



Envestra's FRC Pass-through Application

Final Decision

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PREAMBLE

The introduction of Full Retail Competition (FRC) in the Queensland gas market on 1 July 2007 placed certain new requirements on gas distributors including Envestra.

Envestra's approved 2006 access arrangement allows Envestra to seek approval from the Authority to pass through to customers the costs associated with meeting its FRC obligations.

On 12 February 2007, Envestra applied for approval to do so. Envestra's application included \$11.0 million of capital expenditure and \$9.9 million of operating costs it claimed to have incurred (or would incur) directly as a result of meeting its FRC obligations.

Envestra's FRC costs primarily related to the installation and maintenance of upgraded information technology, billing and metering systems.

The Authority released a Draft Decision on Envestra's application in November 2007. At that time, the Authority proposed to approve \$3.7 million of capital expenditure and \$5.6 million of operating costs.

In response to the Draft Decision, Envestra revised some of its cost estimates based on actual outcomes and accepted some issues raised by the Authority in its Draft Decision. This reduced the amount Envestra was seeking to pass-through to \$7.5 million in capital expenditure and \$7.0 million in operating costs.

Following consideration of Envestra's revised application, submissions received from stakeholders and a report prepared for the Authority by PB Associates, the Authority's Final Decision is to approve the pass-through of costs associated with \$4.7 million of capital expenditure and \$5.8 million of operating costs.

Based on an early assessment of the likely costs of Envestra meeting its FRC obligations, the Authority allowed Envestra to raise a provisional amount of \$2.8 million in its prices in 2007-08. This was done to ensure that prices in the newly competitive gas market were not held artificially low in the first year. The Authority's Final Decision will allow Envestra to raise an additional \$11.2 million in revenue (in nominal 2006 prices). Over the remainder of the current regulatory period, this will add an additional \$2.8 million in revenue to be recovered by Envestra each year. As this amount is consistent with the provisional amount which has already been factored into prices, there should be no further impact on Envestra's prices as a result of this Final Decision.

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1. INTRODUCTION

1.1 Introduction of Full Retail Competition

Full Retail Competition (FRC) commenced in the Queensland retail gas market from 1 July 2007. FRC was implemented through changes to the Gas Supply Act 2003, regulations, licences and the introduction of a new Gas Industry Code.

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 operates a gas distribution network on the north side of Brisbane and in the Rockhampton area. The implications for Envestra from the introduction of FRC related mainly to the need to improve information technology systems and metering equipment to meet the new gas market rules, and to do so effectively by 1 July 2007.

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 were 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 commenced from 1 July 2006 and apply 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 at the time, as these costs could not be estimated with any certainty until the gas retail market rules were finalised.

1.3 Application for Pass-Through

On 12 February 2007, Envestra submitted an application to the Authority for approval to pass-through to customers certain costs relating to the introduction of FRC in Queensland. Envestra's application included \$11.0 million of capital expenditure and \$9.9 million of operating costs. The proposed expenditures were to provide for an upgrade and ongoing maintenance of Envestra's information technology, billing and metering capabilities necessary to meet its FRC obligations.

A key component of Envestra's FRC system provides an automated communication interface between Envestra and external market participants, including retail entities. The system is an adapted version of an FRC facility already implemented in Envestra's Victoria and South Australia operations, and replaced Envestra's manual processes previously in use in Queensland.

In its original application, Envestra argued that the proposed costs were necessary to comply with Queensland FRC requirements. In addition, Envestra stated that the proposed costs had not been included in the approved 2006 access arrangement and thus not already reflected in its existing tariffs.

1.4 Authority's Assessment Process

The Authority assessed Envestra's cost pass-through application against the criteria set out in Envestra's access arrangement and the Code.

On 22 February 2007, the Authority invited submissions from stakeholders and subsequently received submissions from AGL and Origin Energy in response.

Early in its review, the Authority allowed a provisional amount (\$2.8 million) to be included in Envestra's pricing for 2007-08 to reflect anticipated FRC costs. The Authority took this step so that distribution prices in the first year of full competition were not held artificially low.

In response to a request from Envestra, the finalisation of the Draft Decision was delayed so that the Authority might consider it jointly with a submission by APT Allgas for FRC cost pass-through. However, given delays in obtaining relevant information from APT Allgas, the Authority eventually proceeded to finalise its assessment of Envestra's application.

The Authority engaged PB Associates (PBA) to provide an independent technical analysis of Envestra's application. A workshop was held with Envestra on 11 May 2007, with additional comments received from Envestra in response to matters raised at that workshop.

