16 February 2009

Mr Mike Buckley General Manager Network Regulation North Branch Australian Energy Regulator GPO Box 3131 Canberra ACT 2601

Dear Mr Buckley

Integral Energy Submission on the AER's 2009 Draft Distribution Determination

Integral Energy is pleased to provide its submission to the Australian Energy Regulator (AER) in response to the AER's 2009 draft distribution determination. The submission is made in accordance with clause 6.10.2(c) of the Transitional Rules.

Integral Energy has not repeated the substantive arguments made in the original regulatory proposal lodged with the AER on 2 June 2008 or the revised regulatory proposal lodged with the AER on 14 January 2009. This submission contains additional information provided to support Integral Energy's revised regulatory proposal and comments on other aspects of the AER's draft distribution determination as appropriate.

In particular, in order to provide additional supporting information to the AER regarding the required operating expenditure to fund superannuation liabilities, Integral Energy has obtained an actuarial assessment of its expected superannuation contributions from Mercer (Australia) Pty Ltd ("Mercer"). The details of the Mercer actuarial assessment are provided as Attachment 2 of the submission. Integral Energy requests that the information contained in Attachment 2 be treated as confidential and be suppressed from publication.

Integral Energy strongly supports the consultative approach that the AER has established for this review and looks forward to continuing to work with the AER and other key stakeholders throughout the remainder of the review process. For further information on this submission or the revised regulatory proposal, please contact our General Manager Regulatory & Corporate Affairs, Karen Waldman, on 02 9853 6166.

Yours faithfully

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Vince Graham Chief Executive Officer

Going further for you is what we do



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Submission to the Australian Energy Regulator 2009 to 2014

Delivering efficient and sustainable network services





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Front Cover:

Parramatta by night, supported by Integral Energy's Parramatta Field Service Centre.

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Attachments:

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| 1 | Change in Asset Lives |
| 2 | CONFIDENTIAL - Actuarial Assessment of Superannuation Liabilities |
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Introduction

On 2 June 2008, Integral Energy submitted a Regulatory Proposal (the *original proposal*) to the Australian Energy Regulator (AER) for the regulatory control period from 1 July 2009 to 30 June 2014 (the *2009 regulatory control period*), in accordance with the requirements of the National Electricity Rules (the Rules) and the *Transitional Rules*.¹

Integral Energy's *original proposal* was the subject of public consultation and a detailed review by the AER and its consultants. On 28 November 2008, the AER published a draft decision on its distribution determination for the NSW electricity distribution businesses (the *draft decision*).

On 14 January 2009, in accordance with clause 6.10.3 of the *Transitional Rules*, Integral Energy submitted a revised proposal (the *revised proposal*) for the *2009 regulatory control period*.

In preparing its *revised proposal*, Integral Energy carefully reviewed all of the matters raised by the AER in its *draft decision* including, in particular, where the AER made adjustments to Integral Energy's *original proposal*. In many instances, Integral Energy implemented the changes required by the *draft decision*. Where Integral Energy did not fully adopt the AER's *draft decision*, the *revised proposal* provided additional information, including expert reports, to address the matters raised by the AER and to demonstrate that the *revised proposal* satisfies the requirements of the Rules.

This submission is made in accordance with clauses 6.10.2(c) of the *Transitional Rules* that provides that any person may make a submission to the AER on the *draft decision* within the time period specified by the AER, which in this case is by 16 February 2009.

1.1 Global financial crisis

Many of the revisions to Integral Energy's *original proposal* included in the 14 January 2009 *revised proposal* were required to address the onset of the global financial crisis occurring following the preparation and lodgement of the *original proposal* on 2 June 2008.

In its *revised proposal*, Integral Energy submitted expert reports² providing evidence that the world economy faces its most difficult period since the Great Depression. For the first time since the second oil price shock in 1979, the world as a whole experienced an event which, across all

¹ See clause 11.15.2 of the Rules and Appendix 1 of Chapter 11, an amended form of Chapter 6 of the Rules applicable to the NSW and ACT distribution businesses, for the purposes of the 2009-2014 regulatory control period (the *Transitional Rules*).

² See expert reports from the National Institute of Economic Industry Research (NIEIR) and CEG, provided as Appendices A and B, respectively to the *revised proposal*.

countries, generated the expectation of a recession in 2009, making the expectations of a recession (or at the very least, low growth) a reality.

In Australia, the global financial crisis has resulted in unprecedented movements in economic indicators, including reductions in economic activity, which are expected to have significant implications for Integral Energy and its customers over the *2009 regulatory control period*. As stated in Integral Energy's *revised proposal: "The economic conditions prevalent prior to the original proposal on 2 June 2008 are simply no longer relevant*".³

As outlined in this submission, Integral Energy considers that the *Transitional Rules* allow the AER to have regard to the impact of more recent events on expenditure estimates contained in Integral Energy's *regulatory proposal*, which might result in a forecast expenditure which differs from the *original proposal* in some cases.

1.2 Revisions to the original proposal

Integral Energy's *revised proposal* incorporated a number of amendments to the *original proposal* as a result of the *draft decision*. Revisions to the *original proposal* included:

- Updated energy and customer number forecasts that take into account the requirements of the AER's *draft decision* and the downturn in economic conditions as a result of the global financial crisis;
- Associated reductions to capital expenditures as a result of the global financial crisis;
- A revised nominal risk free rate averaging period that recognises the weight of regulatory
 precedent, both in Australia and internationally, that strongly supports the view that it is
 not appropriate to adopt the most recent averaging period if it overlaps with abnormal
 levels or periods of economic crisis;
- Updated cost escalators that reflect the AER's *draft decision* and recent commodity price movements;
- An adjustment to operating costs to remove the forecast "fair value" adjustments to the provisioning for superannuation liabilities that are no longer relevant given current market conditions;
- An adjustment to the efficiency benefit sharing scheme (EBSS) excluded cost categories to enable Integral Energy to move to leasing arrangements for certain assets currently capitalised, including new vehicles; and
- Other adjustments as required to address the issues raised in the *draft decision*.

