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**Envestra's FRC Pass-through  
Application**

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*Draft Decision*

*November 2007*

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## SUBMISSIONS

The Queensland Competition Authority considers public involvement to be an important element of its decision making processes. It therefore invites submissions from interested parties on its Draft Decision regarding the application by Envestra for additional capital and operating expenditure related to the introduction of Full Retail Competition (FRC) to be included in the 2007-08 to 2010-11 regulatory period.

To facilitate the publication of submissions on the Authority's website, it is preferred if submissions are provided electronically by disk or email. Where this is not possible, written submissions are acceptable and should be sent to the address below. **Submissions, comments or inquiries regarding this paper should be directed to:**

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Submissions are due by no later than 18 January 2008.

### Confidentiality

In the interests of transparency and to promote informed discussion, the Authority would prefer submissions to be made publicly available wherever this is reasonable. However, if a person making a submission does not want that submission to be public, that person should claim confidentiality in respect of the document (or any part of the document). Claims for confidentiality should be clearly noted on the front page of the submission and the relevant sections of the submission should be marked as confidential, so that the remainder of the document can be made publicly available. It would also be appreciated if two copies of each version of these submissions (i.e. the complete version and another, excising confidential information) could be provided. Again, it would be appreciated if each version could be provided on disk. Where it is unclear why a submission has been marked "confidential", the status of the submission will be discussed with the person making the submission.

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Information about the role and current activities of the Authority, including copies of reports, papers and submissions can also be found on the Authority's website.

## PREAMBLE

In its Final Decision on Envestra's access arrangements in May 2006, the Authority accepted that costs relating to the implementation of Full Retail Competition (FRC) could be passed through to customers at a later date rather than being included at that time based on forecasts which would necessarily be uncertain due to the lack of detail then surrounding the FRC environment. The Authority also indicated that the normal materiality threshold would not be applied in relation to receiving a cost pass-through application with respect to FRC costs.

On 12 February 2007, the Authority received an application from Envestra for approval to pass-through costs associated with the introduction of FRC. As the assessment of Envestra's application could not be completed prior to the finalisation of prices for 2007-08, the Authority permitted Envestra to include a provisional amount of \$2.8 million in prices for 2007-08. This provisional amount was based on a preliminary assessment of Envestra's cost pass-through application by the Authority's consultant PB Associates (PBA).

In its application, Envestra sought approval to pass-through costs associated with \$11.0 million of capital expenditure and \$9.9 million of operating costs. Following consideration of Envestra's application, the Authority's Draft Decision is to approve the pass-through of costs associated with \$3.7 million of capital expenditure and \$5.6 million of operating costs. Both Envestra's proposal and the Authority's Draft Decision are summarised in the table below.

### FRC Costs (\$m Dec 2006)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Total
<b>Envestra Proposal</b>							
IT Capex	0.0	9.0	1.4	(3.3)	2.5	0.0	9.6
Telemetry Capex	0.1	0.9	0.3	0.1	0.0	0.0	1.4
<b>Total Capex</b>	<b>0.1</b>	<b>9.9</b>	<b>1.7</b>	<b>(3.2)</b>	<b>2.5</b>	<b>0.0</b>	<b>11.0</b>
IT Opex	0.0	0.0	1.8	1.5	1.5	1.5	6.3
Telemetry Opex	0.1	0.4	0.7	0.8	0.7	0.8	3.6
<b>Total Opex</b>	<b>0.1</b>	<b>0.4</b>	<b>2.5</b>	<b>2.3</b>	<b>2.2</b>	<b>2.4</b>	<b>9.9</b>
<b>QCA Draft Decision</b>							
IT Capex	0.0	6.4	1.8	(5.4)	0.0	0.0	2.8
Telemetry Capex	0.0	0.7	0.1	0.1	0.0	0.0	0.9
<b>Total Capex</b>	<b>0.0</b>	<b>7.1</b>	<b>1.9</b>	<b>(5.3)</b>	<b>0.0</b>	<b>0.0</b>	<b>3.7</b>
IT Opex	0.0	0.0	1.35	1.1	1.1	1.1	4.5
Telemetry Opex	0.1	0.1	0.2	0.2	0.2	0.2	1.1
<b>Total Opex</b>	<b>0.1</b>	<b>0.1</b>	<b>1.5</b>	<b>1.3</b>	<b>1.3</b>	<b>1.3</b>	<b>5.6</b>

To recover the costs accepted by the Authority, Envestra will need to raise an additional \$2.5 million in revenue from customers in each of the remaining 3 years of the current access arrangement. As the amounts are consistent with the amount already incorporated into 2007-08 prices, this cost pass-through decision should not impact adversely on future years' prices.

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## **1. INTRODUCTION**

### **1.1 Introduction of Full Retail Competition**

On 28 September 2005, the Queensland Government announced its intention to introduce Full Retail Competition (FRC) into the Queensland retail gas market from 1 July 2007.

Under FRC, the operation of the gas retail market is governed by the gas retail market rules. These rules impose certain requirements on entities operating in the market, including gas distribution businesses, to facilitate the effective operation of the market. The rules were developed by the Queensland Government in consultation with stakeholders.

Envestra owns a gas distribution network on the north side of Brisbane and in the Rockhampton area. The implications of FRC for Envestra have been largely concerned with the need to improve information technology systems and metering equipment to accommodate the requirements of the gas retail market rules.

As a natural monopoly, the prices that Envestra can charge for access to its pipelines are regulated by the Authority under the National Third Party Access Code for Natural Gas Pipeline Systems (the Code). The regulatory arrangements are set out in Envestra's approved access arrangement. The regulatory arrangements applying to Envestra are not affected by the introduction of competition to the retail segment of the gas market.

### **1.2 Regulation of gas distribution**

The Authority approved Envestra's current access arrangement in May 2006. These arrangements are not due to expire until 30 June 2011.

In its 2006 Final Decision, the Authority accepted that costs relating to the implementation of FRC could be passed through to customers at a later date, rather than being included as forecast costs, as these costs could not be estimated with any certainty until the gas retail market rules were finalised.

The potential costs of FRC related to new activities that Envestra would have to perform due to the introduction of FRC and/or an increase in the volume of existing tasks required solely as a result of the introduction of FRC.

### **1.3 Application for Pass-through**

On 12 February 2007, Envestra submitted an application to the Authority for approval to pass-through to customers costs relating to the introduction of FRC in Queensland. This application followed the finalisation of the gas retail market rules a week earlier. The Authority assessed Envestra's cost pass-through application against the criteria set out in Envestra's access arrangement and the Code.

To better understand Envestra's application, the Authority and its consultant, PB Associates (PBA), held a workshop with Envestra on 11 May 2007. Envestra provided its final responses to questions raised at that workshop on 31 May 2007.

PBA provided the Authority with a preliminary draft of its report on 6 June 2007. Envestra was invited to consider and comment on the draft report from PBA prior to the Authority preparing this Draft Decision.

PBA finalised its advice to the Authority on 14 September 2007 having taken into account comments received from Envestra in relation to its draft report.

With the agreement of Envestra, the finalisation of this Draft Decision was delayed in the hope that it could be considered contemporaneously with a (later) submission by APT Allgas regarding its FRC costs in respect of its gas distribution network. Unfortunately, information delays from APT Allgas have meant that this has not been possible and, as a result, this Draft decision has been finalised independently.