The Authority's Terms of Reference required PBA to identify the new responsibilities Envestra faced under Queensland FRC requirements and the options available to address FRC objectives. PBA was also required to report on the prudence and efficiency of the proposed costs given the size of the Queensland network and in comparison to the systems used in other States. Further, the proposed costs were required to be incremental in that they were specifically attributed to the FRC event and not include costs already allowed in previous regulatory decisions. Additional matters which PBA analysed included the cost allocation method and the impacts on gas prices as a result of FRC.

In its report of 14 September 2007, PBA found that the introduction of FRC in Queensland had imposed new requirements on Envestra to improve its business functions and systems, including IT, telemetry and metering functions. The report was supportive of the FRC system proposed by Envestra, noting that this seemed to make use of Envestra's prior experience in implementing FRC systems in Victoria and South Australia.

However, PBA also found that several capital and operating expenditures proposed by Envestra did not satisfy key pass-through tests based on prudence and efficiency grounds.

Those expenditures which PBA consider were not prudent or were unlikely to relate to FRC included the "contingency" allowance proposed for cost overruns, the planned Cordaptix upgrade and operating expenditures to support the FRC system. In particular, PBA considered that considerable uncertainty surrounded the need for and timing of the Cordaptix upgrade, and whether it could be regarded as incremental.

1.5 Draft Decision

In November 2007, the Authority released its Draft Decision for public comment. The Authority accepted that Envestra faced significant time constraints in implementing its FRC obligations. Although this might have precluded the use of a less automated process and the adoption of a lower cost option, the Authority concluded that Envestra's proposed FRC system was satisfactory. The Authority's Draft Decision was to approve \$3.7 million in capital expenditure and \$5.6 million in operating expenditure for pass-through of costs by Envestra during the current access arrangement period.

In its Draft Decision, the Authority noted its concern regarding the potential that some expenditure already included in the costs underlying approval of Envestra's revised access arrangement in 2006 may be superceded by systems changes that would be required by Envestra to meet its obligations under FRC.

Following the release of the Draft Decision, the Authority received submissions from AGL, Origin Energy and Envestra in late February 2008.

AGL and Origin Energy generally supported the Authority's Draft Decision. Origin Energy stressed that proposed FRC costs should be limited only to incremental costs and that additional cost savings might arise in relation to non-metering functions and interval metering.

AGL considered that, on the basis that the management of both Envestra and APT gas networks was now performed by a single entity (the APA Group), resourcing efficiency not previously available could now be achieved. In this regard, AGL requested that the Authority assess possible cost saving arising from this initiative in its Final Decision.

In its submission on the Draft Decision, Envestra provided additional information and updated data to support its application, with actual data replacing forecast data in some instances. The updated data amended Envestra's original submission for pass-through to \$7.5 million in capital expenditure and \$7.0 million in operating costs. This compared with the \$11.0 million of capital expenditure and \$9.9 million of operating costs included in Envestra's original application.

To assist in its assessment of Envestra's revised FRC cost pass-through application, the Authority re-engaged PBA to assess the updated data and information provided by Envestra. The Authority received PBA's final report on 23 April 2008.

In its response to the Draft Decision, Envestra accepted several adjustments made by the Authority in its Draft Decision. Consequently, for this Final Decision, the Authority has focused on those remaining items for which Envestra has higher amounts.

2. FINAL ASSESSMENT OF ENVESTRA'S FRC CAPITAL EXPENDITURE

2.1 Draft Decision

In its Draft Decision, the Authority proposed approving \$3.7 million of capital expenditure for the upgrade of Envestra's core IT system and telemetry for FRC purposes. This compared to \$9.6 million in capital expenditure proposed by Envestra its original FRC cost pass-through application.

Capital expenditure included costs incurred by Envestra relating to general project management and meter data management, network billing activities needed to support the core IT system and expenditure to upgrade the central system for the processing of interval meter data in order to eliminate previous manual processes.

Those costs recognised by the Authority in its Draft Decision and those initially proposed by Envestra in its application are shown in Table 1.