³ Integral Energy Revised Regulatory Proposal to the AER, 14 January 2009, page 4.

The inclusion of the above amendments in the *revised proposal* resulted in a number of consequential changes to individual building block components and X factor calculations as outlined throughout the *revised proposal*.

1.3 Structure of this submission

In this submission, Integral Energy does not repeat the substantive arguments made in the *original proposal* or the *revised proposal*; rather, additional information is provided to support Integral Energy's *revised proposal* and comment is made on other aspects of the AER's *draft decision* as appropriate.

The remainder of this submission provides additional supporting information on the following topics, discussed in turn below:

- Opening asset base;
- Superannuation;
- AER's cash flow modelling;
- Return on capital;
- Pass through arrangements; and
- Other matters raised in the *draft decision*.

Opening asset base

In its *revised proposal*, Integral Energy, with respect to the opening asset base:

- Implemented the AER's *draft decision* with respect to the actual inflation input values and the use of the IPART approved WACC for 2003/04;
- Adopted CPI of 3.0% for 2008/09 as used by the AER in its *draft decision*, recognising this estimate should be updated to include the December 2008 quarter figures; and
- Updated the opening asset base to reflect actual 2007/08 capital expenditures as reported in the 2007/08 regulatory financial statements.

Integral Energy did not accept the AER's *draft decision* to reject the inclusion of approximately \$170 million in the opening asset base for an error in the asset lives of sub-transmission and zone substations. Integral Energy maintains that the *Transitional Rules* provide for the RAB to be increased by \$170 million for this change in asset lives, as discussed below.

2.1 Change in asset lives

In its *original proposal*, Integral Energy submitted that its opening Regulatory Asset Base (RAB) as at 1 July 2009 be increased by \$170 million to \$3,835.3 million in accordance with S6.2.1 of the *Transitional Rules*. The basis for this increase was to rectify an understatement of the RAB by an estimated \$167 million (as at 1 July 1998 and excluding capital contributions) due to an error in the asset lives of sub-transmission and zone substations. When rolled forward in accordance with the *Transitional Rules* this would increase the RAB as at 30 June 2009 by \$170 million.

In its draft decision, the AER concluded that "the transitional chapter 6 rules do not provide for Integral Energy's submission to increase its RAB for errors in asset lives as the threshold tests in second clause S6.2.1(e)(8)(i) and (ii) have not been met. Therefore the AER has decided to reject Integral Energy's proposal to add \$170 million to its RAB."

Integral Energy has reviewed the AER's *draft decision* and considers that other elements of *Transitional Rules*, in particular other clauses in S6.2.1, not specifically addressed by the AER do provide for Integral Energy to increase its RAB for errors in asset lives.

In particular Integral Energy considers that:

• The AER should revisit its application of S6.2.1(c) of the *Transitional Rules* in rolling forward the RAB to 1 July 2009;

- The requirements of S6.2.1(c)(2) and (3) of the Rules provide for the AER to increase the value of Integral Energy's RAB as at 1 July 2004 for the 1998 ODRC valuation to properly reflect the economic approach to valuation to be applied under the Rules; and
- Clauses S6.2.1(c)(2) and (3) of the *Transitional Rules* provide for an adjustment to the value of the RAB as at 1 July 2004 consistent with the economic statutory objectives and the revenue and pricing principles of the NEL and rectify the previous approach to asset valuation adopted by IPART in its 2004 Determination.

Integral Energy considers that the *Transitional Rules* provide for the RAB to be increased by \$170 million as a result of the error in asset lives when other elements of clause S6.2.1 are considered. Attachment 1 sets out Integral Energy's detailed legal arguments supporting this view.

Superannuation

In calculating its forecast operating expenditure for inclusion in its *original proposal* in June 2008, Integral Energy assumed that its superannuation liabilities for its defined benefits scheme would remain relatively unchanged from historic levels.

Since the *original proposal*, the global, and now local, financial crisis has seen a substantial reduction in the value of all Australian superannuation funds (including Integral Energy's). Accordingly, Integral Energy now forecasts that it will be required to make material contributions to the defined benefits fund in the next regulatory period to ensure that it is able to meet its liabilities in any given year.

3.1 Basis for increasing operating expenditures

Revising the forecast for superannuation liabilities is appropriate and importantly allowed in the *Transitional Rules* given that the AER has already recognised in its *draft decision* both the existence of the global financial crisis⁴ and that a DNSP's superannuation liabilities for employees on a defined benefits scheme is impacted not only by the number of these employees that retire in a given year but also by the performance of the superannuation fund. These are both factors that are beyond the control of the DNSP⁵.

Integral Energy considers that it is open to the AER to accept more recent information with respect to increased operating expenditures for superannuation liabilities arising as a result of the global financial crisis.

Clause 6.10.2(a)(4) of the Rules requires the AER to publish an invitation for written submissions on its draft determination. The AER has done this and has set 16 February 2009 as the last date upon which submissions will be accepted in relation to its draft determination.

Importantly, the submissions that may be provided to the AER under clause 6.10.2 of the Rules are not subject to the same limitations as clause 6.10.3 of the Rules. That is, Integral Energy's submissions do not necessarily have to address the reasons given by the AER in its *draft decision*, but are open to raise other issues Integral Energy considers should be taken into account by the AER in making its final determination.

Integral Energy considers that the submission part of the review process is suited to address the impact of the global financial crisis upon Integral Energy's *original proposal* or *revised proposal*.

⁴ AER, New South Wales Draft Distribution Determination 2009-10 to 2013-14, November 2008, pages xv and 97.

⁵ Ibid, page 245.

Integral Energy therefore is of the view that, with respect to the additional costs associated with meeting superannuation liabilities, it is open for Integral Energy to submit that, having regard to more recent information, the AER should, based on forecast expenditure items that did not form part of its *original proposal*:

- Accept Integral Energy's operating expenditure forecasts; and
- Make a determination based on an allowance of an amount greater than the original expenditure forecast in its regulatory proposal.

