INTEGRAL energy

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

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20 October 2006

Dear Sir

Review of Electricity Transmission Revenue Rules – Reasonable Estimates

Integral Energy welcomes the opportunity to further comment on the Draft Determination and Draft Rules for Review of Electricity Transmission Revenue Rules and in particular on the application of reasonable estimates in the determination of electricity transmission revenues.

Integral Energy generally supports the draft Rules with respect to forecast operating expenditure and forecast capital expenditure and considers that the draft Rules accommodate a 'fit for purpose' model.

The draft Rules with respect to forecast operating and capital expenditures recognise that transmission network service providers (TNSPs) are the entities best placed to obtain and understand information required for the efficient and effective operation of their own networks and serve the needs of their customers.

Under proposed clauses 6A.6.6 and 6A.6.7 of the Draft Rules, the forecasts of operating and capital expenditure which TNSPs include in a *Revenue Proposal* must be reasonably required in order to meet the efficient expected demand for prescribed transmission services by consumers, comply with regulatory obligations and maintain the reliability and quality of supply. In deriving these expenditure forecasts, TNSPs must properly allocate expenditure in accordance with the principles and policies set out in the *Cost Allocation Methodology* approved by the AER.

Under the draft Rules, the AER must determine whether the forecast expenditure by a TNSP is 'reasonable'. In reaching this determination, the AER must consider a listing of twelve specific criteria set out in clauses 6A.6.6(b)(2) and 6A.6.7(b)(3) of the draft Rules, as well as a TNSP's compliance with the Cost Allocation Methodology and the AER's own submission guidelines.

The absence of any weighting given to the criteria specified in clauses 6A.6.6(b)(2) and 6A.6.7(b)(3) of the draft Rules deprives the AER of additional guidance in its consideration of a reasonable estimate and increases the risk of regulatory error.

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Where a TNSP can demonstrate that its forecast expenditure is 'reasonable', including through an assessment of the twelve specific criteria listed in clauses 6A.6.6(b)(2) and 6A.6.7(b)(3) of the draft Rules, it is unclear why the AER should have the discretion to determine the forecast expenditure is not a reasonable estimate of the required expenditure for the regulatory control period and reject the forecast expenditure by the TNSP.

Given a regulator's imperfect knowledge of the efficient cost of a TNSP in meeting the efficient expected demand for prescribed transmission services by consumers, complying with regulatory obligations and maintaining the reliability and quality of supply, it is highly likely that the rejection of a TNSP's forecast expenditure and the substitution of a 'best estimate' by the AER will result in regulatory error.

Should substitution of a 'best estimate' by the AER be lower than the 'reasonable estimate' proposed by the TNSP, efficient investment would be prevented from occurring because the amount allowed is less than that amount required in order for the investment to proceed. The result is likely to be under-investment.

Under-investment in areas of emerging network constraints increases the risk of unplanned interruptions where customers would be prepared to pay a higher price to avoid the inconvenience and costs attached to those interruptions.

Should investment proceed in the face of regulatory error, market outcomes are distorted as future investment is discouraged, customers 'free ride', and consumers are exposed to future price shocks as network service providers seek to recover the cost of efficient investment.

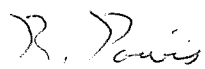
The reasonableness of an error in estimating forecast expenditure extends not only to the standard or quality of the decision-making, but also to the materiality of the estimate. If the AER determines a reasonable estimate of forecast expenditure which is not materially different from that proposed by the TNSP, the AER should accept the TNSPs forecast expenditures as being reasonable and avoid unnecessary administrative costs.

Regulatory error in determining reasonable forecast expenditures has the potential to place load at risk, give rise to a loss of reliability and quality of supply, and generate poor price signals. In the event of these instances occurring, transparency and accountability for the regulatory error becomes a significant issue.

Accordingly, Integral Energy submits that the draft Rules be amended to clarify 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. Consistent with this approach, Integral Energy submits that the accompanying explanatory documentation be amended to remove any doubt with respect to the intention of the proposed Rule change.

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

Yours faithfully



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