Table 1: QCA Draft Decision capital expenditure (\$m, Dec 2006)

Cost Category	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Total Draft Decision	Envestra original application
Core System	0.0	6.4	1.8	0.0	0.0	0.0	8.2	12.9
less Access Arrangement	0.0	0.0	0.0	(5.4)	0.0	0.0	(5.4)	(3.3)
Telemetry	0.0	0.7	0.1	0.1	0.0	0.0	0.9	1.4
Total	0.0	7.1	1.9	(5.3)	0.0	0.0	3.7	9.6

The Draft Decision provided a detailed explanation of the proposed capital costs accepted and not accepted by the Authority at that time. In summary, the main differences between the costs recognised by the Authority and those proposed by Envestra included:

- exclusion of \$2.5 million for a proposed upgrade to Envestra's billing system (Cordaptix) in 2009-10.
- removal of Envestra's proposed "contingency" funding for cost overruns of \$1.7 million;
- a deduction of \$0.4 million to account for cost savings expected by Envestra for its works management system, Maximo;
- a further deduction of \$2.1 million for forecast IT costs included in the 2006 access arrangement (in total \$5.4 million) compared to \$3.3 million deducted by Envestra; and
- a decrease of \$0.5 million in the expected cost of interval meters for large gas customers.

2.2 Envestra's Response to the Draft Decision

In its response to the Draft Decision, Envestra provided updated cost estimates for approval for pass-through associated with \$7.5 million in capital expenditure, down from \$9.6 million in its original application but still \$3.8 million more than that accepted by the Authority in its Draft Decision. Envestra's revised capital costs are presented in Table 2.

Table 2: Envestra updated capital expenditure (\$m Dec 2006)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Revised total	QCA Draft Decision
Core System	0.0	6.9	2.1	0.8	1.9	0.0	11.7	8.2
<i>less</i> Access Arrangement	0.0	0.0	0.0	(5.4)	0.0	0.0	(5.4)	(5.4)
Telemetry	0.1	0.6	0.4	0.0	0.0	0.0	1.2	0.9
Total	0.1	7.5	2.5	(4.6)	1.9	0.0	7.5	3.7

Note: Totals may not add due to rounding

In its submission, Envestra noted that its actual FRC costs were lower overall than the forecasts included in its original cost pass-through application. Envestra also accepted several adjustments made by the Authority in its Draft Decision, including:

- the removal \$5.4 million (instead of \$3.3 million) that had been included in forecast capital expenditure at the time of approving the 2006 access arrangement for IT expenditure that would no longer be required due to system upgrades associated with FRC;
- that actual costs associated with its works management system Maximo were \$0.5 million less than previously anticipated;
- an increase of \$0.9 in actual costs in relation to Core Systems capital expenditure; and
- the removal of \$1.7 million for “contingency” costs associated with its Core System expenditure.

Envestra did not accept all of the proposed adjustments made by the Authority in its Draft Decision and submitted additional information and explanation in relation to these costs, which are discussed below. However, Envestra did not provide any reconciliation of the net increase of \$0.9 million in actual costs noted in dot point 3 above, despite the Authority requesting such information. On this point, in the absence of an explanation, the Authority has been unable to assess the merits of the proposed increase by Envestra and has therefore excluded that amount.

2.3 Core systems capital expenditure

In its submission on the Draft Decision, Envestra indicated that Core System capital expenditure should be \$3.5 million higher than those costs accepted by the Authority in its Draft Decision. Envestra suggested that:

- \$1.9 million needed to be reinstated for the upgrade to Cordaptix;
- \$0.9 million needed to be added to Core Systems capital expenditure based on actual costs;
- \$1.2 million in cost savings associated with Maximo should be reinstated as the Authority had erred in removing this amount; and
- \$0.5 million of savings would eventuate from bringing forward the installation of Maximo 6.

In addition, Envestra provided additional information for IT hardware costs that the Authority had sought (although these costs had been included in its Draft Decision on a provisional basis) and maintained its view that Core Systems should be depreciated over a five year period rather than the 10 years adopted by the Authority.

Cordaptix System Upgrade

Envestra's proposed IT system included the installation of "Cordaptix" to meet its billing requirements and for storing metering data and "Maximo" for managing work orders and asset management. In its original application, Envestra sought approval for \$2.5 million to upgrade the Cordaptix system in 2009-10.

Draft Decision

In its Draft Decision, the Authority proposed that, while costs associated with the installation of Cordaptix would be accepted, the proposed upgrade to the Cordaptix system in 2009-10 was not justified. The Authority considered that, should this investment be considered prudent by Envestra in 2009-10 (or later), the cost of this upgrade would be more appropriately considered in the context of the next access arrangement which is due to be finalised by 1 July 2011.

