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**Review of Regulated Retail
Prices for Electricity
response by
Integral Energy**

**to the
Independent Pricing and
Regulatory Tribunal**

14 May 2004

Mr Jim Cox
Acting Chairman
Independent Pricing & Regulatory Tribunal
Level 2, 44 Market Street
SYDNEY NSW 2000

14 May 2004

Dear Mr Cox

**Response to Draft Determination on NSW Electricity Regulated Retail Tariffs
2004/05 to 2006/07**

Integral Energy is pleased to provide its response to the Independent Pricing & Regulatory Tribunal's (Tribunal) Draft Determination on NSW Electricity Regulated Retail Tariffs 2004/05 to 2006/07.

Within the extremely short two-week timeframe that has been allowed by the Tribunal, Integral has reviewed the Draft Determination with a particular focus on understanding the impact of the proposed decision on Integral's regulated retail tariffs and financial position.

Integral considers that the Draft Determination delivers unsustainable and unacceptable outcomes, which the Tribunal must address prior to the release of its final decision. Integral notes that the Tribunal's media release of 30 April 2004 drew particular attention to the fact that existing retail electricity prices "are much lower than the cost of supply".

Under the Draft Determination, the Tribunal has still failed to address this fundamental issue by proposing a benchmark tariff level that is much lower than Integral's actual costs. If implemented, this approach would perpetuate outcomes that continue to result in Integral supplying regulated retail electricity to customers at a price that is lower than its actual costs.

As a minimum, Integral considers that the Tribunal must ensure that Integral's regulated retail business is not in a loss-making position and that actual costs are reflected in regulated retail prices over the forthcoming regulatory period. Integral's response discusses shortcomings with the draft decision and outlines a set of solutions to deliver a more balanced and acceptable outcome.

Importantly, Integral notes that the Tribunal's Draft Determination has allowed for CPI+3% outcomes for other standard retailers in order to address their revenue recovery issues. Integral considers that a similar outcome is required for Integral to ensure its financial viability. Integral believes the CPI+3% outcome in rural NSW provides a clear indication of the Tribunal's view of "acceptable" price outcomes for customers and therefore expects regulatory consistency between standard retailers in NSW.

The Tribunal's Final Determination represents a critical opportunity to address the key issues associated with regulated retail tariffs in NSW and the ongoing financial viability of standard retailers. Integral urges the Tribunal to give careful consideration to the proposals contained in our submission prior to finalising its decision. For further information on this submission, please contact our General Manager Regulatory & Corporate Affairs Karen Waldman on 02 9853 6166 or our Manager Regulatory & Pricing David Neville on 02 9853 6144.

Sincerely

A handwritten signature in cursive script that reads "R. Powis".

Richard Powis
Chief Executive Officer

Contents

	Page No
1 Overview	1
1.1 Purpose and objectives of the Draft Determination	1
1.2 Summary of Integral's position on the Draft Determination	2
1.3 Key concerns with the Draft Determination	3
2 Purpose and structure of submission.....	7
3 Tribunal's approach to review and decisions.....	8
4 Level of target tariffs	11
4.1 Retail operating costs	11
4.2 Net retail margin	13
4.3 Use of targets for time-of-use tariffs.....	14
5 Limits on price changes.....	15
5.1 Approach to price limits	15
5.2 Level and form of price limits	15
5.3 Integral's proposal for price limits	16
6 Draft Determination	18
7 Glossary	20

1 Overview

This section provides an overview of Integral Energy's (Integral) response to the Independent Pricing and Regulatory Tribunal's (Tribunal) Draft Determination on Regulated Retail Pricing for 2004/05 to 2006/07 dated April 2004 (Draft Determination) and the associated Draft Report (Draft Report).

Within the extremely short two-week timeframe that has been allowed by the Tribunal, Integral has reviewed the Draft Determination with a particular focus on understanding the impact of the proposed decision on Integral's regulated retail tariffs and financial position.

This submission sets out Integral's material concerns with the Tribunal's Draft Determination and Draft Report.