Integral Energy considers that the AER is permitted to depart from the *original proposal* so far as is necessary to allow it to be approved under the Rules, either by exceeding or reducing the amount contained in the regulatory proposal.

Further, it is a fundamental element of proper administrative practice that a decision maker take into account any submissions which correct, update or elucidate on matters originally put forward by Integral Energy and considered by it, in the absence of any statutory confinement on the AER taking into consideration such submissions.⁶

In summary, the Rules provide Integral Energy the opportunity to make submissions to the AER that have regard to more recent events on Integral Energy's operating expenditure estimates relating to superannuation liabilities contained in its *original proposal*, which might result in a forecast operating expenditure which exceeds the *original proposal* or that which the AER would have approved in its draft determination, without the need to revise its *revised proposal*.

3.2 Actuarial assessment of superannuation liabilities

In order to manage the impact of the global financial crisis on Integral Energy's superannuation liabilities, an actuarial assessment of Integral Energy's superannuation contributions was obtained from Mercer (Australia) Pty Ltd ("Mercer"). The Mercer actuarial assessment is provided as confidential Attachment 2.

Mercer's actuarial advice highlights a material funding shortfall for Integral Energy's assessed obligations accruing over the 6 months to 31 December 2008. This unexpected shortfall is in stark contrast to, and in addition to, the forecast \$12 million actuarial gains per annum over the 2009 regulatory control period that were included in the original proposal.

Integral Energy notes that the relevant additional funding requirements provided in Attachment 2 are those calculated in accordance with the Australian Accounting Standard AASB119, the Standard to be applied by an employer in the accounting and disclosure for all employee benefits⁷.

⁶ Per the High Court in Minister for Aboriginal Affairs and Another v Peko-Wallsend Limited and Others, 162 CLR 24

⁷ Except those to which AASB 2, Share-based Payment, applies. See AASB119, Scope 1.

As outlined in Attachment 2, the additional funding requirements for the 6 month period ending 31 December 2008 are based on the following:

- The growth in fund liabilities over the 6 months to 31 December 2008; and
- The reduction in value of the fund assets over the 6 months to 31 December 2008.

Therefore, when combined with the fair market adjustment included in the *original proposal*, and if the market recovers so that Integral Energy is able to meet the annual growth in the liabilities from 1 January 2009 to 30 June 2014, Integral Energy would require operating expenditures that are materially higher than those forecast in the *original proposal*.

AER's cash flow modelling

This Chapter outlines Integral Energy's views regarding aspects of the AER's approach to cash flow modelling where value has not been maintained or where sufficient revenues are not provided to meet the requirements of the *Transitional Rules*. In particular, Integral Energy provides comments on the following topics:

- Securing the value of tax imputation credits ("gamma"); and
- Consistent application of the benchmark gearing assumption.

4.1 Securing the value of tax imputation credits

Integral Energy has undertaken initial analysis of the interaction between the PTRM, the assumed gamma of 0.5 and the cash flows supported by the calculation of equity raising costs in the AER's *draft decision*. Based on the initial findings of this analysis, Integral Energy was not convinced that the *draft decision* would deliver outcomes that are fully consistent with the assumption of 0.5 for gamma required by the *Transitional Rules*.

Integral Energy provided summaries of key elements of the initial analysis in its *revised proposal*, and sought further engagement from the AER on issues by the preliminary analysis.

Integral Energy notes that the report by Mr. Tony Carlton⁸, commissioned by EnergyAustralia and included in EnergyAustralia's *revised proposal*, considered a range of matters relating to equity raising costs, including the payment of dividends and consequential transfer of imputation credits to shareholders. The report supports the nature of the issues raised by Integral Energy in its *revised proposal* and finds that in applying the proposed dividend payout ratio of 70% that:

"...therefore implies that the 70% payout policy means that the equity holders will not receive the target rate of return of 11.334% over the period."⁹

Subsequent to submitting the *revised proposal* Integral Energy engaged KPMG to undertake more extensive analysis and confirm whether Integral Energy had identified a material modelling inconsistency within the PTRM.

KPMG's report, provided as Attachment 4, further supports Integral Energy's initial analysis that, without modifications, the benchmark accounting profits and cash flows derived from the PTRM

⁸ Visiting Fellow at the Applied Finance Centre, Macquarie University, Sydney.

⁹ EnergyAustralia Revised Regulatory Proposal, Attachment 3P - Carlton - Indirect Cost of Equity and Debt Raising, Tony Carlton, pg 26.

4 AER's cash flow modelling

will not fully support the economic outcomes that are the basis for establishing the annual building block revenues.

In evaluating whether the cash flows support the assumption for gamma in the PTRM, and whether this leads to any concerns regarding the achievement of the return on equity, KPMG found, in summary, that:

- The PTRM does not provide sufficient cash flows to enable Integral Energy to pay out a level of dividends and associated imputation credits that is sufficient to support the value that is assumed to flow to shareholders from imputation credits. Under such circumstances the cash flow to equity providers will be lower than that assumed in the PTRM, resulting in a calculated return to equity holders that is lower than the benchmark cost of equity assumed in the inputs¹⁰; and
- The value of imputation credits that is assumed to flow to shareholders in the PTRM can only be supported if dividend payout ratios well in excess of 100% is assumed each year. Even with a 100% dividend payout ratio, there are insufficient accounting profits available to distribute the required level of dividends and imputation credits.¹¹

Having confirmed that Integral Energy's initial analysis is supported by both Mr. Carlton and KMPG, Integral Energy proposes several recommendations for the modelling and assumptions used by the AER in relation to imputation credits.

These recommendations include:

- The payout ratio assumed by the AER for dividends paid out of net profit after tax should be increased to be the lesser of 100% or the dividends necessary to fully distribute all imputations credits, but not less than 70%;
- It should be assumed that the most recently created imputation credits be distributed to shareholders through dividends first in order to minimise the costs to customers;
- The loss in value from the non-distribution of the required imputation credits should be calculated by multiplying the residual economic value of non-distributed imputation credits by the prevailing return on equity as calculated by the Capital Asset Pricing Model (CAPM);
- The loss in value from the non-distribution of the required imputation credits should be compensated for through an increase in the annual building block revenues equal to the grossed-up annual value of the amount lost; and
- Maintaining separate records of the number of undistributed imputation credits and the maintenance of the residual economic value for each vintage (year) of imputation credits.