Envestra's Response to the Draft Decision

In its response, Envestra submitted an updated cost estimate of \$1.9 million to implement the upgrade to Cordaptix in 2009-10, \$0.6 million lower than its original estimate.

Envestra did not accept that the upgrade of the Cordaptix system should be deferred until the next access arrangement period. Envestra argued that, by 2007, the Cordaptix system would be already three years old and delaying the upgrade to the next access arrangement period would mean having a useful life for the system of over 9 years compared to 5 years which it considered appropriate.

In addition, Envestra suggested that vendor support for the Cordaptix system was due to cease in June 2009, which would pose significant and unacceptable risks of an extended outage of its billing system.

Submissions from Stakeholders

No submissions were received on this issue.

Consultant's Assessment

PBA considered that the position taken by the Authority in the Draft Decision should not affect the need or timing of an upgrade as suggested by Envestra, as any business should undertake an upgrade when the benefits (including a reduction in risk) outweigh the costs of the upgrade. In PBA's view, while vendor support may not be available after 2009, the associated risk may still not justify upgrading the system at this point in time.

Furthermore, PBA noted that purchase of Origin Energy Asset Management (which operates Envestra's Queensland network) by the APA Group (which owns the Allgas network in Queensland) in 2007 could result in some rationalisation of network operating systems. As noted by AGL in its submission, this could lead to the adoption of one generic system for both networks. According to PBA, this increased the uncertainty regarding the timing and need for the Cordaptix upgrade.

Given these considerations, PBA maintained its previous position that the upgrade was not warranted within the timeframe proposed by Envestra.

The Authority's Position

Notwithstanding Envestra's downward revision of the forecast cost of the Cordaptix upgrade, the Authority is of the view that a prudent service provider would avoid incurring these upgrade costs until it was clearly necessary. The Authority considers significant uncertainties still remain regarding the likely timing of this upgrade (if it occurs at all) and that it is not prepared to approve the pass-through of costs that may eventually not be incurred or be incurred later than claimed. Given that, even under Envestra's proposed timing, these costs would be incurred one year or less before the end of the current regulatory period, it is not clear that Envestra would suffer any real financial hardship as a result of commencement of recovery of these costs being delayed until mid 2011. For these reasons, the Authority has not changed its view on this issue from that reported in the Draft Decision.

Maximo 6

Draft Decision

The Authority accepted Envestra's asset and work management requirements would become more complex as a result of FRC and included in its Draft Decision costs that would allow Envestra to implement Maximo 6. In its original application, Envestra proposed installing Maximo 4 initially and subsequently upgrading to Maximo 6. Envestra included \$2.1 million of costs in total for this item (\$1.3 million for Maximo 4 and then \$0.8 million for the upgrade to Maximo 6). On the advice of its consultants, the Authority considered that it would be more efficient to install Maximo 6 at the outset. The Authority considered this change should lead to cost savings of \$0.4 million.

Envestra's Response to the Draft Decision

In its submission on the Draft Decision, Envestra accepted that \$5.4 million should be deducted from its FRC cost pass-through application to account for IT capital expenditure that had already been allowed for in approving the 2006 revised access arrangements that would no longer be required due to FRC IT systems being implemented by Envestra. However, Envestra considered that the Authority had erred in removing \$1.2 million of cost savings generated by installing Maximo 6 at the outset, instead of initially installing Maximo 4 and subsequently upgrading to the later version a few years later.

In addition, Envestra noted that the net cost saving of \$0.4 million was now \$0.5 million based on actual costs incurred in the implementation of Maximo 6.

Submissions from Stakeholders

No submissions were received on this issue.

The Authority's Position

The Authority has reassessed the costs associated with implementing Maximo and agrees with Envestra that the \$1.2 million deducted in the Draft Decision for costs savings should not have been removed. The Authority has corrected that decision and only removed the \$0.5 million of cost savings agreed with Envestra.

Core system depreciation

Draft Decision

The Authority noted in its Draft Decision that Envestra had adopted an economic life of 10 years for IT assets in its 2006 revised access arrangement that was approved by the Authority. For consistency, the Authority considered that the same useful life of 10 years was appropriate for similar assets included in Envestra's cost pass-through application.

Envestra's Response to the Draft Decision

In response, Envestra argued that the 2006 access arrangement erred in applying a 10 year depreciation period to IT assets. Envestra claimed that the FRC IT system was newer and had a shorter economic life given its more sophisticated functionalities and the requirement for vendor support and upgrades less than 10 years into the future.

