



RESPONSE TO DRAFT DECISION Envestra Access Arrangement Revisions

(PUBLIC VERSION)

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TABLE OF CONTENTS

1. TERMS AND CONDITIONS	3
2. TRADING POLICY	22
3. EXTENSIONS/EXPANSIONS POLICY	22
4. GENERAL PRINCIPLES FOR DETERMINING REVENUE AND TARIFFS.....	23
5. ROLLING FORWARD THE CAPITAL BASE	29
6. RATE OF RETURN	39
7. NON-CAPITAL COSTS.....	40
8. GAS DEMAND FORECASTS	43
9. REFERENCE TARIFFS AND TARIFF PATH	48

ATTACHMENT A: Comments on the Value of Gamma

RESPONSE TO AMENDMENTS

1. Terms and conditions

1.1 Introduction

This Chapter sets out Envestra's submissions in respect of Chapter 4 of the Authority's Draft Decision – that is, those parts of the Draft Decision relating to the terms and conditions of Envestra's Access Arrangement.

1.2 Code Requirements

Section 3.6 of the Code states that an Access Arrangement must include the terms and conditions on which the service provider will supply each reference service. The terms and conditions included must, in the Authority's opinion, be reasonable.

Section 3.6 requires the Regulator to form an opinion as to whether the proposed terms and conditions are reasonable. The judgments in *Michael's Case*¹, in the *GasNet Decision*² and in the *EAPL Decision*³ are instructive as to the manner in which the Authority should assess the proposed terms and conditions and as to the factors that ought to guide the Authority in its assessment.

There is no single absolute or definitive set of terms and conditions that are reasonable to the exclusion of all other terms and conditions. It is possible to imagine a range of different terms and conditions, all of which might be described as "reasonable". This means that a choice has to be made as to which terms and conditions an Access Arrangement should include.

Michael's Case and the *GasNet Decision* are significant because they indicate that this choice is to be made by the service provider when it formulates its Access Arrangement. The clearest exposition of this proposition appears in the *GasNet Decision*, where the Australian Competition Tribunal stated:

"It is important to recall that the preparation of a proposed AA together with a proposed AAI, begins with the Service Provider of a Covered Pipeline. It is the obligation of the Service Provider to design a proposed AA with AAI which is consistent with the provisions of the Code

The proposed AA may include any relevant matter but must include the elements in s3.1 to s3.20: s2.5. The proposed AAI must contain such information as would enable Users and Prospective Users to understand the derivation of elements in the proposed AA and to form an opinion as to compliance of the AA with the provisions of the Code: s26. ... The choices available under the Code are for the Service Provider to make, subject only to the limitation that the implementation of the choice must be consistent with the principles contained in s8 of the Code."⁴

In a similar vein, in discussing Reference Tariff Principles, the Tribunal stated:

"It is clear in the reasoning in Michael that there is no single correct figure involved in determining the values of the parameters to be applied in developing an applicable Reference Tariff. Principles involve issues of judgment and degree. Different minds acting reasonably, can be expected to make different choices within a range of choices which nonetheless remain

¹ *Re: Dr Ken Michael AM; ex parte Epic Energy (WA) Nominees Pty Ltd & Anor* [2002] WASCA 231.

² *Application by GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6.

³ *Application by East Australian Pipeline Limited* [2004] ACompT 8.

⁴ [2003] ACompT 6, at paragraphs 36 and 37.

consistent with the Reference Tariff Principles. Where the Reference Tariff Principles produce tension, the Regulator has an overriding discretion to resolve the tensions in a way that best reflects the statutory objectives of the Law. However, where there are no conflicts or tensions in the application of the Reference Tariff Principles, and where the AA proposed by the Service Provider falls within the range of choices reasonably open and consistent with Reference Tariff Principles, it is beyond the power of the Relevant Regulator not to approve the proposed AA simply because it prefers a different AA which it believes would better achieve the Relevant Regulator's understanding of the statutory objectives of the Law.⁵

Based on these decisions, it is Envestra's submission that, in assessing the terms and conditions, the function of the Authority is simply to determine whether the terms and conditions proposed by Envestra are "reasonable" (within the meaning of that term as used in section 3.6 of the Code).

Envestra believes that it is beyond the power of the Authority to reject terms and conditions that are reasonable, or to require Envestra to amend terms and conditions that are reasonable, within the meaning of that term as used in section 3.6 of the Code.

In particular, it is Envestra's submission that, if the terms and conditions proposed by Envestra are reasonable, then it is beyond the power of the Authority to require Envestra to adopt other terms and conditions because the Authority prefers them to the terms and conditions proposed by Envestra.

In this regard, Envestra also notes the statements made by the Australian Competition Tribunal in the *EAPL Decision*, where the Tribunal stated:

"A regulator ...has a delicate task. It must be conscious of the interests of parties other than the proponent of the access arrangement and is bound to scrutinise carefully the information provided in support of it. On the other hand, it must have regard to the legitimate business interests of the proponent and should not put itself in an adversary position in relation to the proponent so that it may be perceived as a champion of other interests such as those of consumers."⁶

It is unclear from the Draft Decision whether the Authority has assessed whether the terms and conditions proposed by Envestra are reasonable or unreasonable (within the meaning of section 3.6 of the Code).

While the Draft Decision refers to "reasonableness", the Authority's stated reasons for rejecting some terms and conditions do not explain why the Authority considers that those terms and conditions are not reasonable. Rather, the Draft Decision states that the Authority has rejected some terms and conditions because it prefers other terms and conditions on the basis of consistency with:

- (a) the terms and conditions used by other Queensland service providers; or
- (b) the Authority's perception as to "normal" commercial practice.

Envestra believes that it is beyond the power of the Authority to require Envestra to amend terms and conditions on these grounds. As was stated in the *GasNet Decision*, the choices available under the Code are for the service provider to make and it is beyond the power of the Relevant Regulator not to approve the proposed Access Arrangement simply because it prefers a different Access Arrangement⁷.

Moreover, in other cases, it appears from the Draft Decision that the Authority has rejected some terms and conditions not because the terms and conditions proposed by Envestra are "unreasonable" (within the meaning of section 3.6) but because Users have proposed changes to the terms and conditions to satisfy their wants or requirements.

⁵ [2003] ACompT 6, at paragraph 29.

⁶ [2004] ACompT 8, at paragraph 33.

⁷ See comments in the text, at footnote 5.

Envestra believes that it is beyond the power of the Authority to require Envestra to amend terms and conditions on these grounds. As was stated in the *EAPL Decision*, the Authority should not put itself in an adversary position in relation to the proponent so that it may be perceived as a champion of other interests, such as those of consumers.⁸

In Envestra's submission, in considering whether the proposed terms and conditions are reasonable, the Authority must take account of:

- (a) the factors described in section 2.24 of the Code⁹; and
- (b) the provisions of the existing Access Arrangement.

Envestra believes that this follows from section 2.46 of the Code and from the decision in *Michael's Case*.

Michael's Case contains extensive discussion of section 2.24. This section is in almost identical terms to section 2.46 and, in Envestra's submission, the observations made in *Michael's Case* about section 2.24 apply equally to section 2.46.

In *Michael's Case*, referring to section 3.6, Parker J held an obvious purpose and function of section 2.24(a) to (g) of the Code is to provide guidance to the Regulator in forming its opinion (as to whether terms and conditions are "reasonable" or not). He said:

"In my view, in the context of the Act and the Code, the Regulator is required by section 2.24 to take the stipulated factors into account and to give them weight as fundamental elements in assessing a proposed Access Arrangement with a view to reaching a decision as to whether or not to approve it."¹⁰

Parker J considered that the phrase "must take the following into account" (as used in section 2.24 and also section 2.46 of the Code):

"is apt to convey as an ordinary matter of language that the Regulator must not fail to take into account each of the six matters stipulated in (a) to (f), and by (g) any other matter the Regulator

⁸ See comments in the text, at footnote 6.

⁹ The factors set out in section 2.24 are: "*In assessing a proposed Access Arrangement, the Relevant Regulator must take the following into account:*

- (a) *the Service Provider's legitimate business interests and investment in the Covered Pipeline;*
- (b) *firm and binding contractual obligations of the Service Provider or other persons (or both) already using the Covered Pipeline;*
- (c) *the operational and technical requirements necessary for the safe and reliable operation of the Covered Pipeline;*
- (d) *the economically efficient operation of the Covered Pipeline;*
- (e) *the public interest, including the public interest in having competition in markets (whether or not in Australia);*
- (f) *the interests of Users and Prospective Users;*
- (g) *any other matters that the Relevant Regulator considers are relevant."*

¹⁰ [2002] WASCA 231 at paragraph 55.

considers relevant. ... It is difficult to conceive that it could have been intended that the Regulator might decide to give no weight at all to one or more of the factors specified in s2.24(a) to (f).¹¹

Parker J concluded:

"In my view, ..., the legislative intention appears to be that in assessing a proposed Access Arrangement, which includes a consideration of s3.1 to s3.20 ... , the Regulator is required to take into account, in the sense indicated earlier, the factors set out in section 2.24(a) to (g).

It does not follow from this ... that those factors are intended to be, or are capable of being, applied to every issue presented by s3.1 to 3.20. The precise nature of the elements and principles set out in s3.1 to s3.20 will determine whether there is scope for the application of the s2.24(a) to (g) factors to guide the exercise of discretion by the Regulator in his assessment."¹²

It follows from these observations that, when the Authority assesses whether Envestra's proposed terms and conditions are reasonable (within the meaning of section 3.6 of the Code), the Authority must not fail to take account of the factors set out in section 2.24 and also the provisions of the existing Access Arrangement.

The Authority has not clearly explained in its Draft Decision whether it has taken these factors into account or, if it has taken these factors into account, how it has reached the decisions contained within the Draft Decision.

1.3 The Discretion of the Service Provider

Amendment 4.1

In order for Envestra's access arrangement to be approved, Envestra must replace the words in sections 5.5(c), 9.8(c), 10.7(c), 21.4(c) and 21.5(c) of the terms and conditions "... on whatever basis Envestra considers reasonable ..." with "... on a reasonable basis ...".

1.3.1 Draft Decision

The Authority has stated that, in sections 5.5(c), 9.8(c), 10.7(c), 21.4(c) and 21.5(c), Envestra must replace the words "... on whatever basis Envestra considers reasonable ..." with "... on a reasonable basis...".

It appears from the Draft Decision that the reasons for the Authority's decision are as follows, namely:

- (a) the wording proposed by Envestra may provide it with a significant discretion;
- (b) this has the potential to shift risk from Envestra to Users;
- (c) the proposed wording may make it difficult for a User to challenge Envestra's decision; and
- (d) the proposed wording may restrict a User's access to dispute resolution.

1.3.2 Envestra's Submissions

It is not clear whether the Authority has determined that the words used in sections 5.5(c), 9.8(c), 10.7(c), 21.4(c) and 21.5(c) are "unreasonable" within the meaning of section 3.6 of the Code. The Authority's reasons are not expressed in terms of assessing the reasonableness or unreasonableness of the words.

¹¹ [2002] WASCA 21 at paragraph 55.

¹² [2002] WASCA 21 at paragraphs 61 and 62.

It is also not clear whether the Authority has taken account of the factors in section 2.24 of the Code or the provisions of the existing Access Arrangement or, if it has taken those factors into account, how it has done so.

Envestra submits that, having regard to the factors set out in section 2.24 and to the provisions of the existing Access Arrangement, sections 5.5(c), 9.8(c), 10.7(c), 21.4(c) and 21.5(c) are “reasonable” within the meaning of section 3.6 of the Code.

1.3.3 Envestra's Response to the Authority's Comments

Envestra agrees with the Authority's observation that the words “... on whatever basis Envestra considers reasonable ...” give Envestra a discretion.

Envestra does not necessarily agree with the Authority's description of this discretion as “significant”. In the case of each section, the discretion is constrained by the requirements of the law and the terms of any rules or agreement that bind Envestra and the Network User.

Envestra does not agree that the discretion has the potential to shift risk from Envestra to Users. Envestra does not understand what “risk” the Authority has in mind.

Envestra does not agree that the language of sections 5.5(c), 9.8(c), 10.7(c), 21.4(c) and 21.5(c) makes it any more difficult for Users to challenge an exercise of Envestra's discretion or that it restricts a User's access to dispute resolution. A User would have exactly the same rights to challenge a decision. The difference between the language proposed by Envestra and the language proposed by the Authority only affects the question of what the User has to prove in order to challenge Envestra's decision.

1.3.4 Envestra's Explanation of the Proposed Words

The language proposed by Envestra would require Envestra to form a genuine and honest belief that it has a reasonable basis to allocate delivery and receipt point quantities to the User (section 5.5(c) and section 21.5(c)); correct meter readings (section 9.7(c)); estimate quantities of gas in the absence of meter readings (section 10.7(c) and section 21.4(c)). That is, the key issue is whether Envestra has a genuine and honest belief in the reasonableness of the basis it proposes to use. If Envestra does not genuinely and honestly believe in the reasonableness of its basis, a User can challenge that decision.

If the sections were changed to require Envestra to act “...on a reasonable basis...”, this would allow Envestra to use any basis for making corrections as long as that basis was objectively reasonable. On this formulation, if a User wished to challenge Envestra's decision, a court would hear evidence from people with expertise in meter readings and the operation of distribution networks to determine whether the basis on which Envestra acted was “...reasonable...”. A User could challenge corrections if, based on the expert evidence, the court determined that the basis on which Envestra acted was unreasonable.

The difference between these formulations raises issues like those raised by the “business judgment rule” and similar concepts in other contexts. Envestra's language requires Envestra to conduct business honestly and does not allow Users to challenge the way in which Envestra conducts its business as long as Envestra is honest. It allows Envestra to make honest business judgments, without subjecting those judgments to scrutiny. The Authority's language requires Envestra to conduct business in an objectively perfect manner and penalises Envestra if it adopts practices that courts and experts, with the benefit of hindsight, determine to have been imperfect. In the case of the Authority's language, Envestra can be penalised even if it acts honestly.

The clause has been drafted using the first of these two formulations because the second formulation creates uncertainty for Envestra. The second formulation allows courts and expert witnesses to “second guess” the basis on which corrections were made to meter readings. Accordingly, whenever Envestra corrects meter readings, it would bear the risk that the corrections would be set aside because a court did

not agree with the basis on which the corrections were made. There is an increased risk of disputes in relation to the correction of meter readings.

Such increased risk is inappropriate. In the case of meter readings and allocation of deliveries certainty is desirable. That is, Envestra should be in a position to proceed in the knowledge that, as long as it has acted genuinely and honestly, the estimations, allocations and corrections it has made will be upheld. Envestra should not be placed in a position (provided Envestra has acted honestly) where months after it has made and relied upon an allocation or correction there is a risk that such allocation or correction will be overturned (with the consequent subsequent adjustments).

In particular, where allocating deliveries between multiple Users Envestra does not wish to be faced with the risk of two Users each arguing that Envestra should employ a different allocation procedure (ie a situation where each User is arguing for the allocation procedure that most benefits that User). Providing individual Users with ammunition to argue for the employment of allocation procedures which serve their individual interest is disruptive of the effective administration and operation of the network.

It is true that the first formulation does not allow as much scope for dispute. Envestra could rely on the corrections to meter readings as long as Envestra honestly and genuinely believes that the corrections were made on a reasonable basis.

However, the first formulation should not significantly disadvantage Users. The first formulation would not allow Envestra to make corrections on a basis that it knows, or should know, is incorrect or unreasonable, as Envestra would not then have an honest and genuine belief the basis on which the corrections were made was reasonable. At the same time, the first formulation reduces the opportunity for Users to exploit the uncertainty created by the ability of experts and a court to second-guess corrections.

Envestra notes that both the formulations of "whatever basis Envestra considers reasonable" and "reasonable" are used in the Access Arrangement. In designing its Access Arrangement Envestra has considered those clauses where a standard of "objective" reasonableness is appropriate and those cases where a standard of acting genuinely and honestly is appropriate. Section 16.4 is an example of the former. Sections 5.5(c), 9.8(c), 10.7(c), 21.4(c) and 21.5(c) are the cases of the latter, particularly due to the need for increased certainty in the case of metering corrections and allocations.

1.4 Prepayment

Amendment 4.2

In order for Envestra's access arrangement to be approved, Envestra must amend section 19 of its terms and conditions to the effect that network charges will be invoiced in arrears.

1.4.1 Draft Decision

In respect of the provisions of Envestra's Access Arrangement dealing with the prepayment of Network Charges, the Authority has stated:

"While Envestra has not changed the provision in its current access arrangement, Envestra's practice with regards to the advance payment of network charges is not normal practice for gas or electricity distribution in Australia. The Authority is of the view that the terms and conditions of the Queensland service provider's should be consistent where possible. As such, the Authority requires Envestra to amend its access arrangement so that network charges will be invoiced in arrears."