For 2007-08 pricing, the Authority allowed a provisional amount (\$2.8 million) to be included in Envestra's pricing to reflect potential FRC related costs. The Authority took this step so that distribution prices in the first year of full competition were not held artificially low. This provisional allowance will be taken into account in determining the actual amount the Authority approves for pass-through.

#### **1.4 Submissions**

The Authority invited submissions on Envestra's cost pass-through application on 22 February 2007. In response, submissions were received from AGL and Origin Energy. Both raised a number of concerns regarding Envestra's application and, in particular, questioned whether amounts already included in the access arrangement were being double counted in the cost pass-through application.

The Authority was also concerned about this aspect of Envestra's cost pass-through application and also the possibility that some expenditure approved in the access arrangement (for example, expenditure on a new billing system was accepted as part of Envestra's revised access arrangement) may be superseded by expenditure on seemingly unrelated items in relation to FRC. As a result, considerable attention has been focussed on the extent to which FRC related expenditure proposals put forward by Envestra have been demonstrated to be incremental to, and directly related to, the pass-through event.

#### **1.5 Independent Technical Analysis**

The Authority engaged PBA to provide an independent technical assessment of whether the capital and operating expenditure proposed by Envestra was consistent with the pass-through conditions set out in the Authority's Final Decision. The terms of reference for the consultancy required PBA to:

- identify the scope of Envestra's additional responsibilities under FRC in Queensland;
- review Envestra's existing IT and other systems and identify the options available to either augment or replace existing systems and processes needed to meet FRC obligations;
- determine whether the options and costs proposed by Envestra were prudent given the size of Envestra's Queensland network and costs incurred in other States. In this regard, compatibility with Envestra's systems in other States was not a sufficient justification of itself to select any particular option unless it also resulted in lower costs to Envestra in Queensland than would be the case for a stand alone operation;
- identify the extent to which costs are incremental, with incremental costs being those costs that:
  - can be specifically attributed to the introduction of FRC; and
  - have not previously been allowed for in the capital and/or operating expenditure included in the Authority's Final Decision of May 2006 on Envestra's revised access

arrangement (including any expansion/replacement of related systems previously approved);

- identify any efficiencies/synergies from the new systems (for example, Envestra's overall operating costs may be lower than previously allowed by the Authority due to the new system) and replacement of old systems (for example, old systems may no longer need to be enhanced/maintained or old systems may be able to be sold or redeployed in other areas of Envestra's operation);
- identify the level of prudent and efficient incremental FRC costs (for both capital and operating expenditure), having considered all the matters above; and
- consider whether the proposed allocation of FRC costs between customer groups and the manner of recovery (for example, fixed or variable charge adjustments) is reasonable.

## **1.6 Criteria for Assessment**

In considering Envestra's cost pass-through application, the Authority has taken into the requirements of the Code and the specific provisions covering cost pass-through included in Envestra's approved access arrangement.

Sections 8.16 and 8.37 of the Code require that capital and operating expenditure must, amongst other things, be consistent with a prudent service provider acting efficiently, in accordance with accepted good industry practice to achieve the lowest sustainable cost of providing the reference service.

In normal circumstances, for a cost pass-through to be considered, it must first meet certain materiality criteria. However, in its 2006 Final Decision on Envestra's revised access arrangement, the Authority indicated that a materiality test would not be applied to FRC costs. This provision was included because, at the time, while the Government had announced its intention to open the gas market to retail competition, the obligations that might flow from this decision were not clear. The Authority took the view that it was preferable to allow Envestra to make an as-of-right cost pass-through application at a later date than to attempt to include uncertain forecast costs in the arrangement at the time.

## 2. ENVESTRA'S APPLICATION

In its application, Envestra sought the Authority's approval to pass-through costs associated with \$11.0 million of capital expenditure and \$9.9 million in operating costs. According to Envestra, these costs were associated with implementing and maintaining IT systems, and telemetry and metering costs directly associated with the requirements of FRC. Envestra claimed that the costs included in its application were either not included in its approved access arrangement or that an appropriate adjustment had been made to account for costs that were already being recovered in existing tariffs.

Envestra indicated that, as a result of FRC, its IT systems would need to provide an automatic interface with external market participants, including VENC Corp (the Gas Retail Market Operator) and retail entities. Such an interface would require a significant upgrade to its current system capabilities. Envestra also considered that a further system upgrade would be required in 2009-10.

The costs associated with Envestra's pass-through application are summarised in Table 1.

**Table 1: Envestra proposed cost pass-through (\$m Dec 2006)**

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Total
<b>Core System:</b>							
Capital expenditure	0.0	9.0	1.4	(3.3)	2.5	0.0	9.6
Operating costs	0.0	0.0	1.8	1.5	1.5	1.5	6.3
<b>Sub Total</b>	<b>0.0</b>	<b>9.0</b>	<b>3.2</b>	<b>(1.8)</b>	<b>4.0</b>	<b>1.5</b>	<b>12.9</b>
<b>FRC Telemetry:</b>							
Capital expenditure	0.1	0.9	0.3	0.1	0.0	0.0	1.4
Operating costs	0.1	0.4	0.7	0.8	0.7	0.8	3.6
<b>Sub Total</b>	<b>0.2</b>	<b>1.3</b>	<b>1.0</b>	<b>0.9</b>	<b>0.7</b>	<b>0.8</b>	<b>5.0</b>
<b>Total</b>							
Capital expenditure	0.1	9.9	1.7	(3.2)	2.5	0.0	11.0
Operating costs	0.1	0.4	2.5	2.3	2.2	2.3	9.9
<b>Total</b>	<b>0.2</b>	<b>10.3</b>	<b>4.2</b>	<b>(0.9)</b>	<b>4.7</b>	<b>2.3</b>	<b>20.9</b>

Note: Totals may not add due to rounding

### 2.1 Envestra's Proposed FRC System

Envestra's current IT system uses 'Cordaptix' for storing meter data and 'Maximo' for managing work orders and asset management. Maximo includes a works management system for asset maintenance scheduling and a meter management system which provides a registry of meter assets. These systems include a manual interface with Envestra's geospatial information system (GIS). In addition, the exchange of information between Envestra's internal systems and market participants has been undertaken manually.

Under FRC, Envestra was required to provide an automated electronic communications interface between its systems, VENC Corp and retailers, which precluded retention of the existing largely manual interfaces.

Following the announcement in 2006 that FRC would commence on 1 July 2007, Envestra undertook a high level cost benefit assessment of alternative systems that it could adopt to meet what it expected to be its obligation under FRC. In its application, Envestra explained it was required to commit to an FRC system well before details of its obligations under FRC were known. This was a result of the short amount of time available to put in place appropriate systems before FRC was due to commence.

Envestra considered three alternative ways in which it could meet its FRC obligations based on the requirements of FRC systems in other jurisdictions. Envestra considered the three options described below.

Option 1: Copy the FRC solution used by Envestra in Victoria and customise it to meet the specific requirements of the Gas Retail Market Rules in Queensland.

Option 2: Modify the FRC system already in use in Victoria to create a single system capable of meeting the different requirements of each jurisdiction.

Option 3: Develop a new FRC system for Queensland by reworking its existing systems, developing internally a completely new system or purchasing an FRC solution from a third party service provider.