1.1 Purpose and objectives of the Draft Determination

The current Retail Determination (2001 Retail Determination) commenced on 1 January 2001 and will expire on 30 June 2004. The NSW Minister for Energy has asked the Tribunal to determine appropriate default retail tariffs and charges for a further three years until 30 June 2007.

Integral has previously noted in its submissions to the Tribunal that the Government's TOR expressly require the Tribunal to:

1. Consider an "appropriate" allowance for retail operating costs and net margin in the setting of retail prices.
2. Consider the Government's policy aim of reducing customers' reliance on regulated prices and the effect of the determination on competition in the retail market.
3. Ensure tariffs cover costs while recognising consumers' ability to adjust to new prices.

Therefore, the Tribunal must ensure the Determination delivers against the explicit requirements of the TOR and is consistent with the role of the regulated tariffs as default prices¹.

As the Tribunal has recognised, this challenge is complicated by the need for the retail component of prices to increase, coupled with the pass through of the real network price increases foreshadowed in the Draft Network Determination in January 2004.

¹ Integral supports the view presented in the Tribunal's Draft Determination that regulated retail tariffs have a role in the transition to effective retail competition in the national energy markets. As the Tribunal noted in section 1: "*These regulated tariffs act as a safety net or default prices for customers who do not choose to participate in the competitive market.*"

1.2 Summary of Integral's position on the Draft Determination

Integral considers that the Draft Determination is unacceptable and inconsistent with the TOR.

The Tribunal's Draft Determination will severely impact the financial viability of Integral's regulated retail business during the regulatory period. As a minimum, Integral considers that the Tribunal must ensure that Integral's regulated retail business is not in a loss-making position and that actual costs are reflected in regulated retail prices over the forthcoming regulatory period.

While Integral believes that the Tribunal's approach is inconsistent with the TOR, Integral also believes that the outcome of the implementation of the Draft Determination would not reflect the Tribunal's stated aim of balancing the need for prices to increase to ensure the retail suppliers' ongoing viability with the need to protect small retail customer from significant price shocks. It also does not reflect the "appropriate" retail margin contemplated by the TOR.

Integral proposes that a more appropriately balanced and acceptable outcome would be achieved through a decision with:

1. Target tariffs set based on the following allowances for cost components, which are in line with the low end of recent allowances made in Victoria, Tasmania, South Australia and the ACT:
 - Retail operating costs of at least \$80/customer annually;
 - Retail net margin of at least 3%.
2. An increase in the flexibility of price movements. Integral recommends that there be no restriction on revenue at a tariff level and limits to changes in individual customer bills be defined as the maximum of:
 - Annual change in the R component of the form proposed in the Draft Determination, with the limit set at CPI+3%; or
 - Annual change in an individual total customer's bill of \$35.

Integral assesses that this alternative proposal would:

- Produce a more acceptable outcome for the viability of Integral's retail business.
- Provide Integral with a similar outcome to other standard retailers as allowed by the Tribunal in the Draft Determination. In particular, Integral believes the proposed CPI+3% outcome in rural NSW provides a clear indication of the Tribunal's view of "acceptable" price outcomes for customers and therefore expects regulatory consistency between standard retailers in NSW.
- Address the Tribunal's concerns related to protecting small customers from significant price increases, while not being overly restrictive on tariff restructuring. Integral's analysis shows that the customer

outcomes under this proposal would be comparable to those set out in section 4.1 of the Draft Report.

In addition, Integral notes that the recently released New South Wales Treasury's Research and Information Paper on *A Risk Management proposal for New South Wales' Electricity Businesses* may have significant implications for the cost structures of the standard retailers. Integral considers that in the event this or a similar proposal is implemented during the regulatory period, the Tribunal should provide for the 2004 Retail Determination to be re-opened.

Integral's key concerns with the Tribunal's Draft Determination are set out below.

1.3 Key concerns with the Draft Determination

1.3.1 The Tribunal's approach and decision does not reflect an appropriate balance

Integral considers that the combination of the Tribunal's approach to analysis and decision-making has led to an imbalance between customer outcomes and business viability.

Integral contends that the combination of the Tribunal's approach, analysis, and lack of regard for business viability has meant that the Tribunal's Draft Determination is flawed.

