

Submission to the Essential Services Commission

Approval of Forecast New Facilities Investment and a Surcharge in Relation to an Extension Project to Supply Natural Gas to Nine Towns in the Yarra Valley



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**New Facilities Investment to Supply Natural Gas to
Nine Towns in the Yarra Valley**



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1 Natural Gas Extension Program

The State Government of Victoria, through Regional Development Victoria (RDV) has committed \$70 million to implementing the Natural Gas Extension Program (NGEP), an initiative to extend reticulated natural gas into regional Victoria. The Government considers that reticulated gas supply will offer residential and commercial customers a competitively priced energy source that has the potential to facilitate economic development in country Victoria.

As part of the NGEP, Multinet Gas (Multinet) proposed a project to deliver natural gas to nine regional towns in the Upper Yarra Valley region. These towns (the Nine Towns), located between 45 and 70 kilometres east of Melbourne, are within the local government area of the Shire of Yarra Ranges and are:

- Yarra Glen;
- Wandin;
- Seville;
- Seville East;
- Woori Yallock;
- Launching Place;
- Yarra Junction;
- Wesburn; and
- Millgrove.

In November 2004 the State Government announced that it had selected Multinet to deliver natural gas to the Nine Towns.

1.1 The regulatory framework and New Facilities Investment

1.1.1 Background

The regulatory framework applicable to the investment in the Nine Towns is the Third Party Access Code for Natural Gas Pipeline Systems (the Access Code) and the current Multinet Access Arrangement (MAA).

Section 5.6.2(c) of the MAA describes how Users will be charged for a Reference Service where the provision of the Reference Service requires New Facilities Investment constituted by an Extension or an Expansion covered by the MAA (such Users are Incremental Users).

It is proposed that the service of reticulation of gas to the Nine Towns be the Haulage Reference Service in the MAA, requiring New Facilities Investment constituted by an Extension covered by the MAA (pursuant to section 5.6.1(a) of the MAA). Users of the reticulation will be Incremental Users.

Section 5.6.2(a) of the MAA describes how Incremental Users will be charged where the New Facilities Test passes the Economic Feasibility Test (EFT) (defined in the MAA, in effect, as the test in section 8.16(a)(ii)(A) of the Access Code). Section 5.6.2(c) of the MAA provides the regulatory approach where New Facilities Investment does not pass the EFT.

1.1.2 The Nine Towns

New Facilities Investment required to reticulate the Nine Towns does not pass the EFT.

Multinet proposes to “roll-in” to the Capital Base that part of the New Facilities Investment that passes the EFT. It proposes to recover the amount of New Facilities Investment that does not pass the EFT by way of:

- State Government contribution in the form of capital expenditure and marketing subsidies; and
- a locational surcharge in addition to existing Residential and non-Residential tariffs approved under the MAA.

Under section 5.6.2(c) of the MAA, where New Facilities Investment does not pass the EFT:

- (1) Multinet will seek to include the relevant part of the New Facilities Investment in the Capital Base at the next review of the Access Arrangement (Multinet may, at its discretion, seek the Regulator’s agreement prior to the next review of the Access Arrangement that the relevant part of the New Facilities Investment passes the requirements of section 8.16 of the Access Code (as permitted by 8.21 of the Access Code));
- (2) The remaining New Facilities Investment may be (subject to the Access Code):
 - (A) Recovered by charging Incremental Users according to prevailing Reference Tariffs plus a Surcharge approved by the Regulator under section 8.25 of the Access Code;
 - (B) included in a Speculative Investment Fund under the Reference Tariff Policy in Part B, section 6.3 (in which case Incremental Users would be charged according to the prevailing Reference Tariffs); or
 - (C) recovered by a combination of these approaches (in which case Incremental Users would be charged according to the prevailing Reference Tariffs plus a Surcharge approved by the Regulator under section 8.25 of the Access Code); and
- (3) The Service Provider will notify the relevant Users of its choice between these approaches prior to the relevant New Facility entering in to service.