Envestra suggested that a five year depreciation period for FRC IT assets had been adopted in Victoria and South Australia and that this created a regulatory precedent for Queensland.

Submissions from Stakeholders

No comments were received on this issue.

Consultant's Assessment

PBA considered that IT assets should be depreciated over their economic life and that major IT systems, such as Envestra's FRC IT systems, would normally have an economic life of at least 7 years to 10 years.

The Authority's Position

The Authority considers that the relevant depreciation period is that which reflects a reasonable expectation of the useful economic life of the asset or groups of assets that form part of the regulated asset base. In this instance, the asset lives for these assets have already been established in determining the regulated asset base that underlies Envestra's 2006 revised access arrangement and is not open to review now.

While the approach used in other jurisdictions may provide a guide in making regulatory decisions, other relevant factors also need to be taken into account. Amongst other things, the relative sizes of the respective markets and the activity within them need to be considered when determining the justification for replacing major assets in the respective markets. In this regard, the Queensland retail gas market is quite small when compared with those in Victoria and South Australia.

The Authority is also of the view that consistency with the existing asset base is important and is not the matter of review at this time. Accordingly, the asset base and the associated economic lives included in the 2006 access arrangement establishes the basis for determining the appropriate economic life to be associated with similar assets. As there is no strong evidence to differentiate these core IT assets from those already included in the regulatory asset base, the Authority has not been convinced to change its approach from that included in the Draft Decision and remains of the view that a 10 year asset life (and hence depreciation period) is appropriate for the capital expenditure associated with core IT assets included in Envestra's cost pass-through application.

IT infrastructure

The core systems capital expenditure included the costs of purchasing new hardware and software as well as the costs associated with tailoring the FRC IT system to meet Envestra's requirements.

Draft Decision

In its Draft Decision, the Authority accepted that the majority of capital expenditure for the core systems were prudent and reasonable. However, the Authority sought additional explanations from Envestra on its proposed expenditure of \$400,000 for servers, data storage and additional software licenses and indicated that, in the absence of adequate explanations for these costs, these amounts would be reduced in the Authority's Final Decision.

Submissions from Stakeholders

No comments were received on this issue.

Envestra's Response to the Draft Decision

In response, Envestra submitted that, on the basis of the actual costs incurred to date, a revised lower amount of \$385,000 for servers, data storage and additional software licenses was reasonable. Envestra provided copies of receipts for these purchases in support of its revised costing.

Envestra stated that it had sourced its IT systems at competitive prices through its relationship with, and buying power of, its larger partner (Origin Energy). Envestra also identified additional cost savings from the use of existing infrastructure via the upgrade rather than taking the option to purchase a new computer server for its FRC system.

Envestra's revised costings included an increase of \$30,000 to a revised total of \$100,000 to acquire the 'Control – M' License and reductions in other cost categories previously claimed for licenses and hardware.

Consultant's Assessment

PBA reviewed and compared Envestra's updated IT infrastructure costs against available market prices and its own information (with the exception of the Control-M License cost). On this basis, PBA considered the revised IT infrastructure costs were prudent.

PBA was not able to undertake a similar benchmarking for the costs associated with the Control-M License due to the site specific nature of Control-M license pricing. Nevertheless, PBA concluded that the use of the Origin Energy procurement contract in acquiring these licenses was likely to result in a prudent cost being obtained.

The Authority's Position

The Authority has reviewed the updated information provided by Envestra, the PBA analysis and the cost savings in purchase of the IT hardware and software achieved. In the Draft Decision, the Authority was concerned that the proposed costs were excessive. The new information provided by Envestra has addressed those concerns.

The Authority also accepts the advice of PBA concerning Control-M licence costs.

2.4 Telemetry capital expenditure

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

Draft Decision

In its Draft Decision, the Authority accepted the costs proposed by Envestra to upgrade its central IT system to manage FRC telemetry requirements. However, the Authority did not accept some costs associated with site installations of interval meters and was of the view that capital expenditure of \$0.9 million for these installations was appropriate rather than the forecast costs of \$1.4 million proposed by Envestra.

In reaching this view, the Authority reviewed Envestra's proposal regarding the installation of interval meters for sites consuming more than 10 TJ per year. On the basis of the information available (or lack thereof), the Authority decided to allow for meter installation costs of \$2,500 per meter.