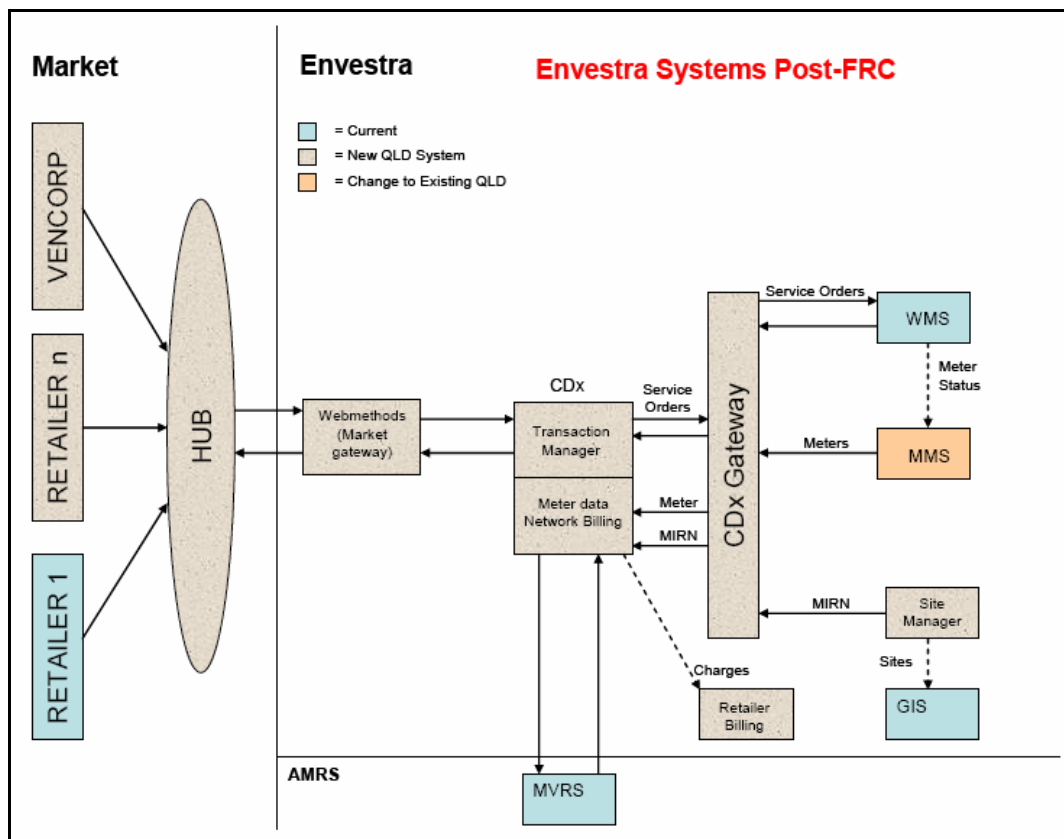
According to Envestra, Option 2 would have been attractive had the market rules in both Victoria and Queensland been similar. However, the significant differences meant that a single system would have incurred re-development costs that would have more than offset cost savings from having a single system.

Envestra claimed that the variants within Option 3 would have either taken more time than was available or could have been subject to potential delays that would have been beyond its control. Envestra considered that being unable to meet its obligations on the date that FRC was to commence was not acceptable.

Consequently, Envestra chose Option 1, being the Victorian based system copied and revised for use in Queensland. This Option is shown diagrammatically in Figure 2.

However, Envestra acknowledged that a lower cost solution may have been possible under Option 3 had more time (12 to 18 months) been available rather than the 6 months within which it had to meet its obligations.

**Figure 2: Envestra's Proposed FRC System**



Source: Envestra

Envestra stated that the proposed solution would provide the following outcomes:

- a web based market gateway to manage the external interface;
- storage of meter reading data and transaction data retrieval within Cordaptix;
- a retail billing system for calculating total haulage charges for each volume tariff meter for a billing period, to be aggregated for each retailer; and
- a Cordaptix Gateway to provide the interface between Cordaptix and meter reading service providers.

Envestra suggested the IT systems would provide co-ordinated internal data management and electronic communication of information with other market participants. These IT systems would handle nearly all work requests from third parties automatically and highlight unusual work requests that would need to be performed manually by Envestra.

*Consultant's Assessment*

As noted earlier, PB Associates (PBA) was engaged by the Authority to provide technical advice on the merit of the FRC cost pass-through application submitted by Envestra.

PBA was supportive of the approach used by Envestra to evaluate alternative options for meeting the requirements of FRC. PBA noted that Envestra's current access arrangement provided for upgrades to existing IT systems that were also part of the option that Envestra had chosen to meet its FRC obligations, in particular, upgrades to Cordaptix and Maximo.

PBA accepted Envestra faced significant time constraints to prepare for the commencement of FRC. The analysis performed by Envestra regarding the costs and benefits of the various options was, in PBA's view, sufficient to meet the requirement of the Code with respect to prudence and efficiency. In summary, PBA considered that Envestra had:

- considered an appropriate range of options;
- made the best use of existing available systems from other jurisdictions;
- adopted sensible automation of processes and interfaces where manual processing would not work well or not be acceptable under the Queensland gas market retail rules;
- selected a least cost solution that could be implemented within the (limited) time available; and
- demonstrated a flexible approach that could incorporate additional and improved features during the system's implementation.

#### *Stakeholder Comments*

Origin Energy (2007) acknowledged that Envestra's assumptions appeared reasonable. However, Origin Energy suggested that further analysis of the proposed system was required by an independent party with greater access to all information to clarify the costs associated with an accelerated implementation.

#### *Authority's Position*

The Authority acknowledges that Envestra had limited time to evaluate, design and implement systems capable of meeting its obligations under FRC. Envestra appears to have examined a reasonable range of alternative options that could fulfil its requirements.

It is of some concern that the choice of FRC system adopted by Envestra was made prior to the final resolution of the gas market retail rules which would fundamentally affect the requirements of the system. Envestra's choice of system, by its own admission, was significantly affected by the limited time available.

An alternative approach may have been to develop an interim, perhaps less automated, solution than that chosen by Envestra, followed by a more careful assessment of system requirements based on observed market outcomes (customer churn). This may have yielded an ultimately lower cost outcome. However, the gas retail market rules did not permit such a transitional approach.

Given the constraints placed on Envestra and the options available, the Authority is satisfied that the choice of FRC system adopted by Envestra meets the requirements of the Code.

A more detailed analysis of Envestra's proposed FRC systems is presented in the following sections.

## **2.2 Core Systems Capital Expenditure**

The core systems capital expenditure includes the costs of purchasing new hardware and software as well as the costs associated with tailoring the system to meet Envestra's requirements. Consultancy fees, labour and administrative costs associated with the design and implementation of the new systems have been capitalised by Envestra under this cost category.

A summary of Envestra's proposed core systems capital costs over the current regulatory period are provided at Table 2.

**Table 2: Envestra FRC core system capital expenditure proposal (\$m Dec 2006)**

	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>Total</i>
System Capex	9.0	1.4	0	2.5	0.0	12.9
Less Allowance in Access Arrangement			(3.3)			(3.3)
FRC related costs	9.0	1.4	(3.3)	2.5	0.0	9.6

Envestra also disaggregated this capital expenditure into individual cost categories, as shown in Table 3, which are discussed below.