Multinet’s proposal falls for consideration under section 5.6.2(c)(1) of the MAA in relation to the proposed “roll-in” and for consideration under section 5.6.2(c)(2)(A) in relation to the proposed locational surcharge.

2 Nine Towns Project

2.1 Background

The Shire of Yarra Ranges, formed in 1994 following the amalgamation of the former Shires of Healesville, Lilydale, Sherbrooke and Upper Yarra, offers a mixture of urban and rural communities, with over 55 suburbs, townships, small communities and rural areas, making it one of the most diverse of any municipality in the State. Multinet currently distributes natural gas to all but one of the major population centres within the Shire.

Previous attempts to extend gas reticulation within areas of the Shire have failed for economic reasons. In 1999, in response to community petitions, the Shire tendered for works to reticulate natural gas supply to areas including the townships of Yarra Glen and those along the Warburton Highway eastwards from Wandin North – Wandin East, Seville, Seville East, Woori Yallock, Launching Place, Yarra Junction, Wesburn, Millgrove and Warburton. No conforming tenders were received and the Shire advised the Office of the Regulator-General (the Office) accordingly.

At the time of the Shire's tender, Multinet via its Agent United Energy Distribution, in response to the Tender Approval Request lodged by the Shire, commented to the Office that inherent project risks in the proposed tender approach were unacceptable for a distributor and that an alternative approach was necessary.

2.2 Project Outline

With assistance from the Government's Regional Infrastructure Development Fund to expand accessibility to natural gas, Multinet believes it is now feasible to economically reticulate the township of Yarra Glen and the townships along the Warburton Highway of Wandin, Seville, Seville East, Woori Yallock, Launching Place, Yarra Junction, Wesburn and Millgrove. Multinet has not included supply to, and reticulation of the township of Warburton in the project. Inclusion of Warburton causes a severe negative economic impact due to difficult construction conditions and associated construction costs. Warburton may be reticulated in a subsequent stage (subject to economic feasibility, Victorian Government and community support).

The economics of the Nine Towns project as submitted to RDV are based on:

- The provision of a customer connection Network Marketing Subsidy from the Victorian Government which will be used by Multinet to partially cover the conversion of customers' LPG appliances to natural gas (where required), and/or customer connection costs to the reticulation network, and/or to provide a discount to customers' purchase of new natural gas appliances.
- The provision of a Capital Offset contribution to the project by the Victorian Government. The precise amount of capital agreed between Multinet and the Victorian Government is confidential and will be provided to the Commission under strict "commercial – in confidence" conditions.

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- The ability to apply a locational surcharge within the Nine Towns area in addition to Multinet's Residential and Non-Residential tariffs approved under the current Access Arrangement.

A summary of the Nine Towns project is as follows:

- There are around 6,000 domestic dwellings and commercial businesses in the Nine Towns area;
- Of these approximately 3,950 have been forecast to connect;
- There are no greater than 10 TJ per annum consumers in the Nine Towns project;
- Gas demand in the order of 265 TJ per annum is expected by 2019;
- The project involves the construction of approximately 150 kilometres of gas main over three years at an estimated cost of \$24 million.
- A government contribution (in the form of a Capital Offset subsidy and a Network Marketing subsidy), as well as a surcharge to Multinet Reference Tariffs, are required to make the project economic;
- Regulatory outcomes, construction costs and demand forecasting risks are the major risks facing the project.

2.3 Project Management

A formal project management structure has been implemented to deliver the Nine Towns project. Segregated streams, focussed on the key project deliverables of construction (installation of gas infrastructure) and marketing (physical connection of properties), have been established.

A formal governance structure is in place to monitor and report on project milestones, including those set by government, financial and progress performance, change control and issues and risk management. Cost control will be managed through regular performance reports and will be monitored via the cost management plan. Issues and Risk registers are in place and all changes are to be managed through an established Change Control process.

