INTEGRAL
energy
The power is in your hands

Mr Sebastian Roberts
General Manager
Transition Group
Australian Energy Regulator
GPO Box 520
MELBOURNE VIC 3001

17 October, 2005

Dear Mr Roberts,

Regulatory Accounting Methodologies Position Paper

The Australian Energy Regulator (AER) has published the above paper, seeking submissions from interested parties by 17 October. Integral Energy wishes to provide this letter as its submission to AER.

Integral Energy is the owner of a NSW electricity distribution network, and is currently regulated by the Independent Pricing and Regulatory Tribunal (IPART). Integral Energy is currently subject to IPART's 2004 Network Determination, which commenced on July 1, 2004, and extends to June 30, 2009. As an IPART regulated entity, Integral Energy has gained some experience in alternative regulatory accounting methodologies.

With regard to the Position Paper, Integral Energy notes thatAER's Position Paper is limited *(1)* to discussing two possible approached to the timing of recognition of capital expenditure, and therefore the commencement of returns on and of capital, the "as-incurred" and "as-commissioned" approaches, which are as follows:

"as-incurred"
Returns on and of capital are based on recognising the capital expenditure incurred in that year, and therefore commence in the year of incurrence.

"as-commissioned"
Return of capital is based on recognising the capital expenditure commissioned in a year. Return on capital is calculated on actual expenditure each year, and the rolled-up value recognised on commissioning.

Integral Energy notes, however, that it's current IPART regulatory regime does not follow either of the above approaches, and instead adopts a third "hybrid" approach:

"hybrid"
Return on capital is based on recognising the capital expenditure incurred in that year, and commences in the year of incurrence, however return of capital is based on recognising that capital expenditure only when commissioned, and therefore commences in the year of commissioning.

Contact name Craig James Direct phone 9853 6810 Fax 9853 6022
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

Integral Energy prefers the "hybrid" approach to either the "as-incurred" or "as-commissioned" approaches, for the following reasons:

1. As noted already, the "hybrid" approach is that adopted under Integral's current regulatory regime. The identical approach should apply to the other NSW electricity distribution businesses, of Energy Australia and Country Energy, although Integral Energy does not have access to their "building block" models to confirm this.

2. The "hybrid" approach is consistent with Australian Accounting Standards AASB 116 Property, Plant and Equipment and AASB 136 Impairment, however the "as-incurred" approach is not allowed under paragraph 55 AASB 116, which states as follows:

   "55. *Depreciation of an asset begins when it is available for use, that is, when it is in the location and condition necessary for it to be capable of operating in the manner intended by management..."*

   As AASB 116 does not allow return of capital (depreciation) to commence until the asset to which it relates has been commissioned, the "as-incurred" approach is inconsistent with this Australian Accounting Standard.
   In addition, AASB 136 provides for Integral Energy to conduct an impairment test at the end of each reporting period, to ensure that the value of each asset is not over-stated, and immediate reduce the carrying value of any assets which are over-stated to their recoverable value. Effectively, AASB 136 provides for a "prudency" test of each asset at the end of each reporting period. The only exception is for intangible assets, which must be tested, and if necessary their carrying values reduced, whenever an impairment indicator is present, irrespective of reporting dates.

3. The "as-incurred" and "as-commissioned" approaches represent extremes of allowing returns on and of capital on capital expenditure, while the "hybrid" approach offers an intermediate position between the two.

   Allowing Network Service Providers ("NSPs") with immediate returns both on and of capital, as in the "as-incurred" approach, is likely to result in poor regulatory outcomes, asNSPs will have limited incentive to actually commission assets, and therefore provide benefits to consumers, if they are already receiving full compensation for capital expenditure as incurred.

   Likewise, allowing NSPs only a delayed return both on and of capital, as in the "as-commissioned" approach, exposes them to financial hardship, and creates a disincentive to engage in constructing assets with long commissioning times, which is likely to also disadvantage consumers.

   The "hybrid' approach allows NSPs to be compensated for any financial hardship experienced on constructing assets with long commissioning times (by providing a return on capital), while also providing an incentive to commission those assets (be delaying the return of capital until commissioning occurs). Indeed, in its Position Paper AER notes *(2)* that:

"... it could be argued that it is appropriate to only begin to recover the cost of an asset once it is operational and delivering service to transmission users."

That is, return of capital should be delayed, as under the "hybrid" approach.

4. Integral Energy's recording of capital expenditure is undertaken through fixed asset registers, separate registers providing asset information for both statutory accounting and taxation purposes. The adoption of either of the "as-incurred" or "as-commissioned" approached would result in Integral Energy being required to maintain a third fixed asset register for regulatory purposes, which would need to be reconciled to the other two on an on-going basis.

   This would result in Integral Energy incurring material initial and on-going capital and operating expenditures, for which Integral Energy would need to seek recovery from consumers through AER.

5. The continuation or adoption of the "hybrid" approach could be an option for TNSPs and other DMNSPs. AER notes its preliminary view *(3)* that:

   "any price shocks associated with transitioning from the "as-commissioned" approach to the "as-incurred" approach is not likely to be significant."

   and that while the "as-commissioned" approach *(4):*

   "may produce a more lumpy revenue profile" (than the "as-incurred" approach) in circumstances where there are changes in investment over time"

   any effect is not expected to be significant.

   Therefore, as the "hybrid" approach involves a more gentle transition again, any price shock arising from its continuation or adoption will be even less significant.

Based on the above, Integral Energy would recommend that AER considers a third alternative, the "hybrid" approach, as an alternative to the "as-incurred" and "as-commissioned" approached currently discussed in its Position Paper.

If you have any queries in relation to the above, please do not hesitate to contact Mr Craig James, General Manager Finance, on telephone number 9853 6810.

Yours faithfully,

R. Powis.

Richard Powis
Chief Executive Officer

References:

(1) Regulatory Accounting Methodologies Position Paper, 1.1, page 3
(2) Regulatory Accounting Methodologies Position Paper, 2.4, page 13
(3) Regulatory Accounting Methodologies Position Paper, 2.4, page 13
(4) Regulatory Accounting Methodologies Position Paper, 2.4, page 13