26 February 2010

Mr John Tamblyn

Chairman
Australian Energy Markets Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Tamblyn

**Review into the Use of Total Factor Productivity (TFP) for the Determination of Prices and Revenues – Response to Preliminary Findings Paper**

Integral Energy welcomes this opportunity to provide comments on the Commission's Preliminary Findings Paper. Integral Energy is encouraged by your comments at the public forum held in Melbourne emphasising a genuine desire to test, and where appropriate adjust, your thinking in relation to the preliminary findings contained in your paper.

While the conduct of the review must be lauded, Integral Energy does have reservations regarding some of the Commission's preliminary findings with particular attention to alternative options for the next steps of the review.

**The Case for TFP**

Integral Energy is not yet convinced that a TFP based form of regulation will ultimately yield the improved outcomes relative to the building block approach suggested by the theoretical assessment.

Integral Energy reiterates concerns raised earlier in the review process that the "need" for TFP had not been well established and that a comparison against the current version of the building block regime appears premature recognising that only one review under the National Electricity Rules (the Rules) has been completed. At this early stage it is not unreasonable to expect that both businesses and the AER are still engaged in a process of understanding the practicalities of the Rules, with the commensurate level of debate. Once a sufficient body precedent and common understanding of the Rules is developed it is not unreasonable to expect that concerns around the application Rules will be significantly reduced.

Thus it would appear that any assessment of the current arrangements is likely to be influenced by history under the National Electricity Code, rather than the Rules as they currently stand.

Integral Energy is also concerned that the case for TFP appears to be based on the presumption that quality of supply and reliability matters (costs) can be removed from the benchmarked costs and managed under a separate incentive scheme.

Reliability performance, security of supply, safety and price are the primary elements of the network/customer compact and are intrinsically linked. Indeed in NSW (as in some other states) the Government has imposed minimum security of supply and reliability requirements as part of the licensing regime.

As part of the 2009 to 2014 distribution determination process, Integral Energy submitted that its forecast capital costs associated with meeting its Licence obligations exceed $400 million over the regulatory period, or approximately 14% of the forecast capital program. In addition, a further $73 million of the forecast capital program was proposed to improve reliability and quality of supply. These costs were reviewed and accepted by the AER.

It is worthwhile noting that these costs are only those that are directly and separately attributable to maintaining or improving reliability and supply quality. The "all-up" costs exceed these estimates as the other categories of capital investments, such as growth, are also influenced by the design planning and reliability standards as the standards must be considered when assessing the project timing, its design and construction standards and interconnection to other network elements or feeders.

Recognising the importance of network reliability to customers, and the commensurate materiality of costs, Integral Energy could not support at this time a regulatory regime that did not have the maintenance of adequate supply reliability and performance as a key and direct input. Moreover, in a TFP context, it is difficult to conceptualise how the application of the NSW supply reliability standards to the range of customer supply areas[1] would be amenable to benchmarking between the NSW DNSPs let alone to DNSPs in other jurisdictions where different operating conditions and customer expectations appropriately require different standards to those that are appropriate for the NSW context.

Therefore, Integral Energy would object to the characterisation of costs associated with design planning and reliability and its impact on the operation of DNSPs (at least in NSW) as being *"not so significant"*[2] as the NSW standards have a pervasive influence throughout the network planning and design functions and thus directly or indirectly impacts every capital investment made by Integral Energy.

## Optionality

It is critical that the regulatory framework does not become less adaptive to change by removing the optionality of alternative forms of regulation, in favour of a "one-size fits all" approach. As was discussed at the public forum and in the Preliminary Findings paper, there are indeed situations/businesses where applying a TFP approach would not be appropriate, such as the gas transmission networks. While recognising the differences between the gas transmission networks, it is not obvious to Integral Energy that the similar differentiation is not also applicable to electricity distribution networks recognising the range of network attributes and characteristics across the NEM.

The current building block framework provides much greater scope to be responsive to emerging issues, particularly where no benchmarking history exists, and therefore the building block approach must remain the primary option for network businesses until a holistic review of all available options us undertaken, as discussed below.