**Table 3: Envestra FRC core system capital expenditure categories (\$m Dec 2006)**

<b>Cost Category</b>	<b>Total</b>
General Project Management	3.0
Meter Data and Network Billing	3.4
Business Process Management	0.6
AMS Modifications	1.3
IT Infrastructure	0.4
Contingency	1.7
Upgrade Costs in 2009-10	2.5
Sub Total	12.9
<i>Minus</i>	
Access Arrangement - Billing System Allowance	(3.3)
<b>Total</b>	<b>9.6</b>

### General Project Management

Envestra forecast that general project management costs associated with the implementation of these systems would be \$3 million in total. These costs related to activities associated with:

- general project management labour costs;
- pre-scoping and scoping phase costs;
- project office costs; and
- post-implementation clean up costs.

Envestra derived these costs from internal and external labour rates and estimates of the number of labour days to implement its proposed systems as provided in Table 4.

**Table 4: Project management expenditure (\$m Dec 2006)**

<b>Cost Category</b>	<b>FTE Days</b>	<b>Cost (\$k)</b>
Pre-scoping and scoping	-	451
Vendor project management	3.4	336
Internal project management	0.8	370
Project office support	0.6	143
Vendor technical support	1.3	168
Internal technical support	0.4	66
Post implementation clean up	1.7	530
General costs (eg IT infrastructure)	-	936
<b>Total</b>		<b>3,000</b>

### Meter Data and Network Billing

According to Envestra, meter data and network billing costs are associated with system design, building of interfaces and converting data from old systems into Envestra's new systems. Envestra derived these costs from estimated labour rates and labour days to complete the identified tasks. Envestra estimated that meter data and network billing costs relating to its FRC system would total \$3.4 million. The major costs components identified by Envestra are presented in Table 5.

**Table 5: Meter data and network billing costs (\$m Dec 2006)**

<b>Cost Category</b>	<b>FTE Days</b>	<b>Cost (\$k)</b>
Design - Vendor	140	196
Design - Internal	220	121
Development - Vendor	240	336
Data conversion	-	768
Configuration - Vendor	60	84
Configuration - Internal	300	204
Testing	1,050	613
Environment support - Vendor	100	140
Environment support - Internal	360	245
Delivery manager	180	122
Other		571
<b>Total</b>		<b>3,400</b>

### Business Process Management

Envestra's estimate of business process management costs covers the design and development costs to upgrade Cordaptix to allow for the gateway between Envestra's main internal systems. Envestra expected that costs of \$0.6 million for business process management would allow it to translate and co-ordinate data flows. These costs also covered the provision of services from the Cordaptix vendor.

### AMS Modifications

Envestra forecast \$1.3 million would be required for the modification of its existing Asset Management System (AMS) to increase its functionality to support FRC market messaging requirements. The proposed costs included an upgrade to Maximo 4 in order to meet FRC market messaging requirements. Envestra stated that it was required to upgrade its meter management system and that there would be associated site management costs.

### IT Infrastructure

Envestra's IT infrastructure costs cover the IT hardware associated with additional central processing system memory and disk space on its existing servers. These costs were forecast by Envestra to be \$400,000.

### Contingency

Envestra proposed a contingency allowance of 20 per cent of its proposed capital expenditure costs to account for unforeseen expenditure items, project delays and changes in system requirements. Overall, the contingency sought by Envestra was \$1.7 million.

### Upgrade Costs

Envestra expected that a system upgrade to Cordaptix would become available in 2009-10. As the Cordaptix vendor indicated that it would only provide limited support for previous versions up until 2012, Envestra proposed an upgrade of Cordaptix in 2009-10 at an expected cost of \$2.5 million.

### Access Arrangement Allowance

Envestra proposed \$12.9 million of core system capital expenditure over the access arrangement period, to be offset by \$3.3 million in recognition that some of the costs relating to its FRC systems duplicated costs for IT systems that had been previously allowed for in its existing tariffs.

Envestra considered that, of the \$5.4 million of capital expenditure included in its access arrangement for a billing system upgrade, \$3.3 million would be used to upgrade systems for FRC and, as a result, that amount should be offset against the costs of its proposed FRC system upgrade costs.

### *Stakeholders' Comments*

In its submission, AGL (2007) noted that Envestra's project management costs translated to 2,000 days at a rate of \$1,500 per person per day. AGL considered that, as these costs applied to a system that Envestra was already familiar with, expected project management costs should be lower.

AGL also sought clarification on whether other jurisdictions in which Envestra operated would also benefit from any upgrade to Cordaptix and whether the upgrade costs would be shared accordingly.

Both Origin Energy and AGL sought clarification on system costs that had previously been included for IT systems as part of the approved access arrangement and whether these costs had been accounted for in Envestra's submission.

### *Consultant's Assessment*

In considering Envestra's proposed core systems capital expenditure, PBA examined how all eight cost categories had been derived. Where costs included labour components, PBA examined labour rate benchmarks to determine whether the rates were reasonable. Similarly, the amount of labour (numbers of days) was also examined to determine whether the scope of work and time allocated to the task was reasonable.

Based on this approach, PBA considered that the costs proposed by Envestra in relation to five of the cost categories were reasonable. A more fulsome discussion and breakdown of how these costs were assessed is provided in the report prepared by PBA for the Authority and available on the Authority's website. PBA considered the cost for the following categories was reasonable:

- General Project Management;
- Meter Data and Network Billing (including Cordaptix);
- Business Process Management;
- AMS Modification (including Maximo); and
- IT Infrastructure.

However, PBA did not accept the costs proposed by Envestra under for the following three cost categories.

### Contingency

PBA considered that Envestra, having twice previously implemented FRC systems in other jurisdictions, should be reasonably familiar with the scope and costs of work to implement FRC in Queensland. PBA also considered that, in response to the Authority's Draft Decision, Envestra should be able to submit revised costs that would reflect most, if not all, actual commitments to FRC related projects. On the basis, PBA did not consider a contingency was required.

### Cordaptix Upgrade Costs

While PBA acknowledged that the need to upgrade IT systems was inevitable, it considered that the current version of Cordaptix should be able to support Envestra through to 30 June 2011, the end of the current regulatory period. PBA suggested that Envestra should evaluate its requirements at that time rather than committing to an upgrade that may not be required.

### Access Arrangement Allowance

PBA noted that the FRC system adopted by Envestra would lead to improvements in IT systems for which costs of \$5.4 million had previously been accepted by the Authority in approving Envestra's current access arrangement.

Envestra had acknowledged this principle in its application and had deducted \$3.3 million from its proposed FRC expenditure in recognition of costs already included in its revised access arrangement. However, Envestra considered that the remainder, \$2.1 million, would still be required to upgrade to Maximo 4 in 2008-09 as originally forecast in its access arrangement.

While PBA accepted that identifying the incremental costs associated with FRC was not a simple task, PBA was of the view that the IT systems that were required to meet Envestra's FRC obligations would supersede all the previously planned IT upgrades that had been included in Envestra's access arrangement. Consequently, PBA recommended that the full amount of \$5.4 million previously included in Envestra's access arrangement should be deducted from the FRC cost pass-through application, rather than the \$3.3 million that Envestra had proposed.