The Authority noted that Envestra's claimed costs of \$15,000 per meter for 16 interval meters already installed during 2005-06 and 2006-07 was much higher than that forecast for meters to be installed in the future. Although 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 appeared excessive. Furthermore, as the (higher cost) ad hoc roll out during 2005-06 and 2006-07 was within Envestra's control, the Authority considered that an average cost of \$2,500 per meter across all meter installations was reasonable.

Submissions from Stakeholders

In its submission on the Draft Decision, Origin Energy agreed with the Authority decision to reduce interval meter costs to \$2,500 per meter.

Envestra's Response to the Draft Decision

In response to the Draft Decision, Envestra agreed that \$2,500 was reasonable for a standard meter installation and proposed revised telemetry cost of \$1.2 million reflecting this lower unit cost for all future meters. However, Envestra retained the high unit cost for the 16 meters installed in 2005-06 and 2006-07.

On this matter, Envestra noted that the 16 meters installed for large customers during 2005-06 and 2006-07 had required specialist resources and equipment due to their size, with resulting costs generally higher than for a standard installation. Envestra provided some documentary evidence of the costs quoted for this type of installation which indicated the \$15,000 cost proposed was not excessive.

Envestra also explained that its roll out of interval meters during 2005-06 and 2006-07 was targeted at the largest customers (100+ TJ of annual consumption), as this was necessary to provide accurate gas consumption data for retailers' daily gas nominations and related FRC purposes. According to Envestra, the requirement to undertake this function in a limited timeframe had also resulted in higher costs.

Consultant's Assessment

PBA had previously agreed with Envestra that the costs for large meter installations were acceptable. With the additional information provided by Envestra in response to the Draft Decision, PBA confirmed this view. PBA noted that the installation costs for large meters tended to be specific to the nature of the meter and the physical site. Also, the installation costs for the largest customers were likely to be much higher than the installation cost for remaining customers.

The Authority's Position

Following the receipt of this further information from Envestra, the Authority is satisfied that the installation cost for the 16 meters during 2005-06 and 2006-07 was directly related to FRC requirements and the costs reflected the nature of the meters installed at these sites. The Authority has therefore accepted the telemetry costs proposed by Envestra of \$1.2 million.

2.5 Summary

Table 7 provides a summary of the capital expenditure proposed by Envestra and the capital expenditure accepted by the Authority for the purposes of this Final Decision.

Table 7: QCA final capital expenditure (\$million, Dec 2006)

	<i>2005-06</i>	<i>2006-07</i>	<i>2007-08</i>	<i>2008-09</i>	<i>2009-10</i>	<i>2010-11</i>	<i>QCA total</i>	<i>Envestra revised</i>
QCA Final Decision								
Core system	0.0	6.9	1.2	0.8	0.0	0.0	8.9	11.7
<i>less</i> Access Arrangement	0.0	0.0	0.0	(5.4)	0.0	0.0	(5.4)	(5.4)
Telemetry	0.1	0.6	0.4	0.0	0.0	0.0	1.2	1.2
Total Capex	0.1	7.5	1.6	(4.6)	0.0	0.0	4.7	7.5

Note: Totals may not add due to rounding

3. FINAL ASSESSMENT OF ENVESTRA'S FRC OPERATING COSTS

3.1 Draft Decision

With respect to the operating expenditure required to support Envestra's FRC obligations, the Authority's Draft Decision proposed to approve the pass-through of costs associated with \$5.6 million of IT and telemetry related operating costs, compared to total costs proposed by Envestra of \$9.9 million.

In its Draft Decision, the Authority accepted that Envestra's FRC obligations would create extra demand for staff and increase related costs to operate and maintain the FRC system. However, the Authority considered that low rates of expected customer churn would not warrant the increases in staff that had been proposed by Envestra.

The costs accepted by the Authority in its Draft Decision are shown in Table 8.

Table 8: QCA Draft Decision operating costs (\$m Dec 2006)

Category	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Draft Decision	Envestra original application
Core System	0.0	0.0	1.3	1.1	1.1	1.1	4.5	6.3
Telemetry	0.1	0.1	0.2	0.2	0.2	0.2	1.1	3.6
Total	0.1	0.1	1.5	1.3	1.3	1.3	5.6	9.9

Note: Totals may not add due to rounding

3.2 Envestra's Response to the Draft Decision

In its response to the Authority's Draft Decision, Envestra revised its forecast operating costs from \$9.9 million down to \$7.0 million in total.

With respect to core systems operating expenditures, Envestra accepted the Authority's reduction to office costs and training overheads and four additional staff to meet its FRC operational requirements. However, Envestra considered that an additional \$0.3 million would be required to undertake manual data processing tasks prior to the completion of its automated core system.