[1] The design planning and reliability standards for NSW are differentiated between CBD, urban and rural supply areas. In addition these definitions are specific to NSW and are not consistent with the definitions subsequently adopted by the AER for its national Service Target Performance Incentive Scheme.

[2] Preliminary Findings – Review into the use of total factor productivity for the determination of prices and revenues, Australian Energy Market Commission, 19 December 2009, page 73.

**TFP "end-game"**

Integral Energy supports comments made at the public forum by the Commission rejecting the proposition that a fully de-linked "*set and forget*" style of regulation is, or should, be the ultimate "end-game" for economic regulation.

Any form of regulation that does not allow for a periodic reset of revenues relative to costs risks losing the disciplines of a repeat game which requires regulated businesses and regulators to be accountable for their past claims and decisions in the light of actual outcomes.

A regime devoid of the repeat game discipline risks being subject to business "gaming" and/or excessively severe regulatory decisions (based in part on the potential for "gaming") with the outcomes being theoretically locked in for perpetuity, to the detriment of customers in the longer term.

Without the threat of an effective and public review of commercial investment practices the suggested set and forget TFP "end-game" may create short to medium term incentives for investment decisions that are not in the public interest; such as inappropriately low safety or maintenance expenditures, which in all likelihood would only be revealed in the aftermath of a network incident, or an unexpected decline in network performance.

**Informed and holistic review of the regulatory regime**

Integral Energy submits that the Commission should delay the development of any Rule or legislative changes required to implement a specific TFP model subject to the completion of a holistic review of existing and potential regulatory frameworks.

There would appear to be a significant option value in waiting to determine whether to implement a TFP model and any form that it might take, until a more robust body of information on which to base the decision has been accumulated. It is not unreasonable to expect the data gathered over the next 8 years may reveal opportunities for more targeted regulatory reforms or incentives that could yield the majority of expected benefits at a significantly lower cost to market participants and ultimately end consumers than TFP.

Integral Energy submits that the next stage of the review should be commenced 5 years after the national reporting regime is established, with a particular consideration of the impacts of carbon policies, smart grid, smart meters, the operation of the NEL and NER, any other "intelligence" revealed by the data collected, and other key international developments (such as the UK RPI-X@20 review).

In addition the review should consider the longer term energy infrastructure needs in light of relevant Australian and International drivers. As is becoming clearer for other developed countries, most notably Great Britain, factors such as energy supply security, carbon constraints on the economy, and continuing energy consumption require long term plans to be developed and implemented sufficiently in advance of the "just in time" need to avoid energy supply and financial market risks.

Within this context it is critical that the regulatory regime is complementary to the longer term needs of Australia and positively support Government initiatives in this area without imposing unnecessary costs on economy.

**ENA Submission**

Integral Energy also supports the key themes of the ENA submission. However Integral Energy would like to draw particular attention to the following aspects of the ENA submission:

- There appear to be instances in the Preliminary Findings paper where generalised belief or theory is treated as fact without clear reference to specific examples or evidence to substantiate these positions. Integral Energy would encourage the Commission to address the ENA's concerns in these areas.

- Consistent with our submission above, the ENA is also of the view that the option value of delaying a final decision on a revolutionary change to the economic regulatory regime and the necessary changes to the NEL and NER should not be understated. Over the next several years the regulatory and environmental information available to the Commission and market participants is expected to increase significantly with a commensurate increase in the value of decisions based on that information. Indeed it is expected that:
    - the national reporting regime to be developed by the AER is likely to identify common areas within the operations of the network businesses that may be better addressed through targeted incentives within the building block regulatory regime rather than blunt incentives under a TFP approach;

    - there will be significantly greater clarity of how the current regulatory regime truly operates and its strengths and weaknesses that can only be achieved following at least one full regulatory cycle; and

    - the myriad issues arising from the two largest changes to occur in the electricity distribution sector in decades (the national response to carbon and the deployment of smart grid and smart meter technologies) will become much clearer and may present alternative regulatory options into the future.

If you have any queries regarding this submission please do not hesitate to contact me on (02) 9853 6101 or our Manager Regulatory & Pricing, Mr Michael Martinson on (02) 9853 4375.

Sincerely,

Vince Graham

**Chief Executive Officer**