networks in Victoria and Queensland. The PwC supplementary report examined efficiencies that are additional to those calculated under the standalone SA business model, which could be generated through incorporating the Queensland and Victorian businesses. The report found that the additional savings of including the interstate businesses were marginal compared to the original SA business model and, therefore, the conclusion that the Operating Agreement provides a lower cost option than operating a standalone business still held.

The Commission observes that, as the supplementary PwC analysis is incremental to the analysis in the March 2006 PwC report, the analysis does not alleviate the Commission's stated concerns with the benchmarking approach used, including its reliance on confidential information that was not open to scrutiny.

The Commission also notes that its Final Decision made it clear that, even if it could be demonstrated that Envestra could not undertake the functions performed by OEAM at a lower cost than incurred by OEAM, this does not mean that it is inappropriate for the costs actually incurred by OEAM to be used as the best indicator of the costs that would be incurred by a "prudent Service Provider acting efficiently". This is because the costs incurred by Envestra are greater than the costs incurred by OEAM (as provided for under clause 10.2 of the Operating Agreement) by the amount of the network management fee.

The Commission remains of the view (expressed in its Final Decision) that the best indicator of the costs that would be incurred by a prudent Service Provider acting efficiently is to examine directly the costs actually incurred by OEAM, rather than through attempting to derive "benchmark" margins. As noted in the ACG report[14], this is because the benchmarking of margins requires very careful attention to ensure that the base or included costs of the firms being compared are the same, otherwise the margin or excluded costs are not comparable.

(A.5) Costs attributable to the network management fee

Envestra has argued that the network management fee provides for the reimbursement of various indirect costs incurred by Origin Energy, including:

- Origin Energy management time and advice on technical and corporate matters;
- provision of IT infrastructure;
- working capital;
- corporate governance costs;
- rate of return on finance, human resources, procurement and IT Service assets used in connection with the provision of services under the operating agreement.

[14] The Allen Consulting Group, (August 2006), *KPMG Second Statement on the Network Management Fee*, third page of an un-numbered report.

Information on the nature of the indirect costs associated with the network management fee was included in Envestra's submission to the Draft Decision. However, the submission provided little information in relation to the amounts of the costs, arguing that it was difficult to quantify these indirect costs and that OEAM did not ordinarily calculate the costs associated with the fee.

Envestra's response to the Final Decision contains more detailed confidential information in relation to the amounts of the costs that are reimbursed through the network management fee. In particular, it has submitted information prepared by OEAM that provides a breakdown of such costs. The total of these costs reported by OEAM represent an amount that approximately equals the amount of the network management fee.

The Commission's consideration of the nature of the indirect costs was discussed in the Commission's Final Decision.[15] The Commission concluded that it did not consider it credible that any material costs would be omitted from the costs that OEAM is allowed to recover under clause 10.2 of the Operating Agreement, given the breadth of that clause. In its Final Decision, the Commission concluded that the provisions of clause 10.2 were sufficiently broad to incorporate all direct and indirect costs. In particular, clause 10.2 allows for the recovery of:

[CONFIDENTIAL INFORMATION REMOVED]

including

[CONFIDENTIAL INFORMATION REMOVED]

Envestra argued that the construction of clause 10.2 by Envestra and OEAM is that it relates only to direct costs incurred by OEAM. It asserted that indirect costs are recovered through the network management fee. Envestra has provided statements from OEAM concurring that the agreement is administered in this way.

Notwithstanding this, the Commission remains of the view that clause 10.2 of the Operating Agreement allows for the recovery of indirect costs incurred by Origin Energy. Apart from asserting it to be the case, Envestra and OEAM have not provided any evidence to support their restrictive interpretation of clause 10.2. The Operating Agreement itself does not contain any definition of the term "network management fee" and the Commission has not been provided with any documents or other material that demonstrates that, at the time the Operating Agreement was entered into, there was a link between the fee and the indirect costs referred to in

[15] Essential Services Commission of South Australia, *Proposed Revisions to the Access Arrangement for the South Australian Gas Distribution System: Final Decision*, March 2006, pp 137-140.

Envestra's submission. If the fee is indeed related to specific indirect costs, it would be expected to be calculated by reference to those costs, albeit with some margin for profit added. The apparently arbitrary, escalating structure of the fee, which is calculated as 2.5% of Total Revenue until 30 June 2001 and increases to 3% of Total Revenue after that date, is inconsistent with a fee that is based on actual costs incurred. In these circumstances, the Commission was unable to place significant weight on the assertion by Envestra and OEAM that the fee was intended to recover indirect costs incurred by Origin Energy. More importantly, there was simply no evidence that this was, in fact, the case.

Despite the provision of additional information regarding the nature and amounts of the indirect costs associated with the network management fee, the Commission remains of the view that there is insufficient justification for concluding that the recovery of the network management fee is consistent with the requirements of the Code. In order for the Commission to approve the recovery of these indirect costs, the Commission would have to be satisfied that the costs meet the following necessary criteria:

1. **That the indirect costs are related to the delivery of the Reference Service, as required under sections 8.36 and 8.37 of the Code.**

For example, although Envestra's working capital requirements are considered to be costs incurred in the delivery of the Reference Service, Origin Energy's working capital requirement arising from the Operating Agreement may not be. For it to be recovered through Reference Tariffs, Envestra must demonstrate that this additional working capital requirement is a cost incurred in the delivery of the Reference Service and is not merely an outcome of the Operating Agreement between Envestra and Origin Energy.

As another example, although the costs relating to the Managing Director of Envestra can be deemed to be costs incurred in the delivery of Reference Services, the costs relating to the CEO of Origin Energy may not be. Envestra must demonstrate that these costs are necessary for a prudent Service Provider and not merely a cost incurred due to the existence of an Operating Agreement between Envestra and Origin Energy.

Envestra has not presented any evidence that demonstrates to the Commission's satisfaction that each of the indirect costs associated with the network management fee is related to the delivery of Reference Services.

2. **That these indirect costs have not already been allowed for under other Non Capital Cost items or other components of the Total Revenue requirement, ie. there is no double-recovery of these costs.**

In the Final Decision, the Commission concluded that there are two types of costs that are unlikely to be included in the cost-based element of the contract price that would justify a margin, which are compensation for:

- Any risk that is transferred from Envestra to OEAM; and
- Financing costs that are incurred by OEAM (ie. working capital).

However, the Commission concluded that it did not consider it appropriate for either of these items to be included in forecast Non Capital Costs, as compensation for risk and working capital incurred overall in providing Reference Services were taken into account elsewhere in the calculation of Total Revenue.

Envestra's response to the Final Decision argued that the Commission's conclusion was in error, as:

> *the allowance for risk and financing costs in the WACC only provides compensation to equity holders for market/systematic risk and to debt capital providers for the costs of debt finance (ie. no compensation for business specific risk).*[16]

Envestra described these business risks as including:

> *…risk of incurring liability to Envestra under the Operating Agreement, risk of incurring liability to third parties in the course of performing services under the Operating Agreement, risk of Envestra refusing to reimburse specific costs incurred by OEAM and reputation risk (which risk is potentially greater for OEAM than for Envestra given the OEAM business operates in multiple, competitive markets).*[17]

In deciding to examine the costs associated with the network management fee rather than to accept the contract price as being efficient, the Commission accepts that it should review all costs associated with the provision of Reference Services, including a compensation for risk. The WACC that has been allowed for in the Commission's Final Decision provides compensation for the operational risks associated with the provision of Reference Services. Pursuant to the requirements of section 8.31 of the Code, the rate of return has been calculated by reference to a financing structure that reflects standard industry structures for a going concern and best practice. The cost of capital is therefore based on a notional Service Provider and does not reflect the actual financing structure of the SA gas distribution business. The Rate of Return to the Service Provider is not dependent on whether network operations are outsourced or not and, to the extent that there are any risks that arise specifically as a result of the outsourcing arrangement, it is inappropriate for such risks to be compensated for. Risk is assessed on the basis that Reference Services are provided by a single regulated business. Where there is outsourcing of operations, it is then a matter between the regulated business and the contractor as to how the risks are allocated between the two parties. These risks do not necessarily justify higher charges to customers.