#### Additional Cost Savings

In its FRC cost pass-through application Envestra had proposed upgrading to Maximo 4 in 2006-07 and then undertaking a further upgrade to Maximo 6 in 2008-09. Following discussions with Envestra, it was agreed that upgrading immediately to Maximo 6 would be a more cost effective approach which would save an additional \$0.4 million.

#### *Authority's Position*

The Authority accepts that Envestra was required to incur additional IT spending to meet its FRC obligations, over and above the amount allowed for in Envestra's approved access arrangement. In considering this cost pass-through application, the objective of the Authority is to ensure that the amount invested by Envestra is prudent and efficient (as required by the Code) and that this expenditure justifies a higher reference tariff during this regulatory period.

In its report, PBA identified a number of capital expenditure items that it considered prudent and reasonable. The Authority accepts this assessment except for costs relating to IT infrastructure. Envestra included an amount of \$400,000 to purchase servers, data storage and additional software licenses not included elsewhere. The hardware costs included in this item appear excessive and the Authority will seek further explanation of these costs following release of this Draft Decision. However, for the purpose of this Draft Decision, the costs have been included on the basis that PBA had initially assessed them as reasonable.

PBA also identified several cost components that it considered were not prudent or efficient and did not represent an incremental cost above what had already been included in Envestra's access arrangement. In particular, PBA considered that there was insufficient uncertainty to warrant a large contingency allowance.

The Authority notes that, by the time this Draft Decision is released, the retail gas market will have been open to competition for a number of months. Envestra's systems will have been in place for this period of time and major capital expenditure will have been completed. The Authority also notes the comments by PBA that Envestra has significant experience from other jurisdictions in rolling out new systems to meet FRC requirements, albeit that these may be somewhat different in each jurisdiction. On this basis, the Authority considers that a contingency allowance is not warranted.

With respect to Envestra's proposed Cordaptix system upgrade in 2009-10, PBA observed that systems of this nature typically have useful lives of 5-10 years. The Authority is of the view that a commitment to upgrading this system in 2009-10 is not necessary at this point in time and, should this subsequently be deemed to be a prudent investment in 2009-10 (or later), the costs of this upgrade would more appropriately be considered in the context of approving Envestra's next access arrangement which is due to be finalised by 1 July 2011.

In approving Envestra's 2006 revised access arrangement, the Authority included costs of \$5.4 million associated with significant upgrades to Envestra's existing (pre-FRC) IT systems. As a result, the accompanying costs for these upgrades are already being recovered in current prices. The IT systems, now being proposed by Envestra to address FRC related purposes, share many

of the same functional capabilities of the system upgrades that were already recognised in the current access arrangement, creating the potential for significant costs to be double counted.

Envestra has already accepted this possibility and deducted \$3.3 million from its originally proposed costs. PBA has suggested that the potential double counting is greater than this and recommended the Authority reduce Envestra's proposed costs by the full \$5.4 million accepted in access arrangement. The Authority has accepted PBA's advice on this issue.

The system capex costs accepted by the Authority are presented in Tables 6 and 7 respectively.

**Table 6: Core system capital expenditure categories accepted by the QCA (\$m Dec 2006)**

<b>Cost Category</b>	<b>Envestra</b>	<b>QCA</b>
General Project Management	3.0	3.0
Meter Data and Network Billing	3.4	3.3
Business Process Management	0.6	0.6
AMS Modifications	1.3	1.3
IT Infrastructure	0.4	0.4
20 per cent Contingency	1.7	0.0
Upgrade Costs in 2009-10	2.5	0.0
<b>Sub Total</b>	<b>12.9</b>	<b>8.6</b>
<i>Less</i>		
Access Arrangement - Billing System Allowance	(3.3)	(5.4)
Additional Cost Savings	-	(0.4)
<b>Total</b>	<b>9.6</b>	<b>2.8</b>

**Table 7: Core system capital expenditure accepted by the QCA (\$m Dec 2006)**

	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>Total</i>
System Capex	6.4	1.8	0.0	0.0	0.0	8.2
Less Allowance in Access Arrangement			(5.4)			(5.4)
FRC related costs	6.4	1.8	(5.4)	0.0	0.0	2.8

### 2.3 Core Systems Depreciation

Envestra proposed a five year depreciation period for its IT assets.

#### *Stakeholder Comments*

AGL sought clarification on the rationale for this approach.

#### *Consultant's Assessment*

PBA considered that IT systems typically have useful lives of between 5 and 10 years. As Envestra adopted a 10 year life for major IT systems in its access arrangement and as 10 years is within the typical tax depreciation range for such assets, PBA considered an economic life of 10 years should be applied to Envestra's FRC IT systems.

### *Authority's Position*

The economic life for IT assets adopted by Envestra in the revised access arrangement was 10 years. To be consistent with the current access arrangement and noting the comments by PBA, the Authority considers that an economic life of 10 years is appropriate for these assets.

## **2.4 Core Systems Operating Costs**

Core systems operating costs refer to the ongoing costs of the systems to be put in place to meet Envestra's FRC obligations. A summary of the costs associated with Envestra's proposed core systems operating requirements for FRC are shown at Table 8.

**Table 8: Envestra FRC core systems operating expenditure proposal (\$m Dec 2006)**

<b>Cost Category</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>	<b>Total</b>
Staff	1.1	0.8	0.8	0.8	3.5
IT & Related Costs	0.3	0.3	0.3	0.3	1.2
Administration & Other	0.4	0.4	0.4	0.4	1.6
<b>Total</b>	<b>1.8</b>	<b>1.5</b>	<b>1.5</b>	<b>1.5</b>	<b>6.3</b>

### Staffing

In its cost pass-through application, Envestra indicated that it required an additional seven staff (on top of its existing 20 direct employees) to cater for an increase in activity as a direct result of the introduction of FRC. Envestra indicated that the additional staff would be required for the following tasks:

- 1 FTE for metering activities ;
- 1 FTE for billing activities ;
- 2 FTEs for transaction monitoring ;
- 2 FTEs for IT system support; and
- 1 FTE for site connection, administration and co-ordination.

As a result, Envestra proposed total annual wages costs of \$771,000 plus an additional 28.1 per cent for on-costs such as payroll tax, annual leave, long service leave, superannuation and workers compensation

In addition to these costs, Envestra proposed a six month bedding down allowance of \$385,500 to apply in 2007-08 to assist with initial churn and teething problems.

### IT & Related Costs

Envestra identified ongoing IT related vendor and license support costs of \$300,000 per year, which are payable to third party service providers.

### Administration & Other

Envestra claimed that it would incur \$400,000 a year in meeting additional training requirements, market participation costs and office costs as a direct result the introduction of FRC.

### *Stakeholder Comments*

With churn rates expected to be relatively low, both Origin Energy and AGL questioned the need for an additional seven FTEs to manage non-metering FRC workload on the basis that Envestra already undertakes billing and connection activities.

Origin stated that, with the inclusion of new automated FRC systems, some man hours could be saved. For instance, network billing was a network function prior to FRC and special meter reads for customer transfers will be separately charged to retailers if they are requested. Therefore, this should not be the cause for additional operational staff. Origin suggested that more detail was required from to assess if man hour savings have also been allowed for with the introduction of the new FRC systems.

### *Consultant's Assessment*

#### Staffing

PBA recognised that, while business processes surrounding new customer connections may change, it did not see any justification for an additional FTE to manage site connection and co-ordination beyond the first year. PBA considered that the increased workload resulting from FRC transactions should be able to be absorbed by the existing customer connection staff and the additional FTE Envestra that had sought for transaction monitoring.