Envestra also revised its forecast costs for telemetry related operating costs down to \$2.2 million (from \$3.6 million), but still twice the amount accepted by the Authority in its Draft Decision.

Details of Envestra's revised operating expenditure proposal are provided in Table 9.

Table 9: Envestra updated operating cost (\$m, Dec 2006)

Cost Category	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	Revised total	Draft Decision
Core System	0.0	0.0	1.4	1.1	1.1	1.1	4.8	4.5
Telemetry	0.2	0.2	0.3	0.5	0.5	0.5	2.2	1.1
Total	0.2	0.2	1.7	1.6	1.6	1.6	7.0	5.6

Note: Totals may not add due to rounding

3.3 Core system 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. In its cost pass-through application, Envestra included forecast costs associated with staffing, IT and related costs and administrative costs.

Draft Decision

The Authority accepted that Envestra would require additional staff due to an increase in the number of customer and data transaction activities associated with FRC. This was despite the fact that many of the activities would become automated. However, the Authority was not convinced that the additional staffing proposed by Envestra, or that recommended by PBA, was reasonable or prudent, given the apparent low customer churn rates of around 2 to 3 customers per day.

Overall, the Authority accepted \$4.5 million for core system related operating expenditure.

Submissions from Stakeholders

In their responses to the Draft Decision, both AGL and Origin noted that, while there may be new tasks associated with FRC, it was not clear that these necessarily required additional staff and that some of these tasks could not be absorbed by existing staff.

Origin Energy supported the position of Authority in that 4 FTEs proposed were sufficient. Origin Energy suggested that further reductions should also be possible as FRC systems and processes became fully automated.

Envestra's Response to the Draft Decision

In its response to the Draft Decision, Envestra accepted the forecast costs included in the Authority's Draft Decision for IT and related and administrative costs but submitted revised costs associated with its staffing requirements that were higher than those included in the Authority's Draft decision.

Envestra suggested the transition to FRC had been more complex than anticipated and provided examples of additional functions and processes affected by FRC. In addition, its customer connection function still had a large number of outstanding transactions and service orders, which required additional work time and manual handling. As a consequence, Envestra suggested that an additional \$0.3 million was required to cover what it described as one-off bedding down costs for the implementation of FRC to date. Envestra stated that these additional costs had been incurred to retain an additional five FTEs for a short period of time during the transition period to handle the additional manual tasks, data processing and reconciliation of customer data due to the short timeframe allowed and incomplete automation after the commencement of FRC.

Consultant's Assessment

In its review of Envestra's updated submission, PBA considered that the additional amount sought by Envestra was reasonable and reflected the actual costs it had incurred in 2007-08.

The Authority's Position

The Authority notes that, Envestra's claim for additional core system operating costs refers only to an additional \$0.2 million while Envestra's submission included a total amount that

suggested this cost was \$0.3 million. Envestra was unable to reconcile these figures following a request from the Authority for further explanation. Consequently, while the Authority accepts that additional costs were incurred, it has included only \$0.2 million in this Final Decision.

3.4 Telemetry operating costs

Draft Decision

In its Draft Decision, the Authority accepted PBA's recommendation regarding Envestra's telemetry related operating costs. PBA did not support the estimates proposed by Envestra, as it was of the view that the proposed telemetry operating costs in Queensland were significantly higher than in NSW, with no apparent reason why such a difference would exist. Based on benchmark data of costs in other Australian jurisdictions, PBA estimated that a reasonable cost for this activity was \$600 per site per year (equivalent to 0.5 FTE staff).

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

Submissions from Stakeholders

No comments were received on this issue.

Envestra's response to the Draft Decision

In its response to the Draft Decision, Envestra maintained that it required 4.5 FTEs (\$0.5 million) to manage the operation and maintenance of telemetry equipment. In support of this position, Envestra outlined the additional tasks that the proposed technical staff would be required to undertake. Envestra's proposed additional staffing should include:

- gas operations engineer (1 FTE);
- data analyst/system support (2 FTE); and
- maintenance technician (1.5 FTE).

Envestra noted that inadequate staffing carried the high risk of failure (or unacceptable delay) of correct data being supplied to the market and this could cause significant problems for regulators, customers and the distributor.