Marketing aspects of the project be the responsibility of the Marketing Manager, however it is anticipated the Retailers will also take an active role in gaining connection contracts. Design and construction components will be resourced through several service provider contracts that will be the subject of competitive tender processes.

Formal meeting arrangements and schedules for both the project management team and external service providers have been implemented and will be extended as additional service providers are engaged.

2.4 Project timeframe

Project implementation activities have commenced with construction activities scheduled for commencement in April 2005, subject to the Commission's approval of the Multinet submission.

3 Application

By this application Multinet seeks:

- in accordance with section 5.6.2(c)(1) of the MAA and section 8.15 and 8.21 of the Access Code, the Commission's agreement prior to the next review of the MAA that the relevant part of the New Facilities Investment (plus 10%) passes the requirements of section 8.16(a) of the Access Code and will be included in Multinet's Capital Base with the effect that the Commission is bound by that agreement when it considers revisions to the MAA for the regulatory period commencing 1 January 2008 and so the Commission will not re-consider the amount agreed;
- in accordance with section 5.6.2(c)(2)(A) of the MAA and section 8.25 of the Access Code, the Commission's approval of a Surcharge in accordance with New Reference Tariffs outlined in section 5 and Schedule 1; and
- under clause 3(b) of Multinet's Distribution Licence, the Commission's agreement to an amendment to the Licence to add the postcodes relevant to the Nine Towns project to Schedule 2.

4 Economic Analysis and Regulatory Arrangements

4.1 Methodology and EFT Result

Multinet’s proposed project for the Nine Towns is based on the premise that the anticipated incremental revenue generated by the new facility does not exceed the New Facilities Investment and could not proceed without subsidisation..

To test this, Multinet followed the computation of the “EFT” outlined in Schedule 2 of the Gas Distribution System Code Version 8 – effective from 1 January 2003.

However, the proposed Nine Towns project is economic from a business perspective in that it results in a forecast real pre-tax IRR which meets Multinet’s regulatory hurdle rate when the deficit generated by the computation is offset by an upfront contribution to the initial capital cost by the Victorian Government through its Regional Development Fund and consumers pay a locational tariff surcharge above Multinet’s metropolitan Tariffs.

Multinet developed a demand forecast, which it believes is realistic with an assumed retail gas price and estimated network marketing expenditure, from demographic, housing and business data provided by the Shire and market survey data provided in the Government’s Program Data Room.

The estimated network marketing expenditure includes a contribution from Government which will be used by Multinet to partially cover the conversion of customers’ LPG appliances to natural gas (where required), and/or customer connection costs to the reticulation network, and/or to provide a discount to customers’ purchase of new natural gas appliances.

The relevant computations show the amount of New Facilities Investment that does pass the EFT (section 8.16(a)(ii)(A)) and which Multinet seeks to be included in its Capital Base at the next revision of the MAA as discussed in the next section.

Table 1: Project Costing Summary

Overall Project Details for the 20 years	Real \$M (2004)
Total revenue	31.5
Revenue funded by surcharge	13.9
Revenue from prevailing tariff	17.6
Total project cost	24.5
Capital expenditure	16.3
Capital expenditure net of contribution	14.4
Operating expenditure	8.2
Government contribution	4.2

4.2 New Facilities Investment and Regulatory Certainty

As outlined in section 1.1.2, the Nine Towns project requires New Facilities Investment for the purposes of providing Reference Services. In accordance with section 5.6.2(c)(1) of the MAA and section 8.21 of the Access Code, Multinet seeks the Commission's agreement prior to the next review of the MAA that the relevant part of the New Facilities Investment passes the requirements of section 8.16 of the Access Code.

Multinet needs an acceptable degree of certainty from the Commission before making an investment in the project to reach potential new gas customers in the Nine Towns.