The Commission also notes that the forecast Non Capital Costs include an allowance for insurance premiums which covers public liability risk. Accordingly, it is possible that some of the risk of liability to third parties will be reduced by insurance arrangements.

The Commission therefore concludes that the calculation of Total Revenue already provides appropriate compensation for the risks associated with the provision of Reference Services and that it is not appropriate to allow for additional

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16 Envestra Ltd, (July 2006), *Response to ESCOSA Final Decision: Network Management Fee*, p4.

17 Envestra Ltd, (July 2006), *Response to ESCOSA Final Decision: Network Management Fee*, p4.

compensation to address risks that are attributable solely to the contractual relationship between Envestra and OEAM.

3. **That these indirect costs are consistent with the requirements under section 8.37 of the Code, that forecast Non Capital Costs must represent costs that would not be incurred by a prudent Service Provider, acting efficiently, in accordance with accepted and good industry practice, and to achieve the lowest sustainable cost of delivering the Reference Service.**

If Envestra could satisfy the Commission that the indirect costs meet both of the preceding criteria (that they are related to the provision of Reference Services and are not being recovered elsewhere under the Total Revenue requirement), it would then have to demonstrate that the costs are consistent with the "lowest sustainable cost" test under section 8.37 of the Code. The Commission would expect to see a statement of regulatory accounts setting out all costs directly and indirectly associated with the provision of Reference Services, including a description of the bases for any common costs are allocated to the South Australian gas distribution business, with appropriate audit assurance.

In the absence of this information, or similar information, the Commission is not able to be satisfied that the indirect costs associated with the network management fee meet the requirements of section 8.37 of the Code.

Despite providing additional information relating to the indirect costs associated with the network management fee, Envestra has also argued that it is not necessary to link the network management fee to any specific costs, as the efficient course of action for Envestra is to engage the services of OEAM and pay the requisite fee. The fee should therefore be recoverable, irrespective of how the fee is applied by OEAM.

Again, this argument was presented as part of Envestra's submission to the Draft Decision. The Commission believes that it has clearly set out its reasons for examining the costs associated with the network management fee.

(A.6) Benchmarking evidence

Envestra has criticised the Commission's decision not to rely upon the benchmarking analysis presented by Envestra or undertaken by the Commission, in reaching a Final Decision on the forecast Non Capital Costs submitted by Envestra, including in relation to the network management fee. The Commission's Final Decision relied upon separate reviews of each Non Capital Cost category, having regard to costs incurred in respect of each item during the first Access Arrangement Period.

The Commission concluded that the benchmarking analysis conducted by WorleyParsons and Benchmark Economics on behalf of Envestra was not sufficiently robust to be relied upon in reaching a decision as to whether Envestra's

Non Capital Cost forecasts are consistent with the requirements of the Code.[18] This conclusion was reached by the Commission having regard to advice from Pacific Economics Group (PEG) on Envestra's submitted benchmarking analysis.

Envestra has maintained its position that its benchmarking analysis provides a reliable approach for reviewing forecast Non Capital Costs, and has argued that PEG's criticisms of the benchmarking analysis are not valid. In particular, Envestra has argued that:

- its approach of excluding marketing expenditure from the Non Capital Cost benchmarks is appropriate as Envestra's marketing costs have separately been reviewed by the Commission and have been accepted as prudent and efficient; and
- while accepting the limitations of benchmarking, there is no evidence to suggest that Envestra's forecast Non Capital Costs are not prudent and efficient. Envestra has provided a separate confidential letter to Envestra from Benchmark Economics to support this point, and has referred to a previous study conducted by PEG that suggests that Envestra's actual Non Capital Costs were 34% below its predicted value.

The Benchmark Economics letter submitted by Envestra argues that its benchmarking analysis provides a valid approach for the purpose of reviewing Envestra's forecast Non Capital Costs, arguing that:

> *The points raised* [in the PEG critique of Benchmark Economics' original study] *are more appropriate to large sample, multi-period data sets, not to the simple analysis of the Australian gas sector operating and maintenance costs. For the Australian gas sector there are 10 observations with data limited to a few years. Different techniques and standards must apply to reflect these differences; it would be unrealistic to expect otherwise.*[19]

PEG has provided to the Commission a response to the Benchmark Economics letter. In this response, PEG notes that:

> *The fundamental objective of* **any** *benchmarking analysis must be to obtain a reliable inference on the efficiency of the management of the enterprise (or group of enterprises) in question. This standard must apply regardless of the amount of data that are used for the analysis. When benchmarking the efficiency of Envestra's outsourcing contract with OEAM, it is especially important for benchmarking assessments to be robust since outsourcing arrangements between related corporate parties raise inherent regulatory concerns.... Thus far from supporting lowered standards, ... the context and motivation for benchmarking Envestra's operating expenses call for especially high standards.*[20]

The Commission agrees with PEG's conclusion that, for the purpose of reviewing Envestra's forecast Non Capital Costs against the requirements of the Code, any

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18 Essential Services Commission of South Australia, (June 2006) *Proposed Revisions to the Access Arrangement for the South Australian Gas Distribution System: Final Decision*, page 133.

19 Benchmark Economics letter to Envestra Limited dated 24 July 2006 titled *Pacific Economics Group Report on Non Capital Costs in the Access Arrangement for Envestra*, page 1.

20 Pacific Economics Group LLC, (August 2006), *Non-Capital Costs in the Access Arrangement for Envestra: Response to Benchmark Economics Letter*, pp1-2.

benchmarking analysis must be sufficiently robust before being relied upon. The Commission maintains the view expressed in the Final Decision that there are deficiencies in the benchmarking analysis presented by Envestra and that it is more appropriate to review the forecast Non Capital Costs through separate reviews of each Non Capital Cost item.

In addition, Envestra has pointed to the Commission's Gas Standing Contract Price Determination, which did rely on benchmarking of operating costs, suggesting possible inconsistencies in approaches. The Commission notes that, in deciding to rely on benchmarking for the assessment of operating costs of the gas standing contract retailers, the Commission concluded that a benchmarking approach was appropriate given the complexity of conducting an actual cost approach.[21] The difficulties in reviewing the manner in which operating costs are allocated by a national energy retailer to its SA gas standing contract retail business was a key determinant of the decision not to use actual cost data. In the case of Envestra, operating costs can be more easily attributed to the SA gas distribution business and, therefore, actual cost analysis is considered a reliable approach.

(B) Environmental Management Costs

The Commission's Final Decision was to reject the inclusion of the proposed environmental management costs in Envestra's Non Capital Costs, principally as they do not meet the definition of Non Capital Costs under the Code.

Consistent with the Final Decision (although making clear that it did not necessarily agree) Envestra has removed the environmental management costs from the Access Arrangement, and the references to them in the Access Arrangement Information. To that extent the Commission approves this aspect of the amended revision.

