27 April 2010

Warwick Anderson
General Manager
Network Regulation North Branch
Australian Energy Regulator

By email: qldsagas@aer.gov.au

Dear Mr Anderson

RE: ENVESTRA SOUTH AUSTRALIA ACCESS ARRANGEMENT DRAFT DECISION AND REVISED PROPOSAL

As a leading gas retailer in South Australia, Origin appreciates the opportunity to provide comment to the Australian Energy Regulator (AER) on its Draft Decision on the Access Arrangement for Envestra in South Australia.

Access Arrangement Terms and Conditions

Advance payment

In Origin's submission on Envestra's initial Access Arrangement proposal Origin argued that the advance payment arrangement in South Australia should be discontinued, on the basis that it was costly and did not serve the National Gas Objective.

The AER's draft decision was not to discontinue advance payment, as Origin had not explained why the current arrangement was costly. At the forum on the Access Arrangement[1] Origin undertook to substantiate its position. These arguments are outlined below.

1. Cost of capital

Under the advance payment arrangement network users carry working capital instead of Envestra, whereas in all other regulated gas distribution networks, the reverse is the case. Origin has a higher cost of capital than Envestra, so it is more expensive for the customer if Origin carries working capital on Envestra's behalf.

Origin and Envestra have a different cost of capital because Origin is a higher risk business that competes for customers and undertakes risky projects across the supply chain, while Envestra operates monopoly assets. Higher risk businesses rely more heavily on equity finance, which is more costly.

[1] Held in Adelaide on March 2, 2011

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At the time Envestra acquired the Country Energy gas distribution networks in 2010 it reported[2] a gearing ratio of 74 percent, in comparison with Origin's gearing ratio of around 25 percent[3]. Envestra's high debt levels are a defining feature of its business model, allowing the business to reduce costs to consumers while maximising returns to shareholders.

In light of Origin and Envestra's differing business and funding models it is inaccurate to assert that the choice of payment alternative is cost neutral for the end customer. The current arrangement is more costly. Origin has made its own assessment of the cost impact of advance payment and it is in excess of the estimates of cost made by the Essential Services Commission of South Australia (ESCOSA) when it last examined this issue in 2008.

Given the higher cost of advance payment for the end customer compared to the alternative, the arrangement should be discontinued, unless it can be shown to deliver clear countervailing benefits. Origin maintains that this arrangement delivers no countervailing benefit and presents several other drawbacks.

2. This arrangement was designed for a specific purpose that no longer applies

The advance payment arrangement was set up around the time of Envestra's inception, when the company was split from Boral in 1997. The purpose of the arrangement was to assist Envestra with working capital in its early days. At that time, Origin (then Boral) and Envestra were still related parties, which meant Origin undertook to manage the increased cost of this arrangement to support the new enterprise.

It seems unlikely that Envestra still requires this assistance. Envestra is a large business with assets valued at over $2.6 billion, the bulk of which deliver a regulated return on capital. Envestra just made acquisitions in New South Wales worth $100 million, demonstrating its ability to raise capital to support significant expansion. The business has strong and highly predictable revenues, as is evident from its high level of gearing. To the extent Envestra requires working capital this would be better addressed through its allowance for operational expenditure.

Supporting Envestra in its early days was the sole purpose of advance payment. Origin notes that the arrangement has since been ascribed to other purposes (in particular to the provision of credit support), but in fact it relates to none of these. The provision of credit support is addressed by other measures, as outlined below.

Envestra's has cited[4] the fact that advance payment has been in place since the company's inception as grounds for maintaining the arrangement. However, in Origin's view this is not a justification, because advance payment is no longer required for the reason it was put in place. Instead, the arrangement should be discontinued.

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2 "Envestra to acquire Country Energy's New South Wales Gas Networks Business for $107 million", Envestra Media Release, October 2010, p.3

3 As reported in Origin's 2009/10 Annual Report, p.102. Origin generally calculates gearing as Debt/(Equity+debt), but Envestra calculates gearing as Debt/Equity, so Origin's gearing is presented in this format above to aid comparison

4 Response to AGL SA Submission to Envestra Access Arrangement Review, December 2010

3. ESCOSA contemplated that Envestra should prepare to remove this arrangement

ESCOSA reviewed the advance payment and initially determined that it should be discontinued to bring Envestra into line with all other major Australian gas distributors.[5]

ESCOSA ultimately reversed its decision, in part because Envestra needed time to address the issue. However, ESCOSA made clear in its decision that Envestra should prepare for the arrangement to be removed at its next review in the national context, stating:

The Commission recognises that Envestra's prepayment terms are not replicated in any other jurisdiction. In this regard, the Commission notes that a national regulator is likely to have significant concerns with such prepayment arrangements (particularly as there is an increasingly nationally focused retail market). However, this is an issue for Envestra to consider going forward and the Commission notes that Envestra will have the next five years to prepare itself for the possibility of a change to its payment terms at the next review. [6]

ESCOSA's support for prepayment was conditional on Envestra preparing itself for change, based on what ESCOSA considered were likely to be "significant concerns" in the national context. Yet in the intervening five years Envestra has, to Origin's knowledge, produced no cost benefit analysis or other assessment to support continuation of the arrangement.

Envestra has cited[7] ESCOSA's decision in 2006 as grounds for maintaining advance payment in the forthcoming period. In Origin's view, ESCOSA's highly qualified support should not be relied upon beyond the end of the current access arrangement period. ESCOSA acknowledged the value of a uniform national approach, recognising also that the opportunity to address this situation arises only once every five years. Envestra has had ample time to address this situation, in the interests of South Australian gas customers, but has failed to act.

4. Advance payment is not a credit support policy

Envestra has at times sought to justify advance payment by describing it as a credit support mechanism.[8] Yet Envestra has a separate credit policy.

Envestra's Credit Policy exists in the current access arrangement (clause 6.3) and Envestra has proposed a similar arrangement in its Proposal for the coming period (clause 6.4). To Origin's knowledge, no submissions have raised concerns with this Credit Policy, which applies equally in Queensland, where advance payment has been removed.

Envestra's Credit Policy gives Envestra sole discretion to determine the appropriate credit rating below which credit support may be required, without any input from network users. The Policy targets credit risk directly, as it relates to a user's credit rating, whereas advance payment applies to all network users and so increases costs for

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5 *Proposed Revisions to the Access Arrangement for the South Australia Gas Distribution System*, Draft Decision, ESCOSA, March 2006, p.26

6 *Proposed Revisions to the Access Arrangement for the South Australia Gas Distribution System, Final Decision*, ESCOSA, June 2006, p.26

7 *Response to AGL Energy Submission*, Envestra, December 2010

8 See for example Envestra's Submission to ESCOSA in 2006, *Review of Envestra's Gas Distribution Access Arrangement Terms and Conditions*, February 2006, pp.26-29

all customers unnecessarily. (Advance payment was intended to assist in working capital requirements, so it is unsurprising that it is ill suited to addressing credit risk.)

Maintaining advance payment as a redundant credit support mechanism in South Australia makes Envestra less efficient in that state than it is in Queensland, where advance payment has been removed. As a result, customers in South Australia are paying more for similar services, which does not serve the National Gas Objective.

Origin notes that the National Energy Customer Framework (NECF) includes its own credit risk policy. Origin understands that the AER will address the question of Envestra's current Credit Policy at the time the NECF is introduced. Advance payment is not an issue addressed in the NECF and should be addressed by the AER now as part of Envestra's terms and conditions.

5. Envestra has accepted the credit risk of the major retailers

As outlined at point 4., above, advance payment is ill suited to addressing credit risk. Furthermore, it is evident that Envestra does not have genuine concerns about the creditworthiness of the major retailers, because it operates without advance payment in Queensland and Victoria.

Envestra has 630,000 customers in Queensland and Victoria compared with some 400,000 in South Australia, and Envestra deals with the same large retailers in all three states. If the creditworthiness of the major retailers was a genuine concern it would be of greater concern in Victoria and Queensland, yet evidently it is not, since in those states Envestra is comfortable with businesses rated above BBB not providing credit support or paying in advance.

Envestra's actions demonstrate that it does not genuinely see advance payment as a credit support mechanism.

6. Advance payment contributes to barriers to entry

Maintaining an arrangement for one gas distributor that differs from gas distribution in all other regulated jurisdictions could create a barrier to market entry for smaller retailers. The arrangement will increase pressure on the cash flow of a small retailer, and add to the administrative burden.

As noted at point 4., above, Envestra can already request credit support under its Credit Policy, specifically, a bank guarantee for 3 months of payment from all network users with ratings below BBB. Bank guarantees are very costly for smaller companies that have low ratings or are not rated. The advance payment arrangement further compounds the impost on retailers that are not rated, thereby increasing barriers to entry.

It serves the National Gas Objective to minimise barriers to entry to the extent possible, since it encourages competition and efficient pricing of gas services, particularly in light of the small number of gas retailers currently in South Australia.