1.4.2 Test under Code

Envestra submits that in reaching its decision in relation to the issue of prepayment of Network Charges, the Authority has not correctly applied the provisions of the Code.

As noted above in section 1.2, section 3.6 of the Code provides:

“An Access Arrangement must include the terms and conditions on which the Service Provider will supply each Reference Service. The terms and conditions included must, in the Relevant Regulator’s opinion, be reasonable.”

That is, the test which must be applied by the Authority is not whether the prepayment clause is normal practice or whether it is consistent with other Access Arrangements. The test which must be applied is whether the prepayment provision is reasonable. The paragraph quoted above from the Draft Decision suggests that the Authority has not addressed this matter in reaching its decision.

We note that, having regard to the precedents set by the Australian Competition Tribunal, the effect of section 3.6 is that the Authority must approve the prepayment clause if it is reasonable. The Authority may not substitute another mechanism for providing security to the prepayment clause because the Authority prefers to utilise that alternative mechanism. If the mechanism proposed by Envestra is reasonable, the Code requires it to be adopted.

In this respect Envestra notes the comments of the Australian Competition Tribunal in the *GasNet Decision* quoted in section 1.2 of this submission.

In the context of section 3.6 of the Code, “reasonable” does not mean “reasonable” in the absolute discretion of the Authority. Rather it means reasonable as assessed against the criteria to which the Authority is to have regard in reaching a decision under the Code. In this respect, Envestra notes section 2.46 of the Code which provides:

“2.46 The Relevant Regulator may approve proposed revisions to an Access Arrangement only if it is satisfied the Access Arrangement as revised would contain the elements and satisfy the principles set out in sections 3.1 to 3.20. The Relevant Regulator must not refuse to approve proposed revisions to the Access Arrangement solely for the reason that the Access Arrangement as revised would not address a matter that sections 3.1 to 3.20 do not require an Access Arrangement to address. In assessing proposed revisions to the Access Arrangement, the Relevant Regulator:

(a) must take into account the factors described in section 2.24; and

(b) must take into account the provisions of the Access Arrangement.”

Envestra notes that the effect of section 2.46 is that in considering revisions to an existing Access Arrangement not only is the Regulator required to take into account, as fundamental factors, each of the criteria in section 2.24; the Regulator must also treat as a fundamental factor the existing terms of the Access Arrangement. There is an assumption in section 2.46 that, other things equal (or in the absence of circumstances warranting a change in terms), the terms of an Access Arrangement should remain consistent over time. That is, section 2.46(b) supports the fact that, in assessing Access Arrangements, the existing terms of the Access Arrangement are to be given weight as fundamental factors. In this respect Envestra notes the decision of the Supreme Court of Western Australia in *Michael* that the words must take into account mean that “*the Regulator is required by s 2.24 to take the stipulated factors into account and to give them weight as fundamental elements in assessing a proposed Access Arrangement with a view to reaching a decision whether or not to approve it.*”

Envestra also notes that the fact clause 19 is included in the current Access Arrangement demonstrates that the clause has previously been assessed as reasonable. Envestra does not consider that any

submissions to the Authority, nor the Draft Decision, explain what developments have occurred to now render the clause unreasonable.

1.4.3 Reasonableness

The prepayment provision is reasonable. It is a form of security designed to protect Envestra against the risk of a User's default. It is clearly reasonable that some form of security be provided to Envestra. The reasonableness of the provision is demonstrated by the following outline of its practical application.

The User is invoiced on (approximately) the 4th (Business Day) of each month. This invoice covers:

- (a) a reconciliation of charges for the previous month (in which the User has received services);
- (b) an updated estimated charge for the current month (in which the User is receiving services, i.e. part prepayment of services);
- (c) an estimated charge for the following month (prepayment of services).

The User has 14 days to pay the invoice, i.e. by (approximately) the 18th of the month. This means that the User will have prepaid for the remainder of that month and for the following month, i.e. 42 days. This represents an average pre-payment of 21 days.

If a User was to default on its payment (on the 18th of the month), Envestra would issue a notice (clause 24.2(a) of the terms) requiring payment within 7 days, i.e. by the 25th of the month. If payment is still not received, Envestra may terminate the agreement in 7 days, i.e. by the 2nd day of the following month, which is in the period for which no prepayment has been made. (It is noted that Envestra has not requested security deposits or bank guarantees.)

When one considers the above, and the fact that no "retailer of last resort" scheme is in operation whereby customers of a failed retailer are transferred to another retailer (meaning that Envestra may be delivering services without payment for an even longer period than outlined above), it can be seen that Envestra can quickly become financially exposed despite the average 21-day prepayment period.

Furthermore, the above example assumes that events unfold at the most rapid rate possible. In reality the situation is different. Given the political, regulatory and financial consequences of terminating a User's haulage agreement, it is extremely unlikely Envestra would proceed as quickly as the above example contemplates. Envestra would need to obtain legal advice on the course it should take and is likely, given the political consequences of termination, to need to consult with the regulator (and possibly the Minister). When more realistic timeframes are taken into account, it becomes apparent that by the time Envestra terminates a User's haulage agreement any prepayment made is likely to have been long exhausted.

Envestra also notes that there is no allowance in the calculation of the Reference Tariff for bad debts. Rather Envestra has elected, as it is entitled to do given the terms of the Code and the *GasNet* and *EAPL* decisions, to protect itself against bad debts through the prepayment clause.

The amount of the prepayment is therefore reasonable in light of the risk Envestra faces.

Envestra also notes that it is in the interests of User's generally that Envestra's financial position be appropriately protected by the prepayment mechanism. While any form of security will impose a cost upon an individual User, it is in the interests of Users collectively to ensure that Envestra is not financially exposed to the failure of an individual User. If Envestra were so exposed, then failure of an individual User may jeopardise Envestra's own financial position and expose all remaining Users to the threat they may not receive haulage services or may only be in a position to receive services from an insolvent (and therefore unreliable) network operator.

In its submission, Origin has asserted that Envestra's prepayment mechanism is inefficient. Origin has not provided any support for this position or explained why the mechanism is inefficient. It has simply

made an assertion. Origin's submission contains no support for the position that the prepayment mechanism is unreasonable.

Further Envestra notes that the prepayment mechanism of which Origin now complains has its genesis in previous dealings between Origin and Envestra. Envestra was formed in July 1997, when the gas distribution assets in Queensland and South Australia, previously owned by Boral Ltd, were sold to the newly incorporated Envestra Ltd. At that time Envestra became a company listed on the Australian Stock Exchange, with Boral Ltd (subsequently Origin Energy) retaining a 19.9% shareholding in Envestra Ltd.

Prior to this sale, all gas and electricity businesses in Australia were operated as "bundled businesses" with distribution and retail functions carried out as a single operation. The tariffs charged to consumers were set by government agencies in all States. Up to this time, there was no need to separately charge for distribution network services, so in 1997 no agreements existed setting out payment terms for such services.

As part of the process of setting up Envestra, it was necessary to establish the payments that would be made by Boral Ltd, the only retailer using the distribution assets owned by Envestra in Queensland and South Australia. At that time the National Gas Code had not commenced operation and there were no approved Access Arrangements in place in Australia setting out network charges and associated terms and conditions.

As part of the process of selling the distribution assets to Envestra, Boral Ltd proposed a haulage agreement which specified the charges and payment terms that would apply up to the time when the first Access Arrangements were approved. Those payment terms specified that at the commencement of each month, an invoice would be issued setting out the estimated charges for the next two months, and adjustments to prior months' charges to account for the differences between the estimated and actual charges.

At the time this agreement was executed, there were no precedents available on which to base the payment terms for an unbundled network business.

The price paid to Boral Ltd for the distribution assets, and the distributions paid to Envestra shareholders were then based on cash flows resulting from these payment terms, including the prepayment. The prepayment provided Envestra with the working capital it required to fund the business for the six week period up to the time when it would have received its first revenue under a payment in arrears environment.

Since the formation of Envestra in 1997 a number of changes have occurred:

- The energy business owned by Boral Ltd in 1997 has been "demerged" from the other Boral operations and is now known as Origin Energy Ltd. The decisions made to establish Envestra under the terms described above were made by the business now known as Origin Energy;
- The National Gas Code came into operation and gas distribution and retailing functions were required to be separated and operate as separate legal entities. Initially this was done by setting up subsidiaries, but progressively distributors have been sold to owners other than the incumbent retailer; and
- Access Arrangements have been approved for distributors in all mainland States, which other than in Queensland and South Australia, do not happen to include prepayment terms as outlined above, but invariably include credit protection arrangements for the distributors such as requirements for guarantees, security deposits, or other measures.

In summary therefore, the current payment terms were:

- introduced by Origin Energy (Boral) when Envestra was formed;
- established at a time when there were no precedents for the timing of payments for distribution network charges; and

- not followed by other distributors when submitting their first Access Arrangements, as at the time of those respective first Access Arrangements they were owned by an affiliated (retailer) business.

Origin Energy, the originator of the prepayment term, has made submissions to the regulator in Queensland and South Australia requesting that the payment terms be amended so that all payments are made in arrears.

Origin Energy is the only network user to have submitted this request (there are three other network users in SA and one other network user in Queensland).

Origin Energy will be the major beneficiary of any change in payment terms in that it will receive a significant one-off cash flow benefit in the month that the change is made (the benefit will be spread over the period the change is phased in, if it is phased in over a longer period).

Both Origin Energy and the Authority have commented that the prepayment mechanism is not “normal practice”. This is not the relevant test under the Code – the relevant test is whether a provision is reasonable. A provision can be reasonable while not reflecting standard practice. No argument has been cited to support the position the prepayment clause is unreasonable.

In any event, the prepayment clause is not abnormal. Prepayment of charges is common in commercial dealings (e.g. lease payments, retail purchases), including in the utility sector, e.g. Dampier to Bunbury pipeline, Alice Springs network, water and sewer service charges, postal charges, telecommunication service/line charges, Port of Brisbane Corporation asset charges, to name but a few. It is therefore factually incorrect for the prepayment mechanism to be labelled not normal practice.

The Authority has also stated: *“The Authority is of the view that the terms and conditions of the Queensland service provider’s should be consistent where possible.”*

There is nothing in the Code which requires Access Arrangements to be consistent. Indeed the entire premise of the Code is that a service provider is free to design their own Access Arrangement, so long as it meets the criteria in the Code. In this respect, Envestra refers to the *GasNet decision* quoted earlier.

For the Authority to reject Envestra’s prepayment clause on the basis that it is not “normal” or not consistent with another Access Arrangement is an error of law which will vitiate the Authority’s decision.

1.4.4 Impact of Altering Invoicing Terms

If the recommendation were implemented, Envestra would be deprived of revenue for a period of time. This would have a significant impact on Envestra’s cash flow position. If prepayment was terminated, Envestra would only receive revenue collected from monthly invoices issued in arrears. This would significantly reduce Envestra’s cash flow at the time payment terms were altered.

Furthermore, Envestra would be unable to fund the shortfall in revenue through working capital as it is prohibited from doing so through its financial covenants with financiers. Envestra is only permitted to raise capital to incur financial indebtedness to fund capital expenditure relating to the business. This implies that any funds that needed to be raised as a result of the loss of prepaid haulage revenue would have to be raised via an equity issue at the equity rate of return. Whether such funds could be raised, given the reason for the need i.e. regulatory intervention, is most problematic. The Authority has given no consideration to this nor considered the timing required for such equity funding to be undertaken, i.e. it simply cannot occur by 1 July 2006.

Abolition of the prepayment would therefore be inconsistent with Envestra’s legitimate business interests and investment in the Covered Pipeline, a matter the Authority is specifically required to consider under section 2.24 of the Code.

1.4.5 Summary

In summary:

- (a) Envestra considers the Authority's decision in respect of the prepayment clause is in error because it does not consider the issue of whether the clause is reasonable nor does it have regard to the provisions of section 2.46 of the Code. Rather the decision assesses the provision against criteria of whether the clause is "normal" and "consistent with other access arrangements", neither of which criteria are supported by the Code;
- (b) no submission to the Authority has explained why the prepayment clause is unreasonable – the submissions simply make assertions unsupported by evidence;
- (c) the prepayment clause is reasonable – it provides a form of security which is proportionate to the risk faced by Envestra should a User breach its haulage agreement; and
- (d) implementation of the Authority's decision would be inconsistent with Envestra's legitimate business interests.

1.5 Quality of Gas

Amendment 4.3

In order for Envestra's access arrangement to be approved, Envestra must amend its terms and conditions to include a requirement on the network operator to maintain the quality of gas injected into the network in accordance with the relevant legislation.

1.5.1 Draft Decision

The Authority has stated that it is reasonable that, as suggested by Energex Retail, the network operator maintain the quality of gas injected into the network in accordance with the relevant legislation. It held: "*The Authority is of the view that the comment by Energex Retail is reasonable and would be important in the more competitive environment likely to result from the introduction of full retail contestability on 1 July 2007.*"

1.5.2 Envestra's Submission

Envestra submits that the Authority's decision does not take into account the fact that it is retailers, not Envestra, who control the specifications of gas in the network. The quality of gas in the network is determined by the specifications of the gas injected by retailers. It is not a matter over which Envestra has control – Envestra does not do anything to gas once it has entered the network to influence its quality. If gas in the network does not comply with the legal specification, this will have occurred due to the actions of a retailer (or their supplier or the transmission system operator).

To require Envestra to always ensure that gas complies with the specifications required by law is to impose upon Envestra an obligation to ensure a matter occurs, despite Envestra not having control over that matter. Such an amendment is not reasonable. Furthermore, Envestra has not incorporated into its cost forecasts any amount to undertake this function.

Given the above it is submitted the gas quality provision set out in Envestra's submitted terms and conditions meets the criteria of reasonableness set out in section 3.6 of the Code. The amendment proposed by the Authority is not necessary to ensure that those provisions meet the criteria of reasonableness.

1.6 Invoicing

Amendment 4.4

In order for Envestra's access arrangement to be approved, Envestra must adjust its invoicing policy so that:

- it is required to provide sufficient information to allow reconciliation of DUOS charges at an individual customer level;
- it is required to provide a valid tax invoice to the network user; and
- both Envestra and users have the same timeframe to rectify undercharging, and that this should be the same timeframe as adopted by Allgas.

1.6.1 Draft Decision - DUOS Charges

In respect of the provision of information to allow reconciliation of DUOS Charges, the Authority has indicated its agreement with Energex Retail "that the introduction of full retail contestability will require the service providers to provide additional billing information, sufficient to allow the reconciliation of DUOS charges at an individual customer level."

1.6.2 Envestra's Submission

The retail market rules for the whole of the gas market in Queensland are yet to be formulated. Given this, Envestra considers that it is inappropriate to endeavour to pre-empt in the Access Arrangement the type of information that retailers may require from Envestra in connection with those rules. Obligations to provide information to meet the requirements of FRC retail market rules are most appropriately dealt with in the rules themselves. That way, the information provision obligations may be tailored to the specific provisions of the rules and the requirements of market participants in light of those rules. To require Envestra to pre-empt uncertain future obligations is not reasonable.

Envestra therefore submits that the Access Arrangement should not be amended to require the provision of information linked to reconciliation of DUOS Charges at an individual level. This is an FRC Retail Market Rules issue not an Access Arrangement issue.

1.6.3 Tax Invoices and Undercharging

Envestra agrees to amend its Access Arrangement to make clear that there is a requirement to provide a valid tax invoice in respect of a taxable supply made to the User. Similarly if a User should make a taxable supply to Envestra, it will also be required to provide a tax invoice in respect of that taxable supply to Envestra.

Envestra also agrees to the inclusion of a clause restricting its right to rectify an undercharge (or overcharge) to 12 months from the date of issue of the invoice containing the undercharge. That is, section 20 of Envestra's terms and conditions will be amended such that both Envestra and the User may only make claims for adjustments to an invoice within 12 months of the date of the invoice.

In any event, Envestra always supplies tax invoices to retailers and has a legal obligation to do so.

1.7 Capacity Management – Network Limitations

Amendment 4.5

In order for Envestra's access arrangement to be approved, Envestra must amend clause 5.6 of the terms and conditions to the effect that Envestra will not undertake to deliver a quantity of gas from the network if it is apparent that, under 'normal conditions', there will be insufficient capacity in the network to meet the anticipated demand for gas at any user delivery point.

1.7.1 Draft Decision

The Draft Decision states:

“Origin Energy (2005) argued that Envestra need not necessarily add new delivery points in order to oversell capacity and that Envestra may simply undertake to deliver more additional gas from existing delivery points than the network can deliver. Origin suggested that Envestra amend clause 5.6 (which only refers to overselling capacity by adding a new delivery point).

The Authority is of the view that Origin Energy's suggestion is a reasonable one.”

1.7.2 Envestra's Submission

Envestra notes that in reaching its decision, the Authority appears to have applied an incorrect test. The test is not whether Origin's suggestion is reasonable, but whether the terms and conditions as submitted by Envestra are reasonable. Only if those terms are not reasonable, can amendments be required to them.