However, Envestra has included an additional Non Capital Cost item relating to Osborne lease costs. It argues that this is necessary as the costs originally proffered assumed that this lease would be exited during the Access Arrangement Period. The Commission notes that this is a "new" cost, which, other than through the manner of its presentation in Envestra's submission, is not an environmental management cost.

In respect of this new cost, the Commission observes the following:

- presentation of this new proposal after the Final Decision provides no opportunity for other interested parties to comment and avoids the other scrutiny to which Non Capital Costs were subjected by the Commission prior to the Final Decision;
- notwithstanding that Envestra argues that it only included lease costs for 2006/2007 in its original submission, it has included lease costs across each of the five years in its amended revisions (thus at least double counting early years);
- Envestra has presented no information to show that any Osborne lease costs either were or were not included in its original submission; and

[21] Essential Services Commission of South Australia, (June 2005) *Gas Standing Contract Price Path: Final Inquiry Report and Final Price Determination*, page A-64.

- prior to the Draft Decision, Envestra described the Osborne site as being vacant land other than for the presence of a regulator on a small part of it, thus leaving open the question of why the lease cost of the entire site should be attributed to distribution (assuming that any such cost should be included at all).

The Commission is not satisfied that the amended revision incorporates or substantially incorporates the amendment specified, nor is it satisfied that the amended revision otherwise addresses the reasons for the Final Decision. Therefore, the Commission does not approve the amended revision in relation to the inclusion of $1.12m of Osborne lease costs.

Envestra has also proposed a new Specified Event for a trigger adjustment mechanism in relation to "statutory orders" requiring the clean up of contamination. This proposal is a further evolution from one it proposed in its submission to the Draft Decision. The Commission set out in the Final Decision that it would not approve the use of a trigger event mechanism for costs that it could not accept for inclusion in the Non Capital Costs.

On this occasion the proposal (in clause 4.5 of the amended revised Access Arrangement) is linked to "the cost to Envestra of providing a Reference Service". This is intended to remove the possibility of allowing a pass through of costs that cannot be included in any case.

The proposal is also intended to be symmetrical, for both cost rises and falls, although the definition of Statutory Order provided only makes provision for costs incurred, not costs avoided. Thus, it would only account for cost increases. The proposal is also limited to costs beyond Envestra's control.

The explanation for this proposed Specified Event is presented in the context of environmental management costs. For example, Envestra discusses the risk that the Environmental Protection Authority (EPA) may require a clean up of contamination resulting from gas distribution. (The Commission notes it is likely that such costs, to the extent that they might arise, and without comment as to whether they could be included, would be in the control of Envestra.)

However, the proposal is not so limited – it would apply to any cost increase arising from a statutory order of any type. This proposal goes well beyond the environmental management costs issue and is thus an entirely new revision to the Access Arrangement.

The Commission is significantly concerned at the inclusion of such a broad new revision following the Final Decision, thus allowing other interested parties no opportunity to comment on it. Further, the revision's breadth would need to be assessed in the context of Envestra's entire set of revisions to its Access Arrangement – considering allowances for Non Capital Costs, New Facilities Investment, risk profiles, etc. To allow such a broad ranging pass-through arrangement would have implications for the decisions made in respect of allowances across the board. The Commission is not satisfied that the amended revision incorporates or substantially incorporates the amendment specified, nor is it satisfied that the amended revision

otherwise addresses the reasons for the Final Decision. As such, the Commission does not approve the Specified Event revision.

(C) IT Non Capital Costs

The Final Decision required Envestra to amend its forecast IT Non Capital Costs to reflect operating costs commencing in the year following project implementation. This decision was made having regard to the recommendations of ECG, who conducted a detailed assessment of Envestra's forecast IT Non Capital Costs.

Envestra has not complied with the Commission's required amendment, instead adopting the approach as argued in its submission to the Commission's Draft Decision, where for 50% of the IT projects, it assumes that IT Non Capital Costs will be incurred in the following financial year, with the remaining 50% of projects having Non Capital Costs incurred in the same financial year.

In its resubmitted Access Arrangement Information, Envestra asserts that it has examined the six IT projects allowed for in the Final Decision, and suggests that three of these IT projects will be completed within a six-month timeframe.

The Commission notes that there is no supporting information presented by Envestra to substantiate this claim. It is therefore difficult for the Commission to determine the validity of this claim, and to conclude that Envestra's proposed treatment of IT Non Capital Costs meets the requirements of the Code.

Therefore, the Commission's Further Final Decision is to not approve Envestra's resubmitted amendment to IT Non Capital Costs as the information provided is insufficient to demonstrate that it has otherwise addressed the reasons for the Commission's Final Decision. The Commission has included in its AA Explanatory Information the IT Non Capital Costs as determined under the Commission's Final Decision.

(D) Compliance Costs

Envestra has argued against the Commission's Final Decision to not approve the proposed increased compliance costs as part of Envestra's forecast Non Capital Costs. The Commission did not approve the increased costs on the basis that there did not appear to be any well-founded basis for assuming an increase in regulatory costs, notwithstanding Envestra's advice that it has already recruited an additional person to work on regulatory compliance matters.

Envestra has reiterated its position that the increased costs should be approved by the Commission as it has already recruited an additional person in this area. Envestra has included in its resubmitted Access Arrangement Information the person's job description as evidence of the person's employment.

The concern raised by the Commission in the Final Decision did not relate to whether Envestra had employed an additional person or not, but to the reasons for employing an additional person. Envestra has assumed that there will be an increase in workload on regulatory compliance matters. The Commission was not, and is not, persuaded that regulatory compliance costs will increase above current levels, particularly in light

of the movement towards national-based regulation which is intended to reduce the costs of regulation. Envestra has not presented any information to satisfy the Commission that the employment of an additional person is justified and the Commission therefore does not approve Envestra's amendment to include the costs of employing this additional person. The Commission's amended Access Arrangement does not incorporate this Non Capital Cost increase.

Envestra has also responded to the Commission's Final Decision to reject increased compliance costs associated with Australian Standard AS2885. The Commission did not approve Envestra's proposed increased costs on the basis of discussions with the relevant Australian Standards Committee regarding the impact of the new standard. Advice from this Committee suggested that changes to AS2885 should not lead to increased costs. In contrast, the advice indicated that changes to AS2885.1 may create opportunities for certain cost reductions.

As part of its resubmitted Access Arrangement Information, Envestra has argued that the Commission has not considered how certain aspects of the standard applies to Envestra's network. For example, it argues that changes to construction or operation standards for rural pipelines may lead to cost reductions, but is of little relevance to Envestra's gas distribution network which consists mainly of suburban pipelines.

It also argues that AS2885.1 is being expanded such that Envestra will now be required to conduct and document procedures to a greater extent. Envestra has attached to the resubmitted Access Arrangement Information a report prepared by WorleyParsons[22] arguing that changes to AS2885.1 will lead to increased costs for Envestra in relation to record keeping, signage and patrol frequency.

The advice given to the Commission by the Committee responsible for reviewing AS2885, including the Chair of that Committee, suggests that the Standard does not mandate patrol frequency. Patrol frequency is dependent on the pipeline operator's assessment of risk and this has not changed since 1997.

In addition, the Standard does not mandate signage intervals, which are similarly subject to the operator's risk assessment. The requirement that a sign can only be counted as an effective measure if it is visible at the threat location has been in place since 1997. Finally, the Committee advises that record-keeping requirements have been set down in AS2885.3 since 2001. Any changes proposed under the revised AS2885.1 reflect what is already considered to be good practice. The Committee noted that public consultation processes for all parts of the Standard have provided opportunity for all stakeholders to comment on issues that may affect them. The Committee was not aware of any concerns raised by Envestra on issues pertaining to AS2885.1.

