Integral Energy

Review of Regulated Retail Tariffs and Charges for Electricity 2007 to 2010

8 September 2006

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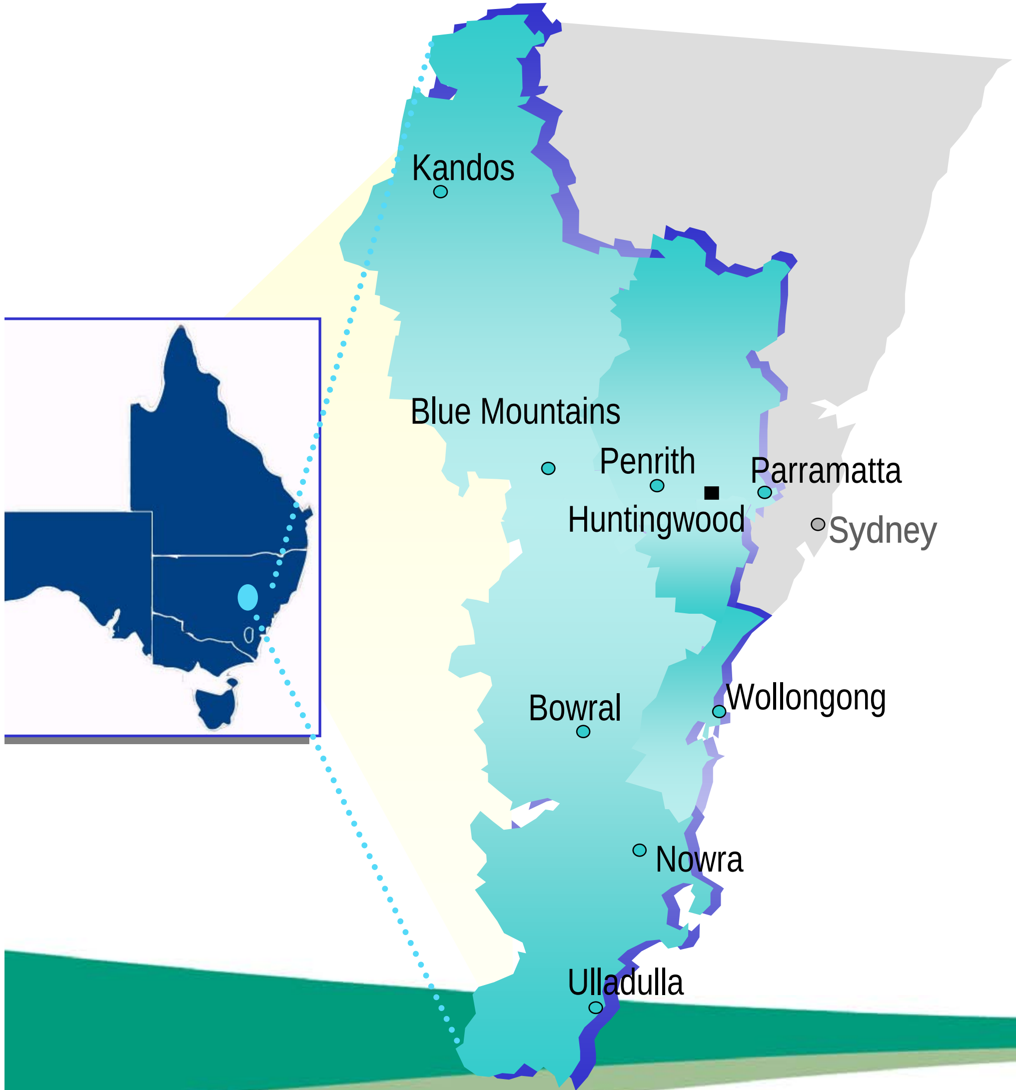
Outline

- Integral Energy – who we are
- Context for the 2007 Retail Review
- Integral's experience under the 2004 Retail Determination
- Form of regulation
- Costs to be recovered
- Customer assistance package

Integral Energy – Who we are

Integral Energy



- Integral Energy is a NSW Energy Corporation that holds Distribution and Retail Licences
- Over 820,000 customers
- Over $1.2bn in revenue
- All of Integral Energy's regulated customers are within our network supply area
- Any 'small' retail customer within our supply area is eligible to purchase electricity under our default retail contract