¹⁰ KPMG, Review of Certain Assumptions in the AER's Financial Model to support the NSW Distribution Network Revenue 2009-2014, page 3

¹¹ Ibid, page 14

A full description of these recommendations, supporting arguments and analysis are included as Attachment 3.

4.2 Consistent application of the benchmark gearing assumption

In its *revised proposal*, Integral Energy advocated for the inclusion of "repayment of debt" to be incorporated into the cash flow modelling used by the AER to calculate the residual internal cash flows available for reinvestment in forecast capital expenditure under the "pecking order" method adopted by the AER.

Including the repayment of debt into the cash flow modelling was supported by the CEG report attached to the *revised proposal* which established that failure to include recognition that a portion of the return of capital (regulatory depreciation) relates to the debt funding of the RAB would lead to a breach of the gearing assumption specified in the *Transitional Rules*.

"In order to model cash flows consistently with a 60% gearing ratio it must be assumed that 60% of the return of capital is used to retire existing debt. That is, it must be assumed that the business retires existing debt at the same rate that the value of existing assets falls".¹²

Following the submission of the *revised proposal* Integral Energy engaged KPMG to review the cash flow modelling used by the AER in determining the equity raising costs to determine if the modelling should be expanded to include repayment of debt as recommended by CEG.

KPMG undertook a detailed analysis of the PTRM and constructed benchmark regulatory cash flow statements, balance sheets and profit and loss statements in order to determine whether repayment of debt was required to be included in the cash flow analysis supporting the equity raising costs. The results of this analysis provide further support to Integral Energy's *revised proposal* and independently verify the findings of the CEG report.

Based on its detailed analysis KPMG found that:

"The PTRM's calculation of the amount of equity to be raised by Integral Energy from external sources is flawed. We believe that the error occurs because the AER's calculation of cashflows fails to take into account the requirement to repay debt each year. This requirement is necessary in order to maintain the benchmark gearing assumption of 60% of the value of the regulatory asset base";¹³

¹² CEG, Debt and equity raising costs - A response to the AER 2008 draft decisions for electricity distribution and transmission, page 22

¹³ KPMG, Review of Certain Assumptions in the AER's Financial Model to support the NSW Distribution Network Revenue 2009-2014, page 3

"As a result of the failure to take into account the requirement to repay debt each year, the PTRM violates the benchmark gearing assumption. It results in the ratio of debt to RAB each year rising from 63% in 2009-10 to 72% in 2013-14^{"14};

and

"The AER's failure to take into account the requirement to repay debt each year also leads to an incorrect calculation of the amount of external equity required to be raised. We estimate that Integral Energy will need to raise a total of \$630.25 million between 2009-10 to 2013-14. By contrast, the AER's PTRM assumes that Integral Energy will only need to raise \$24.02 million over the same period. The AER's PTRM therefore significantly understates the amount of external equity raising required by Integral Energy."¹⁵

In addition to these key finding KPMG noted that:

*"We observe that the AER's internal cash flows calculations ignores the requirement to repay debt. This is despite the fact that its calculations of interest expense are based on a debt balance which assumes an annual repayment of debt".*¹⁶

The KMPG report is included as Attachment 4.

It should be noted Integral Energy accepts that the notional repayment of debt arising from the return of capital calculated by the regulatory depreciation may not in all instances form an actual repayment of debt under some debt funding arrangements. However, the approach to recognising the available debt capital in the cash flows is equally applicable under any funding arrangements as these funds would either be paid to providers of debt under a structured loan or reinvested to fund the debt portion of future capital expenditure where structured repayments of principle are not required.

In either situation the internally generated cash flows are attributed to the debt financing of the RAB.

As a test of the veracity of these claims the counterfactual example is to consider what would occur where new debt and equity were not required to meet future capital expenditure needs, and what the regulatory framework would assume the DNSP would do with the residual cash flows.

In this instance the RAB would be decreasing, and therefore to ensure that the total value of capital invested in the DNSP is equal to the current value of the RAB, the DNSP would necessarily reduce (repay) both debt and equity by repaying the "principal" down to the value of the RAB while maintaining the assumed gearing.

¹⁴ KPMG, Review of Certain Assumptions in the AER's Financial Model to support the NSW Distribution Network Revenue 2009-2014, page 3.

¹⁵ Ibid, page 21.

¹⁶ Ibid, page 21.

Based on the recommendations of the CEG report, and the consistent recommendations independently provided by KPMG, Integral Energy submits that the AER should review the cash flow modelling underpinning the calculation of the equity raising costs and include cash flows to account for the notional repayment of debt.

Return on capital

In its *revised proposal*, Integral Energy implemented the findings of the *draft decision* with respect to the cost of capital, with the exception of the agreed period and associated start date for the nominal risk free rate and the debt premium.

5.1 Averaging period for the risk free rate

In accordance with clause 6.5.2(c) of the *Transitional Rules*, Integral Energy originally proposed an averaging period to estimate the risk-free rate of 15 days in length, commencing 40 business days following submission of the *original proposal* on 2 June 2008.

The AER did not agree with the period proposed by Integral Energy on the basis that it considered the proposed dates of the periods were too far removed from the final determination date and the commencement of the regulatory control period and that such dates may not provide the most relevant information. The AER further stated its *draft decision* is consistent with past practice by the AER and other state regulators, and supported by CAPM theory.

The AER advised Integral Energy that it did not agree with the proposed averaging periods and proposed a period of 15 business days (noting that the length of the period had not changed from Integral Energy's proposal). The AER, however, rejected Integral Energy's proposed start date and instead proposed a period starting on a date as close as possible to the final determination.

Integral Energy considers that the averaging period for the risk free rate and the debt risk premium should be one that is likely to provide a rate of return on capital consistent with providing the network service provider with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing direct control network services, in the context of fixed parameters.

