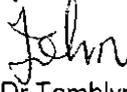


11 May 2007

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Dear Dr Tamblyn



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Rule Change Proposal: Economic Regulation of Transmission Services undertaken by Distributors

In response to a recent request for contributions by the Australian Energy Regulator, EnergyAustralia wishes to provide the AEMC further information in support of its Rule change proposal. Following discussions with key stakeholders, EnergyAustralia has identified two main issues that are being considered by participants:

1. Is there any material benefit in moving from a cost allocation at the beginning of the process to the end of the regulatory process?
2. Can't a status quo approach to pricing occur without subjecting dual function assets to a separate pricing regime?

These are important issues which have been raised in other areas as well. The issues are also somewhat interrelated as explained below.

Is there any material benefit in moving from a cost allocation at the beginning of the process to the end of the regulatory process?

We note in our rule proposal that we see the benefits in moving to an up front assessment of our single network mainly in administrative improvements and the integrity of regulatory decision making. This is evidenced by:

1. a single revenue proposal, draft determination and final determination on the one network rather than two processes on the one network allocated into two categories;
2. a more appropriate assessment and consultation process for the investment and expenditure program that is not complicated by an arbitrary allocation of the asset base in the first instance and the transfer of assets to and fro as the system is reconfigured;
3. a more appropriate consideration of the allocation of generic assets and expenditure (ie. non-system assets and overhead are allocated across the entire network based on appropriate drivers rather than allocated according to transmission and distribution classifications which are themselves a secondary allocation);



4. a more appropriate consideration of the allocation issues between transmission and distribution at the end of the process – ie. when the proposal, consultation, assessment and determination of the investment program is finalised.

In summary, while there is not expected to be any material difference in revenue and pricing outcomes, the Rule proposal focuses on substantially improving the efficiency and integrity of the regulatory process. The financial and overall market benefits are likely to be at the margin, but in terms of regulatory process the Rule change would be a very worthwhile improvement on the status quo.

It is important to note that the fourth point is only necessary if the AER believes there is benefit in a separate transmission pricing arrangement applying to a business's transmission assets. In some circumstances it may be that only the first limb would be invoked by a DNSP, for example where distribution pricing was already in place.

Can't a status quo approach to pricing occur without subjecting dual function assets to a separate pricing regime (ie. can't the same outcome be achieved by creating distribution tariffs that mimic the existing transmission/distribution price?)

In EnergyAustralia's case, our customers have been subject to the pricing arrangements of two regulatory regimes (within the single network business) for almost 10 years. Only providing the first limb would require us to reverse the regulatory and market arrangements that have been developed over the decade. We believe that modifying the Rule proposal so that only the first limb is available would result in EnergyAustralia not requesting a single regulatory process.

This is because:

1. EnergyAustralia would have difficulty in explaining to customers the reasoning behind significant price changes as a result of the new Rule – it is important to note that for many of these large customers network charges represent a significant proportion of their cost structure and investment decisions have been made by these businesses on current arrangements.
2. EnergyAustralia would have difficulty in explaining to its existing customers why their underlying network price will increase by 2% for sunk investment that serves a dual function of supporting local distribution services but also supports the backbone of transmission investment for customers outside the distribution area.
3. The settlement boundary for the market corresponds with the boundary of the transmission network. Losses and network charges are calculated in a different manner to the distribution network, to enhance the efficiency of pricing signals in the market. For consistency in pricing, EnergyAustralia would have to redefine the transmission boundary for market settlements, to revert to the boundary between EnergyAustralia and TransGrid, so that the transmission component is correctly calculated. This would be at a cost to the market.
4. EnergyAustralia would also have to recalculate loss factors to reflect the increase in the distribution loss factors (correspondingly adjusted for marginal loss factors). Again this is a complicated process at a cost to the market and with uncertain pricing outcomes – there would be winners and losers from this arrangement.

In specific response to the question of whether a modified pricing regime would remove the need for the Rule change to accommodate for Transmission pricing, this approach would only mitigate the first problem. It does not address the other issues raised above but creates another. EnergyAustralia would effectively have to propose (and have approved, subject to consultation) a pricing allocation that backsolves to the current split of transmission and distribution pricing for larger customers:

- This would be administratively difficult to achieve without alarming some customers.
- It would not be defensible against the established procedures for either the transmission or distribution pricing cost allocation.
- We also believe it would open a Pandora's box for any customer to argue for any range of pricing structures that have no established methodology. This may impact the prices of smaller customers in the medium term.

Moreover, replacing the formal consideration of transmission pricing with a flexible pricing arrangement for distribution would not result in the same pricing outcome (EnergyAustralia's smaller customers network prices would increase by 2% on average) and would also create complications for the regulatory process and market arrangements. In essence any gains made in improving the transparency and integrity of revenue regulatory arrangements would be undone by the reduced transparency and complication of pricing and market arrangements.

In summary, unless EnergyAustralia is provided with some mechanism to allow the status quo arrangements for transmission pricing and settlements, the argument that the resultant Rule change would promote the NEM Objective is very weak. EnergyAustralia would simply not submit a request under a Rule change which permitted a single determination, without retaining the existing pricing arrangements.

Please do not hesitate to contact me if there is any further clarification I can provide. If you have any queries or comments regarding this submission please do not hesitate to contact me on (02) 9269 2115, or Mr. Harry Colebourn, Manager – Network Regulation and Pricing on (02) 9269 4171.

Yours sincerely



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