Consultant's Assessment

Envestra's forecast expenditure was not supported by PBA, on the basis that the additional information provided by Envestra did not demonstrate that the expenditure was prudent or efficient. PBA noted that Envestra had 24 sites fitted with full telemetry equipment and proposed that 1.5 maintenance technicians were required maintain the sites. This implied a maintenance effort of 2.4 hours per week per site. PBA suggested that this was far in excess of the maintenance effort that would be expected of an efficient provider.

PBA also considered that, while Envestra had provided additional information on the tasks to be performed in its operation and maintenance of telemetry system, it had not established these were provided in a prudent or efficient manner. Accordingly, PBA did not revise its view of the efficient cost of providing telemetry systems operations and maintenance services.

The Authority's Position

The Authority remains of the view that the proposed operating costs still far exceed the costs incurred in other jurisdictions or what appear to be normally expected of an efficient provider. The Authority does not consider that Envestra has justified why its costs in Queensland should be significantly different to those in other jurisdictions.

On balance, the Authority considers that the estimate of telemetry related operating costs of \$600 per site per year proposed in the Draft Decision remains appropriate. This amount was based on an upper limit of the \$950 per site each year allowed in NSW and a lower limit of \$250 per site each year representing 10 per cent of the average cost of an interval meter of \$2,500.

3.5 Summary

Table 9 provides a summary of the expenditure proposed by Envestra and the expenditure accepted by the Authority for the purposes of this Final Decision.

Table 9: QCA final operating costs (\$m Dec 2006)

	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	QCA	Envestra revised
Core system	0.0	0.0	1.4	1.1	1.1	1.1	4.7	4.8
Telemetry	0.1	0.1	0.2	0.2	0.2	0.2	1.1	2.2
Total Opex	0.1	0.1	1.6	1.3	1.3	1.3	5.8	7.0

Note: Totals may not add due to rounding

4. REVENUE AND TARIFFS

4.1 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 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) as used in Envestra's current access arrangement, applied to new FRC related capital costs.

Costs provided by Envestra were 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% that was adopted by Envestra in its revised access arrangement.

Table 10 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 10: 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	0.3	0.2	2.0	
Depreciation	0.4	0.9	0.8	0.5	0.5	3.1	
Non-capital Costs	0.2	1.7	1.4	1.4	1.5	6.2	
Tax	0.0	(0.2)	0.0	0.2	0.3	0.2	
Inflationary Gain	0.1	0.2	0.2	0.1	0.1	0.6	
Total	0.8	2.8	2.5	2.3	2.5	10.9	8.3

Note: Totals may not add due to rounding

As previously noted, the Authority allowed a provisional amount of \$2.8 million to be included in Envestra's 2007-08 pricing. Raising the remaining revenue 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 11.

Table 11: 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	2.8	2.8	2.8	11.2	8.3

4.2 Envestra's proposed tariffs

While the purpose of this Final 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 distribution price impacts associated with the cost pass-through amounts that the Authority has accepted in this Final Decision.

Envestra previously 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.

On this basis, in 2007-08, Envestra imposed an additional fixed charge of \$8,333.28 per year (approximately \$23 per day) on demand customers. 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 consumption based charges and was expected to raise 20% of the costs to be recovered from volume customers, with the remaining 80% to be recovered from the fixed charge.

In its response to the Draft Decision, Envestra indicated that it would recover its FRC costs in future years from customers in a similar manner to that proposed in its original submission.

Submissions from Stakeholders

In its original submission, AGL stated that the method for allocating costs to customers was likely to have a significantly greater impact on smaller volume customers and smaller demand customers. Given this, 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.

In its original submission, 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.

In its response to the Draft Decision, Origin supported applying the same pricing approach in 2008-09 as was applied in 2007-08 given the similar size of the cost pass-through being proposed.

Consultant's Assessment

In its report for the Final Decision, PBA confirmed its previous view that the tariff structure proposed by Envestra was generally appropriate. However, PBA had previously acknowledged that the 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.

The 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 that the costs of opening up the retail market to competition for customers consuming less than 1TJ should be borne largely by those (volume) customers. Similarly, 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). Either approach appears equally defensible and there is no theoretically best solution. 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 amounts proposed in this Final 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 due to FRC costs.

5. FINAL DECISION

The Authority's Final Decision is to approve the pass-through of costs by Envestra associated with an additional \$4.7 million in capital expenditure and \$5.8 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 \$11.2 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 12.

Table 12: 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	2.8	2.8	2.8	11.2

Consistent with this Final Decision, Envestra will be able to recover these additional revenue amounts through the price approval process in the relevant year.