The Rules provide for the network service provider to propose the averaging period and Clause 6.5.2(c)(2)(i) of the *Transitional Rules* provides that the AER is not to "unreasonably withhold" its agreement to this period. Integral Energy considers that the AER's role is to consider the case put forward by the service provider for its proposed averaging period and only if the AER considers that the period is not consistent with the relevant Rule and Law provisions, can it withhold agreement.

Integral Energy considers that the AER cannot withhold agreement simply because Integral Energy has not proposed a period consistent with the AER's preferred regulatory practice or that it may result in a lower rate of return by selecting a later period.

Integral Energy submits that:

 The AER's decision to reject Integral Energy's proposed averaging period was incorrect in that, for the reasons in the revised proposal, and having regard to the current market evidence it would be unreasonable to withhold agreement to the original proposed period; and

 Notwithstanding that view and without prejudice to that position, Integral Energy revised its regulatory proposal to address the AER's reasons for rejection, namely that the commencement date of the averaging period was not sufficiently proximate to the final decision. In providing an updated commencement date, Integral Energy has selected a date that would result in the averaging period concluding prior to the commencement of the abnormal financial market conditions associated with the global financial crisis.

Integral Energy contends that in light of the evidence in relation to the abnormal financial market conditions associated with the global financial crisis (as discussed in the *revised proposal*), it would be unreasonable for the AER to withhold agreement to the revised period for the reason that it is not sufficiently proximate to the final determination.

Clause 6.5.2 of the Rules requires the AER to provide an adequate rate of return. Evidence provided by Integral Energy (see expert CEG report provided as Attachment B in the *revised proposal*) establishes that determining a rate of return in an abnormal market will not provide an adequate rate of return. In the event that the AER does not agree to Integral Energy's revised averaging period, it should not determine a rate of return based on an observation of nominal Commonwealth Government Securities in such an abnormal market without an appropriate adjustment. This position is without prejudice to the submission that the AER should agree to Integral Energy's revised proposed period and was in error in rejecting the first proposed period.

5.1.1 Nominal risk free rate averaging period

As discussed in detail in its *revised proposal*, Integral Energy considers that the impact of the global financial crisis on bond markets is such that adopting an averaging period so affected will result in a less reliable estimate of both the cost of equity and the cost of debt compared to adopting an averaging period further into the past. Reliable estimates can only be expected if the averaging period adopted is prior to early September 2008 when the financial crisis reached a new level.

Integral Energy also does not support the AER's suggestion that there is a financial logic that compels the adoption of an averaging period proximate to the beginning of the regulatory period. As set out in the *revised proposal*, the weight of regulatory precedent, both in Australia and internationally, is firmly on the side of not adopting the most recent averaging period if this also overlaps with abnormal levels of the risk free rate or periods of economic crisis.

To adequately address the impact of the global financial crisis, Integral Energy proposed that the AER adopt the 15 day averaging period (consistent with Integral Energy's proposed length of period) as close as possible to the final decision, but prior to the onset of the global financial crisis.

Integral Energy considers that the relevant date would be 15 days ending on 5 September 2008, the closest trading day prior to when the US institutions "Fannie Mae" and Freddie Mac" went into conservatorship.

5.1.2 Debt Risk Premium

In calculating the debt risk premium, Integral Energy has adopted the same averaging period (i.e. a 15 day averaging period prior to the events of early September 2008) proposed for calculating the nominal risk free rate, and has also used the same start date for the averaging period as for the nominal risk free rate.

5.1.2.1.1 Methodology for calculating the debt risk premium

While there are some imperfections with the AER's approach of taking the Bloomberg fair yield for BBB rated 8-year corporate bonds and adding the Bloomberg fair yield spread between A rated 8 and 10-year corporate bonds to derive a proxy 10-year BBB+ corporate bond yield, Integral Energy considers that the AER's methodology is not unreasonable for the purposes of determining the benchmark debt risk premium.

As discussed in Appendix B of the *revised proposal*, Integral Energy proposes that the AER adopt the same averaging period and start date as for the nominal risk free rate.

Integral Energy notes the proposals from other network businesses to use an average of the annualised BBB+ debt risk premium rates derived from the Bloomberg and CBA Spectrum. Recognising that greater statistical confidence may be achieved from increasing the number of data points, Integral Energy submits that the use of an average of the two services may reduce errors in measuring the DRP and should be fully considered by the AER.

As with other aspects of the return on capital, if the AER considers that an average of the two services is appropriate to calculate the debt risk premium, Integral Energy submits that it should be applied consistently to all of the NSW DNSPs.

5.2 Revised cost of capital

In accordance with the *Transitional Rules*, Integral Energy's *revised proposal* incorporated a nominal vanilla WACC value of 10.02%. Integral Energy notes that its revised WACC is a reduction from the WACC of 10.3% calculated using actual market data from the averaging period put forward by Integral Energy in its *original proposal*.

Pass through arrangements

In its *original proposal*, and in addition to the pass through events defined in Chapter 10 of the Rules, Integral Energy nominated a number of events that it considered should be treated as pass through events.

In its *Draft decision*¹⁷, the AER considered the following pass through events proposed by Integral Energy are likely to be regulatory change events and therefore considered that separate nominated events are unnecessary:

- The introduction of smart meters;
- The introduction of an emissions trading scheme;
- Distribution loss event;
- Retailer of last resort;
- Obligations relating to EMF; and
- Changes in reporting requirements.

The following sections discuss Integral Energy's nominated pass through events in response to the AER's *draft decision*.

6.1 Nominated pass through events

Integral Energy considers that the AER erred in its *draft decision* on this matter as each of the above nominated pass through events with the possible exception of an EMF event are expressly defined to exclude events which fall within other categories of a pass through event (including a regulatory change event). Therefore each of these events cannot meet the criteria of a regulatory change event. In this case, Integral Energy would be denied the opportunity to recover its efficient costs incurred in respect to the nominated pass through events.

In the event the subjects to which the nominated pass through events relate do not become regulatory change events, the additional material costs incurred by Integral Energy in respect to the nominated pass through events would not be addressed.