The MAA and the Access Code enable the Commission to agree that New Facilities Investment will be included in the Capital Base in the next Access Arrangement Period (section 8.21). Any agreement reached is binding on the Commission and, as such, is designed to provide Multinet with investment certainty. The Productivity Commission, in its recent review of the gas access regime, referred to the binding nature of this mechanism and endorsed the fact that this mechanism enables regulators to provide Service Providers with investment certainty (p.286). A binding agreement from the Commission enables Covered Pipelines to be improved and expanded during the Access Arrangement period, to the ultimate benefit of gas consumers. This is particularly the case where the New Facilities Investment will enable gas to be supplied to new consumers in remote areas, as envisaged by the Victorian Government's Natural Gas Extension Program.

Multinet does not seek complete certainty in relation to *all* costs ultimately actually incurred but, to satisfy its regulatory risk management criteria in relation to up front investment in the Nine Towns project, it does need the Commission to agree a forecast, plus a margin, as the "relevant amount" which passes the requirements of section 8.16 of the Access Code and to expressly acknowledge that the Commission will not reconsider this agreed amount.

In the event that ultimately the actual cost exceeds the agreed amount, in response to any application Multinet may make to include that excess amount in its Capital Base, the Commission will need to test whether that excess amount meets the requirements in section 8.16(a) of the Access Code. In doing so, Multinet acknowledges that the Commission may need to examine the overall management of the project and the costs incurred but only for the purposes of deciding whether the excess amount meets the requirements in section 8.16(a) of the Access Code; in such a process the amount agreed now under section 8.21 will not, in any way, be the subject of re-examination or be at risk of not being included in Multinet's Capital Base.

In providing its agreement under 5.6.2(c)(1) of the MAA and section 8.21 of the Access Code, Multinet looks forward to a clear statement that the Commission will not "re-consider the amount agreed under section 8.21 of the Access Code". With such a clear statement, Multinet will be able to make the Yarra Ranges investment certain that the agreed costs will not be reconsidered.

Table 2: Forecast Regulatory Asset Base (RAB)

RAB Roll in Summary	Real \$m (2004)
New Facilities Investment to 31 Dec 2007	15.4
Less Government Contribution	(1.9)
Net Capex	13.5
Total Revenue to 31 Dec 2007	(2.4)
Opex to 31 Dec 2007	6.6
Less Marketing Subsidy	(4.2)
Return of Capital	0.5
Economic Depreciation to 31 Dec 2007	0.5
RAB to rolled in 1 January 2008	14.0

Multinet has forecast expenditure that it considers to be economically efficient. Multinet also considers that these forecast expenditures plus a margin of 10% of New Facilities Investment meets the requirements of 8.16(a) of the Access Code.

4.3 Distribution Licence

Section 22(1) of the Gas Industry Act 2001 provides that a person must not provide services (other than the sale of gas by retail) by means of a distribution pipeline, either as principal or agent, unless the person is the holder of a licence issued by the Commission authorising that person to provide those services. Multinet's current distribution area is defined by postcodes set out in Schedule 2 of the Distribution Licence. Multinet seeks that under clause 3(b) of the Distribution Licence, the Commission approve the addition of the postcodes relevant to the Nine Towns project to Schedule 2 of Multinet's Distribution Licence.

5 Reference Tariffs

5.1 New Reference Tariffs

New Facilities Investment to reticulate gas to the Nine Towns project has an economic shortfall under the EFT. As outlined above, Multinet will recover this shortfall by a Government capital contribution and through a locational surcharge of \$3.00 per GJ (indexed by CPI) in addition to the 2004 Reference Tariffs approved under the MMA.

Calculation of the surcharge is based on the submission made to the State Government as part of the NGEP process and the costs included in that submission are considered to be prudent and efficient. Multinet is prepared to make separately available to the Commission, on a “commercial – in confidence” basis, the costs included in the submission to the State.