The Tribunal has allowed an annual real retail price increase of 1% even though prices are currently "much lower than the cost of supply²." Integral forecasts that this would result in 2007 prices being \$18 million below the cost of supply compared with Integral's forecast costs and cost allowances made in other jurisdictions.

This is a serious concern and affects the ability of the determination to achieve the Tribunal's objectives for the review.

Integral considers that it is possible to achieve an appropriate balance and still achieve customer impact outcomes similar to those set out in the Draft Determination.

² IPART Media Release 30 April 2004.

1.3.2 Effect of Draft Determination on financial viability

The Tribunal's Draft Determination would have an unacceptable and unsustainable adverse impact on Integral's regulated retail business.

The Tribunal's Draft Report recognises the need for retail business viability. A decision that severely compromises viability is not in the interests of customers or Integral's shareholder.

Integral has assessed the impact of the Draft Determination on its regulated retail business and concluded that the decision severely affects its viability. As a minimum, Integral considers that the Tribunal must ensure that Integral's regulated retail business is not in a loss-making position and that actual costs are reflected in regulated retail prices over the forthcoming regulatory period.

1.3.3 Level of target tariffs

The target tariffs are unsustainably low.

The unsustainably low target tariffs mean that Integral would not be able to recover reasonable costs and it would incur a negative net retail margin.

This outcome is inconsistent with the Government's TOR that require the Tribunal to consider appropriate retail operating costs and an appropriate retail margin. An outcome that eliminates any profitability is clearly at odds with this requirement.

The Tribunal's allowance for retail costs and retail margin is discussed in the following sections.

1.3.4 “Allowance” for retail operating cost in target tariff

The Tribunal’s proposed level of operating costs is well below Integral’s actual costs and is not supported by benchmark analysis

The Tribunal’s allowance of \$65/customer annually for retail operating costs is well below Integral’s actual operating costs and also below the level asserted by other industry participants as necessary to undertake retail activities.

Integral believes that the Tribunal’s draft decision is not justified by the analysis presented by the Tribunal or its consultants. The analysis set out in the Draft Report and more recent benchmark analysis completed in other jurisdictions, but not considered by the Tribunal, suggests a range of \$80 to \$93 (2004/05\$)/customer for retail operating costs.

Integral requests that the Tribunal make allowance for at least \$80/customer annually for retail costs in its determination of the target tariff. An allowance at this level is at the lower end of recent decisions in other jurisdictions on the appropriate level of operating costs.

1.3.5 Allowance for retail net margin in target tariff

The Tribunal’s proposed net margin does not provide Integral with adequate compensation for undertaking its retail activities

The Tribunal has stated that retailers require a net margin to cover a return on capital and business risk. However, in making its decision, the Tribunal has not quantified these costs. Rather, the Tribunal has relied on the 2001 Retail Determination, which also had not quantified these costs.

Integral has provided the Tribunal with a report prepared by KPMG Corporate Finance that calculates the cost of capital employed and concludes that a margin of 2.4% to 4.8% would be required to cover the cost of capital. This allowance does not cover any business risk. The Tribunal’s draft decision of a 2% net margin falls well short of this range and does not provide Integral with an appropriate return on capital employed.

Integral believes that the Tribunal’s approach to determining the net margin is fundamentally flawed.

Integral requests that the Tribunal make allowance for at least a 3% net margin in its determination of the target tariffs. A higher net margin will provide Integral with an appropriate return for the capital employed and the risks associated with the business and is consistent with other recent precedents.

1.3.6 Limits on price changes

The proposed form and level of price constraints will result in significant and unacceptable under-recovery of target tariffs

The constraints on price movements proposed by the Tribunal are excessively restrictive.

The Tribunal forecasts a total under-recovery of \$25 million compared to the revenue from target tariffs over the regulatory period as a result of the proposed level of price constraints. However, Integral forecasts that the combination of the unsustainably low target tariffs and restrictive price constraints will result in a total under-recovery relative to actual costs of approximately \$60 million over the regulatory period.