On this basis, PBA considered that Envestra had only provided sufficient justification to support the need for an additional 7 FTEs in the first year of FRC, while only 6 FTEs were justified thereafter following the initial 'learning period'.

PBA was satisfied that the wage rates and on-costs proposed by Envestra were reasonable and comparable to those applied by other utilities.

#### IT & Related Costs

PBA considered the ongoing IT vendor and other license requirements that had been proposed by Envestra were reasonable.

#### Administration and Other

PBA noted that Envestra's proposed additional office costs of \$102,000 per year represented 15 per cent of Envestra's proposed additional labour costs. As PBA had recommended 6 rather than 7 additional FTEs on an on-going basis, PBA also reduced the office costs by the same ratio, to \$86,000 per year.

At 12 per cent of labour costs, PBA considered Envestra's proposed training costs to be excessive compared to a normal training overhead of around 5 per cent. PBA suggested that Envestra's proposed training costs should be reduced from \$79,000 per year to \$29,000 per year to reflect a more usual training overhead.

PBA accepted Envestra's inclusion of Energy Ombudsman fees of \$93,000 per year as these were a cost incurred by Envestra directly associated with the introduction of FRC.

### *Authority's Position*

The Authority accepts that the introduction of FRC is likely to result in additional staffing requirements by Envestra due to an increase in the number of customer and data transaction activities. This is despite the fact many of the activities will become automated. However, the

Authority is not convinced that the additional staffing proposed by Envestra, or that recommended by PBA, is reasonable or prudent, given the apparent low customer churn rates of around 2 to 3 customers per day. As noted by AGL and Origin, while there may be new tasks, it is not clear that these necessarily require additional staff and that some of these tasks could not be absorbed by existing staff. Due to these uncertainties, the Authority has included costs associated with only an additional 4 staff for the purposes of this Draft Decision. Envestra is welcome to provide a more detailed justification for additional staff in its response to the Draft Decision. Comments would also be welcome from other parties on this issue.

While the Authority accepts the thrust of the recommendation by PBA regarding office costs and training overheads, it has further reduced these to reflect its decision to include only 4 additional staff. Office costs have been reduced to \$53,000 per year and training to \$20,000 per year.

The Authority has accepted the costs proposed by Envestra regarding its contribution to meeting the costs of the Energy Ombudsman in Queensland.

The systems operating costs accepted by the Authority are presented in Table 9.

**Table 9: Core system operating expenditure accepted by the QCA (\$m Dec 2006)**

Cost Category	2007-08	2008-09	2009-10	2010-11	QCA	Envestra
Staff	0.7	0.4	0.4	0.4	1.9	3.5
IT & Related Costs	0.3	0.3	0.3	0.3	1.2	1.2
Administration & Other	0.3	0.4	0.4	0.4	1.4	1.6
<b>Total</b>	<b>1.3</b>	<b>1.1</b>	<b>1.1</b>	<b>1.1</b>	<b>4.5</b>	<b>6.3</b>

## 2.5 Telemetry Capital Expenditure

To meet its obligations under FRC, Envestra stated that it would be required to upgrade its central IT system to be able to collate, store and report interval metering data from gas delivery points. Envestra also noted that it was required to provide sites consuming more than 10 TJ per year with an interval meter within 2 years of the commencement of FRC.

A summary of Envestra's proposed telemetry costs are shown in Table 10.

**Table 10: Envestra telemetry capital expenditure proposal (\$m Dec 2006)**

Cost Category	2005-06	2006-07	2007-08	2008-09	Total
Central System	0.0	0.7	0.0	0.0	0.7
Site Installations	0.1	0.2	0.3	0.1	0.7
<b>Total</b>	<b>0.1</b>	<b>0.9</b>	<b>0.3</b>	<b>0.1</b>	<b>1.4</b>

### Central System

In its application, Envestra suggested that its existing SCADA system for processing interval meters had to be upgraded in order to eliminate all manual processes. Envestra suggested that the removal of manual processes would also improve reliability and accuracy of interval data.

### Site Installations

Envestra indicated that the revised market rules require all customer sites consuming greater than 10 TJ per year to have an interval meter installed within two years of the commencement of FRC. Envestra stated there were 58 sites connected to its network which consumed more than 10TJ of gas per year and would require an interval meter to be installed.

### *Stakeholders' Comments*

AGL noted that Envestra had proposed the application of correctors on all interval meters at a cost of \$4,500 per meter. AGL suggested that, while correctors were warranted for supply points with very high gas flows, they were not warranted for all supply points.

Origin Energy sought clarification of Envestra's \$1,200 provision per interval metering site for "other costs".

### *Consultants' Assessment*

### Central System

PBA suggested that Envestra could continue using semi-manual processes to deliver interval meter data but that this approach would increase the likelihood of errors. Any resulting errors could have an impact on other market participants as well as Envestra. Consequently, PBA accepted that the enhancement of Envestra's SCADA system was reasonable. PBA also acknowledged that the costs proposed were comparable with similar costs in other jurisdictions and, on that basis, considered the proposed costs to be prudent and efficient.

### Site Installations

PBA accepted that the additional 58 meters would be required at sites consuming greater than 10TJ per year but did not accept the costs for meter installation that were proposed by Envestra.

In its cost pass-through application, Envestra proposed a cost of \$9,450 per site to install interval meters. While Envestra subsequently acknowledged that a cost of \$2,500 per site was more probably more appropriate, which PBA accepted as a more realistic estimate, Envestra noted that it had already incurred costs of \$15,000 per site for the installation of 16 meters.

PBA accepted that there were reasons why the cost for these 16 sites were significantly higher than for other sites due to the need for pressure correctors to be installed as well. In addition, as meters were installed on these sites on an ad hoc basis there was limited scope for savings that could be expected from a planned larger-scale roll out of meters. Consequently, PBA recommended that costs of \$15,000 per site for the 16 meters installed over 2005-06 and 2006-07 be accepted as reasonable but remaining meters be costed at \$2,500 per site.

### Depreciation of Telemetry Equipment

PBA considered that the typical economic life for minor IT works and enhancements, such as the telemetry IT expenditure, would be five years as proposed by Envestra.

### *Authority's Position*

The Authority accepts the recommendation by PBA to allow for meter installation costs of \$2,500. Envestra has acknowledged the proposed costs in its cost pass-through application were too high on average.

However, the Authority does not accept the higher cost of \$15,000 for the 16 interval meters installed over 2005-06 and 2006-07 was justified. While these meters may have been for higher usage customers and may have required high cost correctors, the disparity between the cost of completed meter installations and the expected cost of future installations is excessive. Furthermore, the (higher cost) ad hoc roll out during 2005-06 and 2006-07 was within Envestra's control. The Authority considers that an average cost of \$2,500 across all meter installations is reasonable.

The core system operating costs accepted by the Authority are presented in Table 11.

**Table 11: Telemetry capital expenditure accepted by the QCA (\$m Dec 2006)**

Cost Category	2005-06	2006-07	2007-08	2008-09	QCA	Envestra
Central System	0.0	0.7	0.0	0.0	0.7	0.7
Site Installations	0.0	0.0	0.1	0.1	0.2	0.7
<b>Total</b>	<b>0.0</b>	<b>0.7</b>	<b>0.1</b>	<b>0.1</b>	<b>0.9</b>	<b>1.4</b>

## 2.6 Telemetry Operating Expenditure

Envestra based its forecasts for the on-going cost of telemetry services on its experience with the introduction of FRC in South Australia.