The AER also excluded Integral Energy's nominated pass through events for functional change and business continuity from being a pass through events.

¹⁷ AER, New South Wales Draft Distribution Determination 2009-10 to 2013-14, November 2008, p 281

Attachment 5 sets out Integral Energy's detailed comments with respect to the AER's *draft decision* on pass through arrangements.

In summary, Integral Energy seeks express recognition from the AER that each of the above events be included as a pass through event.

In order to address the matters raised by the AER in the *draft decision*, Integral Energy's *revised proposal* also set out revised definitions for automated meter events and electric and magnetic field events and proposed a new "insurance event" that is similar to the pass through event and the definition in the Rules currently applying to *Transmission Network Service Providers*.

6.1.1 Emissions trading scheme

With respect to a pass through event for the introduction of an emissions trading scheme, Integral Energy notes the recent statement by the Ministerial Council on Energy (MCE) regarding its policy intent regarding the costs of introducing the Carbon Pollution Reduction Scheme (CPRS):

"The MCE recognised the importance of addressing regulatory impediments to carbon cost pass-through associated with the efficient functioning of the CPRS. To ensure a national commitment to the pass-through of carbon prices to end-use consumers, the MCE will ask that Council of Australian Governments (COAG) amend the 2006 Australian Energy Market Agreement to specify that where retail prices are regulated, energy cost increases associated with the CPRS shall be passed through to end-use customers."¹⁸

Integral Energy considers that the above statement by the MCE lends support to Integral Energy's contention that any uncertainty regarding the costs associated with the introduction of an emissions trading scheme should be removed by the AER making a positive statement that the costs will be recognised in pass through arrangements when and if they occur.

6.1.2 Federal Government stimulus package

Integral Energy notes that on 13 February 2009 parliament passed the Commonwealth Government's \$42 billion economic stimulus package. Integral Energy is currently assessing the implications of the stimulus package on its network business; however, Integral Energy would seek to ensure that any additional costs imposed on the business as a result of the package would be considered regulatory events for the purposes of the AER's pass through arrangements.

¹⁸ Ministerial Council on Energy Communiqué, 6 February 2009, Attachment A, page 4.

Other matters raised in the draft decision

This Chapter provides Integral Energy's views on the following matters raised in the *draft decision*:

- EnergyAustralia's proposed "G factor";
- Negotiable components;
- Assignment / re-assignment of customers; and
- Demand management innovation allowance (DMIA).

7.1 EnergyAustralia proposed "G factor"

In its *revised proposal*, EnergyAustralia has proposed revising the control mechanism to account for uncertainty in growth forecasts.

Notwithstanding the specific linkage to the introduction of the CPRS as proposed by EnergyAustralia, Integral Energy considers that there is merit in applying a "G factor" to the overall impact of outturn volumes compared with the volume assumptions made at the time of the final determination.

A G factor that applies to outturn volumes recognises that actual volumes, including energy consumption and customer numbers, are uncertain, particularly in light of the global financial crisis, and are largely outside the direct control of the distributor.

The G factor would be applied to the "right hand side" of the WAPC equation in the following manner:

$$<= (1 + \Delta CPI)^{*}(1 - X_{t})^{*}(1 - D_{t})^{*}(1 - G_{t})$$
 ("Formula 1")

Integral Energy notes that the cost pass through arrangements contained in the Rules do not provide remedy for volume variations as they do not result in changes in costs per se and as such would not trigger a pass through event. Therefore, to manage volume risk, Integral Energy supports the proposal by EnergyAustralia for the inclusion of a G factor adjustment to the WAPC formula, with some minor modifications as discussed in section 7.1.1 below.

The G factor, as proposed by EnergyAustralia, includes an adjustment to the WAPC formula if cumulative network revenues vary by more than "L"%, where "L" is the maximum permissible deviation from target revenue. The G factor, based on a variation of L%, would act in the following way:

- It would not act to adjust network prices if cumulative network revenues remain within L% of the lagged target based on efficient costs as determined by the AER;
- In the event that cumulative revenues were to exceed target by more than L%, the G factor would act to reduce revenue to within L% of the target; and
- If cumulative revenues were to fall short of target costs by more than L%, the G factor would act to increase the revenue to within L% of the target.

Integral Energy notes that the variable "L" is not to be confused with the IPART "L" factor used in clause 7.1 of the IPART 2004 Network Determination for the setting of network tariff price limits.

7.1.1 Size of the L% constraint

EnergyAustralia's G factor proposal does not specify the magnitude of the variation from the determination revenue outcomes ("L") and leaves this to the AER to set. The G factor mechanism is designed to limit excursions above or below the acceptable bounds of the intended target revenue but that a DNSP would still be subject to potential gains and losses consistent with the intention of the WAPC within the bounds set under the G factor.

Integral Energy supports the position that it is not reasonable for a DNSP to bear all risk of outturn volume shortfalls (relative to the assumptions underpinning the determination); nor is it reasonable for customers to bear all the risk of outturn volume increases (relative to the assumptions underpinning the determination), particularly when there is considerable uncertainty surrounding volume forecasts in light of the global financial crisis and other significant policy initiatives such as the introduction of the CPRS.

Therefore, Integral Energy considers that it is appropriate that the WAPC formula contain a G factor and that the G factor should operate only if a significant variation occurs in outturn volumes relative to the forecasts underpinning the determination beyond a specified "band".

Furthermore, Integral Energy notes that isolating the volume effect is important in distinguishing between the operation of a revenue cap and providing a reasonable sharing of risks for volume variations. As an example, actual revenues in a given year will be affected, positively or negatively, by many factors including billing cycles, changes in tariff mix, level of miscellaneous and monopoly fee activity, as well as actual demand, customer numbers and customers' consumption.

Integral Energy proposes that the G factor should not be linked to overall revenues (i.e. a revenue cap); rather it should be limited to outturn volume changes relative to the forecasts underpinning the final determination. Integral Energy notes that volume variations will have a revenue impact; however this is distinct from a revenue cap in that all other elements of Integral Energy's network revenue would not be impacted by the G factor.