Based on this advice, the Commission's Final Decision was to not allow for any increased costs associated with changes to AS2885 on the basis that the changes did not impose any firm additional requirements on a pipeline operator. The information presented by Envestra in its response to the Final Decision would not have persuaded the Commission to reach a different conclusion on this matter.

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22 WorleyParson, (July 2006), *Increased AS2885.1Code Compliance Costs*.

2.8.2 Amendment 63.

Amendment 63 required Envestra to 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 and removing references to environmental management costs.

2.8.2.1 Further Final Decision

As Envestra has not incorporated the Commission's Final Decision on forecast Non Capital Costs in the Access Arrangement, it has not amended the Access Arrangement Information to reflect these costs. The Commission has not approved Envestra's resubmitted forecast Non Capital Costs and, therefore, does not approve its amendments to the Non Capital Costs forecasts presented in the Access Arrangement Information. The Commission has incorporated its forecast Non Capital Costs into its AA Explanatory Information.

The Commission notes that Envestra has removed from the Access Arrangement Information all references to environmental costs as required by the Final Decision, and has incorporated the Commission's UAFG costs.

2.8.3 Amendment 64.

The Final Decision required Envestra to delete clauses 9.9 and 9.10 and Attachment 5 of the submitted Access Arrangement Information as the Commission was of the view that these clauses and attachment do not assist Users or prospective Users to understand the derivation of the elements in the proposed Access Arrangement and to form an opinion as to the compliance of the Access Arrangement with the provisions of the Code.

2.8.3.1 Further Final Decision

In its resubmitted Access Arrangement Information, Envestra has deleted the text that appeared in clauses 9.9 and 9.10 and Attachment 5 of the originally submitted revised proposed Access Arrangement Information. The Commission is therefore satisfied that Envestra has incorporated Amendment 64.

2.9 Total Revenue

2.9.1 Amendment 65.

This amendment required Envestra to adopt 6.14% as the real, pre-tax rate of return in its Access Arrangement Information.

It states that:

> *The real pre-tax weighted average cost of capital estimate referred to at page 3 of the submitted Access Arrangement Information (and thereafter) should be amended from 7.3 percent to 6.14 percent.*

2.9.1.1 Further Final Decision

In responding to the Final Decision and proposing amended revisions to its Access Arrangement, Envestra rejected the Commission's Final Decision in relation to the value of the cost of capital estimate. In its response, Envestra put new materials before the Commission as well as repeating arguments previously put to the Commission prior to the Commission making its Final Decision. The Commission has had regard to these matters (as outlined below).

The material which Envestra provided in response to the Final Decision argued that a new figure of a 7.4% real, pre-tax rate of return (as opposed to the 7.3% real, pre-tax rate of return argued for in its submission to the Draft Decision in May 2006) is the appropriate real pre-tax weighted average cost of capital estimate for the purposes of the Code.[23] Envestra based its estimate on a revised range of 6.04% to 8.67% (as compared with its May 2006 submission suggesting that the appropriate range is 6.00% to 8.5%). These revised values were not, however, reflected in the terms of either the revised Access Arrangement or Access Arrangement Information that were submitted to the Commission at the same time, where Envestra proposed a 7.3% real, pre-tax weighted average cost of capital.

There are four main differences in the input variables between the Commission's Final Decision and Envestra's amended revisions. Those differences relate to the following input variables:

- Equity beta (β_e);
- Value of imputation credits (γ);
- Market risk premium (MRP); and
- Debt margin (r_d)

On the first three issues, many of the arguments put forward by Envestra replicate those it submitted in response to the Commission's Draft Decision. However, Envestra also submitted new information following the Final Decision, including the provision of a report developed by SFG Consulting in relation to the value of imputation credits (gamma), as discussed below.

Regarding debt margin, Envestra submitted that the change in the debt premium between the Draft and Final Decision is only in the order of –1 to –2 basis points and not –18 basis points as determined by the Commission in its Final Decision. This is also discussed in further detail below.

Having considered all of the information provided by Envestra in response to the Final Decision, and taking into account the relevant Code provisions, the Commission is not satisfied that the amended revisions put forward by Envestra incorporate or substantially incorporate the amendments specified, or otherwise address the reasons for the amendments specified. The Commission therefore does not approve the amended revisions.

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[23] Envestra Ltd (24 July 2006), *Further Materials Submitted with Amended Access Arrangement*, Section 4 - Rate of Return, sections 4.1 (p. 1) and 4.10 (p. 7).

The Commission's drafted and approved Access Arrangement and AA Explanatory Information reflect the value of the equity beta, the market risk premium and the value of the franking credits (gamma) as set out in its Final Decision in the derivation of 6.14% as the real, pre-tax rate of return.

(A) Value of Imputation credits (γ)

In its Final Decision, the Commission accepted that the estimate of γ is a matter about which different minds, acting reasonably, may make a range of choices that are consistent with the Reference Tariff Principles. However, for reasons set out in section 7.8 of that Final Decision, the Commission did not accept that the range of values proposed by Envestra, being between zero and 0.35, falls within such a range. Rather, the Commission determined that a range of between 0.35 and 0.60 is a reasonable range for the purpose of determining the rate of return and gave reasons for that determination.

(A.1) Background

Under Australian taxation laws, the company tax paid by Australian resident companies on dividends paid to their shareholders is imputed, or attributed, to those shareholders. This imputation occurs through the issuing of franking credits to the shareholders in relation to dividends paid to them. This legal position is recognised by Australian regulators, through the use of the term gamma (γ) in WACC calculations. For those purposes, γ is the value (between zero and one) of imputation tax credits created as a proportion of their face value. γ depends on the value of distributed credits (theta (θ)) and the proportion of credits distributed (F ratio). Various studies have used different methodologies and time periods to estimate the value of γ and there is a wide range of views among experts as to what the best estimate of γ is.

A value for γ of zero would indicate that Australian investors do not value those credits, while a value of one would reflect the assignment of a full value. The question addressed by the Commission in the Final Decision is what is the value to be ascribed to γ for the purposes of the Code?

As recognised by the Commission in the Final Decision, there is inherent uncertainty surrounding the value of γ. As noted above, given the subject matter represented by γ, its value is widely recognised as not being amenable to empirical confirmation through use of a single methodology.

Recognising these difficulties, and the uncertainties associated with γ arising from changes to taxation laws and market conditions since the dividend imputation system was introduced in 1987, Australian regulators have generally set a value of 0.5 for γ in regulatory decisions as shown in Table 2.5.

Table 2.5: Recent regulatory decisions on γ

YEAR	REGULATORY DECISION	γ
2006	Queensland Competition Authority – gas distribution	0.5
2005	Essential Services Commission, Victoria – electricity distribution	0.5
2005	Economic Regulation Authority, WA – Alinta gas distribution	0.3 – 0.6
2005	Australian Competition and Consumer Commission - Energy Australia electricity transmission	0.5
2005	Australian Competition and Consumer Commission – Transgrid electricity transmission	0.5
2005	Essential Services Commission of SA – ETSA Utilities electricity distribution	0.5
2005	Independent Pricing and Regulatory Tribunal, NSW – AGL gas distribution	0.3 – 0.5
2005	Independent Pricing and Regulatory Tribunal, NSW – Country Energy gas distribution	0.3
2005	Queensland Competition Authority – electricity distribution	0.5
2004	Independent Pricing and Regulatory Tribunal, NSW – electricity distribution	0.5
2004	Independent Competition and Regulatory Commission, ACT – electricity distribution	0.5
2003	Office of the Tasmanian Energy Regulator – electricity distribution	0.5
2003	Australian Competition and Consumer Commission – Transend electricity transmission	0.5
2003	Australian Competition and Consumer Commission – Murraylink electricity transmission	0.5
2003	Australian Competition and Consumer Commission – MTS gas transmission	0.5
2002	Essential Services Commission, Victoria – gas distribution	0.5
2002	Australian Competition and Consumer Commission – ElectraNet SA electricity transmission	0.5
2002	Australian Competition and Consumer Commission – SPI PowerNet electricity transmission	0.5

The Commission notes that adoption of this value is, in itself, imprecise, but it is nevertheless one that recognises that there has been little compelling evidence that any other value can be assigned (whether higher or lower than 0.5) with any great certainty.