A summary of Envestra's proposed telemetry operating costs is provided at Table 12.

**Table 12: Envestra FRC telemetry operating expenditure proposal (\$m Dec 2006)**

Cost Category	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Total
Staffing	0.1	0.4	0.7	0.7	0.7	0.7	3.3
IT Costs	0.0	0.0	0.1	0.1	0.1	0.1	0.4
<b>Total</b>	<b>0.1</b>	<b>0.4</b>	<b>0.7</b>	<b>0.8</b>	<b>0.7</b>	<b>0.8</b>	<b>3.6</b>

Note: Figures may not add up due to rounding

### Staffing

Envestra proposed an additional 4.5 FTEs would be required to undertake all the operating, processing and maintenance of telemetry equipment and meter data processing. Envestra proposed that additional staff comprising an engineer, 2 installation/maintenance fitters and 1.5 administration officers would be required as a result of FRC. These additional staffing resources were made up of 0.5 engineers and 2 installation fitters to undertake telemetry operating, processing and maintenance services and a further 0.5 engineers and 1.5 administration officers to manage delivery point registration, churn administration and data management. Envestra suggested this estimate reflected its experience with its network in South Australia.

Envestra also proposed costs of around \$25,000 for the remainder of the current regulatory period for minor administration costs.

### IT Costs

Envestra suggested it would be required to meet ongoing costs of \$1,490 per demand customer per year associated with telemetry system support which would be provided by telemetry IT service providers.

Envestra also suggested there would be additional maintenance costs in relation to:

- software maintenance for CITECT and Historian applications;
- CITECT and Historian application upgrades; and
- communications maintenance.

#### *Stakeholders' Comments*

AGL suggested that ongoing maintenance for 74 interval meter sites would not appear to warrant 2 fitters or an engineer.

Both AGL and Origin Energy suggested consideration should be given to whether maintenance and response could be more efficiently managed through external contractual arrangements.

AGL suggested that the implementation of FRC is unlikely to warrant an additional 4 full-time ongoing staff members. The metering functions are currently being performed by Envestra, albeit to a different standard and, once the roll-out of interval meters to the estimated 74 sites has been completed, ongoing maintenance and responses should not warrant 2 full-time fitters nor a full-time engineer.

#### *Consultant's Assessment*

##### Staffing

PBA indicated that the per customer cost of telemetry maintenance claimed by Envestra equated to \$3,685 per demand customer per year for the remainder of the current regulatory period. PBA noted that, in NSW, the cost of providing and maintaining on-site data and communication equipment was \$950 per site per annum. PBA could not identify any reason why there would be such a large difference between Envestra's proposed costs and the costs incurred in NSW. PBA was of the view that a reasonable estimate of these costs would lie somewhere between an upper limit of \$950 per site each year (based on the costs in NSW) and a lower limit of \$250 per site each year (representing roughly 10 per cent of the \$2500 cost of an interval meter). PBA opted for a mid-point between these limits of \$600 per site per each year.

With respect to activities associated with delivery point registration, churn administration and data management, PBA considered that, given the amount of work expected to be generated from 74 sites with telemetry equipment would be less than that proposed by Envestra, PBA was of the view that only an additional 0.5 engineers and 0.5 administration staff would be required.

##### IT Costs

PBA considered that Envestra's proposed costs of providing communications IT maintenance were reasonable. However, PBA considered that Envestra's proposed software upgrades every second year were not necessary as such systems tend to have a much longer useful life.

#### *Authority's Position*

PBA did not support the costs proposed by Envestra for operating and maintaining the telemetry equipment and instead provided its own estimate based on benchmark data. In the absence of any compelling reason why telemetry costs in Queensland should be significantly higher than in NSW, the Authority accepts PBA's estimate of a reasonable cost for this activity of \$600 per site per year. This equates to 0.5 FTE staff.

The Authority accepts that Envestra will incur operating costs in relation to delivery point registration, churn administration and data management as a direct result of the introduction of FRC. However, given that levels of churn are not expected to be significant (in the 4 months to the end of October 2007 only 554 customers had changed retailer) and there is only data from 74 interval meters to be managed, the Authority agrees with PBA that costs associated with an additional 0.5 engineers and 0.5 an administration officers should be sufficient for the task.

As PBA supported the need and costs to install communications equipment to each interval meter, the Authority accepts the IT operating costs proposed by Envestra are reasonable, with the exception of the proposed software upgrades every second year.

The telemetry operating expenditure accepted by the Authority is presented in Table 13.

**Table 13: Telemetry operating expenditure accepted by the QCA (\$m Dec 2006)**

Cost Category	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	QCA	Envestra
Labour	0.1	0.1	0.1	0.1	0.1	0.1	0.7	3.3
IT Costs	0.0	0.0	0.1	0.1	0.1	0.1	0.4	0.4
<b>Total</b>	<b>0.1</b>	<b>0.1</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>1.1</b>	<b>3.6</b>

Note: Totals may not add due to rounding

## 2.7 Summary

Table 14 provides a summary of the expenditure proposed by Envestra and the expenditure accepted by the Authority for the purposes of this Draft Decision.

**Table 14: Pass-through costs accepted by the Authority (\$m Dec 2006)**

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Total
<b>Envestra Proposal</b>							
IT Capex	0.0	9.0	1.4	(3.3)	2.5	0.0	9.6
Telemetry Capex	0.1	0.9	0.3	0.1	0.0	0.0	1.4
<b>Total Capex</b>	<b>0.1</b>	<b>9.9</b>	<b>1.7</b>	<b>(3.2)</b>	<b>2.5</b>	<b>0.0</b>	<b>11.0</b>
IT Opex	0.0	0.0	1.8	1.5	1.5	1.5	6.3
Telemetry Opex	0.1	0.4	0.7	0.8	0.7	0.8	3.6
<b>Total Opex</b>	<b>0.1</b>	<b>0.4</b>	<b>2.5</b>	<b>2.3</b>	<b>2.2</b>	<b>2.4</b>	<b>9.9</b>
<b>QCA Accepted</b>							
IT Capex	0.0	6.4	1.8	(5.4)	0.0	0.0	2.8
Telemetry Capex	0.0	0.7	0.1	0.1	0.0	0.0	0.9
<b>Total Capex</b>	<b>0.0</b>	<b>7.1</b>	<b>1.9</b>	<b>(5.3)</b>	<b>0.0</b>	<b>0.0</b>	<b>3.7</b>
IT Opex	0.0	0.0	1.3	1.1	1.1	1.1	4.5
Telemetry Opex	0.1	0.1	0.2	0.2	0.2	0.2	1.1
<b>Total Opex</b>	<b>0.1</b>	<b>0.1</b>	<b>1.5</b>	<b>1.3</b>	<b>1.3</b>	<b>1.3</b>	<b>5.6</b>

Note: Totals may not add due to rounding

### 3. REVENUE

Based on the costs accepted above as being reasonable to pass-through to customers due to the introduction of FRC, the Authority has calculated the corresponding revenue requirement as the sum of:

- additional non-capital costs (including tax); plus
- depreciation on new capital expenditure; plus
- a return on new assets.