By this application, in accordance with section 5.6.2(c)(2)(A) of the MAA and section 8.25 of the Access Code, Multinet seeks the Commission’s approval of a Surcharge of \$3.00 per GJ (indexed by CPI) as an additional charge to the 2004 Reference Tariffs approved under the MMA.

6 Retail Contestability

The Victorian Government has advised that the project should proceed on the basis of full retail contestability without any imposed ceilings on retail tariffs. This submission is made on the basis of that premise.

Multinet has assumed that retail tariffs available to customers in the Nine Towns will be based on the metropolitan or central 2004 Energy Retail Tariffs published in the Victorian Gazette in December 2003 plus Multinet's locational distribution surcharge. It is on this basis that Multinet has forecast customer penetration and loads used in the project economic analysis.

7 Project Planning

7.1 Timeline

The network rollout milestones are in accordance with the milestones stipulated in the Development Agreement with final completion by 30th June 2008. They are:

1. Completion of the project planning and approvals process by 30 April 2005.
2. Provision of stage 1 gas supply infrastructure by December 2005
3. Provision of stage 2 gas supply infrastructure by 31 March 2006.
4. Provision of stage 1 distribution infrastructure by 30 June 2006.
5. Provision of stage 2 distribution infrastructure by 30 June 2007.
6. Provision of stage 3 distribution infrastructure by 30 June 2008.

Achievement of these milestones will lead to gas being made available as follows:

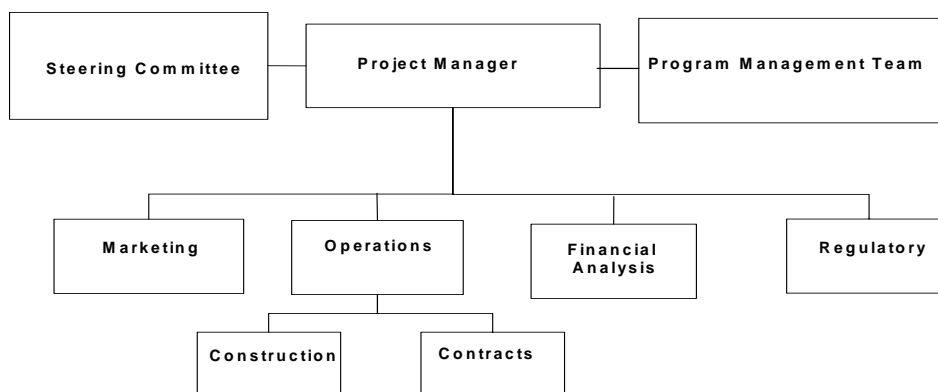
Town	December 2005	June 2006	June 2007	June 2008
Yarra Glen	100%	40%	80%	100%
Wandin	100%	40%	80%	100%
Seville	100%	40%	80%	100%
Woori Yallock	100%	40%	80%	100%
Seville East		100%	50%	100%
Launching Place		100%	50%	100%
Yarra Junction		100%	50%	100%
Wesburn		100%	50%	100%
Millgrove		100%	50%	100%

Supply main construction and % completed
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Reticulation main construction and % completed
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7.2 Governance

Three levels of management govern the Yarra Valley Gas Reticulation Project.



7.3 Responsibilities

7.3.1 Asset Owner

- Approval of capital and operational expenditure.
- Sign-off key deliverables (strategy, scope, marketing plan, workplan, budgets, spend, risk evaluation)

7.3.2 Steering Committee

- Provide overall project governance including ratification of project scope, objectives, risks and workplan.

7.3.3 Project Management Team

- Provide appropriate resources to workstreams as required.
- Assist in the development of the workplan including timely provision of tasks, timeframes and dependencies.
- Ensure timely resolution of applicable workstreams and risks.
- Provide appropriate level representation to various workshops as required. Eg risks workshops

7.3.4 Project Manager

- Manage stakeholder expectations through formal specification and agreement of goals, objectives, scope, outputs, resources required, budget, schedule, project structure, roles and responsibilities.