This level of under-recovery is unacceptable and is a continuation of the shortcomings with the 2001 Retail Determination. It is inconsistent with the Government TOR which require the Determination to ensure, as far as practicable, that regulated tariffs are at cost reflective levels for all retail customers by 30 June 2007. Integral notes that there is no analysis in the Draft Determination as to whether it is practicable for regulated tariffs to reach cost reflective levels by 30 June 2007.

Integral considers that side constraints should be set to move prices to cost reflective levels within as short a time as possible while managing price changes to customers. Therefore, Integral proposes that the side constraint be increased to 3% to allow Integral to achieve Integral's proposed target tariffs. A 3% side constraint is consistent with the levels the Tribunal considers appropriate for other standard retailers in its Draft Determination.

2 Purpose and structure of submission

This submission is made by Integral in relation to the Tribunal's investigation and report on regulated retail tariffs and charges for small retail customers³ to apply between 1 July 2004 and 30 June 2007 under Division 5 of Part 4 of the Electricity Supply Act 1995.

The purpose of this submission is to set out Integral's material concerns with the Tribunal's Draft Determination and Draft Report.

This submission is structured as follows:

Section	Purpose	Details
3	Tribunal's approach to review and decisions	This chapter sets out Integral's concerns with the Tribunal's approach to the Draft Determination.
4	Level of target tariffs	This chapter sets out Integral's position on the level of target tariffs and allowances for the cost components used to set the targets.
5	Limits on price changes	This chapter sets out Integral's concerns about the proposed form and level of price limits.
6	Draft Determination	This chapter sets out drafting errors identified by Integral, or areas requiring clarification by the Tribunal.

³ Small retail customers for electricity are defined in the Act as a customer that consumes electricity at less than 160 MWh per year as prescribed in clause 7 of the Electricity Supply (General) Regulation 2001. A small retail customer is eligible for supply under a standard customer supply contract.

3 Tribunal's approach to review and decisions

The Government's TOR stated:

"For the purposes of section 43EB(2)(b) of the Electricity Supply Act 1995, the Tribunal must consider the Government's policy aim of reducing customers' reliance on regulated prices and the effect of its determination on competition in the retail electricity market."

It goes on to state:

"More specifically, the Tribunal is to take account of the following matters in undertaking its review:

- *ensuring regulated tariffs cover the costs listed above while recognising consumers' ability to adjust to new prices;*
- *consider options for restructuring tariffs to promote demand management."*

Section 1.1 of the Tribunal's Draft Report stated sets out what the Tribunal sees as the principle underlying the Draft Determination it states (in part):

"The Tribunal's draft determination aims to balance the need for prices to increase to ensure retail suppliers' ongoing viability with the need to protect small retail customers from significant price shocks."

Integral contends that the combination of the Tribunal's approach, analysis, and lack of regard for business viability has meant that the Tribunal's Draft Determination is flawed. Integral believes that the Draft Determination fails to adequately consider business viability and retail competition.

The Tribunal's approach is fundamentally inconsistent with the TOR. It is also inconsistent with recent judicial authority that where one of the guiding principles to be taken into account by a regulator in making a decision is the service provider's legitimate business interests and investment, than significant weight should be given to those criteria.⁴

This is a serious concern and affects the ability of the determination to achieve the Tribunal's objectives for the review.

The following points set out Integral's specific concerns with the Tribunal's approach and analysis.

⁴ *Re Michael; Ex parte Epic Energy (WA) Nominees Pty Ltd* [2002] WASCA 231.

1. **The Tribunal's approach to setting the target R is inconsistent with the Government's TOR for the review and the Tribunal's objectives of the decision.** The Tribunal has adopted a building block approach to setting R. Integral accepts that such an approach is appropriate for objectively determining a target tariff.

As stated in its previous submissions, Integral believes an approach to deciding the individual component costs that considers the actual costs of the retailer would be consistent with the Government's TOR.

However, the Tribunal's approach appears to focus on the hypothetical benchmark of efficient cost components of incumbents rather than the actual costs of the standard retailers or new entrant retailers.

Adopting a benchmarking approach raises a number of issues about the use and interpretation of the benchmark data.