(A.2) Envestra's response

Envestra responded to the Final Decision in three separate tranches.

First, in its response to the Final Decision on 24 July 2006, Envestra asserted that the "*Commission's determination of a value of gamma in the range of 0.35 to 0.60 is incorrect*" and reasserted that a value of γ in the range of 0 to 0.35 is correct (noting that, in Envestra's view, the actual value for γ ought to be zero).[24] In support of its assertions, Envestra provided a report entitled "*Response to Final Decision, Access Arrangements for SA Gas Distribution: Cost of Capital Issues*"[25],

[24] Envestra Ltd (24 July 2006), *Further Materials Submitted with Amended Access Arrangement*, Section 4 - Rate of Return, section 4.5, p. 3.

[25] Referred to by Envestra Ltd as "*SFG Report No. 2*".

commissioned from SFG, which argued, relevantly, that only a γ value set at zero is consistent with the requirements of the Code.[26]

Secondly, Envestra wrote to the Commission on 31 August 2006, arguing that it had, through its consultant, SFG, identified errors in the analysis within the ACG advice relied upon by the Commission in its Draft Decision and Final Decision. The errors it claimed were:

- faults in the data used by ACG (e.g., some data points were double counted and there were timing errors); and
- that ACG partitioned the data to achieve the desired outcomes.

Envestra also enclosed a further report commissioned from SFG, "*Value of distributed imputation credits implied by large, high-yield firms from 2000-2005*" (dated 18 August 2006) in support of its arguments. Envestra argued that the report corroborated its response to the Final Decision and stated that it is "*clear that the upper value for imputation credits is 0.35 and the most likely value is* zero".[27]

Finally, Envestra wrote to the Commission on 27 September 2006, enclosing a further report commissioned from SFG entitled, "*The Value of Dividend Imputation/Gamma*" (dated 27 September 2006). In its letter, Envestra adopted arguments put in the SFG report that, in the opinion of SFG, the reasons for decision of the Australian Competition Tribunal in *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6 demonstrate that the Commission's position in relation to the value of γ is inconsistent with the Code. Envestra argued that its proposal is consistent with the *GasNet* decision and, therefore, that the Commission should approve that proposal.

(B) Commission's Consideration

The Commission has had regard to the matters put by Envestra.

In relation to the 24 July 2006 response and supporting materials, the Commission notes that the arguments presented do not differ materially from those presented to the Commission prior to it making the Final Decision and no new issues of substance were raised. The Commission considered and rejected Envestra's reasons for its proposed range of zero to 0.35 as a value for γ in the Final Decision. In particular, the Commission observed that the Envestra range does not incorporate the value of 0.5, which has been generally adopted by regulators as set out in Table 2.5. Having regard to these previous decisions, the Commission believes that at the very least, 0.5 should sit within what is considered a reasonable range. Further, the Commission does not accept that zero was the likely bottom end of a range that meets the requirements of the Code. The Commission has noted that the Hathaway/Officer (2004) study calculated a value for γ of 0.35 for an average firm. That study has been widely accepted and the Commission considers that the Hathaway/Officer value is the

[26] Strategic Finance Group (July 2006), *Response to Final Decision, Access Arrangements for SA Gas Distribution: Cost of Capital Issues*, section 4.8, p. 39.

[27] Envestra Ltd, *letter to the Commission dated 31 August 2006*.

most credible evidence of a γ value below 0.5. The Commission concluded that, despite Envestra not being representative of an "average" firm, the value of 0.35 was more likely than not, in the context of the Code, to represent the bottom end of an appropriate regulatory range.

For these reasons, the Commission does not accept Envestra's proposed range as being reasonable. No further arguments have been adduced which persuade the Commission that it should reconsider its rejection of Envestra's range.

In relation to the 31 August 2006 letter and supporting materials, the Commission notes that the SFG report provided by Envestra suggests that the ACG analysis relied upon by the Commission suffered from a number of sampling errors in estimating the value of distributed dividend imputation credits. SFG argued that, as the upper end of the Commission's 0.35 to 0.6 range for the value of γ was based on advice from ACG, and given that SFG identified errors in that ACG advice (described above and in detail at section 2.2 of the SFG report), there is no justification for the upper end of the Commission's range.

SFG argued that the:

> *... errors consist of the duplication of several observations and the matching of some dividend events with the wrong stock price changes. Correction of these errors leads to a fall in the implied estimate for the value of a distributed credit (theta), from 0.74 to 0.41 for July 2003 to June 2005.*[28]

The Commission sought further advice from ACG to ascertain the impact of these alleged errors on ACG's analysis. ACG provided two responses to the Commission, a report dated 14 September 2006 and a report dated 29 September 2006.[29]

In its advice of 14 September 2006, ACG admitted that its previous analysis suffered from some data errors. Crucially, however, ACG also observed that its empirical analysis was only one of a number of pieces of evidence it used to estimate the value of dividend imputation credits, with the recommended value being based on various empirical evidence as well as previous regulatory decisions. ACG argued that no single piece of evidence could be relied upon in estimating γ, given the various methodologies that have been used in past studies and the changes to tax laws and market conditions over the past decade.

Having reviewed the other matters raised in the SFG report, ACG argued that the application of a regulatory γ can never be based on a single piece of evidence and cannot be based on a mechanical interpretation of statistics. ACG maintained its position that a point estimate of γ of 0.50 is appropriate for regulatory purposes as this is consistent with existing regulatory practice and therefore has the benefit of creating stability across regulatory decisions. ACG further noted that it has not been demonstrated that a WACC based on a Market Risk Premium of 6% and a γ of 0.5

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28 Strategic Finance Group (August 2006), *Value of distributed imputation credits implied by large, high yield firms from 2000 – 2005*, p. 3.

29 The Allen Consulting Group (14 September 2006), Memorandum, *Preliminary Response to SFG Report on the value of distributed imputation credits*; The Allen Consulting Group (29 September 2006), Draft Memorandum, *Note on sources of evidence about gamma considered by ACG*.

would provide inadequate returns to investors, and that other external evidence (such as the prices at which assets have been traded and the level of investment taking place) supported the proposition that the standard regulatory returns do not understate the required returns.

In its advice of 29 September 2006, ACG provided further details of the evidence it relied upon in forming its view as to the appropriate value for γ under the Code.[30] In terms of θ, ACG referenced a recent study that has provided estimates of up to over 60% (Hathaway/Officer 2004). It noted some uncertainty regarding the proportion of credits distributed, where studies have tended to estimate distribution rates of the entire market, rather than for the utilities sector only. The study also suggested that there is a theoretical argument for market segmentation in determining the distribution rate, but the extent to which such segmentation should occur is limit by its practicality. In theory, the distribution rate for the utilities sector may be greater than the market, as utilities tend to make greater dividend payments than the average company, with Envestra's dividend yield around twice that of the average firm. With higher yields, it would be expected that the utility would distribute a greater amount of its franking credits than average. As discussed in the Draft Decision, it is likely that the proportion is close to 100%. Using a franking credit value of 0.6 and a 100% distribution rate would lead to a γ value of 0.6. Based on evidence available, the value of γ is not expected to exceed this value and therefore forms the upper limit of the Commission's reasonable range.