That said, Envestra is prepared to accommodate an amendment in the nature of that suggested by Origin and the Authority. However in framing the terms of that amendment, it is important to have regard to the fact that Envestra does not undertake to deliver defined quantities of gas. While larger delivery points may have an MDQ/MHQ not all delivery points do so. There is no overall restriction on the quantity of gas which a User may take delivery of (unless that User only uses delivery points with an MDQ). Even in such circumstance, Envestra cannot, practically, prevent a User exceeding MDQs. Envestra's only remedy against a User exceeding MDQs would be to terminate the User's haulage agreement. Envestra cannot physically prevent a User from exceeding MDQ.

Consequently Envestra has difficulties with the concept of Envestra "undertaking to deliver a quantity of gas."

Envestra submits that it is only in a position to commit to agree that it will not consent to a User taking delivery of increased volumes of Gas if it is apparent that, under 'normal conditions', there will be, as a result of such increased volumes being taken, insufficient capacity in the network to meet the anticipated demand for gas at any user delivery point. Envestra will amend clause 5.6 to specify that Envestra's consent may be given by:

- (a) creating a new Delivery Point; or
- (b) expanding the capacity of an existing Delivery Point; or
- (c) permitting a User to increase its MDQ or MHQ.

1.8 Supply Curtailment – Order of Priority

Amendment 4.6

In order for Envestra's access arrangement to be approved, Envestra must include a clause in section 16 of its terms and conditions that:

- provides customers with the right to request an explanation from Envestra as to why they have been placed in a particular category; and
- requires Envestra to seek the views of network users in establishing its order of priority for curtailment.

1.8.1 Draft Decision

The Authority's reasoning for its first determination is that it is reasonable to provide retailers with this right to address the risk of Envestra inappropriately categorising a customer for the purposes of determining the priority for curtailment.

In respect of the second determination, the Authority has stated " *it would be reasonable for Envestra to provide an opportunity for retailers to comment on the proposed order of priority.*"

1.8.2 Envestra's Submission – Provision of Information

Envestra agrees with the Authority's position. It assumes that the reference to providing customers with a right is intended as providing Users with a right for an explanation as to why a delivery point has been placed in a particular category (since Envestra does not usually have a contractual relationship with gas consumers, only Users).

1.8.3 Envestra's Submission – Seeking of Information

Envestra does not agree with this change as, in its view, the matter sought to be addressed by the change is already covered by the Terms and Conditions.

The order of priority is already set by clause 16.3. This is the curtailment priority that Envestra will apply as far as practicable having regard to circumstances necessitating a specific curtailment. The decision Envestra must make is not the setting of the order of priority but the allocation of delivery points within that order. In terms of making that allocation, clause 16.4 requires Envestra to determine, on a reasonable basis, into which category a delivery point will fall. In making such a determination Envestra would be required to have regard to any information provided to it by a User from time to time. Indeed to satisfy the obligation to proceed on a reasonable basis Envestra would be required to seek information from a User where it did not consider that it possessed sufficient information to make the relevant determination as to where to classify a delivery point.

There is nothing in the Access Arrangement which restrains a User from providing information to Envestra from time to time. Envestra would be required to take that information into account. There is no necessity to further require Envestra's to actively seek Users' views.

Envestra submits that clause 16 is reasonable in its current format as its existing effect is to require Envestra to take into account information that may be submitted to it by Users as to the appropriate classification of a delivery point.

1.9 Failure to Pay

Amendment 4.7

In order for Envestra's access arrangement to be approved, Envestra must:

- remove "... Interest not paid in the month in which it accrues will be capitalised and will itself bear interest in accordance with this clause."
- provide the Authority with sufficient information for it to determine Envestra's cost of funds in the event of failure to pay and hence the appropriate interest rate to be included in clause 23.1;
- amend the wording in clause 23.2 to "...any amounts due or owing by Envestra under the Agreement to the network user against..."; and
- remove the words "or under any Related Haulage Agreement" from clause 23.3

1.9.1 Draft Decision

In addressing these issues, the Draft Decision quoted three submissions by Origin Energy:

"Origin Energy (2005) argued that clause 23.1 of Envestra's terms and conditions represented a penalty rather than a reasonable estimate of the loss due to the selection of the Corporate Overdraft Reference Rate as the basis for calculating interest. Origin suggested that Envestra amend its definition of interest rate to refer to a 30 Day Bank Bill rate and that Envestra delete "interest not paid in the month in which it accrues will be capitalised and will itself bear interest in accordance with this clause" from clause 23.1 as capitalising interest is not common practice in the gas industry.

Origin Energy also argued that Envestra should amend clause 23.2 as the clause gives the appearance that set off could occur with reference to amounts owing on other agreements and that this was not appropriate commercial practice.

Origin Energy also suggested that Envestra delete the words "any Related Haulage Agreement" from clause 23.3 as the clause gives Envestra the right to suspend the agreement for events which occur that are unrelated to the agreement and relevant only to agreements between the network user and Envestra. Origin suggested that this was not normal commercial practice."

In respect of Origin's submission, the Authority states:

"The Authority is not convinced by Origin Energy's suggestions in relation to clause 23.1 regarding the appropriate interest rate. While there is a difference between the corporate overdraft rate and the bank bill rate, the issue is which best matches the cost of funds to Envestra when payments are not received or delayed. The Authority requires Envestra to provide further information on this matter. However, in relation to capitalising interest, the Authority does agree with Origin Energy that common industry practice is a sound basis for determining the appropriate calculation of interest and therefore the Authority requires Envestra to amend its wording in this respect.

The Authority also agrees with Origin Energy that the terms and conditions under the agreement cannot extend to other agreements. The Authority therefore requires Envestra to clarify this in clause 23.2 and remove the right from clause 23.3."

1.9.2 Envestra's Submission – Capitalisation of Interest

The Authority has stated that "common industry practice is a sound basis for determining the appropriate calculation of interest".

As noted in section 1.2 and section 1.4 (in the discussion of prepayment) common industry practice is not the relevant test to be applied by the Authority. The test is whether the relevant term is reasonable. No arguments have been put forward to demonstrate that the provision proposed by Envestra is not reasonable.

Envestra notes that if interest has not been paid in the month in which it has accrued, this suggests that the relevant User is significantly in default. Invoices are issued by approximately the 4th Business Day of a month and must be paid within 14 days. Interest will therefore commence to accrue from approximately the 18th day of a month (i.e. if an invoice has not been paid). For such interest not to have been paid before the expiry of the relevant month, the relevant debt of the User will be 12 days overdue. Such overdue payments expose Envestra to a significant risk. The capitalisation of unpaid interest is appropriate compensation for the risk to which Envestra is exposed. Envestra does not see a legitimate basis upon which a User who is significantly in default can claim that it is unfair or unreasonable that their interest debt is subject to capitalisation, especially when this reflects Envestra's debt arrangements.

Capitalisation of interest on overdraft facilities is the norm in the banking industry. Where a service provider is not paid by its customers and is required to draw further on its overdraft to continue its operations then that service provider will be exposed to the cost of having its overdraft interest capitalised.

In any event, Envestra notes that no evidence has been provided to support Origin's submission that the capitalisation of interest is not in accordance with gas industry practice. Such an interest capitalisation provision is contained in the following other non-Envestra Access Arrangements: Multinet 2002 Access Arrangement for Victoria (clause 7); SPI 2003 Access Arrangement for Victoria (clause 7) and the Tubridgi Pipeline System Access Arrangement (28 September 2001).

Envestra also notes that the Reference Tariff has been determined without making any provision for bad debts, which further justifies the imposition of appropriate penalties on particular Users who fail to pay debts on time. The alternative of factoring such a bad debt allowance into the Reference Tariff is arguably unfair (and contrary to the collective interests of Users) because it imposes the costs of the risk of default on all Users rather than individual defaulting Users.

1.9.3 Envestra's Submission – Interest Rate

In respect of the quantum of the interest rate, the Authority has stated:

“The issue is what best matches the cost of funds to Envestra when payments are not received or delayed.”

Several factors are relevant in determining an appropriate default interest rate. They are:

- (a) costs incurred by Envestra as a result of the late payment – the Interest Rate reflects Envestra's actual costs. But the costs incurred by Envestra are not limited to Envestra's costs of funds. Envestra will also incur administrative costs in chasing a debt and, potentially, legal costs;
- (b) the interest rate should contain an appropriate punitive element to encourage a User to pay on time. Envestra disagrees with Origin's assumption that a default interest rate is solely designed to cover Envestra's costs of funds. The rate should also be set at such a level so as to provide an appropriate disincentive to Users to make payments late. This is particularly so when regard is had to the fact that Envestra would be reluctant (due to the financial, regulatory and political consequences) to exercise the other remedies available to it in respect of a failure to pay – that is, suspension of service or termination of the agreement. Further, as well as being in the interests of Envestra as service provider (section 2.24(a) of the Code) that a User pay on time, it is also in the collective interests of Users (clause 2.24(f) of the Code) that an individual User be incentivised to pay on time so as to minimise the risks to the solvency of the network operator; and

- (c) an interest rate should be set such that Users do not have an incentive to use Envestra as their banker i.e. deliberately pay Envestra late because their cost of funds exceeds the interest rate they are required to pay Envestra.

Envestra submits that the interest rate set out in the Access Arrangement is an appropriate rate having regard to the above considerations. It also notes Origin has provided no evidence to support its assertion that the 30 Day Bank Bill Rate is the commonly used industry rate (notwithstanding the fact that the use of an industry rate is not the determining factor in the Authority's approval of the clause concerned).

Having regard to the above, Envestra submits that the existing interest rate provisions are reasonable and, therefore, under the Code there is no power to direct that they be varied.

1.9.4 Envestra's Submission – Set-off

No arguments have been presented as to why Envestra's proposed set-off provision is not reasonable. Nor has any evidence been submitted that Envestra's clause is inconsistent with commercial practice. Origin has simply made an assertion, unsubstantiated by evidence.

If a User owes Envestra an amount of money, then why should Envestra be required to pay that User a debt owed by Envestra to the User (however that debt has arisen). That is, why should Envestra be required to pay a User when that User has not paid Envestra? If a User is in default, it is entirely appropriate that, rather than continue to be exposed to the User's default, Envestra be entitled to set-off any debt owed by Envestra to the User and thereby mitigate to some degree the risk to which the User's default has exposed Envestra.

Envestra's submits that the current wording of clause 23.2 is reasonable.

1.9.5 Envestra's Submission – Related Haulage Agreements

Related Haulage Agreement is defined in the Access Arrangement as: "*(in an Agreement between Envestra and a Network User) means any other agreement between Envestra and that Network User under which Envestra delivers, or is to deliver, Gas through the Network to or for the account of that Network User.*"

That is, a Related Haulage Agreement is another contract under which a User is provided with services in the Queensland network.

Where a User has committed a payment default under one haulage agreement, it is appropriate that Envestra be entitled to suspend services under all haulage agreements for use of the network applying between Envestra and that User. For a User to be in payment default, and not remedy that default within 7 days of notice, is a serious event and may indicate that a User is in serious financial difficulties. In such circumstance, it is entirely reasonable that Envestra be entitled to suspend services under all agreements rather than be required to continue to incur costs and exposure to the credit risk of the defaulting User. Why should Envestra be placed in a position where it is required to continue to expose itself to a User which fails to pay its debts?

While a User may have more than one Haulage Agreement in respect of the network, the reality is that Haulage Agreements relating to the network will be administered as a "package". The agreements will operate in an inter-linked fashion – to describe agreements for the provision of the same types of services in the same network as "unrelated" (as Origin has done) fails to correctly characterise the agreements.

Clause 23.3 is also designed to protect Envestra against risks which will arise if a User goes into liquidation or some other form of insolvency administration or otherwise has financial difficulties. A liquidator may elect to make payments under one haulage agreement (which they consider can be administered profitably) but allow a second haulage agreement to go into default. In Envestra's view, leaving this power to "cherry-pick" with a liquidator is inappropriate.

1.10 Method of Payment

Amendment 4.8

In order for Envestra's access arrangement to be approved, Envestra must amend clause 22.2 of its terms and conditions so that it recognises that this clause operates subject to clause 20A(a) is an exemption to the operation of this clause.

Envestra agrees to make the change contemplated by the Authority.

1.11 Force Majeure

Amendment 4.9

In order for Envestra's access arrangement to be approved, Envestra must amend the force majeure provisions in its terms and conditions so that they apply equally to both Envestra and any party that has obligations to Envestra.

1.11.1 Draft Decision

The Authority has stated that the force majeure provisions should be expressed to apply to both the User and Envestra. No express reasoning is given for this decision, other than there being a reference to the terms of Allgas' Access Arrangement.

1.11.2 Envestra's Submission

The force majeure provision in the Access Arrangement does not apply to the User because, when regard is had to the obligations of Users under the terms and conditions, it is not appropriate to provide force majeure protection in respect of those obligations.

The User's principal obligations under the terms and conditions are to:

- (a) pay amounts that are due – it is not appropriate force majeure relief be provided in respect of this obligation;
- (b) to deliver gas at the requisite specification. It is not appropriate to provide force majeure relief in respect of this provision because, if so provided, every time gas was off-specification the User would claim this was due to the omission of its gas supplier and therefore was beyond the User's control. Envestra would have no means of enforcing the obligation to supply gas of the requisite quality because User's would continually claim force majeure. Further, unlike the User, Envestra has no contractual relationship with the User's gas supplier. If gas supplied upstream is off-specification, this is an issue in respect of which the User should take action against its gas supplier rather than pass the risk on to Envestra by claiming force majeure. Envestra, having no contractual relationship with the gas supplier, has no means to manage this risk. If force majeure relief were provided then the loss caused by off-specification gas entering the network would be suffered by Envestra rather than being passed up the contractual chain to the supplier which caused the off-specification gas and therefore should bear the consequences of such gas being off-specification;
- (c) inject gas at the requisite pressure. The reasoning which applies in respect of gas quality equally applies here. The pressure at which gas is injected is determined by the transmission system operator and again it is unreasonable to allow a User to claim force majeure every time the transmission system operator fails to inject gas at the correct pressure. The obligation to inject gas

at the requisite pressure would effectively become unenforceable because the User would always claim force majeure and Envestra has no contractual relationship with the transmission system operator;

- (d) not exceed its contracted quantities. The quantity of gas taken by a User is essentially determined by the take of its customers. It should be the responsibility of the User to impose appropriate MDQ and MHQ limitations upon its customers and require those customers to keep to those limits. Envestra should not be placed in a position where Users can claim force majeure in respect of this obligation on the basis the quantity of gas taken was determined by their customers over whose actions they do not have control. Again Envestra has no contractual relationship with end-use customers;
- (e) provide receipt point metering equipment. A User should not be entitled to relief from this obligation on the basis it has been unable to arrange for receipt point metering equipment to be provided (for example, has failed to come to terms with the relevant transmission service operator to provide such equipment). It is not practicable to place Envestra in a position where it may be required to accept gas into the network without receipt point metering equipment being installed; and
- (f) ensure it has good title to gas. If a User does not have good title to gas this will be because its supplier failed to transfer good title to the gas. Again if force majeure applied to this obligation, the User would always be able to claim force majeure on the basis the failure to provide good title was due to the act of its supplier, which act is beyond the User's control.

In short, given the nature of the User's obligations, providing force majeure relief in respect of such obligations will potentially render these obligations unenforceable (because every time there is a failure to perform such obligations the User will claim force majeure). This will pose unacceptable risks to Envestra and leave Envestra with no contractual remedy to recover damages. The obligations to ensure gas is of the requisite quality and pressure and that contracted quantities are not exceeded are fundamental to the integrity of the Network. Indeed rendering such obligations practically unenforceable exposes all Users to a risk and, in addition to being prejudicial to the interests of the service provider (clause 2.24(a) of the Code), is prejudicial to the interests of Users (clause 2.24(f) of the Code) when viewed collectively. If there is no means to hold an individual User to its contractual obligations which impact on the integrity of the network, then no User can have confidence that the integrity of that network will be maintained.

In contrast to the User, Envestra's principal obligation is to transport gas through infrastructure. Such obligation can be impacted by events over which Envestra has no control and no means to mitigate – weather conditions, third party interference or machinery breakdown. The obligations of Envestra and the User differ and consequently the terms which regulate those obligations differ.

In Envestra's submission it is reasonable that the force majeure clause not apply to the obligations of Users.

2. Trading Policy

Amendment 6.1

In order for Envestra's access arrangement to be approved, Envestra must amend its trading policy to include words to the effect that:

- Envestra will reply to any request from a user for Envestra's consent to a transfer (other than a bare transfer) or for a change in receipt point or delivery point, within 10 business days of receiving the request accompanied by information which is reasonably necessary to enable Envestra to consider the request; and
- If, at the time the request is made, the user informs Envestra that due to hardship the user requires an urgent reply to its request, Envestra will use reasonable endeavours to respond to the request within two business days of receiving the request.