Integral notes that benchmarking is an inherently imprecise science and therefore no benchmarking exercise is wholly deterministic. Integral believes that external benchmarks provide a useful independent point of reference against which actual costs can be assessed. However, care must be taken in interpreting benchmark analysis given that the choice of benchmarks require exercise of judgement as to the hypothetical construct and underlying assumptions adopted.

In particular, Integral believes that careful consideration must be given to individual business characteristics to ensure that the benchmarks reflect the underlying nature of the business to which the benchmarks are being applied.

In making its decisions in the Draft Determination, the Tribunal has applied consistent benchmarks across all the NSW standard retailers. Integral believes that this approach is fundamentally flawed. As an example, customer numbers have a significant impact on operating costs as a result of economies of scale. By not developing appropriate business specific benchmarks the Tribunal is heavily penalising some businesses by setting unrealistic and unsustainable benchmarks, that bear no reference to reality.

2. **Incomplete analysis used to support the Tribunal's decision.** Integral believes that the Tribunal's analysis ignores information and data. For example, the Tribunal's draft decision on operating costs ignores the recent study completed by Charles River Associates for the Victorian Government (see section 4.2 for more detail).
3. **The Tribunal's conclusions on the cost components do not appear to be justified by the analysis as presented.** The analysis of retail operating costs, including benchmark data, appears to suggest a level significantly above \$65 per customer annually. The benchmarking results from other jurisdictions suggest that at least \$80 per customer annually would be a more appropriate decision. In section 4.2, Integral has set out more detail on the inadequacy of the Tribunal's decision on the level of operating costs.

Likewise, analysis of retail profit margin suggests that the Tribunal has not allowed the businesses a market based return on capital employed (refer to section 4.3 for more detail).

4. **The decisions on the allowed values of cost components appear to assume perfect information and certainty**, for example, the Tribunal's draft decision on the operating costs appear to have been made based on the mid-point of a range or band. Yet, the Tribunal's analysis highlights the wide range of values which demonstrates the difficulty in having confidence in the right number.

As noted in Integral's previous submissions, if benchmarks are to be used it is prudent to set values based on a conservative approach by adopting the higher end of possible values identified⁵. Integral believes that a conservative approach would also be consistent with the Government's TOR.

⁵ Refer Network Economics Consulting Group (NECG) paper, "Applying workable competition in the NSW electricity sector", dated November 2003. NECG concluded that the NSW electricity market can be categorised as "workably competitive" that suggests that an invasive or aggressive form of retail price regulation is not appropriate.

4 Level of target tariffs

Integral contends that the level of target tariffs is unsustainable and below that required to meet business viability and retail competition objectives. Integral considers that target tariffs should be increased to reflect changes to allowed cost components.

4.1 Retail operating costs

In Appendix 4 of its Draft Report, section A4.2, the Tribunal states that:

“The \$65 per customer proposed by the Tribunal in the draft determination is at the upper end of the values allowed for each retailer in the 2002 determination (including FRC costs). Based on the evidence provided, the Tribunal does not believe that a significant change in the retail operating cost allowance is justified. Adopting a value of \$65 provides an appropriate recovery of reasonable costs.”

As set out in section 3, Integral considers that the allowance for retail operating costs should be based on Integral’s actual costs.

However, the Tribunal’s Draft Report is based on a benchmarking approach. In particular, the Tribunal engaged National Economic Research Associates (NERA) to develop benchmarks and make recommendations on reasonable operating costs. NERA recommended a range of \$50 to \$80 per customer, the mid point being \$65/customer annually.

Integral noted in its Supplementary Submission dated March 2004, as did a number of other interested parties, that the recommendations made by NERA in its report to the Tribunal dated February 2004 are not supported by substantive analysis, and that the recommendations are inconsistent with recent decisions in other jurisdictions. The Tribunal has not dealt with Integral’s (or other interested parties’) serious concerns with the shortcomings of NERA’s report in its Draft Report.