Integral Energy proposes that the G factor be calculated as follows:

 A G-factor would be added to the "right side" of the WAPC formula as identified in "Formula 1" above;

- A calculation ("Formula 2") would be undertaken to identify the difference between:
 - the smoothed revenue allowance in a particular regulatory year as contained in the determination; and
 - the revenue calculated by multiplying the prices contained in the determination (in the PTRM) by the actual weighted average price cap (WAPC) audited volumes. This difference reflects the revenue associated only with the volume variation between what was assumed in the determination and actual outturn volumes.¹⁹
- Based on the difference calculated in **Formula 2** above in any year, the G factor in the WAPC formula would act to adjust average network prices in the following manner:
 - It would not act to adjust network prices if the difference remains within L% of the smoothed revenue for the regulatory year;
 - If the difference were to exceed L% of the smoothed revenue for the regulatory year, the G factor would act to increase future average network prices to allow recovery of revenue within L% of the smoothed revenues; and
 - If the difference were to fall short by more than L% of the smoothed revenue for the regulatory year, the G factor would act to decrease average network prices to allow recovery of revenue within L% of the smoothed revenues.

Integral Energy considers that an appropriate value of L is between 2% to 5%, representing a band of +/- approximately \$16-40 million (in 2009/10) that would be in place to allow volumes to increase or decrease within the WAPC without adjustment before the G factor would act to adjust average network prices (positively or negatively) in the following year.

Integral Energy considers that a G factor with an L constraint of between 2% and 5% is appropriate, when calculated on an annual basis, to be included in the WAPC formula in order to:

- Provide a reasonable sharing of risks between Integral Energy and its customers in light of the uncertainty and potential significance of volume variations;
- Minimise regulatory intervention; and
- Allow the operation of the WAPC form of regulation.

Integral Energy has developed a model that calculates the effects of the G factor and that adjusts average network prices in a manner consistent with the approach underpinning the D-factor. Integral Energy hopes to work with the AER to contribute to the development of a G factor that could be introduced in the final determination for the 2009 regulatory control period.

¹⁹ As the WAPC audited volumes occur on a 2 year lagged basis, the adjustment for the G factor would necessarily occur on a lagged basis. This would also require an adjustment in the 2014 regulatory control period to adjust for the volume impacts in 2012/13 and 2013/14.

7.2 Negotiable components of direct control services

Integral Energy notes that in the *draft decision* the AER has essentially adopted Integral Energy's proposed classification for negotiable components of direct control services. Integral Energy also notes the concerns raised by EnergyAustralia in their *revised proposal* in relation to the implementation of this classification.

On reviewing the concerns raised by EnergyAustralia, Integral Energy is of the view that there would be merit in amending the proposed classification to address a number the issues raised by EnergyAustralia including their contention that the third limb of the definition is extremely broad and capable of capturing or impacting upon just about every aspect of the connection service. The third limb of the proposed definition is:

"the direct control service is a connection service provided to serve network users at a single distribution network connection point, other than connection services that are provided by one network service provider to another network service provider to connect their networks where neither provider is a market network service provider."

Integral Energy believes that the above dot point should be amended to make it clear that the only components of the connection service that are negotiable are those not covered by other regulatory instruments such as IPART's Capital Contributions Determination and the AER's monopoly service arrangements.

The amendment to the third limb of the definition will reduce any confusion that may arise between the negotiable components framework and the regulatory instruments and would allow the provision of documents and information to prospective connection customers that would enable them to understand what is negotiable and what is not.

7.3 Assignment / Reassignment of customers

As part of its *revised proposal*, Integral Energy expressed some concern at the arrangements for assignment of customers as outlined in Appendix A of the *draft decision* and the possible inconsistency this could create with respect to the reasonable estimates methodology detailed in Appendix J of the *draft decision*.

Integral Energy has further reviewed the proposed process for assignment of customers to tariffs as outlined in Appendix A of the *draft decision* and believes that there is merit in modifying the AER's proposed process to reflect current practice and to remove any disincentives on Integral Energy to pursue innovative tariffs over the course of the *2009 regulatory control period*.

This section provides Integral Energy's comments on the following matters raised in the *draft decision*:

- Assignment of new customers to a tariff class during the regulatory control period;
- Reassignment of existing customers to another existing tariff during the regulatory control period;

- Dispute resolution arising from a re-assignment of customers; and
- Reassignment of existing customers to a new tariff during the regulatory control period.

7.3.1 Assignment of new customers to a tariff class during the regulatory control period

Integral Energy has established processes for assigning customers to tariff classes or for reassigning customers from one tariff class to another.

Chapter 5 of Integral Energy's Network Price List 2008/09 details the tariff classes available and how the most appropriate tariff class is determined for individual customers. As detailed in the Price List the assigned Pricing Option (or tariff class) will depend on the annual energy consumption measured at the supply point, nature and use of the energy, the supply voltage at the supply point, the method of connection to Integral Energy's distribution network and the type of metering installed at the property.

This process complies with the principles governing assignment or re-assignment of customers to tariff classes outlined in the *Transitional Rule* 6.18.4 and aligns with the "Assignment of new customers to a tariff class during the regulatory control period" as detailed in Appendix A of the *draft decision*.

7.3.2 Reassignment of existing customers to another existing tariff during the regulatory control period

On a small number of occasions during the year, Integral Energy is approached by retailers, on behalf of their customers, to re-assign customers to a different tariff class. These re-assignments are generally due to changes in the circumstances of the customer such as increase or decrease in load connected or changes in the connection arrangements. Section 5.1 of Integral Energy's Network Price List 2008/09 details the process to be followed for a re-assignment.

It is important to note that any re-assignment application must be through the customer's retailer so that the retailer is aware of all changes and the necessary amendments are made to the NEMMCO Metering and Settlement Transfer Solution (MSATS) database.

There may also be instances where a DNSP wishes to introduce time of use metering and associated time of use tariffs, or other tariff innovations, and would therefore require the procedures to facilitate this re-assignment to achieve more of the potential benefits of tariff reform for customers.