Envestra notes that the only change from the current policy is the decrease in timeframe for replying to requests, from 14 business days to 10 business days. Given that Envestra has not received any requests for transfers in the first Access Arrangement period, Envestra does not acknowledge any need to amend the existing policy.

The Authority has proposed the change in order to align Envestra's Trading Policy with that of Allgas. Envestra submits that the proposed policy meets the requirements of the Code, and, as explained earlier in this submission, it is not a requirement of the Code that a trading policy of one service provider be the same as that for another service provider.

3. Extensions/Expansions Policy

Amendment 8.1

In order for Envestra's access arrangement to be approved, Envestra must revise its extensions/expansions policy to the effect of the following.

1. A significant extension means an extension to one or more delivery points, where the anticipated quantity of gas delivered exceeds 10 TJs per year and the anticipated capital expenditure for the extension exceeds \$1 million.
2. An extension which is directly connected to an existing covered pipeline will not be treated as part of the covered pipeline through the operation of the extensions/expansion policy if:
 - (a) the extension is a significant extension (or where Envestra can demonstrate the extension represents a special case); and
 - (b) Envestra obtains the Authority's written approval to exclude the extension from the covered pipeline.
3. In the case of a significant extension which is directly connected to an existing covered pipeline, and for which written consent has been provided by the Authority to treat the extension as an excluded extension, the Authority will determine what portion of the revenue generated from that extension will be offset against the total revenue calculation in respect of the covered pipeline in recognition of the use of common or joint assets that form part of the covered pipeline.

Envestra accepts the above amendment.

4. General Principles for Determining Revenue and Tariffs

4.1 Haulage Service Price Paths

Amendment 10.1A

In order for Envestra's access arrangement to be approved, Envestra is required to specify separate haulage service price paths for the demand and volume customer classes as contained in the current access arrangement.

Specifying separate price paths for the demand and volume customer classes is consistent with the price paths contained in the current Access Arrangement, but different to that proposed by Envestra to apply from 2006/07. As highlighted by the following, the basis for the Authority rejecting a single price path mainly relates to a concern that Envestra's tariffs are not cost reflective:

"The Authority is concerned, as it was in 2001, that large volume customers (typically commercial and industrial end users that consume less than 10 TJ) may be paying close to, or above, stand alone costs to compensate for a shortfall in revenue being raised from small domestic customers within this group.

To reduce these concerns, and consistent with the approach adopted in the current access arrangement, the Authority requires Envestra to retain a clear separation between reference tariffs for demand and volume customers to ensure that the potential for cross subsidisation between these customer classes is eliminated." (p. 42)

Envestra has directly addressed concerns over cost reflectivity under Amendments 15.2 and 15.3. As explained under those sections, Envestra's analysis suggests that its proposed tariffs reflect a reasonable allocation of costs to different regions and customers. Envestra therefore does not believe that concerns over cost reflectivity justify a departure from Envestra's proposal to adopt a tariff basket form of regulation.

Envestra believes that a tariff basket has a range of advantages over other regulatory forms. In particular, a tariff basket allows the business to respond to changes in actual demand relative to the regulatory forecasts, which in turn encourages more efficient use of the network. This in turn facilitates efficiency in the level and structure of prices, as required by the gas Code.

Envestra also sought to introduce a tariff basket to be consistent with the manner by which its tariffs are regulated in Victoria and proposed to be regulated in South Australia. In the case of Victoria, the tariff basket is supported by several tariff principles that guide the structure and level of prices. The principles that Envestra must comply with include:

- Regulatory Compliance: Compliance with the regulatory requirements of the Essential Services Commission of Victoria;
- End User impact: Regard to the previous period price levels and relative price changes;
- Competitive Dynamics: The competitive position of natural gas in the energy market;
- Non-Discriminatory Access: The Reference Tariffs and applicable terms and conditions of access apply to all customers in an equal manner;
- Cost Reflectivity: Reference Tariffs will seek to reflect the efficient costs associated with providing the Service, whilst having due regard to reasonable economic bounds on upper and lower pricing limits, particularly as pertaining to efficient investment and network utilisation, and regulatory requirements;
- Pragmatism: Where possible a pragmatic approach is taken to setting Reference Tariffs; and

- Environment: Within the limitations of the scope and context of gas distribution pricing, Envestra will have regard to opportunities to improve utilisation and accommodate environmentally friendly energy technologies, particularly in respect of greenhouse gas emission reduction.

These principles are further supported by a rebalancing constraint that limits the extent that a tariff can change between years. Envestra proposed to the Authority in its Access Arrangement Information that a side constraint of CPI + 5% would be sufficient in terms of managing annual price changes to customers. The Authority could further address any concerns it has through pricing principles and the rebalancing constraint.

Envestra also considers that the additional flexibility of the tariff basket is consistent with that provided by the revenue cap form of regulation set by the Authority in its recent electricity price determination. Both mechanisms provide flexibility to the business to manage their tariffs.¹³ The key difference is that Envestra is exposed to volume risk under the tariff basket form of regulation, which is not the case for the Queensland electricity distributors.

In addition, it does not appear that the Authority in its Draft Decision has considered the above mentioned interests of Envestra in considering whether to accept a tariff basket form of regulation. It appears in the Draft Decision that the Authority has instead only considered one of the objectives of section 2.24 of the Code, being the interests of users and potential users.

Envestra therefore believes that a tariff basket form of regulation is appropriate. Evidence presented later in this submission suggests that Envestra's tariffs are cost reflective, which should address the principle concern of the Authority in not accepting the tariff basket. If not, then outstanding concerns could be addressed through pricing principles and the rebalancing control that is to apply.

Envestra also considers that a tariff basket is in the best interests of both its customers and the business by facilitating better utilisation of the gas distribution network.

4.2 Trigger Events

Amendment 10.1B

In order for Envestra's access arrangement to be approved, Envestra must:

- define the cost pass-through trigger event as;
 - a change in taxation or other statutory charges; or
 - any other major change in government policy (for example, costs associated with the introduction of full retail contestability), and
- include a materiality threshold for cost pass-through events of 1 per cent of (forecast) annual revenue per event based on the forecast revenue in the year in which the event occurred.

In relation to the definition of "impost", the definition proposed by the Authority is too narrow. For example, it may not capture charges imposed by authority where those charges might not be statutory charges, eg some charges by local governments in relation to road works might not be statutory charges. As the intention of the impost pass-through is to allow Envestra to recover fees or charges of which it was unaware at the time of review, it is reasonable to broaden the definition to ensure that such charges are captured. Envestra therefore proposes the following definition:

¹³ Indeed, the Authority in its 2005 Final Determination for the Regulation of Electricity Distribution has provided further flexibility in the revenue cap than would otherwise apply, such as demand triggers based on maximum demand and customer numbers. The Authority notes that the form of regulation reflects the recommendations of the Electricity Distribution and Service Delivery Review that the Authority provide distributors with greater flexibility.

“‘Impost’ means

- (a) any royalty, duty, excise, tax, impost, levy, fee or charge (including, but without limitation, any goods and services tax) imposed by the Commonwealth of Australia, any State or Territory of Australia, any local government or statutory authority or any other body (authorised by law to impose such an impost, tax or charge) on or in respect of the Network (or any part of it) or on or in respect of the operation, repair, maintenance, administration or management of the Network (or any part of it) or on or in respect of the provision of any Network Service; or
- (b) any other major change in government policy (for example, costs associated with the introduction of full retail contestability”

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

If the Authority’s recommendation were implemented and only one event per year eventuated, it would be possible for Envestra to lose up to \$1.7m of revenue over the second Access Arrangement period (this representing 1% of the Authority’s proposed revenue forecast). Such an amount cannot be considered by any reasonable person to constitute an immaterial amount.

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

In any event:

- (a) materiality needs to be considered in the context of costs and benefits of the situation concerned. In this situation, the relevant costs are those of the service provider in preparing a request, the costs of the Authority in assessing a request and the costs of users in adjusting their tariffs if required. It is considered that the total of such costs, depending on the nature of the impost, would be less than \$20,000.
- (b) The Authority’s proposal is not consistent with its own philosophy on materiality, since the 1% threshold is considered as a threshold “per event” rather than an annual threshold. This means that two events in one year, equivalent to 0.9% of the threshold each, could occur with no pass-through. This implies that the Authority considers that an impost equivalent to 1.8% of revenue is not material.
- (c) A materiality threshold is not consistent with the Authority’s intention to allow the service provider to earn the regulated rate of return. To deny Envestra the opportunity to earn 1% of the required revenue equates to the Authority approving a lower rate of return than that recommended in the Draft Decision..

Finally, notwithstanding all of the above, the Authority’s recommendation is inconsistent with the Code. While the Authority may have instituted a materiality threshold for electricity distributors, the electricity regulatory regime does not apply here – the Authority must apply the tests under the Code to determine whether Envestra’s terms are reasonable. It is not for the Authority to determine whether there are additional terms it believes should be incorporated into Envestra’s terms and conditions because of views it may hold in relation to materiality.

When the Authority approves Non-Capital Cost forecasts, it does not do so using a concept of materiality. Hence there is no reason to do so when approving costs under a pass-through as the latter are merely Non-Capital Costs that were not foreseeable at the time of review.

Clause 8.1(a) of the Code provides that a Reference Tariff and Reference Tariff Policy should be designed with a view to providing the Service Provider with an opportunity to earn a stream of revenue that recovers the efficient costs of delivering the Reference Service over the expected life of the assets used in delivering that Service. Other factors are then listed in clause 8.1 but none of those remaining five factors

suggest that Envestra should be required to bear costs caused by government action. The cost-pass through trigger events specified by the Authority are not matters over which Envestra has control. Envestra does not control whether there are changes in taxes or changes in government policy and, particularly in the case of changes in taxes, Envestra is not generally in a position to mitigate the amount of costs it pays. To deprive Envestra of the ability to recover such costs therefore contravenes clause 8.1(a). That is, because Envestra generally has no means open to it to mitigate its liability to costs arising from changes in taxes or government policy, those costs are by definition efficient costs. To prohibit Envestra passing such costs through by means of adjustment to the Reference Tariff means Envestra has no way to earn revenue to recover all its efficient costs.

Section 8.3 of the Code provides:

"Subject to section 8.3A¹⁴ and to the Relevant Regulator being satisfied that it is consistent with the objectives contained in section 8.1, the manner in which a Reference Tariff may vary within an Access Arrangement Period through the implementation of a Reference Tariff Policy is within the discretion of the Service Provider."

That is, it is Envestra's decision as to how its Reference Tariffs may vary during the Access Arrangement Period, provided that the principles in section 8.1 are complied with. Envestra's position is that a materiality threshold should not be included such that Envestra is not able to recover all its efficient costs of delivering services – there is nothing in the exercise of such discretion which is inconsistent with section 8.1.

4.3 Efficiency Carry-over and Fixed Principles

Amendment 10.4¹⁵

For Envestra's access arrangement to be approved, Envestra must remove all reference to the efficiency carry-over mechanism and fixed principles.

The Authority in its Draft Decision requires Envestra to remove all reference to the efficiency carryover mechanism and fixed principles for the Access Arrangement to be approved. The Authority has formed this view on the basis that there are sufficient incentives in the price path mechanism to encourage cost savings.

The Authority has also noted that the experience in other jurisdictions is that efficiency carryover mechanisms, where they have been introduced elsewhere, have encouraged an over-emphasis on cost cutting, which has contributed to underinvestment and deferment of maintenance on the network. This has in turn been attributed to reducing service levels.

Envestra believes that an efficiency carryover mechanism is an important part of the regulatory regime. In particular, the mechanism ensures that the incentive for Envestra to improve the way it operates is consistent over the regulatory period.

The Authority's concern over service reliability appears to be primarily driven by issues raised by the ESCV in its recent electricity price determination. Envestra does not believe that such concerns are relevant to Envestra's Queensland gas distribution business, which has always complied with the service standard framework underpinning prices.

Moreover, service reliability has not been compromised by Envestra where it operates under a regime that has an efficiency carryover mechanism similar to that proposed for Queensland, such as in South Australia and Victoria. In those states, Envestra's service standard targets have been maintained despite

¹⁴ Which section sets out various procedural matters.

¹⁵ Note- the Draft Decision does not contain an Amendment 10.2 or 10.3

the existence of the mechanism. Indeed, Envestra is expecting to exceed both its capital and operating expenditure benchmarks in South Australia over the current Access Arrangement period.

Envestra therefore considers that it is appropriate for some form of incentive mechanism to be put in place to strengthen the incentive-based regulatory regime applying in Queensland.

Fixed Principles

Envestra does not support the Authority's decision to reject all of Envestra's proposed fixed principles. Envestra sought fixed principles in relation to:

- Use of a CPI-X methodology;
- Use of a weighted average price cap approach;
- The method of rolling forward the asset base.

Clause 8.47 of the Access Code allows the service provider to submit, as part of the reference tariff policy, certain fixed principles. In rejecting the proposed fixed principles, the Authority noted¹⁶:

In approving a fixed principle, the Code requires the regulator to consider potential impacts on the service provider, users and prospective users. If it were assumed that changes to the regulatory regime will occur only when the benefits to service providers, users and prospective users exceeded the costs, the need to insulate Envestra from any potential change is questionable.

It is Envestra's belief that while the Authority has acknowledged the Code requirement to consider the potential impacts on the service provider of its decision, it has not actually undertaken this assessment. It has based its decision not to allow the fixed principles on the basis that the parties undertaking future reform will make this assessment for it. This is not acceptable.

Envestra therefore considers that the Authority has not had regard to the interests of Envestra in rejecting the proposed fixed principles. Nowhere in the reasons for decision is there any consideration of the interests of Envestra. Accordingly, Envestra considers that the Authority has not complied with its obligation to have regard for the interests of the service provider. For that reason, amendment 10.4 appears inconsistent with the law.

Envestra believes that its proposed fixed principles are appropriate and consistent with the Code on the basis that each proposed principle:

- provides certainty in the face of potential changes to the Gas Code;
- will be accommodated in the upcoming national regulatory regime administered by the AER; and
- serve to strengthen the incentives embodied within the regulatory regime.

On the first issue, Envestra believes that one of the primary purposes of regulated revenue setting is to provide certainty for service providers and users about how reference tariffs will be determined. Fixed principles are a valuable part of the Code in this respect and provide additional security for companies which have invested in assets with operational lives which are much longer than regulatory setting periods. The application of a fixed principle for the use of a CPI-X approach, for example, provides Envestra with a reasonable level of certainty regarding the method of calculation of the rate of return in future periods. This directly addresses the regulatory risk that Envestra faces that the method used to calculate the rate of return might be changed in future. The need for an additional layer of certainty is particularly important at present given the changes that are being made to the national regulatory regime.

¹⁶ Page 47

This will include changing the regulatory bodies responsible for regulating Envestra's assets, and reviewing and, if necessary, amending aspects of the Code to provide greater consistency with electricity infrastructure regulation. This is a process which has the potential to alter the framework that Envestra invested in and to which it has become accustomed.

Secondly, the material prepared to date by the Commonwealth Government and all of the States clearly envisages that fixed principles will be part of the transition to a national regulator, and will be accommodated in the regime to be administered by the AER. The *Public Consultation on a National Framework for Energy Distribution and Retail Regulation* prepared by NERA Economic Consulting and Gilbert and Tobin (May 2005) specifically recognised existing fixed principles in jurisdictional gas Access Arrangements and:

- proposed that existing fixed principles be taken into account by the AER in regulating the relevant distributors until they expire or until the distributor itself proposes a change to the fixed principle to adopt the national regime; and
- acknowledges that distributors may have made investments on the basis of these principles that should not be put at risk. The paper specifically states that "...it is not considered that continuation of these (fixed) principles represents a significant impediment to the adoption of a national approach to the form of regulation."

Thirdly, the fixed principles have merit and serve to improve the regulatory regime rather than detract from it, simply because fixed principles improve investment certainty. This is particularly the case with the proposed fixed principle for the roll forward of the regulatory asset base. This clearly provides Envestra with greater confidence to invest in the face of a changing regulatory environment.

What Envestra has proposed in its Access Arrangement is no more than an extension of existing Code provisions in relation to fixed principles, to protect certain aspects of its regulatory regime from change in the upcoming review processes. It should also be noted that the fixed principles proposed by Envestra for the form of regulation and the roll forward of the regulatory asset base are proposed to apply only for the third access arrangement period (the first to be administered under the new regime). Envestra is not seeking to permanently lock-in these fixed principles and acknowledges that these will expire at the end of the third access period.

The proposed fixed principles are in Envestra's legitimate business interests. They do not lessen the rights or benefits enjoyed by users. They do not increase costs to users. The only negative implication in accepting the fixed principles, in Envestra's view, is to limit the flexibility of the AER which Envestra believes is not within the Authority's powers to consider, i.e. the Authority must make its decision in the context of the Code and not in the context of which body may be the next "Relevant Regulator".