Integral notes that other benchmarking studies have concluded that benchmark retail operating costs are significantly higher than the Tribunal’s draft decision. For example, as noted in Integral’s Supplementary Submission, Charles River Associates⁶ (CRA) recent analysis of the 2004 domestic and small business electricity and gas retail prices for the Victorian Government adopted an operating cost estimate of \$93 (2004/05\$) per customer. CRA based the operating cost estimate on closer approximation to the Victorian retailers’ views of their operating costs for standing offer customers.

⁶ Electricity and Gas Standing Offers and Deemed Contracts (2004-2007), December 2003, prepared for the Victorian Department of Infrastructure

Integral also notes that the Tribunal’s application of a consistent operating cost benchmark across the standard retailers unfairly penalises Integral by setting an unrealistic and unsustainable benchmark for Integral. This is demonstrated by Table 4-1 that analyses the Tribunal’s benchmark of \$65/customer annually across a customer base of 1,000,000 compared with 700,000 (approximately reflecting Integral’s regulated customer base) assuming that 65%⁷ of total operating costs are fixed customer costs.

Operating cost component	Benchmark retailer	Integral proxy
Number of customers	1,000,000	700,000
Total operating expenditure		
Fixed (65% on per customer basis)	\$42m	\$42m
Variable (35% on per customer basis)	\$23m	\$16m
Total operating cost	\$65m	\$58m
Cost/ customer	\$65	\$83

Table 4-1 – Operating Cost analysis

Table 4-1 above simply demonstrates the potentially significant difference in the appropriate benchmark cost depending on the size of the customer base.

In addition, Integral notes the circularity of referencing some of the previous regulatory studies by NERA and the Tribunal in that initial studies completed by the Tribunal and the Victorian Essential Services Commission relied heavily on the Tribunal’s 2001 decision on electricity prices. Integral believes that the more recent comprehensive studies by the South Australian Essential Services Commission (\$84/customer in 2004/05\$), the Office of the Tasmanian Energy Regulator (excluding FRC costs, \$78/customer in 2004/05\$) and the Victorian Government (\$93/customer in 2004/05\$) reflect the best information available and therefore should be given greater weight.

Integral requests that the Tribunal make allowance for at least \$80/customer annually in its determination of the final R component. An allowance at this level is at the lower end of recent decisions in other jurisdictions on the appropriate level of operating costs.

⁷ In section 3.3 of its Draft Determination, the Tribunal stated that 85% of retail costs are fixed across the business.

4.2 Net retail margin

In section 4.5 of its Discussion Paper DP70, the Tribunal stated that:

“The net retail margin represents a return on capital employed and the risks associated with the business. Retailers must be able to earn a net retail margin if their investment in the business is to be worthwhile (an appropriate retail margin is treated as a cost of supply that must be recovered by regulated tariffs).”

Integral supports the Tribunal’s statement. However, Integral contends that the Tribunal’s Draft Determination does not achieve the Tribunal’s intended outcome stated above; the Tribunal has not demonstrated that its proposed benchmark net margin provides Integral with an appropriate return on the capital employed.

In its Supplementary Submission dated March 2004, Integral provided the Tribunal with a confidential report prepared by KPMG Corporate Finance that concluded an appropriate net margin of 2.4% to 4.8% would be required to cover the cost of capital without any allowance for risks. The Tribunal’s draft decision of a 2% benchmark net margin falls well short of this range.

Further, comparisons made by the Tribunal of net margins allowed by other jurisdictions are fundamentally flawed. The Tribunal incorrectly states that the net margin allowed by other jurisdictions allows for trading risk that the Electricity Tariff Equalisation Fund (EETF) negates. Firstly, as Integral has stated in its previous submissions, EETF does not eliminate all trading risks; the incumbent retailers still face shape risk and risks associated with contracted power purchase agreements⁸. Secondly, recent decisions made by other jurisdictions provide for a cost allowance to hedge against the trading risk. Therefore, the basis of the Tribunal’s approach to determining the net margin is flawed.

In any case, the adoption by the Tribunal of a low net margin on the basis of the existing EETF is inconsistent with the Government’s policy aim of reducing reliance on regulated prices which the Tribunal must consider under the Government’s TOR.

