9 May 2002

Dr Tom Parry
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290, QVB Post Office
Sydney NSW 1230

Dear Dr Parry

Retail Mid-Term Review

Integral Energy would like to thank the Tribunal for the opportunity to participate in the public forum on the Retail Mid-Term Review held on 3 May 2002.

Integral believes that the outcomes of the mid-term review will be critical to ensuring that target tariffs are reset at a commercially sustainable level. This, in turn, will assist the development of a competitive electricity market.

The systems that have been put in place by electricity retailers reflect the fact that 100% of the market now has choice. It is now critical that the target tariffs that are in place also reflect this fact.

The NSW Government has stated that its guiding principles for deregulation of the industry are to:

- Protect consumer's interests;
- To make sure a consistent approach is taken nationally;
- And, that there is a fair and equitable outcome for electricity businesses[1].

Integral strongly supports these principles as the basis for promoting competition and reviewing the existing target tariffs.

From a regulatory perspective, it is also essential that the principle of cost reflectivity be adopted in the re-setting of target tariffs. Otherwise, it will be impossible to achieve commercial outcomes. IPART itself has recognised the importance of setting cost reflective tariffs in its recent decision with respect to tariff customers connected to AGL Gas Network in NSW. IPART has stated that "for competition to be successful in the gas retail market, it is critical that

[1] Media Release; NSW Energy Minister Kim Yeadon; New Energy Choice for Consumers; 6 May 2000

Your contact: Richard Powis ? **Direct: (02) 9853 6101 Fax: (02) 9852 6022**
In Reply Quote: 2002/00743/001
Huntingwood Drive, Huntingwood NSW 2148
Telephone: 131 081 Facsimile: (02) 9853 6000
Postal Address: PO Box 6366, Blacktown NSW 2148. DX 8148 Blacktown
integral@integral.com.au

regulated or default tariffs reflect the cost of gas supply wherever possible, so they can operate in a 'neutral' manner"[2].

Green Allowance

In the original IPART determination there was an allowance for compliance with renewable energy targets in the wholesale energy cost allowance. This allowance was set in the absence of firm information as to the precise make-up of the Mandatory Renewable Energy Target (MRET) at that time and so it was acknowledged that the allowance may require a review. Indeed, MRET was excluded altogether.

Since then the NSW government has announced mandatory greenhouse gas emissions reductions[3]. There are a number of matters that still need to be finalised before agreement can be reached on the true cost of compliance with these new initiatives. Matters such as full recovery of interstate trading and whether the Commonwealth scheme will be recognised are still unclear. It is clear however, that further assessment needs to be undertaken to accurately estimate compliance costs and Integral is willing to work with the Tribunal to assist it in making these assessments.

Long Run Marginal Cost of Energy

In relation to long run marginal cost (LRMC), we believe that new entrant retailers would have difficulty in purchasing supply to match the load shape and volatility of the regulated market at the LRMC identified in the report by Cap Gemini. Integral's view is that the LRMC allowance should accurately reflect the energy purchase cost for new entrant retailers.

IPART in its Determination used a weighted average LRMC in the range $36 to $56 per MWh but chose a value towards the lower end of that range. The current Regulated Energy Charge (REC) being paid by Integral under the Electricity Tariff Equalisation Fund (ETEF) is in excess of the IPART allowance but still within the $36 to $56 range. The ETEF price is based on market rates and this would suggest that the LRMC cost should in fact be higher than that currently allowed by IPART.

In view of these material issues, Integral recommends an LRMC allowance in the upper quartile of Cap Gemini's original range, which would more accurately reflect the energy purchase costs for new entrant retailers.

[2] IPART Final Report; Review of the Delivered Price of Natural Gas to Tariff Customers Served from the AGL Gas Network in NSW; February 2001; page 15
[3] Media Release; Compulsory Greenhouse Benchmarks Get Greenlight; NSW Premier Bob Carr; 8 May 2002

Retail Net Margin

In view of the changes occurring in the NSW electricity marketplace, Integral considers that a retail net margin of 2.5 to 5% would be an acceptable outcome for the period remaining in the current Determination. An outcome within this range would be an appropriate step towards the development of a more commercially acceptable net margin, as the market develops in the period beyond the current Determination. Integral also supports the views expressed at the public forum that the retail net margin should be in the same range as that set recently by the Office of the Regulator General (ORG)[4] in Victoria ie 2.5 to 5%. As was mentioned at the public forum the ORG's range was an attempt to capture all the risks of the retail business but essentially the net margin was regarded as being the margin required to operate a retail business.