Further, Envestra contends that the Authority's assumption that the reform of the national regulatory regime removes its obligations under the Code to consider Envestra's legitimate business interests is at worst unlawful and at best short sighted. The risks to service providers, users and prospective users are currently no less, and indeed certainly more, than when the Code was introduced, yet the Code was drafted and enacted with provisions that offered fixed principles extending beyond an access arrangement period, in order to provide regulatory certainty for service providers.

It is, therefore, unacceptable to Envestra that the Authority undermine the operation of sections 8.47 and 8.48 of the Code.

5. Rolling Forward the Capital Base

Amendment 11.1

In order for the Envestra's access arrangement to be approved, Envestra must amend the roll forward of the capital base for the current period in accordance with Table 11.6.

There are several reasons why Envestra considers that it is not appropriate to adjust the roll forward of the asset base for the current period in the manner described by the Authority in its Draft Decision. This primarily relates to issues of inflation, depreciation and the capital expenditure incorporated into the roll forward (where the Authority has not implemented the intent of its decision).

Envestra will make the necessary amendments to its roll forward once these issues have been finalised by the Authority.

Inflation

The Authority and Envestra have incorporated different measures of inflation into the roll forward of the asset base.

Envestra submitted the annual change in the March quarter CPI to adjust the regulatory asset base for inflation over the current regulatory period. Envestra believes that its approach maintains consistency with the way prices have been adjusted over the regulatory period and makes all necessary adjustments for forecasts of CPI used by the Authority.

The Authority has adjusted the asset base for inflation using the annual change in the June quarter CPI. The Authority did not explain the rationale for using this inflation measure, but presumably it considers this measure to be consistent with the forecast of inflation used in its 2001 Final Decision.

In deciding on the appropriate measure of inflation, thought must be given to the underlying reason for adjusting the value of the regulatory asset base for inflation over time. Such adjustments are undertaken in order to be consistent with the principle of financial capital maintenance underpinning the Code. Under this principle, the value of the asset base is to be maintained in real terms, less any amount returned to investors through depreciation.

The Authority in its 2001 Final Decision applied a DORC methodology to establish a value of Envestra's regulatory asset base. This value was then adjusted by a forecast of inflation of 2.5% through to the end of the current regulatory period. In order to adhere to the principle of financial capital maintenance, the Authority must ensure that the asset base is adjusted to reflect actual inflation since the DORC was established.

The Authority's proposed treatment of inflation has not sought to adjust the forecast of inflation for all years since the DORC was established. This has led to a reduction in the value of Envestra's asset base given actual inflation was higher than that forecast by the Authority. Envestra believes that failing to make this adjustment is not consistent with the principle of financial capital maintenance.

Envestra therefore believes that its approach to applying inflation should be adopted by the Authority given that its application maintains the financial value of the asset base. Envestra also believes that inflation risk is further reduced by ensuring that the application of inflation to adjust the value of the asset base is consistent with that used to adjust prices.

If the Authority maintains its approach of applying the June quarter CPI, then Envestra is of the view that the financial value of capital must be maintained. This would require adjusting all forecasts of CPI for actual outcomes. To do otherwise would erode the value of the asset base initially established by the Authority in its 2001 Final Decision.

Depreciation

The Authority has indicated in its Draft Decision that the regulatory asset base should be adjusted to reflect the benchmark depreciation provided for in its 2001 Final Decision, adjusted for actual inflation. The Authority correctly points out that this approach is consistent with the requirements of the gas Code and the approach proposed by Envestra.

However, the Authority has since advised Envestra that it has not correctly undertaken this adjustment in its Draft Decision. Envestra has set out below its understanding of how the Authority intends to adjust the benchmark depreciation from the 2001 Final Decision for actual inflation. Envestra's depreciation amounts utilise the March quarter CPI inflation index, as discussed above.

Benchmark Depreciation, 2001/02 to 2005/06 (\$m, nominal)

	2001/02	2002/03	2003/04	2004/05	2005/06
Authority 2001 Final Decision	4.8	5.2	5.6	6.0	6.4
Adjusted Benchmark	5.0	5.2	5.7	6.0	6.4

Capital expenditure

The Authority has stated its desire to use gross capital expenditure to roll forward the regulatory asset base. However, the Authority has only included net capital expenditure in rolling forward the regulatory asset base, which is consistent with Envestra's proposal but against the intent of the Authority. As discussed further under section 5.4 (Amendment 11.3), Envestra disagrees with the Authority's proposal to include gross capital expenditure in the regulatory asset base.

Envestra has also submitted further information to the Authority in support of its forecast capital expenditure for 2005/06 (as requested by the Authority in its Draft Decision). Envestra has therefore maintained its proposed capital expenditure for the purpose of rolling forward the asset base over the current period.

Summary

Given the above, Envestra has calculated the roll forward of the asset base in the below table.

Envestra Roll-forward of the Capital Base 2001/02 to 2005/06 (\$m, nominal)

	2001/02	2002/03	2003/04	2004/05	2005/06
Opening Asset Value	180.20	194.59	203.00	213.94	222.21
Plus 50% of net capital expenditure	4.23	3.94	4.77	4.98	7.32
Less 50% Depreciation	-2.48	-2.61	-2.83	-2.98	-3.20
Plus Escalation	10.90	5.76	7.05	4.28	5.34
Plus 50% of capital expenditure	4.23	3.94	4.77	4.98	7.32
Less 50% Depreciation	-2.48	-2.61	-2.83	-2.98	-3.20
Closing Asset Value	194.59	203.00	213.94	222.21	235.80

5.3 Forecast New Facilities Investment

Amendment 11.2

In order for Envestra's access arrangement to be approved, Envestra must amend its forecast capital expenditure for the five years of the next access arrangement period in accordance with Table 11.10. Envestra must also provide the additional information requested by the Authority.

The Authority has indicated that further information needed to be provided by Envestra in a number of areas if the proposed forecasts are to be given consideration:

- SCADA;
- Major projects (in forecast period);
- Mains replacement;
- Periodical meter changes; and
- Information technology.

The above information was supplied on 16 February 2006. The information provided supports Envestra's view that the forecasts set out in the Access Arrangement Information comply with the Code.

Envestra also supplied information that supported the unit rates it has proposed for the forecast period in relation to capital expenditure. As indicated by WorleyParsons, Envestra submits that the unit rates used for its forecasts are appropriate and within a reasonable range for the Queensland environment.

Envestra advises that it has amended its forecast New Facilities Investment (see table below) to be consistent with the MMA forecasts for Tariff V customer (see reply to Amendment 14).

TARIFF V CONNECTION FORECASTS	2006/07	2007/08	2008/09	2009/10	2010/11	TOTAL
Gross New Domestic Connections	1,903	2,198	2,250	2,303	2,358	11,012
Forecast Disconnections	-494	-505	-517	-529	-541	-2,586
Net New Domestic Connections	1,409	1,693	1,733	1,774	1,817	8,426

Gross New I&C Connections	242	212	164	171	164	953
Forecast Disconnections	-40	-40	-40	-40	-40	-200
Net New I&C Connections	202	172	124	131	124	753

NEW FACILITIES INVESTMENT FORECASTS (\$m nominal)	2006/07	2007/08	2008/09	2009/10	2010/11	TOTAL
Mains	10.9	11.1	12.0	11.8	12.2	58.0
Inlets	2.8	3.1	3.6	3.3	4.0	16.9
Meters	2.2	2.4	2.7	2.5	2.9	12.7
Telemetry	0.2	0.2	0.2	0.2	0.2	1.0
IT Systems	1.0	0.1	5.7	-	0.1	6.9
Other Distribution System Equipment	0.4	0.5	0.5	0.5	0.5	2.3
Other	0.4	0.4	0.4	0.4	0.4	2.0
TOTAL	17.9	17.7	25.1	18.7	20.4	99.8

5.4 Capital Contributions

Amendment 11.3

In order for Envestra's access arrangement to be approved, Envestra must:

- provide gross capital expenditure forecasts, which include capital contributions; and
- deduct capital contributions from their revenue requirement in the years in which they are expected to be received.

In addition to the above amendment, the Authority has made other amendments which also relate to capital contributions, namely Amendments 13.3 and 15.1. The rationale for these amendments appears on pages 48, 53 and 65 of the Authority's its Draft Decision:

"The Authority has accepted Envestra's disclosed level of capital contributions over the current access period. It has also accepted this figure as a reasonable forecast for capital contributions for the next access period. Because Envestra provided no forecasts of capital contributions at the time of the last review, both past and forecast capital contributions have been deducted from Envestra's revenues over the next access period and not from the asset base as Envestra proposed. Differences between forecast and actual capital contributions over the next access period will also be adjusted at the next review." [p48]

"Envestra has reported the receipt of capital contributions during the current access period. No forecasts of capital contributions were provided during the approval process for the current access arrangement.

In accounting for capital contributions from customers, these amounts can either be removed from the capital base or the contribution can be subtracted from revenues. Removing capital contributions from the capital base creates an ongoing administrative burden as these assets must be separately identified and managed throughout their productive lives. Unless there is a need to keep track of these contributions, it is far simpler to offset them against revenue and leave the capital base intact. This is the approach adopted by the Authority in its electricity distribution decisions.

Had forecasts of capital contributions been provided at the start of the current access period, the Authority would have required that these be deducted from the revenue, for the reasons noted above. To avoid this group of assets having to be separately tracked over their economic lives, the Authority proposes that these past capital contributions be offset against revenue in the next access period, rather than removed from the capital base. This approach is consistent with the Authority's preferred approach for handling capital contributions in the future. This adjustment is included in Chapter 15." [p53]

"As explained for past capital contributions, the effect will be neutral over the life of the assets, but the capital base will not have to be partitioned into 'normal' assets earning a return on investment and contributed assets which would not earn a return." [p65]

The factors that resulted in the Authority arriving at its decision can be summarized as:

- 1) If forecasts of capital contributions were provided for the 2001/02 – 2005/06 period then they would have been offset against revenue;
- 2) It reduces the administrative burden of separately tracking capital contributions and other items of capital expenditure;
- 3) It is simpler to offset against revenue than remove from the capital base;
- 4) The Authority's approach is net present value neutral over the life of the assets;
- 5) The view that there is discretion available to the Regulator to deal with capital contributions; and
- 6) Offsetting capital contributions against revenue is consistent with the method used in electricity distribution regulatory decisions the Authority has presided over in the past.

Envestra's response to amendments 11.3 and 15.1 can therefore be split into two categories:

- i) Economic issues, which deals with items 1- 4 above, amongst others; and
- ii) Legal issues that address items 5 and 6 above.

Economic Issues associated with Amendments 11.3, 13.3 and 15.1

The New Facilities Investment forecasts proposed by Envestra for the 2001/02 – 2005/06 Access Arrangement period excluded forecasts of capital contributions for two reasons:

- a) Capital contributions are extremely difficult to forecast because they relate to a small number of specific projects that, in the overwhelming majority of cases, are not known prior to the commencement of an Access Arrangement Period; and
- b) Envestra's intention to only include prudent New Facilities Investment (as per section 8.16 of the Access Code) into the capital base for use in determining Reference Tariffs. Capital contributions, by definition, represent the "non-prudent" portion of New Facilities Investment. Hence, forecasts proposed by Envestra for the 2001/02 – 2005/06 period represented the net New Facilities Investment forecasts (i.e. gross New Facilities Investment *minus* capital contributions = net New Facilities Investment).

The proposed 2005/06 – 2010/11 Access Arrangement provides forecasts of net New Facilities Investment that are rolled into the capital base and used in determining Reference Tariffs. This is the correct method for dealing with capital contributions. It is the same as was used in the 2001/02 – 2005/06 Access Arrangement, it is consistent with the Access Code and is well supported by regulatory precedent in NSW, ACT and Victoria.

The proposition put forward by the Authority that the administrative burden of separately tracking capital contributions and other items of capital expenditure would be reduced if Amendments 11.3, 13.3 and 15.1 were implemented would not eventuate on three accounts. The first is that under the post-tax approach to regulation used by the Authority capital contributions are an input to the cost of tax calculation. If for no other reason this requires Envestra to separately track the capital contributions in order to provide base level data to use in Access Arrangement forecasting process. Secondly, the regulatory financial statements produced by Envestra each year, in accordance with the Authority's *General Accounting Guidelines for Gas Distribution Network Service Providers* (Version 2.0), require capital contributions to be accounted for separately from other items of New Facilities Investment.

Thirdly, the Authority stated in the Draft Decision that differences between forecast and actual capital contributions would be adjusted at the next Access Arrangement review. Envestra's understanding is that there would be two adjustments based on the difference between actual and forecast capital contributions, one against the building block revenue (as illustrated in Table 15.2 of the Draft Decision) and the other in the retrospective tax adjustments proposed in Amendment 13.3.

"Differences between forecast and actual capital contributions over the next access period will also be adjusted at the next review" [p48]

"...the Authority requires Envestra to include in its access arrangement provision to allow an adjustment to be made at the end of the access arrangement period to correct the calculation of tax, based on actual information provided in Envestra's annual regulatory accounts." [p104]

Given the Authority's post-tax approach and the *General Accounting Guidelines for Gas Distribution Network Service Providers* (Version 2.0) there is no additional accounting burden for separately tracking capital contributions.

With all of the complexities associated with the regulatory regime and the multitude of calculations necessary to derive building block revenue and price paths, Envestra does not agree with the Authority's

assertion that *it is simpler to offset against revenue than remove from capital base*. Adding net New Facilities Investment to the capital base (which is equivalent to adding gross New Facilities Investment and deducting capital contributions) is, in our opinion simpler, and certainly no more difficult, than deducting capital contributions from revenue. Furthermore, deducting capital contributions from the revenue requirement in the years in which they are expected to be received distorts Reference Tariffs and causes significant cross-subsidy issues. This point is illustrated in the following example:

Example: Cross Subsidies & Capital Contributions under the Authority's Approach

There are approximately 76,000 consumers connected to the gas distribution network in Queensland and one new Tariff D User (call them 'Customer X') wants to connect but the economic feasibility test indicates that a capital contribution \$760,000 is required to allow the Reference Tariff to recover the associated Non-Capital Costs and net New Facilities Investment rolled into the capital base.

If Envestra were to derive Reference Tariffs according to the Authority's intended approach by deducting capital contributions from the revenue requirement then in the year Customer X connects all consumers would pay \$10 less in Reference Tariffs (ie. $\$760,000 \div 76,000 = \10 per consumer) than is otherwise indicated by the cost reflective building block revenue. The effect is that Reference Tariffs are not cost reflective and that Customer X is cross subsidizing all other consumers. This is contrary to the requirements of Section 8.1 of the Access Code.

In contrast, Envestra's proposal to roll net New Facilities Investment into the capital base does not distort Reference Tariffs because all of the 76,000 consumers pay their respective share of the prudent costs included in the building block revenue. There is no cross subsidy from Customer X that lowers the Reference Tariff below what is required to recover the building block revenue. Customer X bears the cost of the non-prudent portion of New Facilities Investment (ie. the capital contribution) with the prudent portion of New Facilities Investment recovered in Reference Tariffs over the life of the asset. This method is consistent with the requirements of Section 8.1 of the Access Code

Envestra's analysis indicates that the method the Authority used to calculate the capital contribution deduction from the building block revenue over the 2006/07 – 2010/11 period is not neutral in present value terms and will lead to a significant under recovery of revenue. For example, the method used by the Authority to determine the 2001/02-2005/06 capital contributions that are deducted from the 2006/07-2010/11 cost reflective revenue stream uses a nominal weighted average cost of capital and a nominal capital value, which double counts inflation to the detriment of the business.

The other negative impact of the deducting capital contributions from revenue in the year they are forecast to occur is that the revenue stream become more volatile because it is leveraged to the actual capital contributions that are received. If the forecast capital contribution revenue does not eventuate then returns to equity will suffer (and vice versa). Thus, given the uncertainty associated with forecasting capital contributions, adoption of the approach recommended by the Authority is more likely to result in Envestra under-recovering or over-recovering revenue at some point during the Access Arrangement period.

In summary, Envestra's proposal to incorporate net New Facilities Investment into the capital base is:

- Consistent with the 2001/02-2005/06 Access Arrangement;
- Simple;
- Supported by regulatory precedent;
- Not an additional administrative burden;
- Not going to distort Reference Tariffs; and
- Consistent with the Access Code.

Legal Issues associated with amendments 11.3 and 15.1

Envestra submits that in reaching its decision in relation to the treatment of capital contributions, the Authority has not correctly applied the provisions of the Code.