ACG noted that regulatory precedent had established a "regulatory norm" for a value for γ of 0.5 and market risk premium of 6 percent, which, for reasons set out in its report, it supported. ACG also expressed the view that "*regulators should be cautious about varying from previous precedent, noting the desirability of creating predictability on regulatory outcomes*".[31]

Based on these materials, the Commission accepts that the ACG advice initially provided to it contained errors as identified by both SFG and ACG itself, which, taken in isolation, might tend to argue against the maintenance of the upper end of the 0.35 to 0.6 range set out in the Final Decision. However, notwithstanding that ACG itself recommended a point estimate value of 0.5, the further material referred to by ACG also contain evidence supporting the Commission's upper range value of 0.6. That evidence, in combination with the evidence previously set out by the Commission in the Draft Decision and Final Decision in relation to the lower end of the range of 0.35, supports the range for γ of 0.35 to 0.6 set by the Commission. In this respect, the Commission also notes that section 8.6 of the Code recognises that there is a level of discretion and uncertainty in the determination of the values for the elements of Total Revenue, including the Rate of Return, that may result in a range of values being

[30] Brown, P. and Clarke, A. (1993) *The Ex-Dividend Day Behaviour of Australian Share Prices Before and After Imputation*, Australian Journal of Management, Volume 18; Bruckner, K., Dews, N. and White, D. (1994), *Capturing the Value of Dividend Imputation*, McKinsey & Company; Hathaway, N. and Officer, R (1996), *The Value of Imputation Credits*, Working Paper, Melbourne University Business School; Cannavan, D., Finn, F., and Gray, S. (2004), *The Valuation of Dividend Imputation Credits in Australia*, Journal of Financial Economics, Vol 73, pp167-197; Hathaway, N. and Officer, R. (2 November 2004), *The Valuation of Imputation Tax Credits: Update 2004*, Capital Research Pty Ltd.

[31] The Allen Consulting Group (29 September 2006), Draft Memorandum, *Note on sources of evidence about gamma considered by ACG*, page 3.

attributed to such parameters and suggests that such uncertainty may be carried forward and resolved in the exercise of the Regulator's discretion to determine Total Revenue. This is the approach that has been adopted by the Commission in its Final Decision.

In relation to Envestra's letter and the SFG report of 27 September 2006, Envestra argued that, based on SFG's opinion as to the effect of the Australian Competition Tribunal's reasons for decision in the *GasNet* decision, the Commission's determination of the range for γ was inconsistent with the Code on two grounds. First, the value used was inconsistent with the market risk premium used; secondly, the value used was inconsistent with the form of Capital Asset Pricing Model (CAPM) used.

The Commission notes that the *GasNet* decision concerned the consistency of treatment of variables within a single equation, whereas the alleged inconsistencies in this case concern different variables across different equations. The *GasNet* decision confirms that, in the first instance, if the Service Provider chooses a well-accepted methodology to be applied under section 8.30 and 8.31, the task of the Regulator is to determine whether the model has been used correctly. In *GasNet*, the Tribunal held that the ACCC erred in concluding that it was open to it to apply the CAPM in an unconventional way by using different values for a "risk free rate" term in the two places it is applied in the CAPM formula. That is, the ACCC adopted a risk-free rate based on 10-year bonds to calculate the MRP but then used five-year bond rates to calculate the base risk-free rates in another part of the CAPM equation. In this case, however, there is no inconsistency in the CAPM formula. Rather, Envestra has argued that γ (which is not included in the CAPM formula) is overstated. The Commission has nevertheless considered the arguments put forward by Envestra.

With respect to the first argument that the γ value used is inconsistent with the Commission's value for the market risk premium, the Commission notes at the outset that the analysis relies upon using "assumed" values for an important parameter (the effective rate of taxation paid by listed entities) rather than a measured one.

Notwithstanding that observation, the main assertion of the SFG report in relation to this ground is that, while the market risk premium assumes only a 1% return from franking credits, the pre-tax WACC assumes that Envestra gets a 2% return, which is an inconsistency. On analysis, however, there is no identifiable inconsistency, as the return from franking credits depends upon the amount of credits that are created (and distributed), which in turn depends on the amount of taxation that is paid. The fact that the franking return to Envestra is higher than the market average reflects the fact that the pre-tax WACC assumes that Envestra has a very substantial taxation liability (which would be expected to overstate the tax that would be paid by an efficient firm in the position of Envestra).

With respect to the second ground, the Commission notes that the argument that there is inconsistency in the estimation methodology for γ and the form of CAPM is a highly technical issue that has not been demonstrated by SFG in its report, but again merely asserted. The Commission also notes that the effect of the proposition would be that the standard approach to estimating and using γ (including by Officer and

Hathaway) would be in error. Finally, the Commission observes that, even if the proposition that a contrived value for γ needs to be used because the assumptions implicit in the form of CAPM being used were to be accepted (which the Commission does not accept), then the market risk premium would need to be reduced to be consistent (by 1% according to SFG's estimate of value of franking credits for the average firm presented on page 4 of its report).

In conclusion, for the reasons set out above, the Commission is not persuaded by Envestra's 24 July 2006 response and supporting materials nor by its letter of 27 September 2006 and supporting materials that it should depart from the conclusions reached in its Final Decision in relation to the reasonable range for gamma. In relation to the 31 August 2006 letter and supporting materials provided by Envestra, while acknowledging that errors were identified by both SFG and ACG in relation to the advice relied upon by the Commission in the Draft Decision and Final Decision, the Commission notes that the errors are not of sufficient materiality, in light of all of the other evidence available to the Commission, to displace its view that:

- the range of values for γ proposed by Envestra of zero to 0.35, as well as its assertion that the best value for γ is zero, does not meet the requirements of the Code; and
- the appropriate range of values for γ for the purposes of the Code is 0.35 to 0.6.

Again, therefore, the Commission is not persuaded that its Final Decision has been addressed, substantially addressed or otherwise addressed by Envestra as required by section 2.41(b) of the Code.

For all of the reasoning outlined above, the Commission, in accordance with the requirements of section 2.41(c) of the Code, does not approve Envestra's amended revisions in relation to the value of γ.

(B.1) Debt Premium

With regard to the debt premium, Envestra has incorrectly quoted the Draft Decision numbers, resulting in an incorrect difference between the Draft Decision and the Final Decision.

In its response to the Final Decision, Envestra have included a table which, it claims, shows that the debt margin for BBB and BBB+ credit ratings have changed only by between -1 and –2 basis points between the Draft and Final Decisions. The table is reproduced below:

Table 2.6: Envestra Submission on Debt Margin

CBA Spectrum Debt Margin (bp)			
Credit Rating	Draft Decision	Final Decision	Change (bp)
BBB+	98.6	96.9	-1.7
BBB	107.7	106.4	-1.3

However, there are errors in Envestra's analysis.

First, the Draft Decision does not use a single source to determine the debt margin. Instead it considers various sources and concludes that:

> *"Having regard to these observations, the Commission accepts that a debt margin of 130 basis points is reasonable and consistent with the Code for the purpose of determining the Rate of Return to be used to determine Reference Tariffs in accordance with section 8.30 and 8.31 of the Code".*

CBA Spectrum data was one of the sources used (together with an assumption about the size of the potential downward bias in the CBA Spectrum figure). However, other sources were also used - including the prediction from the Bloomberg service for 9 year bonds (extrapolated to be consistent with a 10 year term) as well as individual bond issues.