Integral requests that the Tribunal appropriately determines the net margin allowance in its final decision. Integral proposes that an allowance by the Tribunal for at least a 3% net margin will provide Integral with an appropriate return for the capital employed and the risks associated with the business and is consistent with other recent precedents.

⁸ Refer to section 4.2 of Integral’s Supplementary Submission dated March 2004 for more detail.

4.3 Use of targets for time-of-use tariffs

In section 3.1.2 of its Draft Report, the Tribunal is seeking comments on the approach of setting a single variable R component for the target for time-of-use tariffs and requiring the average price charged to a customer to not exceed this amount.

Integral believes that a more appropriate approach is to set a single variable R component such that the revenue for all customers on the tariff does not exceed the target revenue. The price charged to an individual customer will depend upon that customer's mix of peak, shoulder and off-peak consumption. This could be used by retailers to promote demand management, which is a matter that the TOR requires the Tribunal to take into account in making the Determination.

This approach is consistent with the test used by the Tribunal in the current and Draft Determination for comparing tariffs against targets.

The variable component of the target tariff for time-of-use should be equal to the variable component for single rate tariffs as there is no reason to believe that the average cost of energy for a time-of-use customer would be any different from that of a single rate customer. This is consistent with the settlement of the National Electricity Market and the settlement of ETEF, both of which use the same load profile for both time-of-use and single rate customers.

5 Limits on price changes

The Tribunal's draft decision on the limits on price movements and increasing prices is excessively restrictive. To address these concerns, Integral has proposed changes to the Tribunal's approach to price constraints.

5.1 Approach to price limits

The current form of regulation was implemented before customers had access to competitive choice and has overly restrictive constraints on price increases. The current side constraints (set out in the 2001 Retail Determination) prevent Integral from achieving the regulated target tariffs allowed by the Tribunal, resulting in some \$20 million per annum less revenue than would have been received were all the tariffs at the target level. Integral noted in its Submission dated December 2003, that changes to the Tribunal's approach were required to learn from current experience.

Integral is extremely disappointed that the Tribunal's Draft Determination fails, in its opinion, to address the shortcomings of the 2001 Retail Determination.

5.2 Level and form of price limits

"The Tribunal's draft decision is that price limits should be imposed on the R component of the tariff. These price limits should beCPI+1% for Integral Energy"⁹

The Tribunal's draft decision is unacceptable to Integral. The proposed level of constraint in the Tribunal's Draft Determination does not provide Integral with sufficient flexibility to transition under-recovering regulated retail tariffs to cost reflective levels over an acceptable time frame. The Tribunal has estimated that at the end of the regulatory period Integral will still be under-recovering revenue by \$6 million in 2007 relative to the Tribunal's proposed target tariffs.

Integral notes that its actual under-recovery is likely to be far greater given the Tribunal's unsustainably low target tariffs.

As discussed above, Integral considers this to be inconsistent with the TOR that requires tariffs to be at cost reflective levels by 30 June 2007 as far as practicable. The Tribunal has not demonstrated that it would not be practicable for tariffs to be at these levels by 30 June 2007.

⁹ Section 5.4.1 of the Draft Determination.

Integral also notes that the Tribunal has provided Integral with the lowest - price increases in its Draft Determination relative to the other standard retailers. The Tribunal has allowed for up to CPI+3% outcomes for rural NSW in its Draft Determination. Integral considers that a similar outcome is required to ensure its financial viability. Integral believes the CPI+3% outcome in rural NSW provides a clear indication of the Tribunal's view of "acceptable" price outcomes for customers and therefore expects regulatory consistency between standard retailers in NSW.

Integral also has the following other concerns with the price limits:

- The failure of the Tribunal to recognise that price limits need to be explicitly relaxed for obsolete regulated retail tariffs to ensure that the subsidies provided to customers on these tariffs can be eliminated over a reasonable time frame;
- The constraint on increasing the R component of any customer's bill by CPI+1% will severely limit restructuring of customer tariffs towards a cost reflective structure. To allow restructuring towards a cost reflective structure customer bills need to be permitted to move by an annual minimum fixed amount in addition to the annual percentage increase;
- Restricting revenue at a tariff level, (as set out in section 7.2 of the Draft Report) in addition to constraints on customer bills, creates an unnecessary layer of constraint restricting tariff increases. A constraint is only required on either the tariff revenue or customer bills.