Section 8 of the Code provides methods for the derivation of Total Revenue, but does not provide the Authority with any power to make adjustments to that figure once it has been calculated in accordance with section 8. The methodology used by Envestra is the Cost of Service Approach. Under that methodology Total Revenue is "*equal to the cost of providing all Services (some of which may be the forecast of such costs), and with this cost to be calculated on the basis of:*

- (a) *a return (**Rate of Return**) on the value of the capital assets that form the Covered Pipeline or are otherwise used to provide Services (**Capital Base**);*
- (b) *depreciation of the Capital Base (**Depreciation**); and*
- (c) *the operating, maintenance and other non-capital costs incurred in providing all Services (**non-Capital Costs**)."*

There is nothing in the Code which suggests that once the Total Revenue figure has been derived by application of the Cost of Service Approach it may then be further modified. The Code does not permit the Authority to subtract capital contributions, or any other amounts, from Total Revenue.

To the extent that the Code refers to customer capital contributions, it treats them as a matter relevant to establishing the amount of New Facilities Investment to be included in the Capital Base.

Section 8.23 of the Code provides:

*"New Facilities Investment may also be added to the Capital Base when a User makes a Capital Contribution (as defined below) in respect of a New Facility. Nothing in this Code prevents a User agreeing to pay the Service Provider a Charge which exceeds the Charge that would apply under a Reference Tariff for a Reference Service (or, in relation to another Service, under the Equivalent Tariff) in any circumstance including, without limitation, if the excess is paid in respect of the funding of a New Facility (in which case the extra payment is a **Capital Contribution**)."*

Section 8.24 of the Code provides:

"Any expenditure on a New Facility in respect of which a User makes a Capital Contribution constitutes New Facilities Investment incurred by the Service Provider for the purposes of this section 8. The User's obligations to the Service Provider and the Service Provider's obligations to the User with respect to the Capital Contribution shall be as agreed between the Service Provider and User."

Clause 8.24 states that expenditure on a New Facility funded by a capital contribution is New Facilities Investment, which is, as section 8.23 provides, a component of the Capital Base.

Every reference in the Access Code to capital contributions treats them as a matter relevant to determining the quantum of New Facilities Investment (and, in turn, the quantum of the Capital Base). There is no reference in the Access Code to the Total Revenue figure (once derived) being adjusted by the amount of customer capital contributions.

For the Authority to make such an adjustment to Total Revenue it commits a similar error of law to that made by the ACCC and subject to successful appeal in the *Application by GasNet Australia (Operations) Pty Ltd*¹⁷,

¹⁷ [2003] ACompT 6.

where the ACCC adjusted the capital asset pricing model, in a manner not contemplated by the Access Code, to derive a result which the ACCC considered preferable.

Envestra notes that the Authority has, in reaching its decision, relied on the approach it has taken in electricity decisions. However, the National Electricity Code/Rules differs from the Code in respect of its treatment of customer capital contributions.

Clause 6.15.2 of the National Electricity Rules provides:

"In relation to capital contributions, prepayments and financial guarantees:

- (a) the Distribution Network Service Provider is not entitled to receive any asset related cost component of the aggregate annual revenue requirement for assets provided by Distribution Network Users;*
- (b) the Distribution Network Service Provider may receive a capital contribution, prepayment and/or financial guarantee up to the future aggregate annual revenue requirement for any new assets installed as part of a new connection or modification to an existing connection, including any augmentation to the distribution network;*
- (c) where assets have been the subject of a contribution or prepayment, the Distribution Network Service Provider must amend the aggregate annual revenue requirement; and*
- (d) the asset categories referred to in clause 6.13.3 must not incorporate the asset related cost components of the aggregate annual revenue requirement for any asset category covered by clause 6.15.2 and the Distribution Network Users who use any such asset together as a group are to pay less for the ongoing use of that asset category than they otherwise would have paid."*

The Access Code contains no equivalent provisions.

Even if, contrary to Envestra's view, the Access Code did permit capital contributions to be deducted from either the Total Revenue figure or the quantum of New Facilities Investment, the decision as to whether the contributions are deducted from Total Revenue or New Facilities Investment is Envestra's. It is not within the power of the Authority to direct Envestra as to which methodology to use upon the grounds of administrative convenience. As stated by the Australian Competition Tribunal in *Application by GasNet Australia (Operations) Pty Ltd*: "The choices available under the Code are for the Service Provider to make, subject only to the limitation that the implementation of the choice must be consistent with the principles contained in s 8 of the Code." Nothing in the Authority's decision suggests that Envestra's proposed approach is inconsistent with section 8 of the Code – the reasoning put forward for the Authority's approach is to relieve "ongoing administrative burden." Administrative convenience is not, under the Access Code, a permitted basis upon which the Authority may rely in making a decision (that is, it is not listed in section 8 as a factor the Authority may take into account in reaching its decision).

The Authority's rationale for its decision – to avoid an "ongoing administrative burden" - suggests that the Authority considers that Total Revenue will be the same irrespective of whether the contributions are subtracted from Total Revenue or the Capital Base. Envestra notes that this is incorrect. In fact, the Authority's approach results in Total Revenue being lower than it would be if capital contributions were subtracted from the Capital Base. This follows from the fact that, under the "Cost of Service" approach to deriving Total Revenue, only a percentage of the Capital Base (namely a percentage rate of return on the Capital Base less a percentage of the Capital Base for depreciation) is incorporated into Total Revenue, as opposed to the total of the Capital Base.

In summary Envestra considers that the Authority's decision to subtract customer capital contributions from Total Revenue, rather than the Capital Base, is an error of law as the Authority is not permitted by the

Code to make adjustments to Total Revenue. If such contributions are to be deducted, they must be deducted from the Capital Base.

5.5 Redundant Capital

Amendment 11.4

For Envestra's access arrangement to be approved, Envestra must include a capital redundancy mechanism in its reference tariff policy as per its current access arrangement.

As discussed in information provided to the Authority on 16 February 2006, Envestra believes the level of redundant assets in a network is not material, and that the Authority should conclude that the costs of implementing a redundancy policy outweigh the benefits.

5.6 Forecast Depreciation

Amendment 11.5

In order for Envestra's access arrangement to be approved, Envestra must amend its forecast depreciation must be amended in accordance with Table 11.12.

The Authority in its Draft Decision rejected Envestra's proposed deferral of depreciation over the second Access Arrangement period. Instead, the Authority requires Envestra to increase its depreciation allowances to reflect those that would prevail under the normal application of a straight-line approach to calculating depreciation.

The Authority has stated in its Draft Decision that it did not consider that a deferral of depreciation was necessary in practice given the price paths it set in the Draft Decision. The Authority also noted that it does not agree with deferred depreciation (referred to by Envestra as economic depreciation) in principle.

Envestra can understand the Authority's position given the price paths set out in the Draft Decision. However, for the reasons set out in this submission, Envestra considers that the Authority's price paths should not apply in the Final Decision, but should increase to levels closer to that submitted by Envestra.

Envestra believes that economic depreciation is an important mechanism to reduce prices over the long term by encouraging increased network utilisation over the second Access Arrangement period. As stated in the submitted Access Arrangement Information, prices are currently higher than should otherwise apply due to relatively low gas sales in Queensland.

Envestra is undertaking a range of initiatives aimed at increasing sales of gas to its Queensland customers. Such programs would be supported by a reduction in prices over the short term relative to levels that would otherwise apply. Such initiatives, by supporting increased growth in sales, will result in lower prices to consumers over the long term.¹⁸

Envestra also noted in its submitted Access Arrangement Information that the current stay in business capital expenditure is unusually high due to the need to replace cast iron and steel mains. The drop in this expenditure in future periods will accommodate the recovery of the deferred depreciation in future periods without resulting in a price shock to consumers (compounded by the impact of expected higher sales on unit prices).

Importantly, consumers will be better off by Envestra's proposed treatment of depreciation. Envestra solely bears the risk of not being able to recover the deferred depreciation in future periods if market

¹⁸ This is because fixed costs are spread over higher volumes, resulting in lower unit prices to consumers.

circumstances are such that to do so would not be in the best interests of either consumers or the business.

The Code supports Envestra proposed treatment of depreciation over the second Access Arrangement period. In particular, section 8.33 of the gas Code specifies that the depreciation schedule should be designed to result in a reference tariff changing over time in a manner that is consistent with the efficient growth of the market for services.

Therefore, Envestra considers that economic depreciation is required to maintain the price path to be no higher than CPI + 2% over the second Access Arrangement period. Where the proposed price path is less than this, then Envestra agrees with the position of the Authority that economic depreciation is not required.

5.7 Forecast Inflation Rate

Amendment 11.6

In order for Envestra's access arrangement to be approved, Envestra must adjust its expected inflation rate to 2.77 percent over the access arrangement period.

The Authority has implemented the standard regulatory approach to forecasting inflation. The liquidity of the Commonwealth Indexed Bond market can result in volatile estimates of inflation under this method. We note that since 1993 when the Reserve Bank started targeting the 2-3 percent range for inflation it has averaged close to 2.5 percent per annum (excluding GST). The 2.77 percent outcome is within the range proposed by Envestra and can be accepted.

5.8 Roll Forward Calculation

Amendment 11.7

In order for Envestra's access arrangement to be approved, Envestra must amend its roll forward of the capital base for the five years of the access arrangement period must be amended in accordance with Table 11.13.

Envestra has calculated the roll forward of the asset base over the second Access Arrangement period on the basis of the views expressed earlier in this submission.

**Envestra Roll-forward of the Capital Base
2006/07 to 2010/11 (\$m, nominal)**

	2006/07	2007/08	2008/09	2009/10	2010/11
Opening Asset Value	235.80	257.00	278.29	307.24	330.03
Plus 50% of net capital expenditure	8.96	8.86	12.55	9.33	10.18
Less 50% Depreciation	-1.41	-1.52	-1.69	-1.87	-1.99
Plus Escalation	6.08	6.61	7.23	7.87	8.46
Plus 50% of capital expenditure	8.96	8.86	12.55	9.33	10.18
Less 50% Depreciation	-1.41	-1.52	-1.69	-1.87	-1.99
Closing Asset Value	257.00	278.29	307.24	330.03	354.86

6. Rate of Return

6.1 Gamma Used for Tax Calculation

Amendment 12.1

In order for Envestra's access arrangement to be approved, Envestra must amend its value for gamma to 0.5.

The Authority calculates Envestra's revenue requirement using a post-tax rate of return. When the post-tax approach is used gamma is only relevant for the calculation of the tax benchmark. That is, gamma is not a rate of return issue.

Australian regulators have generally adopted a value for imputation credits (gamma or γ) of 0.5, based on the 1999 study by Hathaway and Officer¹⁹, which estimated gamma at close to 0.50²⁰. However, Hathaway and Officer updated that study in 2004 with the estimate of gamma revised to between 0.28 and 0.36²¹, which calls into question the validity of the use of 0.5 for gamma in regulatory decisions.

Envestra proposed a value for imputation credits in the range of zero to 0.35 based on an extensive analysis of Australian Tax Office data, Australian Bureau of Statistics data, empirical research and tenets in economics that underpin the theory of equilibrium and the way prices are determined in competitive markets. Following the review of our analysis by Professor Lally the plausible range for gamma has been re-estimated to be between zero and 0.4. As outlined by the Authority a number of the recent regulatory decisions under the Code have incorporated a value for gamma that overlaps that which has been proposed by Envestra.

Regulator	Value of Imputation Credits
IPART – AGLGN April 2005	0.3 – 0.5
ICRC – ActewAGL October 2004	0.3 – 0.5
ERA – Alinta July 2005	0.3 – 0.6

The gamma of 0.35 proposed in Envestra's submission, and subsequently revised upwards to 0.4, is within the reasonable range determined by Regulators in other jurisdictions, is justified by Hathaway and Officer's empirical analysis, and a relevant consideration in this Access Arrangement review.

The Authority engaged Professor Martin Lally to review Envestra's submission on the valuation of imputation credits. Professor Lally argued that Envestra's analysis was 'flawed' in five areas. A response that addresses Professor Lally's concerns has been prepared and is attached in Appendix A

In summary, Envestra agreed with some of Professor Lally's comments and disagreed with others. Professor Lally seemed to focus on the role of average investors, and assessments of an average value for gamma, rather than the role of the marginal investor and the pricing implications that flow from that. It is the marginal investor that sets the value of gamma rather than some average of investors. This is how competitive markets work, for example the price of electricity in the National Electricity Market is set by the intersection of the demand and supply curves leading to a price at the margin rather than one that reflects some average of demand and/or supply.

The averaging of tax positions is an outcome of a post-personal tax view of the CAPM, an approach that has not been adopted by the Authority or other Australian regulators and one that is not well supported by

¹⁹ Hathaway, N. and R.R. Officer (1999), *The Value of Imputation Tax Credits*, Unpublished Manuscript, Graduate School of Management, University of Melbourne.

²⁰ Economic Regulation Authority, *Final Decision on the Proposed Revisions to the Access Arrangement for the Mid-West and South-West Gas Distribution Systems*, 12 July 2005, p227-8

²¹ Hathaway, Neville and Officer, Bob (2004), *The Value of Imputation Tax Credits: Update 2004*, Capital Research Pty Ltd, p.8.

empirical evidence. In addition a post-personal tax CAPM would need to include an adjustment for capital gains tax - an offset to the value of imputation credits. Hence, the views put forward by Professor Lally have not substantially changed Envestra's position on the value of gamma. We reiterate that a gamma in the range of zero to 0.4 is reasonable and supported by the empirical evidence.

6.2 Forecast Inflation

Amendment 12.2

In order for Envestra's access arrangement to be approved, Envestra must adjust its measure of forecast inflation to 2.77 percent.

This issue has been addressed under section 5.7 (response to Amendment 11.6).

7. Non-Capital Costs

7.1 Various Non-Capital Costs

Amendment 13.1

In order for Envestra's access arrangement to be approved, Envestra must amend its forecast non-capital costs (excluding UAG and cost of tax) over the next regulatory period in accordance with Table 13.4.

The Authority required Envestra to provide further information to justify the cost of self insurance. This information was provided to the Authority on 16 February 2006.

Material Changes

On page 99 of the Decision, the Authority indicated that ECG was not able to obtain sufficient information regarding many of the "other material changes". Additional information was subsequently supplied to the Authority on 16 February 2006.

Change in Capitalisation - Piecemeal Repairs

Additional information on this issue was provided to the Authority on 16 February 2006.

Network Development

Envestra accepts the Authority's proposal in relation to Network Development.

UAFG

Envestra's response in relation to UAFG is contained in section 7.2.

Overall Non-Capital Costs

Taking into account the above, Envestra has set out its forecast of Non-Capital cost in the following table.

NON-CAPITAL COST FORECAST (\$m nominal)	06/07	07/08	08/09	1011	11/12
O&M and UAFG	11.9	12.0	11.8	12.3	12.3
Admin and General	1.8	1.9	2.3	2.4	2.5
Network Development	0.9	1.0	1.0	1.0	1.1
Material Changes	3.7	3.4	3.4	3.0	2.9
TOTAL (\$m nominal)	18.3	18.2	18.6	18.6	18.7

7.2 UAFG

Amendment 13.2

In order for Envestra's access arrangement to be approved, Envestra must amend its forecast UAG over the next regulatory period in accordance with Table 13.4

The relevant table in the Authority's Draft Decision, which sets out the forecast cost of UAFG, is set out below.

	2006/7	2007/8	2008/9	2009/10	2010/11
Total (\$m, nominal)	1.33	1.40	1.49	1.39	1.49

Based on other information provided in the Draft Decision, and on information provided to the Authority by Envestra, it appears that the UAFG expenditure set out in Table 13.4 may have been derived as follows:

	2006/7	2007/8	2008/9	2009/10	2010/11
UAFG Volume					
Price		CONFIDENTIAL			
UAFG Cost					

It is clear that the price provided by Envestra for 2009/10 is incorrect, and in fact all prices will need to be revised based on the firm competitively tendered price received for the supply of UAFG (rather than the indicative price previously advised to the Authority). But first consider the volume of UAFG.

ECG, in its report, provided a forecast of the volume of UAFG based on its recommended mains replacement program "ECG considers the cost of UAFG in the forecast period that is in accordance with the Code is as per Table 8.25".

Table 8-25 provides the following forecast volumes of UAFG.

	2006/7	2007/8	2008/9	2009/10	2010/11
UAFG (TJ p.a.)	298	288	278	268	258

In the Draft Decision the Authority stated that it "has used the forecast provided by ECG but has capped the level of expenditure in any year to reflect a maximum level of loss of 4.8 per cent, the benchmark used in the 2001 Decision".

The Authority has not provided reasons why the Envestra or ECG UAFG costs are not reasonable, or why they are not efficient but has simply referred to its previous decision where it decided that the efficient benchmark was 4.8%. It has then chosen the lower of 4.8% or the level proposed by ECG as the best estimate. That is, the Authority has "cherry picked" the lowest volume for each year²². This is clearly not reasonable.