7. A nationally consistent regime carries the weight of multiple regulatory decisions

Allen Consulting did work for the Queensland Competition Authority (QCA) in 2006 where they examined invoicing arrangements in all Australian jurisdictions.[9] On the basis of this research the QCA determined there was no further justification for the pre-payment arrangement.

Allen Consulting determined that the overwhelming majority of regulated and non-regulated energy services in Australia are invoiced one month to several months in arrears, not two months in advance. Envestra in South Australia is an anomaly.

There is value in maintaining consistency across jurisdictions. Allen Consulting found that the Independent Pricing and Regulatory Tribunal, the Queensland Competition Authority, the Essential Services Commission of Victoria, the Independent Competition and Regulatory Commission and the Economic Regulatory Authority of Western Australia have all examined requests by distributors for working capital allowances. None of these regulators has determined advance payment to be in the interests of consumers. While ESCOSA permitted an interim arrangement for Envestra in South Australia, this was with a view to amending this arrangement when South Australia moved to the national regulator, as outlined at point 3, above. A decision from the AER to discontinue advance payment would bring South Australia into line with decisions from largely all Australia's jurisdictional energy regulators.

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In light of the above arguments, Origin strongly encourages the AER to re-consider its draft decision in relation to advance payment on Envestra's South Australian network.

The policy is costly and has no countervailing benefits. It serves no purpose that is not better served by other means. Envestra has done nothing to advance the case for maintaining this costly and anomalous arrangement since it was encouraged to do so by ESCOSA five years ago.

Origin disagrees with Envestra's entitlement to seek an advanced payment in any form, except as a bank guarantee from users with poor credit ratings. However, if it will allow the AER to make an amendment that serves the interests of customers, to reduce cost and enhance administrative simplicity, then Origin would support a phase in period of up to a year.

<u>Access Arrangement Information</u>

Capital expenditure

Origin supports the AER's decision to require Envestra to base the roll forward of its capital base on forecast depreciation rather than actual depreciation. As noted in Origin's initial submission, price cap regulation provides a strong incentive to underspend capital expenditure. Applying forecast depreciation reduces this incentive.

[9] *Envestra: network charges invoicing policy*, Allen Consulting Group, May 2006

Origin also strongly supports the AER's decision to reject the large margins for contingency that Envestra applied to its capital spending. As noted in Origin's initial submission, Origin was concerned with the scope of the increase in the mains replacement program. Origin learnt from Envestra's initial proposal that it applied contingency margins on its capital expenditure in the range of 10 to 20 percent. From the AER's Draft Decision Origin learnt that the margin on the mains replacement program was 20 percent. Based on expenditure of $232 million, this is a contingency of around $46 million.

Firstly, Origin highlights and concurs with the AER's conclusion that contingency can sometimes lead to reduced costs, rather than increased costs. Secondly, mains replacement is a core activity and Envestra ought to be familiar with the costs involved. As noted by Wilson Cook in its analysis prepared for the AER:

whilst a contingency allowance may need to be called on in some instances, such allowances are unlikely to be called on generally, or to their full extent; and to argue that they would is to say, in essence, that the business concerned is unable to estimate its costs accurately or that it does not wish any risk of cost overruns to remain.[10]

As outlined in Origin's initial submission, Envestra already faces favourable incentives in relation to capital expenditure. If Envestra underspends it maintains any return of capital already collected in the revenue period, and if Envestra has a commercial case to invest beyond the approved amounts it can do so, earn its commercial return and have this spending included in the following revenue reset. In these circumstances such high contingency margins are unacceptable.

Origin notes Envestra's arguments in its revised proposal[11] that only a quarter of the 20 percent margin relates to "contingent risk", with three quarters relating to items that cannot be costed years in advance. Origin agrees that 5 percent is closer to an acceptable level to assign to contingent risk. But Origin questions whether 15 percent of the cost in a mains replacement programme (Envestra's core business) will relate to items to which Envestra cannot assign a cost estimate.

If you have any queries in relation to this submission, please contact me in the first instance on (03) 8665 7155.

Yours sincerely

SIGNED

Steven Macmillan
Regulatory Manager

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10 *Review of Expenditure of Queensland & South Australian Gas Distributors: Envestra Ltd* (South Australia), Wilson Cook & Co, December 2010, p.37

11 *Envestra Revised Proposal*, March 2011, Attachment 7-7 Draft Decision Response: Capital Expenditure, p.6