The price limits are inconsistent with the TOR's requirement that "price constraints" should allow tariff rationalisation and allow movement to full cost recovery over the determination period with regard to the need for a smooth transition for customers.

5.3 Integral's proposal for price limits

Integral proposes relaxing the side constraints slightly in a manner that will result in customer outcomes that are similar to those set out in the Draft Report.

Integral proposes that a more appropriate and acceptable outcome would be achieved through a decision based on the price limits being defined as the maximum of:

- Annual change in a customer's bill in the R component of the form proposed, with the limit set at CPI+3% (compared to the Tribunal's Draft Determination of CPI+1%); **or**
- Annual change in an individual total customer's bill of \$35.

Integral proposes that the restriction on revenue at a tariff level be removed. The above provisions protect customers and the target tariffs prevent increases beyond a maximum limit. Therefore, there is no need for this additional constraint.

Integral believes that this proposal will ensure that:

- Integral's financial viability will be improved as under-recovering regulated retail tariffs can be transitioned to truly cost reflective levels over a more reasonable time frame;
- Changes in the level and structure of network charges can be fully passed through to end-customers without affecting the R component;
- The subsidies associated with obsolete regulated retail tariffs can be reduced over the regulatory period; and
- The customer impacts will be comparable to those documented in the Tribunal's Draft Determination.

6 Draft Determination

Integral's review of the Draft Determination has highlighted that the following matters require clarification or amendment by the Tribunal:

1. The only new regulated retail tariff allowed under the Draft Determination is Energy Australia's new business time of use tariff for customers with a type 5 meter. Integral is proposing to introduce a new domestic time of use tariff for Type 6 metering at the network level. This tariff is being offered as part of the network tariff package that will allow customers affected by the inclining block network tariff with the option to move to a time of use tariff. Integral requests that the Tribunal allows a new regulated retail tariff to match the network tariff as part of the Final Determination.
2. Integral is proposing to introduce revised peak and shoulder time periods as part of the network price proposal. These times are as follows:

Residential

- Peak - 1pm to 8pm on working weekdays
- Shoulder - 7am to 1pm and 8pm to 10pm on working weekdays
7am to 10pm on weekends and public holidays
- Off peak - 10pm to 7am on everyday

Non-Residential

- Peak - 1pm to 8 pm on working weekdays
- Shoulder - 7am to 1pm and 8pm to 10pm on working weekdays
- Off peak - 10pm to 7am on working weekdays and
all day on weekends and public holidays

These proposed times do not align with those defined by the Tribunal in its Draft Determination. Integral requests that the Tribunal's Final Determination definitions of peak and shoulder align with the network business definitions.

3. The definitions of "Network Revenue" and "Regulated Retail Revenue" in the formula in section 7.3 are erroneous and would result in retailers' price movements being restrained beyond the intent of the Tribunal. The definitions should be amended as follows:

Network Revenue: Is that part of the total amount of the bills issued to the small retail customer for the year immediately preceding the relevant price change date that relates to the network use of system component of the customer's regulated tariff.

Regulated Retail Revenue: is the total value of bills issued to the small retail customer for the year immediately preceding the relevant price change date.

4. Section 6.6 requires retailers to publish prices 30 days in advance, however, given the Tribunal's timing for this determination, this timeframe will need to be waived for the 1 July 2004 price change.

7 Glossary

Term	Definition
CPI	Consumer Price Index
CRA	Charles River Associates
ETEF	Electricity Tariff Equalisation Fund
FRC	Full Retail Contestability
IES	Intelligent Energy Systems
LRMC	Long Run Marginal Cost
MWh	Megawatt Hour
NERA	National Economic Research Associates
NSW	New South Wales
N component	Network component
R component	Retail component
TOR	Terms of Reference
Tribunal	Independent Pricing and Regulatory Tribunal of NSW