The Chairman
Australian Energy Market Commission
PO Box H166
AUSTRALIA SQUARE NSW 1215

11 September 2006

Dear Sir

Draft Determination and Draft Rule for Review of Electricity Transmission Revenue Rules

Integral Energy welcomes the opportunity to comment on the Draft Determination and Draft Rule for Review of Electricity Transmission Revenue Rules conducted by the Australian Energy Market Commission (AEMC).

Integral Energy supports the Draft Rules, however, considers the following issues need to be addressed to ensure the intent of the MCE and policy structure is effectively implemented.

AER Guidelines and Models

Integral Energy notes a fundamental principle underpinning the reform of the National Energy Market (NEM) by the Ministerial Council on Energy (MCE) was to ensure a separation of rule making from rule enforcement and economic regulation. Under the policy and legislative framework developed by the MCE, the AEMC was given specific Rule making powers while the AER was given powers to perform Rule enforcement and undertake certain economic regulatory functions.

It is not the intention of the MCE or the legislative amendments to the National Electricity Law (NEL) that the AER be given the power to make 'policy principles' or 'Rules' with respect to the economic regulation of transmission systems.

Section 35 of the NEL sets out the obligations of the AEMC to make Rules for or with respect to the matters or things specified in items 15 to 24 of Schedule 1 of the NEL (relating to transmission system revenue and pricing). Items 18 and 19 of Schedule 1 requires the AEMC to make Rules with respect to:

> *"18. The assessment, or treatment, by the AER, of investment in transmission systems for the purposes of making a transmission determination.*
>
> *19. The economic framework and methodologies to be applied by the AER for the purposes of item 18."*

51 Huntingwood Drive Huntingwood NSW 2148. PO Box 6366 Blacktown NSW 2148. DX 8148 Blacktown
Integral Energy Australia ABN 59 253 130 878 Telephone 02 9853 6666 Facsimile 02 9853 6000 www.integral.com.au

As such, it is clear that the NEL requires the AEMC to make Rules for the economic framework and methodologies to be applied by the AER for the purposes of making the assessment, or treatment, by the AER, of investment in transmission systems for the purposes of making a transmission determination.

Similarly, item 20 of Schedule 1 of the NEL requires the AEMC to make Rules for the mechanisms or methodologies for the derivation of the maximum allowable revenue or prices to be applied by the AER in making a transmission determination.

Accordingly, the AEMC must make Rules with respect to the methodologies and the AER must apply these methodologies in its transmission determination. It is a matter for the AEMC to satisfy itself whether it has the power to confer this power to the AER by inserting in the Rules a requirement for the AER to develop and publish methodologies used in a transmission determination.

Integral Energy submits that any provision in the Draft Rules which purports to confer a requirement for the AER to develop or specify methodologies with respect to investment in transmission systems and the derivation of maximum allowable revenue or prices in making a transmission determination be deleted.

Additionally, given the nature of the guidelines and models being developed by the AER in relation to a transmission determination, it would be appropriate to provide a mechanism to assist the AER ensure that the guidelines and models being developed effectively meet the policy principles, Rules and NEM objective.

Forecast Expenditures - Reasonable Estimates

Under proposed clauses 6A.6.6(b) and 6A.6.7(b) of the Draft Rules, the AER must only accept the forecast expenditures for each regulatory year if:

- the forecast expenditure is properly allocated in accordance with the principles and policies set out in the Cost Allocation Methodology; and
- the AER determines the forecast expenditure is a reasonable estimate of the required expenditure for the regulatory control period.

Under these provisions, the AER has the power to reject funding for reliability augmentations if it determines the forecast capital expenditure is unreasonable.

The proposed provisions also give the AER the express power to deny funding for to a TNSP to comply with any and all applicable regulatory obligations if the AER determines the forecast expenditure (either capital or operating) is unreasonable.

The AER's determination of what is reasonable is based on TNSP compliance with the AER's own submission guidelines, and a listing of certain criteria with no weightings afforded to any of the criteria. As a result little effective guidance is provided to the AER in making a determination.