Secondly, the CBA Spectrum figures that Envestra attributed to the Draft and Final Decisions are incorrect and not consistent with the observations in either of those decisions. Moreover, the period that Envestra assumed to be the averaging period for the Draft Decision was not stated (the actual period was the 20 days ending on 30 September 2005, even though the Draft Decision was released in March 2006). The CBA Spectrum figure (before any adjustment for bias was made) that was reflected in the Draft Decision was 101.6 basis points (not 98.6) and the figure that was used in the Final Decision was 88.3 basis points (not 96.9), implying a reduction of 13.3 basis points (not 1.7). Over the same period, the Bloomberg predicted yield for 9 year bonds fell by 29.6 basis points, and the yields on the other bonds that were quoted in the Draft Decision fell within these extremes.

The Commission considers the debt margin provided in the Final Decision to be a conservative estimate. In particular, the predicted yield by the Bloomberg service for 10-year bonds at the time of the Final Decision was 91.2 basis points. The allowance provided in the Final Decision is about 11 basis points higher than this estimate. In addition, the predicted yield from the CBA Spectrum service plus the potential 'bias' that was assumed in the Draft Decision generate a yield of between 108.3 and 113.3 basis points. The allowance provided in the Final Decision is at the upper end of this range.

As such, the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision. The Commission has therefore amended the Access Arrangement and the AA Explanatory Information to reflect the value of the debt premium and, consequently, the rate of return to be used to determine the Reference Tariffs in accordance with sections 8.30 and 8.31 of the Code.

2.9.2 Amendment 66.

This amendment requires Envestra to change its Access Arrangement Information to reflect the Commission's decision on the rate of return.

It states that:

The real pre tax weighted average cost of capital point estimate referred to in the Table 14 on page 34 of the submitted Access Arrangement Information should be amended from 7.3 percent to 6.14 percent.

2.9.2.1 Further Final Decision

As this is a consequential change to Amendment 65, the Commission repeats the matters outlined earlier under paragraph 2.9.1.1.

As such, the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision. The Commission has therefore amended the AA Explanatory Information to reflect the value of the rate of return to be used to determine the Reference Tariffs in accordance with sections 8.30 and 8.31 of the Code.

2.9.3 Amendment 67.

This amendment is a general amendment required in the Access Arrangement Information relating to the Commission's decision on the Total Revenue.

It states that:

The submitted Access Arrangement Information should be amended to accord with the Commission's Final Decision on Total Revenue for each year of the second Access Arrangement Period.

2.9.3.1 Further Final Decision

Total Revenue is derived after determining appropriate values or ranges of all building block components. Each of the building block components have been discussed throughout this Further Final Decision and as the Commission has not revised any of the building block elements of the Total Revenue, there is no need for the Commission to revisit its Final Decision in relation to Total Revenue.

The revised Access Arrangement submitted by Envestra does not comply with the Final Decision on almost all parts of the building block components and does not comply with the Total Revenue.

Accordingly, the Commission is not satisfied that the revisions to Total Revenue incorporate or substantially incorporate the amendments specified or otherwise address the reasons for amendment specified. The Commission has amended the AA Explanatory Information accordingly.

2.10 Reference Tariffs

2.10.1 Amendment 68.

The Commission required Envestra to include in its Access Arrangement Information a summary of the analysis it has undertaken to demonstrate that the allocation of Total Revenue among its haulage Reference Services results in tariffs that are less than the efficient stand-alone cost of providing each of these services during the second Access

Arrangement Period and are otherwise consistent with the various requirements of section 8.38 of the Code.

2.10.1.1 Further Final Decision

Envestra has included in its resubmitted Access Arrangement Information a summary of the cost allocation analysis as described in section 12.1 of the Commission's Final Decision. The Commission is satisfied that this summary provides a reasonable description of the analysis and therefore accepts that Envestra has incorporated the Commission's required amendment.

2.10.2 Amendment 69.

The Commission's Final Decision required Envestra to amend its Reference Tariff Schedules to accommodate other Amendments required under the Final Decision.

2.10.2.1 Further Final Decision

Envestra has not complied with the required Amendment, as it has not complied with certain other Amendments specified in the Final Decision which impact on the calculated Reference Tariffs.

The Commission has therefore not approved Envestra's resubmitted Reference Tariff schedules and has included in the Commission's revised Access Arrangement the Reference Tariff schedules that reflect the outcomes of this Further Final Decision.

2.10.3 Amendment 70.

The Commission required Envestra to amend its proposed tariff basket approach such that it applies separately to each Haulage Reference Service.

2.10.3.1 Further Final Decision

Envestra has amended the tariff basket approach in its resubmitted Access Arrangement such that the primary price control applies separately to each Haulage Reference Service. The Commission is satisfied that Envestra has incorporated Amendment 70.

2.10.4 Amendment 71.

The Final Decision required Envestra to correct the side constraint formula to provide that the side constraint factor applies relative to the relevant CPI-X price path.

2.10.4.1 Further Final Decision

Envestra has not amended the rebalancing control formula in the resubmitted Access Arrangement, but has included a note in Annexure E of the resubmitted Access Arrangement stating that:

> *For the avoidance of doubt, the 2.5% side constraint applies to the CPI+X price path, irrespective of the value of X.*

Envestra's proposed approach to implementing the Commission's required amendment may lead to some confusion regarding the inconsistency between the rebalancing control formula and the explanatory note. The Commission believes that it would be clearer to amend the formula itself, as specified in the amendment.

As a result, the Commission does not approve Envestra's proposed amendment and has included in its amended Access Arrangement a revision to the rebalancing control formula to clarify that the side constraint is to apply to the CPI-X price path.

2.10.5 Amendment 72.

The Commission required that the side constraint factor applying in any one year be set at 2.5%.

2.10.5.1 Further Final Decision

Envestra has amended the side constraint factor such that it is now set at 2.5%. The Commission is satisfied that Envestra has incorporated Amendment 72.

2.10.6 Amendment 73.

The Commission required that the X factor in Box 1, Annexure E of the revised Access Arrangement be amended to –0.2% for the final four years of the Access Arrangement Period.

2.10.6.1 Further Final Decision

The X factor relates to the price path in the CPI-X form of regulation. It determines the factor by which the revenue control must move annually. A negative X factor implies that the annual movement in the revenue control is above the annual CPI and vice versa.

The X factor is derived from the Total Revenue for each year of the five year Access Arrangement period. In its revised Access Arrangement, Envestra has not complied with the Final Decision and has instead used an X factor of –0.0516 or, when expressed as a percentage, –5.16%.

Since the X factor is a function of the Total Revenue, and the Commission has not accepted the revised Access Arrangement in relation to the Total Revenue, it therefore follows that the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision and has amended the X factor in Box 1, Annexure E of the revised Access Arrangement to –0.2%.

2.10.7 Amendment 74.

This amendment requires that the X factor in clauses 2.3 and 13.2 of the revised Access Arrangement Information be amended to –0.2%.

2.10.7.1 Further Final Decision

Envestra has not amended the Access Arrangement Information in accordance with the Final Decision and the Commission is not satisfied that the revisions incorporate or substantially incorporate the amendments specified or otherwise address the reasons for the amendment specified. The Commission therefore does not approve the amended revision and has made the necessary changes in the AA Explanatory Information.