The Authority also stated in the Draft Decision that:

- It will review the benchmarks applying in other networks before the Final Decision to determine if there has been a material change;
- Envestra is required to review its UAFG information and provide the Authority with any updated numbers once it has investigated the inconsistencies raised by the Authority; and

²² Envestra notes the *Epic Decision* in which the Australian Competition Tribunal held that in determining the cost of line pipe the ACCC was in error in selecting the lowest cost line pipe. Rather than ACCC was required to use an average of the quoted costs of line pipe. Envestra submits that in picking the lowest volumes for each year the Authority is making a similar error of law to that made by the ACCC.

- The Authority also requires Envestra to provide evidence to support its claimed gas prices over the forecast period.

Envestra submits the following information in response to the Draft Decision.

Envestra has reviewed the UAFG decisions by Regulators since 2001. UAFG percentages in NSW and Western Australia were slightly reduced in the most recent decisions, while the percentages applying to the three Victoria networks increased significantly. The Albury network percentage was unchanged and in South Australia the regulator has not yet made a decision, but the amount requested by Envestra is an increase on the percentage applying in the first period. Based on the decisions of these Regulators the industry average UAFG percentage has increased.

Following receipt of the Draft Decision, Envestra has also reviewed the gas demand forecast and made a number of changes to take account of more recent information. This revised demand forecast is included in the response to Amendment 14, and needs to be taken into account when determining the allowance of UAFG

While Envestra does not agree with the method used by the Authority to determine the level of efficient UAFG costs, it would be prepared to accept the 4.8% benchmark (proposed in the Draft Decision) being applied throughout the access arrangement period.

In relation to the cost of UAFG, this was provided to the Authority in a confidential submission dated 16 February 2006.

7.3 Cost of Tax

Amendment 13.3

In order for Envestra's access arrangement to be approved, Envestra must include:

- the forecast cost of tax as outlined in Table 13.6; and
- a provision to the effect that at the end of the next access arrangement period there will be an adjustment made to reflect the actual cost of tax based on the method accepted by the Authority but using actual information.

As the Authority is aware Envestra's preference is for the pre-tax approach to WACC because it is less intrusive, less data intensive and simpler to implement. The Authority has a predilection for the post-tax approach and has required Envestra to include in its Access Arrangement a provision to adjust for the difference between the forecast and actual cost of tax using actual information contained in the annual regulatory accounts (Amendment 13.3).

The main problem Envestra sees with Amendment 13.3 is that it includes a retrospective adjustment to the Access Arrangement. Retrospective adjustments reduce the incentive properties of the regulatory regime to the long-term detriment of consumers.

Although not stated in Amendment 13.3 the Authority does appear to be open to a proposal whereby the adjustment for the difference between the forecast and actual cost of tax would not be required.

Either the service providers need to put forward very robust tax forecasts for the Queensland regulated business which the Authority would be prepared to accept on a 'set and forget' basis or an adjustment mechanism needs to be included, that is clearly enforceable, along with less robust tax forecasts. [p104]

The method proposed by Envestra in its Access Arrangement to forecast cost of tax has been described in detail and is consistent with that used by the Essential Services Commission of Victoria in its electricity and gas price reviews since 2000. As this method uses parameter inputs that are consistent with the regulatory determination Envestra considers it a robust *ex ante* cost of tax forecasting methodology. Furthermore, following discussions with the Authority it became apparent that both Envestra and the Authority calculate the cost of tax (or Forecast Regulatory Tax) in an equivalent manner. Different views on the value of imputation credits cause the outcomes to differ.

This being the case it is submitted that the cost of tax methodology proposed by Envestra is robust. Subject to inputs to the cost of tax calculation being consistent with the rest of the Access Arrangement, the Authority can do away with the requirement to adjust for the difference between the forecast and actual cost of tax using actual information contained in the annual regulatory accounts. This approach would preserve the incentive properties of the regulatory regime in Queensland.

However, should the Authority insist on Amendment 13.3 as it currently stands, it must be implemented in a manner that does not unfairly penalise Envestra. The main issue here is that which occurred in the current Access Arrangement Period, where aggressive demand forecasts were imposed upon Envestra. The forecast demand did not eventuate and a revenue shortfall of \$3.2 million resulted. Holding all else constant, this revenue shortfall would translate into a reduction in the cost of tax for the 2001/02-2005/06 period of \$0.5 million²³ ($\$3.2\text{m} \times 30\% \text{ tax rate} \times 0.5 \text{ gamma} = \0.5m). If the same outcome occurred in the 2006/07-2010/11 period then Amendment 13.3 as it is currently written would seek to reduce the revenue for the 2011/12-2016/17 period by \$0.5 million. So not only would shareholders have to suffer the \$3.2 million revenue shortfall in 2006/07-2010/11²⁴ but an additional \$0.5 million would be stripped from the 2011/12-2016/17 revenue. In this circumstance consumers enjoy windfall gains in the form of lower than required tariffs (as was the case for the current Access Arrangement period), whilst the business is unable to earn the target return on equity. This is unfair, not reasonable and biased towards consumers.

To remedy this Envestra proposes that should the Authority require a tax adjustment in the next regulatory period the adjustment for the difference between the forecast and actual cost of tax include a factor that neutralizes the effect of over-estimated demand, will work with the Authority prior to final approval of the Access Arrangement to find a suitable solution. However, Envestra reiterates that its preference is for a "set and forget" approach, for the reasons outlined above.

8. Gas Demand Forecasts

Amendment 14

In order for Envestra's access arrangement to be approved, Envestra must adjust its gas demand forecasts, and hence the reference tariffs, to reflect MMA's forecasts for demand customers (see Table 14.4).

The Authority has accepted the forecasts proposed by Envestra in September 2005 for Tariff V market segment. Ordinarily Envestra would not dispute this outcome. However, the forecasts of demand for the Tariff V market proposed by Envestra in September 2005 were formulated:

- Without knowledge of the Sustainable Housing Policy. The Queensland Government has subsequently banned standard electric hot water systems in new homes, in favour of solar, gas or electric heat pump systems, which use significantly less energy²⁵. Envestra's demand forecasts had been finalized prior to the 2 August 2005 announcement date of that policy.

²³ This is for the purposes of this example; the exact number has not been calculated.

²⁴ Under the Authority's view a \$0.5m reduction in the value of imputation credits would also be loss to shareholders over the 2006/07-2010/11 period.

²⁵ The Courier Mail, *Electric hot water units outlawed from 2006*, 3 August 2005

- Assuming an additional network development allowance of \$1.15 million in 2006/07 escalating to \$1.5 million in 2010/11 being included in the Non-Capital Costs. This extra network development expenditure was targeted at specific Tariff V consumers and was expected to add 7,200 new domestic connections and an extra 2,000 hot water services to “cooker-only” users. This was forecast to increase demand by 111 TJ over the Access Arrangement Period.

As the Authority has not provided the full amount of the additional marketing allowance and Envestra did not incorporate the impact of the Sustainable Housing Policy, the demand forecasts proposed in September 2005 cannot now be considered best estimates. Hence they do not satisfy the requirements of section 8.2(e) of the Code and cannot be used in the Access Arrangement.

Envestra has reviewed the Tariff V demand forecasts generated by the Authority’s advisor McLennan Magasanik Associates (‘MMA’). Envestra believes that MMA has given due consideration to the drivers, the approved network development allowance, the Sustainable Housing Policy and other issues specific to the Queensland market for natural gas. Moreover, the MMA forecasts would appear to be more consistent with the expectations of Origin Energy, as outlined in its submission to the Authority. As such Envestra is of the view that the MMA forecasts for the Tariff V market satisfy the requirements of section 8.2(e) of the Code and can be used in the Access Arrangement. These forecasts are provided in Table 14 below.

TARIFF V DEMAND FORECASTS					
Customer numbers	2006/07	2007/08	2008/09	2009/10	2010/11
Domestic	72,381	74,075	75,807	77,582	79,399
I&C	4,923	5,095	5,219	5,350	5,474
TOTAL	77,304	79,170	81,026	82,932	84,873
Volume (TJ)	2006/07	2007/08	2008/09	2009/10	2010/11
Domestic	696	696	696	698	700
I&C	1,265	1,306	1,335	1,367	1,395
TOTAL	1,961	2,002	2,031	2,065	2,095

The Authority Draft Decision required amendments to the forecasts of MDQ for demand customers is based on the analysis conducted by MMA. In summary “MMA has forecast MDQ for the demand class by forecasting changes to consumption and to the future load factor”.

“MMA has forecast consumption in the demand class to grow at 3.4 per cent per annum in the Brisbane zone and 4.3 per cent per annum in the Northern Zone” “...MMA has assumed forecast ongoing reductions in the load factor of 0.5 per cent per annum over the forecast period”.

Envestra does not accept the Draft Decision as the MMA analysis does not take account of the impact of individual new large demand customers on both the consumption and load factor data.

Load factor analysis

The load factor analysis carried out by MMA was based on data provided by Envestra which is shown in the following table.

Actual Demand: Large Industrial	2001/02	2002/03	2003/04	2004/05
<i>Maximum Daily Quantity (TJ)</i>				
Brisbane Metropolitan	8.414	8.679	9.318	10.464
Ipswich	4.288	3.996	4.669	6.004
Gladstone	0.130	0.099	0.025	0.130
Rockhampton	0.195	0.260	0.311	0.245
TOTAL - MDQ	13.027	13.034	14.323	16.843
<i>Annual Consumption (TJ)</i>				
Brisbane Metropolitan	1,812	2,038	1,986	2,214
Ipswich	833	786	883	863
Gladstone	23	15.6	12	0.0
Rockhampton	34	38	42	60
TOTAL - CONSUMPTION	2,701	2,878	2,923	3,136
<i>Number of Users by Region</i>				
Brisbane Metropolitan	41	42	43	43
Ipswich	13	13	13	14
Gladstone	1	1	1	0
Rockhampton	3	4	5	4
TOTAL - USERS	58	60	62	61

This data was then used to calculate the historical load factors which are set out below.

<i>Load factor</i>				
Brisbane Metropolitan	0.590	0.643	0.584	0.580
Ipswich	0.532	0.539	0.518	0.394
Gladstone	0.489	0.432	1.272	0.000
Rockhampton	0.475	0.398	0.369	0.666
TOTAL - USERS	0.568	0.605	0.559	0.510
Brisbane tariff zone	0.570	0.610	0.562	0.512
Northern tariff zone	0.480	0.408	0.436	0.435

Based purely on the data it is easy to understand why MMA concluded that load factor is declining. As Authority comments in the Draft Decision, "the reasons for this decline are unclear" so Envestra has reviewed the data to try and determine why the load factor declined, particularly in 2004/05.

The load factor measure used by MMA is the average daily consumption during the year, divided by the maximum daily quantity for the year. Load factors will vary if annual consumption increases or decreases without any change in MDQ, or if MDQ varies without similar movement in annual consumption. The load

factor is also impacted by the addition of a large new consumer where the full MDQ is included at year-end, but the consumer only consumes for a part of the year.

There are three specific facts that need to be taken into account when analysing the load factors:

- An MDQ of 0.13 TJ was included for Gladstone where the annual consumption was nil. Clearly if the annual consumption is nil the MDQ must also be nil. (The MDQ of 0.13 TJ was included because the customer was required under its supply contract to continue to pay the charges for a period after consumption ceased. This requirement ended in May 2005;
- MDQ of [] TJ was included in Brisbane in 2004/05 for []. This consumer operates coal fired boilers and for one or two weeks each year purchases gas while the coal fired boilers are taken out of service for maintenance. This has been occurring for many years but has previously been treated as a Volume consumer. [] pays a flat charge per gigajoule for this service as the cost of the normal demand charge would be prohibitive. The [] TJ MDQ and annual consumption of [] GJ should be removed from the Demand data as this is not the standard demand reference service; and
- An MDQ of 1.2 TJ is included in 2004/05 in Ipswich for a major new consumer, [], which commenced operation in []. Annual consumption in 2004/05 for this consumer was [] GJ but in a full year will be [] TJ. The actual MDQ up to June 2005 was 320 GJ and to December 2005 was [] GJ. It is not clear when [] will reach full production.

When adjustments are made to the historical data for each of the above three points, the adjusted load factors for the four year period are as shown in the table below. This clearly shows that load factors have been stable over the period and there is no evidence to support forecasts of future declines in load factor.

<i>Load factor</i>	01/02	02/03	03/04	04/05
Brisbane Metropolitan	0.590	0.643	0.584	0.609
Ipswich	0.532	0.539	0.518	0.471
Gladstone	0.489	0.432	1.272	0.000
Rockhampton	0.475	0.398	0.369	0.666
TOTAL - USERS	0.568	0.605	0.559	0.566
Brisbane tariff zone	0.570	0.610	0.562	0.564
Northern tariff zone	0.480	0.408	0.436	0.666

MDQ Forecasts

MMA prepared a forecast of annual demand consumption and used this, together with the load factor forecast discussed above to calculate the forecast MDQs for demand customers for the access arrangement period. The forecasts are set out in the following table.

Brisbane	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11
Consumption	3053	3167	3292	3393	3501	3601
Load factor	50.7	50.2	49.7	49.2	48.7	48.2
MDQ	10.5	17.28	18.15	18.89	19.7	20.47
Northern						
Consumption		41.3	42.9	44.5	46.0	47.6
Load factor		43.5	43.5	43.5	43.5	43.5
MDQ		0.26	0.27	0.28	0.29	0.30

If the Load factor forecast is changed to take account of the information above, then the MDQs forecast for Brisbane will reduce by 1.8 to 2.9 TJ per annum. This would reduce the MDQ significantly below the level forecast by Envestra. This clearly is not correct. The forecast prepared by MMA is based on longer term economic trends, and this does not take account of the sudden changes that can occur from time to time due to specific large consumers. In order to come up with a more reasonable forecast it is necessary to also adjust the consumption forecast, in particular to take account of new large consumers.

MMA states in its report when discussing growth in consumption:

“It also does not take into account some demand increase expected from retail contestability which has been recently introduced in the 1 to 100 TJ market”.

MMA does not provide any evidence to support this statement, Envestra operates networks in both Victoria and South Australia which have been fully contestable for a number of years. There was no noticeable increase in consumption in either state following the introduction of full retail contestability.

On the contrary, contestability has had a noticeable impact on the steps taken by large consumers to control or reduce MDQs. New retailers when attempting to gain consumers from the incumbent, will review consumption patterns and offer a more competitive tariff by reducing the MDQ. Hence Envestra's experience suggests that the introduction of contestability has no impact on consumption, but a small negative impact on MDQ.

Envestra has also reviewed the movement in MDQs for demand customers since the original forecast was prepared, which was based on data up to 30 June 2005. In the period to 31 December 2005, the actual MDQ has in total reduced from 16.74 TJ to 16.67 TJ, including the transfer of two additional consumers from Tariff V to Tariff D. This supports Envestra's original view that increases in MDQ are frequently matched by decreases by other customers.

In summary, Envestra is proposing a revised MDQ forecast for demand customers by making the following adjustments to the forecast previously submitted:

- Removing the MDQ for [] of [] TJ as this is not a demand customer using the reference service;
- Assuming that the load factor for consumers other than the two new large consumers discussed below remain stable at 56% for Brisbane and 43.5% for northern zone;
- Allowing for 2% p.a. net growth in consumption and MDQ for demand customers other than the two new large consumers; and
- Including the specific consumption and MDQ forecasts for the two large consumers ([] and []) that have recently or will shortly commence consumption of gas.

The result is the following forecast of MDQ:

	2006/07	2007/08	2008/09	2009/10	2010/11
Brisbane	17.11	17.41	17.71	18.03	18.35
Northern	.26	.27	.28	.29	.30
Total	17.37	17.68	17.99	18.32	18.65

9. Reference Tariffs and Tariff Path

Amendment 15.1

In order for Envestra's access arrangement to be approved, Envestra must revise total revenue requirements for each year of the access arrangement period to those indicated in Table 15.2.

Envestra has raised in this submission reasons why it believes the revenue requirements determined by the Authority will change from that set out in the Draft Decision. These reasons relate to different views between the Authority and Envestra on issues such as the expenditure forecasts, treatment of customer contributions and depreciation.

That aside, Envestra is concerned over the lack of transparency by the Authority in the derivation of the total revenue requirement.

The Authority has advised Envestra that it has a policy of not providing its financial models to external parties. Envestra does not consider that this policy constitutes good regulatory practice, primarily because it prevents Envestra from gaining a full understanding of the manner by which the total revenue requirement has been derived. A more transparent process would increase the robustness of the Authority's decision by allowing submissions to be based on all relevant information.

The lack of transparency also prevents Envestra from ensuring that the intent of the Authority's decision has been correctly implemented, regardless of Envestra's views on particular issues. The complexity of the modeling task increases the potential for human error in this process, which might cause significant and unwarranted financial gains/losses to Envestra or its customers.

The Authority did meet with Envestra to discuss the manner by which the total revenue requirement was modeled. This provided Envestra with a greater understanding of how the Authority arrived at its Draft Decision, but did not allow Envestra to verify the model outcomes²⁶. This discussion highlighted the differences in the manner by which total revenue was calculated.