Non-capital costs include FRC related operating costs and tax (which is the tax payable on revenue after operating costs and depreciation have been deducted). Consistent with the current access arrangement, depreciation has been calculated based on a straight line basis using asset lives as discussed in earlier sections.

The return on assets has been calculated using the WACC of 8.80 % (post tax nominal), the same as used in Envestra's current access arrangement, applied to new FRC related capital costs.

The cost data provided by Envestra was reported in values as at December 2006. For the purpose of calculating the revenue requirement, all figures have been converted to nominal amounts using the same inflation rate of 2.77 per cent that was adopted by Envestra in its revised access arrangement...

Table 15 presents the breakdown of the component parts of the total revenue requirement resulting from Envestra's FRC cost-pass-through application as determined by the Authority.

**Table 15: Envestra pass-through revenue (\$m nominal)**

	2006-07	2007-08	2008-09	2009-10	2010-11	Total	NPV
Return on Capital	0.3	0.7	0.5	0.2	0.1	1.8	
Depreciation	0.4	0.9	0.7	0.4	0.4	2.8	
Non-capital Costs	0.2	1.6	1.4	1.4	1.4	6.0	
Tax	0.0	(0.2)	0.0	0.1	0.3	0.2	
Inflationary Gain	0.1	0.2	0.2	0.0	0.0	0.6	
<b>Total</b>	<b>0.8</b>	<b>2.7</b>	<b>2.4</b>	<b>2.1</b>	<b>2.3</b>	<b>10.1</b>	<b>7.8</b>

Note: Totals may not add due to rounding

As previously indicated, the Authority allowed a provisional amount of \$2.8 million to be included in 2007-08 pricing. Raising the remaining revenue requirement (for the entire period) over the remaining three years of the current access arrangement period, while maintaining the overall net present value, requires annual revenue increases as detailed in Table 16.

**Table 16: QCA accepted Envestra revenue pass-through (\$m Nominal)**

	2006-07	2007-08	2008-09	2009-10	2010-11	Total	NPV
FRC Revenue	0.0	2.8	2.5	2.5	2.5	10.3	7.8

### 3.1 Envestra's proposed tariffs

While the purpose of this Draft Decision is to consider the appropriate level of costs associated with the introduction of FRC to be passed through to customers, rather than to approve resulting prices, it is possible to give some consideration to the likely price impacts so that network users and consumers have some insight into the potential impact on distribution prices of the cost pass-through amounts that the Authority has accepted in this Draft Decision.

Envestra proposed to introduce an additional FRC tariff to recover these costs such that:

- the costs of developing the telemetry/interval metering system would be recovered equally from demand customers;
- the costs of developing the core system would be recovered through a variable charge applied to volume customers; and;
- all other costs would be recovered from a fixed charge shared equally by all customers.

For the purpose of recovering the provisional FRC cost pass-through amount in 2007-08, Envestra imposed an additional fixed charge for demand customers and a fixed and variable charge for volume customers. For demand customers, Envestra imposed an additional fixed charge of \$8,333.28 per year (approximately \$23 per day). For volume customers, Envestra imposed an additional annual fixed charge of \$25.55 (\$0.07 per day) and an additional variable charge of \$0.26 per GJ.

The variable charge for volume customers applied to the first step of the consumption based charges and was expected to raise 20 per cent of the costs to be recovered from volume customers, with the remaining 80 per cent to be recovered from the fixed charge.

Given that the total amounts to be raised in subsequent years are similar (in nominal terms) to the provisional amount allowed for 2007-08, it is expected that Envestra would adopt a similar approach and that the nominal impact on prices would be similar to those of 2007-08 for each of the remaining years of the current regulatory period.

#### *Stakeholders' comments*

AGL stated that the method for allocating costs to customers will have a significantly greater impact on smaller volume customers and smaller demand customers. Given this impact, AGL suggested that alternative methods for allocating costs should be examined such as allocating costs to volume and demand customers based on fixed and per GJ consumption and the use of longer asset lives for the assets being used for FRC.

Origin Energy considered that the proposed additional FRC charges were relatively high and, given that large customers in the lower range of consumption (10-15 TJ) were already contestable, the introduction of FRC provided little additional benefit for them.

#### *Consultant's Assessment*

PBA considered that the tariff structure proposed by Envestra was generally appropriate. However, PBA acknowledged that the cost reflective allocation of costs to fixed and variable charges would vary between individual customers and that some judgement was required on how to achieve an appropriate balance.

*Authority's position*

In its 2006 Final Decision on Envestra's revised access arrangements, the Authority indicated that it did not intend to be prescriptive about how service providers structured individual tariffs other than to ensure that tariffs relating to individual reference services were cost reflective, which is a requirement of the Code. In this same light, the Authority's main consideration with respect to the pass-through of FRC related costs is whether the allocation of these costs between demand and volume customers reflects the incidence of those costs.

In this respect, the Authority accepts that the allocation of telemetry costs to demand customers appears reasonable as these costs are incurred for the purpose of serving only these customers. In respect of the other costs categories, as customers using greater than 1TJ per year have been contestable for some time, it is reasonable to assume that the costs of opening up the retail market to competition for customers consuming less than 1TJ should also largely be borne by those (volume) customers. Similarly, it is reasonable to assume that the benefits of extending retail competition to the less than 1TJ group of customers will accrue to those customers.

As to the approach to pricing best suited to passing on these costs within the volume customer group, it could be argued that either a fixed charge levied on a per customer basis would be reasonable (on the assumption that the cost of introducing FRC is roughly the same for all customers) or a combined fixed and variable charge could be a reasonable (assuming FRC will provide those customers using more gas with a greater gain from the introduction of competition). As either approach appears equally defensible (and there is no theoretically best solution), the Authority currently is not predisposed to either approach. As the approach that Envestra has proposed results in a reasonable allocation of costs to users and reflects the additional costs attributable to each customer group, the Authority considers that this approach is consistent with the requirements of the Code.

Given the similar size of the annual cost pass-through amount proposed in this Draft Decision to that included as a provisional amount in 2007-08 prices, and given the similar distribution of those cost between demand and volume customers, applying the same pricing approach for 2008-09 as applied in 2007-08 should not lead to any further price impact on account of FRC costs as the required amount is already built into the current year's prices.

However, should the final amount to be passed through to customers increase in response to submissions received on this Draft Decision, or the mix between demand and volume customers change significantly, there would be some additional price impact.

#### 4. DRAFT DECISION

The Authority's Draft Decision is to approve the pass-through of costs by Envestra associated with an additional \$3.7 million in capital expenditure and \$5.6 million in operating expenditure during the current access arrangement period.

Based on the same parameters used in the 2006 Final Decision, the Authority has determined the total revenue impact or the cost pass-through to be \$10.3 million (in nominal terms) over the remaining years of the current access arrangement.

The additional revenues to be targeted by Envestra for its future tariffs are shown in Table 17.

**Table 17: Target revenue for future Envestra tariffs (\$m Nominal)**

	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>Total</i>
FRC Revenue	0.0	2.8	2.5	2.5	2.5	10.3

Subject to any changes that may be made in the Authority's Final Decision, Envestra will be able to recover these additional revenue amounts through the price approval process in the relevant year.