Integral also agrees with the comments from NSW Treasury at the public forum indicating that the net margin cannot be considered in isolation from retail operating costs. We strongly endorse the view that if the operating cost targets are not set correctly then the retail business will not achieve its net margin at whatever level it is set. As with the Retail Gas Determination, IPART must ensure that target tariffs in electricity reflect the cost of supply.

Retail Cost to Serve

In relation to retail cost to serve, Integral believes that the benchmarks set in the current Determination for cost to serve have been set too low. In setting retail costs, the Determination drew on international benchmarks that did not allow for the differences in market structures and size. The UK has substantially larger customer numbers so efficiencies can be achieved that are not available in a smaller market such as NSW.

Integral also considers that it is inappropriate to set the retail cost component at the same level for all regulated suppliers. Each supplier has its own efficiencies and economies of scale which can lead to a market advantage being gained by much larger retailers if a 'one-size-fits-all' cost to serve is applied.

At the public forum Energy Australia stated that their forecast retail operating costs were $65 per customer and as they were the largest retailer in NSW their costs would be expected to be at the low end of an appropriate operating cost range. This would indicate cost to serve is, at the very least, somewhere in the range adopted by ORG of $60 to $80 per customer not the $40 to $60 per customer used by IPART in their Determination.

In considering this issue, Integral urges IPART to carefully review the actual cost to serve information provided in our previous submission.

[4] The Office of the Regulator General is now the Essential Services Commission (ESC)

Achieving Target Tariffs

Integral's view is that IPART should provide scope for retailers to move from current (and often under-recovering) tariffs to any new increased target tariffs from the next retail price adjustment date, which is now 1 August 2002.

An important question that also needs to be addressed is: how do we assess if the tariffs have reached the target tariff? Previously, Integral has based this assessment on a revenue approach across a range of consumption patterns. The question then is: is the tariff at target if only the average customer's consumption is at the target level or should it be across the whole range of consumption patterns? Integral's view is that provided the average customer is at the target, based on this revenue approach, then the tariff should be considered to have achieved target.

At the public forum PIAC advocated that any existing cross subsidy between tariffs above target and those below should be allowed to remain. Integral would not support this approach as the customers above target are more likely to enter the competitive market and hence the cross subsidy would disappear. It would also appear that PIAC have assumed that the extent of the cross subsidy is such that those above target exactly compensate those below target. This is clearly not the case. In Integral's experience approximately 80% of the customer base are on tariffs below target and 20% are on tariffs above target.

Side Constraints

In relation to side constraints, the current asymmetry between retail and network side constraints effectively means retail tariffs below target, cannot be increased to achieve target. In fact, where the full network side constraint is passed through, the under-recovering retail tariff moves further away from target. This is unsustainable and needs to be addressed by the Tribunal.

There is also a need for greater flexibility with side constraints to provide for the efficient transfer to any new increased target tariffs from 1 August.

Where this stepped change is greater than CPI or $25pa, Integral recommends that IPART allow a relaxation of retail side constraints to enable current tariffs to efficiently transfer to any new increased target tariffs. In the short period since the Retail Determination was released in December 2000, IPART has shown that it is willing to allow greater than CPI increases in the retail energy sector. For example in the final report on "Review of the Delivered price of Natural gas to tariff Customers Served from the AGL Gas Networks in NSW" of February 2001, IPART allowed side constraints of the greater of $15 or 3% above CPI. IPART also did not apply a side constraint to gas industrial and commercial customers on default tariffs as it stated that the "Tribunal believes that the competitive market will impose sufficient pressure to protect these customers from price shocks"[5]. Similar arguments apply in electricity, in particular at the high consumption bands of the domestic customer class.

---

[5] IPART Final Report; Review of the Delivered Price of Natural Gas to Tariff Customers Served from the AGL Gas Network in NSW; February 2001; page 18

Integral considers IPART's recent decision on side constraints for the retail gas market in NSW provides a relevant precedent for an equally flexible approach for the retail electricity market in NSW, in order to achieve commercially sustainable retail target tariffs. As an outcome from this review, Integral recommends that IPART allow for similar flexibility in the application of side constraints, particularly in those cases where tariffs are below target.

Should you have any questions in relation to this submission, please contact Integral Energy's Regulatory and Pricing Group via David Neville on 02 9853 6144 or Frank Nevill on 02 9853 6598.

Yours Sincerely

Richard Powis
Chief Executive Officer