If, during the 2009 regulatory control period, Integral Energy were to change its policy on new and replacement meters and install time of use meters in all instances, then the process in Appendix A of the *draft decision* would not permit the customers to be re-assigned to a time of use tariff as there has been no change to their load or connection characteristics. Integral Energy therefore recommends that the AER modify its wording in section 5 of Appendix A of the *draft decision* so that a change in connection characteristics specifically includes the installation of a meter with time of use capabilities in order to enable the re-assignment of the customer to a time of use tariff.

7.3.3 Dispute resolution arising from a re-assignment of customers

Integral Energy is also concerned that under the draft procedures the AER becomes the dispute resolution body for any dispute arising from a re-assignment of customers. As the majority of customers would be "small" customers, that is, customers consuming less than 160MWh per annum, they would be covered by the NSW Energy and Water Ombudsman. Integral Energy believes that this would be the more appropriate body for referral of any disputes.

Should the AER wish to become the dispute resolution body for matters relating to re-assignment, Integral Energy believes that section 12 of Appendix A of the *draft decision* needs to be revisited. Section 12 states that, in making a decision regarding a request for re-assignment, if the AER does not give a written notice under section 11 within 30 business days of receiving a relevant request or within such period as the AER may decide, then the customer should not be re-assigned. Integral Energy considers that this section as currently worded does not provide an appropriate incentive on the AER to resolve the matter in a timely manner, particularly if large numbers of customers are proposed to be re-assigned as may be the case with the introduction of time of use tariffs.

Integral Energy suggests that section 12 of Appendix A of the *draft decision* be revised such that if the AER does not make a decision within 30 business days of receiving a relevant request, then the re-assignment proceeds to ensure that there are no unintended barriers to the introduction of innovative tariff and metering options.

7.3.4 Reassignment of existing customers to a new tariff during the regulatory control period

The AER's *draft decision* requires a reasonable estimate for distributor directed changes to tariffs, tariff structures and customer re-assignments that have occurred or are planned to occur. This includes the re-assignment of existing customers and their load when:

- A new tariff is introduced;
- A pre-existing tariff structure is changed, including the introduction of a new tariff component, the removal of an existing component and changes to timing and other application definitions such as the peak, shoulder and off-peak time periods in a time of use tariff; and
- Re-assignment to an alternate, pre-existing tariff is directed by the distributor.

These reasonable estimates are used in the annual WAPC calculation. As noted in Section 17.2 of the *revised proposal* and as discussed above, Integral Energy has detailed its concerns in relation to the reasonable estimates calculation and the restriction this would place on Integral Energy's ability to introduce innovative time of use energy tariffs and demand tariff structures.

Integral Energy is also seeking clarification of a discrepancy in the quantity lags used in the WAPC detailed in Section 4.5 of the *draft decision* and the quantity lags used in the reasonable estimates methodology detailed in Appendix J of the *draft decision*. The WAPC and side

constraint formulas are calculated using quantities from year t-2, however, the reasonable estimates methodology detailed in Appendix J uses quantities from year t-1.

Integral Energy believes that Appendix J should be amended such that the reasonable estimates are calculated for quantities in year *t*-2, consistent with the WAPC and side constraint formula.

7.4 Demand management innovation allowance scheme

Integral Energy supports the AER's approach to the demand management innovation scheme subject to the change to the innovation allowance and the clarification of a number of matters as detailed below. Integral Energy acknowledges that the AER's introduction of the demand management innovation allowance (DMIA) is a positive move to encourage demand management innovation and intends to undertake innovative tariff and non tariff-based programs to pursue demand reductions across the network during the 2009 regulatory control period.

In section 14.6 of its draft decision, the AER "seeks written confirmation of [Integral Energy's] agreement for the purposes of clause 6.6.3(c) of the transitional chapter 6 rules" if Integral Energy agrees that the original DMIA is to be replaced by the replacement DMIA.

Integral Energy has reviewed the demand management innovation allowance set out in the AER's "Demand management incentive scheme for the ACT and NSW distribution determinations", published in November 2008 (the replacement DMIA).

Integral Energy agrees that the demand management incentive scheme to apply to Integral Energy is the DMIA set out in the AER's "Demand management incentive scheme for the ACT and NSW 2009 distribution determinations – Demand management innovation allowance scheme", November 2008 (the replacement DMIA), and the D-factor scheme set out in IPART's "Guidelines on the Application of the D-factor in the Tribunal's 2004 NSW Electricity Distribution Pricing Determination", with the following exception:

Integral Energy proposes, consistent with the position taken in both its *original proposal* and its *revised proposal*, a demand management innovation allowance (DMIA) of \$1 million per annum to apply to Integral Energy, rather than the \$0.6 million allowance per annum as per the replacement DMIA.

Integral Energy also seeks clarification of the following three matters:

- Footnote 2 under Section 3.1.4 of the replacement DMIA states that the AER's ex-post review will take place once audited data is available for the previous regulatory year. There is no requirement in the replacement DMIA for auditing of data so Integral Energy assumes that the audited data referred to is for the weighted average price cap. Integral Energy seeks confirmation that this is the case.
- 2. Under Section 3.2.1 the AER has stated that tariff based demand management programs are those that aim to provide signals to electricity customers at time of peak electricity demand, for example critical peak pricing trials. Integral Energy is considering implementation of direct load control programs which will require installation of equipment on customers' premises and appliances and will have a tariff component associated with them. It is not clear from the AER's statement whether these programs would be

classified as tariff based or non-tariff based programs. Integral Energy seeks clarification from the AER on this issue.

3. At the end of the paragraph at the top of page 9 of the replacement DMIA the AER have stated that it will not allow a DNSP to recoup foregone revenues resulting from demand management carried out independently of the DMIA. Integral Energy assumes that this means that the AER will not allow recovery of foregone revenue through the DMIA for programs outside the DMIA. If this is not the case then recovery of foregone revenue through the D factor would be prohibited. Integral Energy seeks confirmation that its assumption is correct.

Attachments

Integral Energy submission to the AER