Moreover, Integral Energy considers it is contrary to the NEM objective for the AER to have the power to reject funding for reliability augmentations. Similarly, where the forecast capital expenditure has satisfied the *regulatory test,* it is also inappropriate for the AER to reject the forecast capital expenditure.

Accordingly, Integral Energy submits that the Draft Rules be amended to provide that the AER must accept the forecast expenditure of a TNSP where a TNSP can demonstrate that the forecast capital expenditure and forecast operating expenditure is reasonable and properly allocated in accordance with the principles and policies set out in the Cost Allocation Methodology.

Pass Through Events

An omission in the Draft Rules is the treatment of costs relating to certain regulatory changes which arise during the regulatory period. Should regulatory changes occur during the year which are not related to insurance, tax, service standard or terrorist events there is no mechanism to enable the TNSP to recover the costs associated with the regulatory change.

Section 16 of the NEL requires the AER in making a transmission determination to provide a reasonable opportunity for the regulated transmission system operator to recover the efficient costs of complying with a regulatory obligation. The AER cannot fulfil its legal obligations in the absence of any mechanism to recover the efficient costs of complying with a regulatory obligation other than those related to insurance, tax, service standard or terrorist events.

These regulatory change costs can be most appropriately accommodated through an amendment to the definition of Pass Through Events to include a regulatory change event. This treatment of regulatory change costs is practiced in NEM jurisdictions by jurisdictional regulators.

Therefore, Integral Energy submits that the definition of Pass Through Events be amended to include a "regulatory change event" and the definition of a Regulatory Change Event be inserted in the Glossary as follows:

"Regulatory Change Event means:

(a) a decision made by an *Authority*;
(b) the coming into operation of an *applicable regulatory instrument* or *Rules*; or
(c) the coming into operation of an amendment to an *applicable regulatory instrument* or *Rules*".

Contingent Projects

Integral Energy notes that for a project to be determined by the AER to be a Contingent Project, its capital expenditure must exceed 5% of the value of the regulatory asset base. Integral Energy believes that it is more appropriate to consider contingent projects in the context of capital expenditure in a transmission determination, rather than as a percentage of the regulatory asset base. Therefore Integral Energy submits that in the event a proposed contingent project is 'triggered' the capital expenditure threshold for a contingent project should be consistent the materiality threshold applied in the Draft Rules.

Accordingly, Integral Energy proposes that the capital expenditure threshold for a proposed contingent project should be 1% of the maximum allowed revenue for the TNSP for that regulatory year (being the materiality threshold on the Draft Rules) or $10 million (being the threshold for a new large network asset) whichever is the lesser.

WACC

Integral Energy strongly supports the inclusion of the WACC parameters in the Rules as giving greater certainty for all regulated businesses.

Integral Energy submits that any amendment to individual WACC parameters or methodologies in the Rules in future should only occur after persuasive evidence has been provided and due recognition is given to the long lives of transmission assets.

Service Target Performance Incentive

In order for a TNSP to meet service target performance incentives set by the AER, it must have assets which are able to meet those service target performance incentives above the standard of *Prescribed Transmission Services* and which form a part of the incentive arrangements. For the AER to do otherwise is to penalise the TNSP by firstly restricting its ability to meet the service target performance incentives and then reducing the TNSP's MAR for not achieving the incentive service target.

Accordingly, Integral Energy submits that the service target performance incentives be linked to the performance effort of the TNSP (based on a measure of ability and capacity of each TNSP) rather than the capital asset structure of the TNSP.

Integral Energy further considers a service target performance incentive of +/- 1% of the MAR consistent with recent practice, is a material and sensible level of incentive for the service target performance incentives.

Should you wish to discuss the issues raised in this letter, would you please contact Erik Beerden, telephone number (02) 9853 6904 in the first instance.

Yours faithfully

Richard Powis
Chief Executive Officer