Envestra is of the view that the methodology it has used to determine total revenue complies with section 8 of the Code. The main difference between the Authority and Envestra lies in the manner by which the post-tax nominal framework has been applied. Envestra's framework is underpinned by the assumption that all revenues and costs are incurred in the middle of each year, while the Authority assumes end of year revenues.

Envestra has provided additional support for certain aspects of its approach throughout this submission, including:

- the desire to ensure that the inflation adjustment made to roll forward the regulatory asset base in the current period is consistent with the principle of financial capital maintenance;
- the view that economic depreciation is consistent with the requirements of the Code; and
- capital contributions should not be included in the regulatory asset base.

²⁶ Given that Envestra was not provided with direct access to the Authority financial model. Discussions were therefore focused on approach rather than being directly informed by the model itself.

Envestra is concerned by the Authority's decision to adopt an approach to calculating total revenue that is different to that proposed by Envestra. In doing so, the Authority has not set out why it considers that Envestra's approach does not comply with the requirements of the Code²⁷. The approach taken by the Authority appears to contradict the underlying propose/accept or reject framework underpinning the Code.

Amendment 15.2

In order for Envestra's access arrangement to be approved, Envestra must amend:

- the weighted average price path for demand customers to CPI – 8.10 per cent over the revised access arrangement period (with a value in 2005-06 of \$540.27 per GJ of MDQ); and
- the weighted average price path for volume customers to CPI – 2.51 per cent over the revised access arrangement period (with a value in 2005-06 of \$14.85 per GJ).

The Authority requires Envestra to amend its price path proposal to include a separate price path for demand and volume customers, which is consistent with current arrangements. The price path proposed in the Draft Decision for demand customers is the annual change in the CPI less 8.1% and for volume customers it is the CPI less 2.51%.

The Authority has since advised Envestra of an error in these price paths, stating that the inflation amount of 2.77% needed to be added to the percentage reductions (otherwise referred to as X factors). The price paths for demand and volume customers become CPI-10.87% and CPI-5.28% respectively. Envestra is concerned that it is not able to determine whether the Authority has correctly calculated the price paths, or indeed whether the initial price paths were appropriate.

Envestra is also concerned with the approach taken by the Authority to set the price paths in its Draft Decision. The Authority has determined the price path by setting an average price for each customer class, from which an X factor is determined such that the total tariff revenue equals the building block revenue for each customer class. Given the use of average prices, the Authority's approach does not capture compositional shifts in demand over the regulatory period²⁸.

In contrast, Envestra's price path was based on the proposed tariffs to apply from 2006/07. Each tariff component, including fixed and variable charges, are adjusted by the proposed X factor. By using this approach, the impact of customer and volume growth has been captured. Envestra considers that this approach is as robust as that used by the Authority, and as such, complies with the Code. This issue reinforces Envestra's view that the Authority has used its own approach to setting prices without stating why Envestra's approach is not Code compliant.

That aside, Envestra has assessed the manner by which the Authority has determined the price paths to apply over the second Access Arrangement period. The Authority's price paths depend on both the allocation of the building block revenue to the volume and demand customer groups and the 2005/06 average revenue from which the price path is determined.

With regard to the former, in the next section Envestra has undertaken an analysis that shows Envestra's tariffs are cost reflective. Envestra therefore agrees with the allocation of building block revenue by the Authority if two separate price paths are to be set, which is based on current shares of total revenue recovery from tariffs.

²⁷ The Authority has decided to adopt an approach that appears to be consistent with that used in its recent electricity distribution price determination, which Envestra considers is not relevant to making a decision under the gas Code.

²⁸ That is, the Authority will not capture the impact on total revenue recovery of different growth rates in customer numbers and sales over time (but will remain fixed at 2005/06 levels).

With regard to the 2005/06 average revenues used by the Authority, Envestra has calculated the starting values using the latest forecasts of volumes and the actual tariffs. The average revenue per gigajoule of consumption for volume tariff consumers is \$13.84, and the average revenue per gigajoule of MDQ for demand consumers is \$472.87.

Amendment 15.3

In order for Envestra's access arrangement to be approved, Envestra must provide further information on the cost-reflectivity of proposed tariffs, as detailed above.

The Authority has noted in its Draft Decision that, to be economically efficient, the allocation of costs amongst customer groups should result in prices which reflect:

- at least the incremental costs associated with the provision of a service (or other users of the network would be better off if that customer was not supplied); and
- no more than the stand alone cost of providing the service (or the user could potentially bypass the network and other users would lose their contribution to fixed assets).

The Authority states that a cross subsidy exists where prices do not fall within these bounds.

The incremental cost can be thought of as the costs avoided by the distributor from not supplying an additional customer, which includes the cost of providing a meter (and the associated inlet) and reading that meter. Generally, upstream network assets are not allocated to the additional customer as it is assumed that the network is required to serve other customers on the network.

The stand alone cost on the other hand represents the total cost to the distributor of supplying a customer, as if all other customers on the network did not exist (unlike the incremental cost). This includes all network assets involved in transporting gas to that customer, along with the costs of operating the distribution network.

Envestra has assessed whether the proposed tariffs lie within the band set by incremental cost and the stand alone cost of providing reference services to domestic, commercial and small industrial and demand customers. The following revenue/cost streams were determined for the 2005/06 to 2010/11 period for each customer group:

- Average revenue (\$/GJ);²⁹
- Incremental cost (\$/GJ) of a new connection; and
- Stand alone cost (\$/GJ) of a new connection.

All assumptions used, such as the proposed price path and forecast demand, are consistent with that submitted by Envestra to the Authority as part of its Access Arrangement revisions.

Envestra has determined an incremental cost based on the cost to Envestra of connecting a new customer that has access to the gas distribution system. The costs include the cost of providing the new customer with a meter and the service from the gas mains to the customer's meter. An incremental operating expenditure amount has also been included of \$11.60 per customer³⁰.

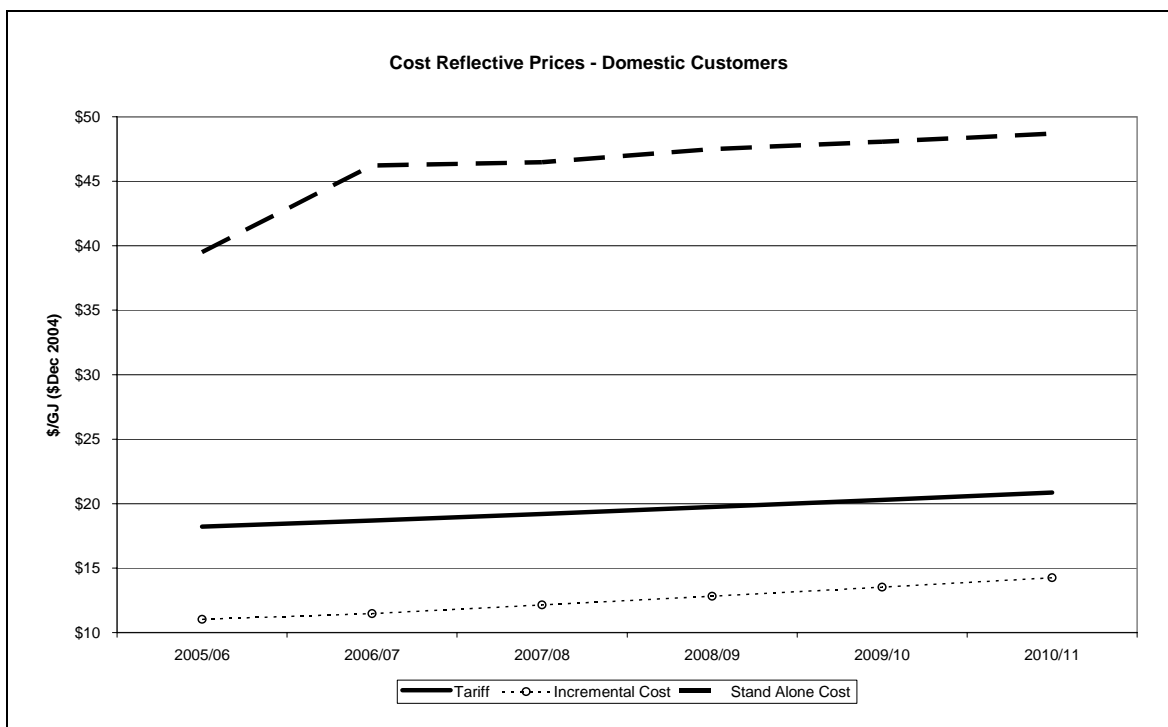
²⁹ Average consumption for each customer group is determined by dividing the total volume for each group by the total customer numbers in that group. This yields an average consumption for domestic, commercial and small industrial and demand customers of 10 GJ, 25GJ and 53,400 GJ respectively.

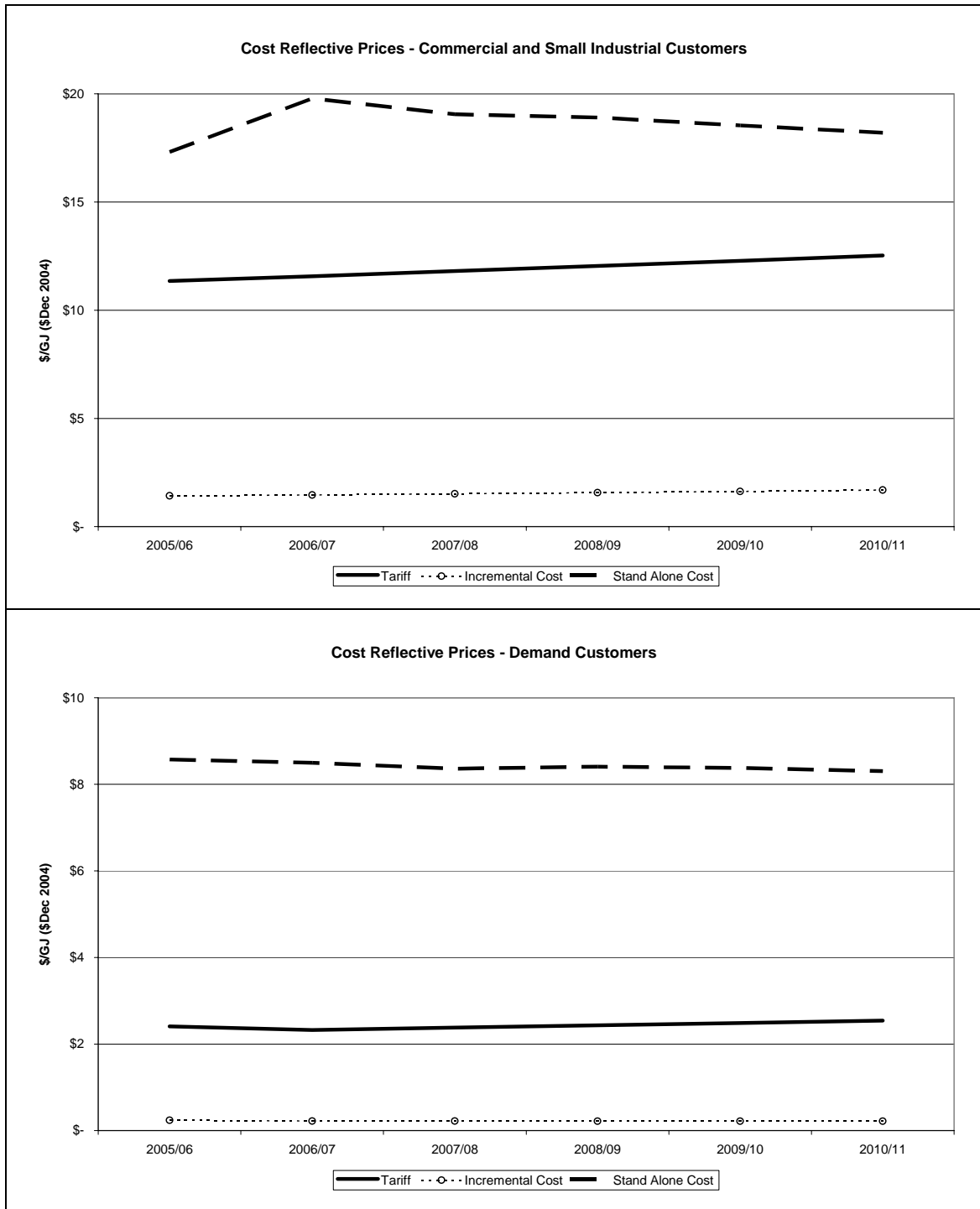
³⁰ This amount reflects that used by the ESCV in its 2002 Final Decision on the Victorian gas Access Arrangement's to adjust operating expenditure benchmarks for growth in new connections above that forecast for determining the efficiency carryover amount (see pg. 170 of the ESCV 2003 Final Decision). Envestra has updated the cost used by the ESCV (\$11/customer) for inflation.

The stand alone cost adds to the incremental cost an amount for the use of the upstream gas distribution assets. This was undertaken by allocating a share of the capital cost components of the building block based on the share of total consumption in each customer group. A stand alone network cost is determined by dividing the allocated capital costs by total customer numbers in each group.

Likewise, stand alone operating costs are derived by dividing total operating expenditure by the number of customers in each customer group. This assumes that the total magnitude of operating costs is not required if only one customer were served by the network. The stand alone cost is the sum of the network capital and operating costs for each customer group.

As shown below, the analysis demonstrates that Envestra's tariffs for all customer groups lie within the band set by incremental and stand alone costs. This further supports Envestra's belief that its proposed tariffs (and cost allocation) are cost reflective, and as such, should be accepted by the Authority in its Final Decision.





Amendment 15.4

In order for Envestra's access arrangement to be approved, Envestra must revise its tariff schedules so that they are consistent with the revenue requirement amendments of this Draft Decision.

There are a number of matters that need to be taken into account when finalising the tariff schedules.

Transition from Tariff V to Tariff D

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

A volume consumer using 10,000 GJ per annum on the 2005/06 Volume tariff in Brisbane will pay an annual network charge of \$88,336 or \$8.83 per GJ (exc GST).

Consumers using 10,000 GJ per annum or more are eligible for the Demand tariff, and a consumer at this level would have a Maximum Daily Quantity of about 50 GJ. The annual charge (at 2005/06 tariffs) for a MDQ of 50 GJ is \$66,335 or \$6.63 per GJ. It is illogical that a consumer should receive such a large reduction in tariff for consuming slightly more gas as it moves above the 10,000 GJ threshold. The cost of supplying the consumers will be almost the same, except as a tariff D consumer demand metering and telemetry will be required.

There are a number of changes to the structure of the V and D tariffs that could be made to address this problem:

- Increase the fixed charge for tariff V consumers;
- Reduce the last step of the V tariff; and/or
- Increase the first step of the Demand tariff.

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

Tariff Zones

In the Draft Decision, the Authority encouraged Envestra to consider the establishment of a further price zone within the current Brisbane zone for tariff D consumers. Separate tariff zones are appropriate where the cost to supply particular groups of consumers vary significantly due to the geographical location of the consumers.

Envestra considers that within the Brisbane area there is no need to introduce separate zones for consumers supplied through the Murrarie city gate, but there are four tariff D consumers in the Dinmore industrial estate that require special attention.

These four consumers are supplied from a separate gate station on the Roma-Brisbane pipeline and a short transmission pipeline to this estate. These consumers are all in a position where new gas infrastructure could be constructed at a cost significantly lower than the Brisbane tariff D. These four consumers are currently charged at individual negotiated tariffs based on the costs of constructing bypass pipelines. This issue was not considered at the time of the first access arrangement, but Envestra now proposes to introduce a separate Dinmore D Tariff to apply to these four consumers and any additional consumers that may move into the Dinmore industrial estate. Details of the MDQs for these consumers will be specified in the revised demand forecast to be supplied to the Authority on a confidential basis.

Negotiated Tariffs

There are two other demand consumers included in the demand forecast that also require special attention. One is a co-generation load for a hospital, supplied under a long-term contract (25 years) that was executed in the mid 1990's, long before the first Access Arrangement was finalised. The tariff for this consumer, which is below the current reference tariff, was negotiated in order to secure the load onto the network.

The second consumer in Brisbane is a case where the price of an alternate fuel means that the consumer will not use natural gas if required to pay the Brisbane demand reference tariff. A lower tariff has been negotiated, Envestra accepting a discount to the reference tariff in order to retain the load. This is considered to be a prudent discount as all customers are better off relative to the alternative of the loss of all load from this consumer.

Further information about these special cases will be provided to the Authority on a confidential basis.

Envestra has not yet amended its tariff schedules as the total revenue requirements in the Final Decision are likely to differ from those set out in the Draft Decision. Envestra will ensure that its tariff schedules included in its approved Access Arrangement are consistent with the revenue requirements of the Authority's Final Decision.