2.10.8 Amendment 75.

This amendment required Envestra to remove the last sentence in clause 2.3 of the submitted Access Arrangement Information.

2.10.8.1 Further Final Decision

Envestra has deleted the sentence, as required in the Final Decision.

2.10.9 Amendment 76.

The Commission's Final Decision required some alterations to the pass-through trigger event adjustment mechanism in relation to imposts.

Final Decision Amendment 76 was as follows:

> *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 provision (as in the current Access Arrangement); and*
> - *clarify that the resultant Reference Tariff variation is subject to the Commission's approval in accordance with the Code.*

2.10.9.1 Further Final Decision

Envestra has met the requirements of the amendment. The Commission notes that Envestra achieved the first point by reference to changes unexpected as of 30 June 2006. This approach deals with the reasoning for this element of the decision as set out in the Draft Decision and confirmed in the Final Decision. Therefore, the Commission is satisfied that the revisions otherwise address the reasons for the amendment specified. The Commission therefore approves the amended revision.

2.10.10 Envestra's further amendments

Pursuant to the discussion in section 12.7 of the Final Decision, Envestra has included at clause 4.5 of its amended revised Access Arrangement two additional Specified Events in relation to capital works (the Eastern Ring Main & Southern Loop and the Central Business District (CBD) renewal).

The Commission's Final Decision indicated that the Commission would accept such inclusions, as long as the events were worded appropriately. The Commission was particularly concerned to receive significant assurance in relation to the projects occurring.

Envestra has provided appropriate wording for these Specified Events and the Commission therefore approves the amended revision.

2.11 Fixed Principles and Incentive Mechanism

2.11.1 Amendment 77.

The Commission's Final Decision required Envestra to delete the references to the proposed Fixed Principles 1, 2 and 3 from the proposed revised Access Arrangement. These fixed principles related to the future use of incentive-based regulation adopting a CPI-X approach, the roll-forward of the Capital Base into future Access Arrangement Periods and the use of the Capital Asset Pricing Model to determine the Rate of Return on the Capital Base.

2.11.1.1 Further Final Decision

Envestra has removed the proposed Fixed Principles 1, 2 and 3 from the resubmitted Access Arrangement. The Commission is satisfied that Envestra has incorporated the required Amendment.

2.11.2 Amendment 78.

Amendment 78 required section 3 of the proposed revised Access Arrangement Information to be deleted, with any deleted material considered directly relevant to understanding the derivation of a particular element in the approved Access Arrangement being included in that section of the Access Arrangement Information dealing specifically with that element.

2.11.2.1 Further Final Decision

Envestra has deleted the original material from section 3 of the Access Arrangement Information, but has retained a brief factual statement regarding the Access Arrangement revision process. While not strictly incorporating the required Amendment, the Commission is satisfied that Envestra has otherwise addressed the reasons for the Amendment.

2.11.3 Amendment 79.

The Final Decision required Envestra to 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 efficiency gains by the business.

2.11.3.1 Further Final Decision

Envestra has included under section 5.1.2(2) of the resubmitted Access Arrangement some clarification of the "no claw back" provision in accordance with the Commission's requirements. The Commission is satisfied that Envestra has addressed the Commission's required Amendment.

2.11.4 Amendment 80.

Envestra was required to 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.

2.11.4.1 Further Final Decision

Envestra has incorporated the required Amendment in the Access Arrangement and the Commission is satisfied that Amendment 80 has been addressed.

2.11.5 Amendment 81.

The Commission required Envestra to amend its proposed Incentive Mechanism by deleting reference to the 10-year carryover period and inserting reference to a five-year carryover period.

2.11.5.1 Further Final Decision

Envestra has amended the proposed Incentive Mechanism to change the carryover period from 10 years to five years. The Commission is satisfied that Envestra has incorporated Amendment 81.

2.11.6 Amendment 82.

Envestra was required to 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.*

2.11.6.1 Further Final Decision

Envestra has deleted the specified sentence from the resubmitted Access Arrangement and the Commission is satisfied that Envestra has incorporated the required Amendment.

2.11.7 Amendment 83.

The Final Decision required Envestra to 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 that impose material additional costs to the Service Provider.

2.11.7.1 Further Final Decision

Envestra has included in the resubmitted Access Arrangement a statement clarifying that adjustments resulting from scope changes relate only to those arising from exogenous factors that impose material additional costs to Envestra. The Commission is satisfied that Envestra has incorporated the Commission's required Amendment.

2.11.8 Amendment 84.

Envestra was required to 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.

2.11.8.1 Further Final Decision

Envestra's resubmitted Access Arrangement does not include a provision that allows for such an adjustment to the expenditure benchmarks. The Commission is satisfied that Envestra has incorporated the required Amendment.

2.11.9 Amendment 85.

The Commission required Envestra to 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.

2.11.9.1 Further Final Decision

Envestra has included in its resubmitted Access Arrangement a provision that allows for the treatment of any negative efficiency carryover amount calculated at the end of the Second Access Arrangement Period to be determined by the Regulator at the time of the next review. The Commission is satisfied that Envestra has incorporated the Commission's required Amendment.

2.11.10 Amendment 86.

The Final Decision required Envestra to clarify that the forecast expenditure amounts that are used as the basis for measuring efficiencies relate to the expenditure benchmarks approved by the Regulator as part of the Final Approval of the Access Arrangement.

2.11.10.1 Further Final Decision

Envestra has included in its resubmitted Access Arrangement a statement that clarifies that the forecast expenditure amounts that are used as the basis for measuring efficiencies relate to the expenditure benchmarks approved by the Regulator. The Commission is satisfied that Envestra has incorporated the Commission's required Amendment.

2.11.11 Amendment 87.

Envestra was required to make consequential amendments to section 14.3 of its submitted Access Arrangement Information to reflect Amendments 79 to 86.

2.11.11.1 Further Final Decision

Envestra has included the consequential amendments to the Access Arrangement Information to reflect each of the required amendments relating to the second Period Incentive Mechanism. The Commission notes, however, that the Access Arrangement Information retains the argument relating to Envestra's original proposal for a 10-year carryover period, which has now been amended to a five-year period. The Commission has removed this argument from its AA Explanatory Information as it does not assist Users or prospective Users in understanding the Access Arrangement.

2.11.12 Amendment 88.

The Commission required Envestra to delete the second paragraph of section 14.3 that provides Envestra's interpretation of section 8.46 of the Code.

2.11.12.1 Further Final Decision

Envestra has deleted the specified paragraph from the resubmitted Access Arrangement Information. The Commission is satisfied that Envestra has incorporated the Commission's required Amendment.

2.11.13 Amendment 89.

The Commission required Envestra to amend the Access Arrangement such that the Incentive Mechanism must not apply as a Fixed Principle.

2.11.13.1 Further Final Decision

Envestra has removed the proposal for the Incentive Mechanism to apply as a Fixed Principle until the end of the third Access Arrangement Period. The Commission notes that the heading for clause 5.1 of the resubmitted Access Arrangement is titled "Fixed Principle – Incentive Mechanism". Although the Commission notes that clause 1.4 of the Access Arrangement provides that headings are for convenience only and do not affect interpretation of the Access Arrangement, to avoid any confusion, the Commission has amended this in its revised Access Arrangement..

2.12 Extensions/Expansions Policy

2.12.1 Amendment 90.

Amendment 90 was as follows:

> *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.

2.12.1.1 Further Final Decision

Envestra has included the required amendment in the resubmitted Access Arrangement and the Commission is satisfied that Amendment 90 has been incorporated.