

23 September 2008

Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Energy Regulator
GPO Box 520 Melbourne Vic 3001

Dear Mr Pattas

Review of the WACC parameters for electricity transmission and distribution

Integral Energy welcomes the opportunity to submit its views on the review of the weighted average cost of capital (WACC) parameters to be adopted in determinations for electricity transmission and distribution network service providers (the Review).

The Review will provide important guidance as to how the AER will assess the specified WACC parameters in regulatory reviews occurring during the upcoming five years. As the determinations set by the AER will generally be for a five year period, investments up to the year 2018 will effectively be made under the conditions of the Review, thereby highlighting the importance of the Review for investment in electricity networks over the next decade.

In preparing this submission, Integral Energy has contributed to a program of work facilitated through the Energy Networks Association (ENA) involving a number of industry associations intended to deliver a whole of industry view on the appropriate WACC methodologies and values. Integral Energy endorses the material submitted by the ENA.

The work in establishing WACC parameters is necessarily detailed and technical and as such the industry has engaged a range of experts to provide advice on key matters. Rather than repeating the work of the ENA, this submission summarises the key challenges and recommendations contained in the industry submission.

Key investment challenges over the next decade

To meet their regulatory and legislative obligations in delivering safe and reliable networks, electricity network businesses will need to invest in essential infrastructure at record levels over the next decade. It will therefore be essential for the AER to enshrine sound fundamentals into its WACC framework to balance the need to attract capital to the industry with the need to ensure prices to customers are set at reasonable levels.

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INTEGRAL ENERGY ABN 59 253 130 878
51 Huntingwood Drive Huntingwood NSW 2148
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In striking this balance, the AER will need to consider the following challenges in its Review:

1. All parts of the national grid require investment. Many localities, including the Integral Energy franchise area, are experiencing steeply growing electricity demand. In addition, some assets are ageing and the system needs rejuvenation;
2. The Australian community has set high expectations for its policy makers to improve climate outcomes. These expectations can only be met if the policy settings induce a redesign of the energy supply system from 'top to bottom' from generation to transmission to distribution and retail. This cannot occur without significant new investments (while retaining the existing infrastructure); and
3. The world economy is entering a period of uncertainty and contraction and investment funds are rapidly becoming scarcer. This is occurring at a time of continuing and increasing global demand for energy and resources infrastructure, fuelled by rapid economic growth experienced in both China and India. Australian firms will be competing globally with other firms seeking to attract finance to fund investment in this infrastructure.

The Review must allow capital to be attracted for investment in electricity networks at a time when many other parts of the world are also competing to attract funds for their infrastructure needs. This will be particularly challenging in the face of an uncertain outlook for financial markets combined with expected significant calls for capacity expansion and system redesign.

Outcomes of the Review

Consistent with the joint industry submission, Integral Energy considers that:

- The majority of the WACC parameters should remain 'as is' to reflect where the current regulatory debate has landed;
- There should be a clear restoration of a consistent equity beta of 1.0; and
- A correction should be made to the tax imputation credit ("gamma") and or the Market Risk Premium (MRP) parameters.

Integral Energy considers that the industry position is both moderate and responsible. It does not seek to maximise returns at every turn, but rather seeks a balanced approach that advocates for more generous parameters where warranted in order to legitimately attract investment capital to the industry.

To be effective, the Review needs to align the cost of capital of distribution networks, confirm the previously adopted parameters for transmission networks and correct for the errors identified in the ENA submission relating to the market risk premium (MRP) and tax imputation credits ("gamma").

Integral Energy considers that the only basis for moving away from current values is where there is persuasive evidence to do so, and on this basis considers that the ENA submission provides such evidence in relation to individual parameters.

Integral Energy supports the ENA position with respect to the following WACC parameters:

	Previously Adopted Values (T)	Previously Adopted Values (D)	Proposed Values (T & D)
Equity Beta	1.0	1.0*	1.0
Market Risk Premium	6.0%	6.0%	7.0%
Debt / (Debt + Equity)	60%	60%	60%
Credit Rating	BBB+	BBB+	BBB+
Source of Nominal Risk Free Rate	10 year CGS	10 year CGS	10 year CGS
Gamma (netted off tax liability)	0.5	0.5	0.2

* Legal advice is provided as part of the ENA response setting out why 1.0 is the value that is best described as the previously adopted value.

The AER is encouraged to seek to establish a sustainable regulatory regime characterised by predictable, rational outcomes in order to provide regulatory certainty to attract and maintain investment in regulated electricity infrastructure in Australia.

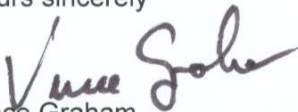
Conclusion

To meet their regulatory and legislative obligations in delivering safe and reliable networks, electricity network businesses will need to invest in essential infrastructure at record levels over the next decade. It will therefore be essential for the AER to balance the need to attract capital to the industry with the need to ensure prices to customers are set at reasonable levels.

Integral Energy acknowledges that achieving this balance will be no small feat given the uncertain outlook for financial markets and the increasing global demand for energy infrastructure investment.

Please do not hesitate to contact Mike Martinson, Manager Regulatory & Pricing on (02) 9853 4375 to discuss this response.

Yours sincerely


Vince Graham
Chief Executive Officer