- Co-ordinate responsibility across identified workstreams, including overall project workplan, identification / escalation of key project milestones and dependencies, identification / escalation and timely resolution of project level issues and risks.
- Deliver the defined project outputs, including agreed schedules and meeting project milestones.

7.3.5 Project Workstream Leads

- Provide workstream expertise to the overall project.
- Progress workstream workplans. ie tasks to agreed schedule.
- Develop workstream options and recommendations to suit requirements of the project.
- Resolve / escalate workstream issues on a timely basis.
- Develop mitigation strategies for identified workstream risks.
- Provide timely status reports to the Project manager as required.

7.4 Stakeholder Communications

7.4.1 Project Management Communication

Stakeholder Group	When W=Weekly F=F'nightly M=Mthly	How M=Meeting E=Email N=Newsletter P=Presentatn R=within Mthly Report	What
Program Management Team	M	R	<ul style="list-style-type: none"> ▪ Monitor milestone progress ▪ Monitor all risks ▪ Monitor all issues ▪ Change Requests
Project Steering Committee	M	M	<ul style="list-style-type: none"> ▪ Monitor milestone progress ▪ Monitor extreme and high risks ▪ Monitor critical and high issues ▪ Resolve escalated issues ▪ Change requests
Asset Owner	M	M	<ul style="list-style-type: none"> ▪ Strategy ▪ Current & potential issues ▪ Risks ▪ Milestone Progress

Stakeholder Group	When W=Weekly F=F'nightly M=Mthly	How M=Meeting E=Email N=Newsletter P=Presentatn R=within Mthly Report	What
Project Management Team	F	M	<ul style="list-style-type: none"> ▪ Progress update ▪ Issues update ▪ Risks update
Change Control Forum	As required	M	<ul style="list-style-type: none"> ▪ Table project change requests
ANS Leadership Team	W	M	<ul style="list-style-type: none"> ▪ High level updates
General ANS audience			<ul style="list-style-type: none"> ▪ High level updates (bulletins)

7.4.2 External Communication:

Stakeholder Group	Direct Mail	Consultations / Briefings	Advertising eg. Local newspapers	Personal Meetings
Customers	X	X	X	
Community Groups		X	X	X
Local Council		X		X
Contractors		X		X
Suppliers		X		X
Consultants		X		X
Energy Retailers		X		X
Regulatory Bodies		X	X	X
Associations / Channels (eg UDIA)	x	X	X	X
Partners (Retail Outlets, Plumbers etc)		X		X

7.5 Project Approvals

It is intended to break the project's business case into components, given that commitments have been made prior to an overall business case being completed.

The following is to be approved and / or endorsed by the Asset Owner prior to the project team committing Multinet in the relevant areas.

- Project Budget
- Rollout Plan
- Marketing Plan
- Incentive Plan
- Contracting Strategy
- Approval of individual spend commitments beyond the agreed delegation limits.

The above list is subject to change by the Steering Committee to allow the approval structure to be flexible to allow for evolving needs of the project.

7.6 Change Control

A request for change to the

- Network Milestones
- Network Extension Map or
- Minimum Network Capacity Requirements
- Other scope changes associated with that previously approved
- Project Budget

must be made in writing to the Steering Committee, and contain full details of the proposed variation. Any request for a variation to the Network milestones must be made as soon as it has become aware, or if practical at least 21 days prior to the date of the milestone to meet the governments required 14 days notice period.

All project change requests will be tabled at Change Control Forums which will be called on an as needs basis, and will include attendance by Steering Committee members.

7.7 Logistics

The project team shall be housed at Moorabbin Office complex.

A sharefile area has been set up as follows:

- Yarra_valley on 'Fileprd17'

All electronic project documentation shall be filed in this sharefile directory under the appropriate folders.

All documentation associated with the project shall be marked "Confidential" and shall be managed accordingly.