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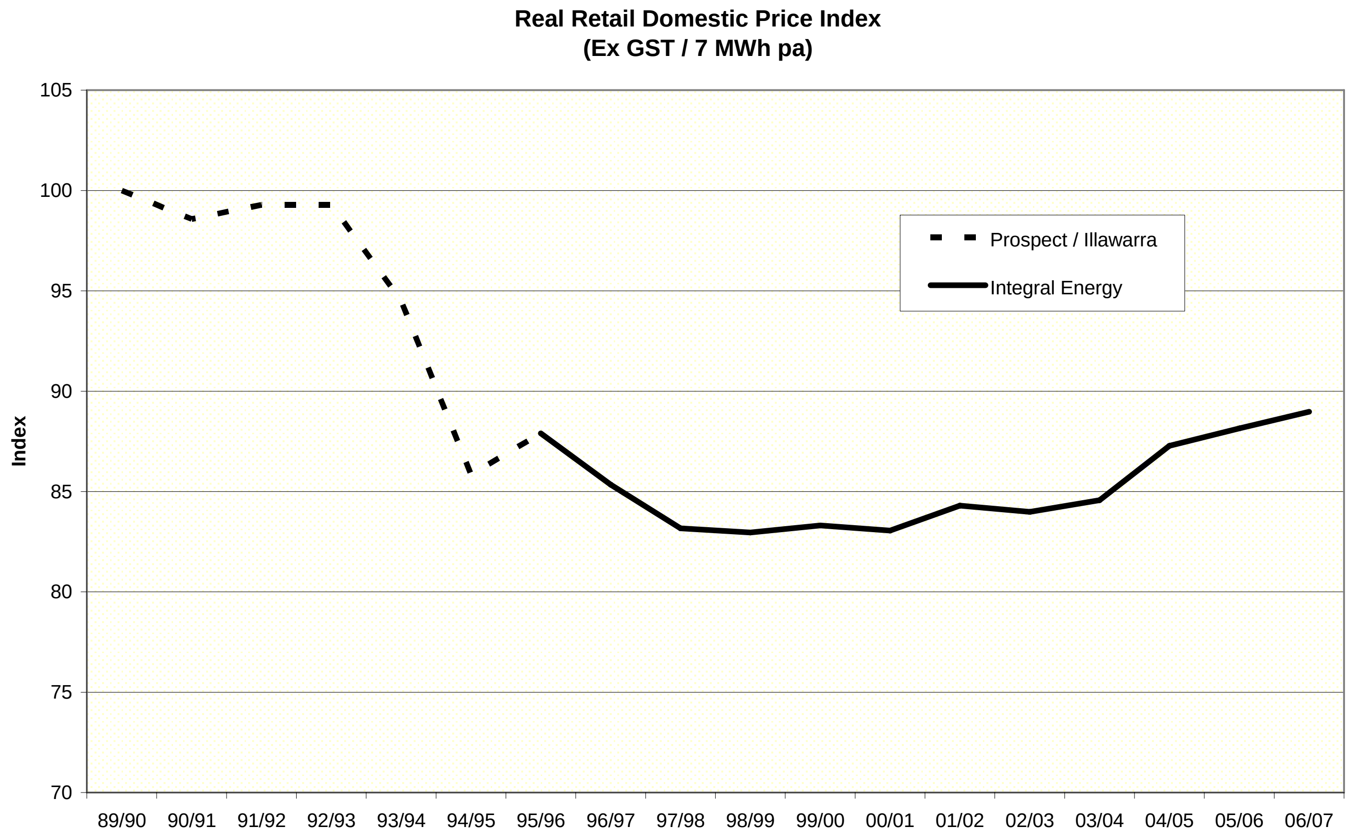
Issues facing Integral Energy

- We are facing extensive growth
- We must be responsible
  - ➢ In how we secure and deliver our energy sources
  - ➢ In managing customers in hardship
  - ➢ In meeting customers' increasing expectations
- We are undertaking trials to provide customers with more tools to signal, and manage, their consumption and bill outcomes

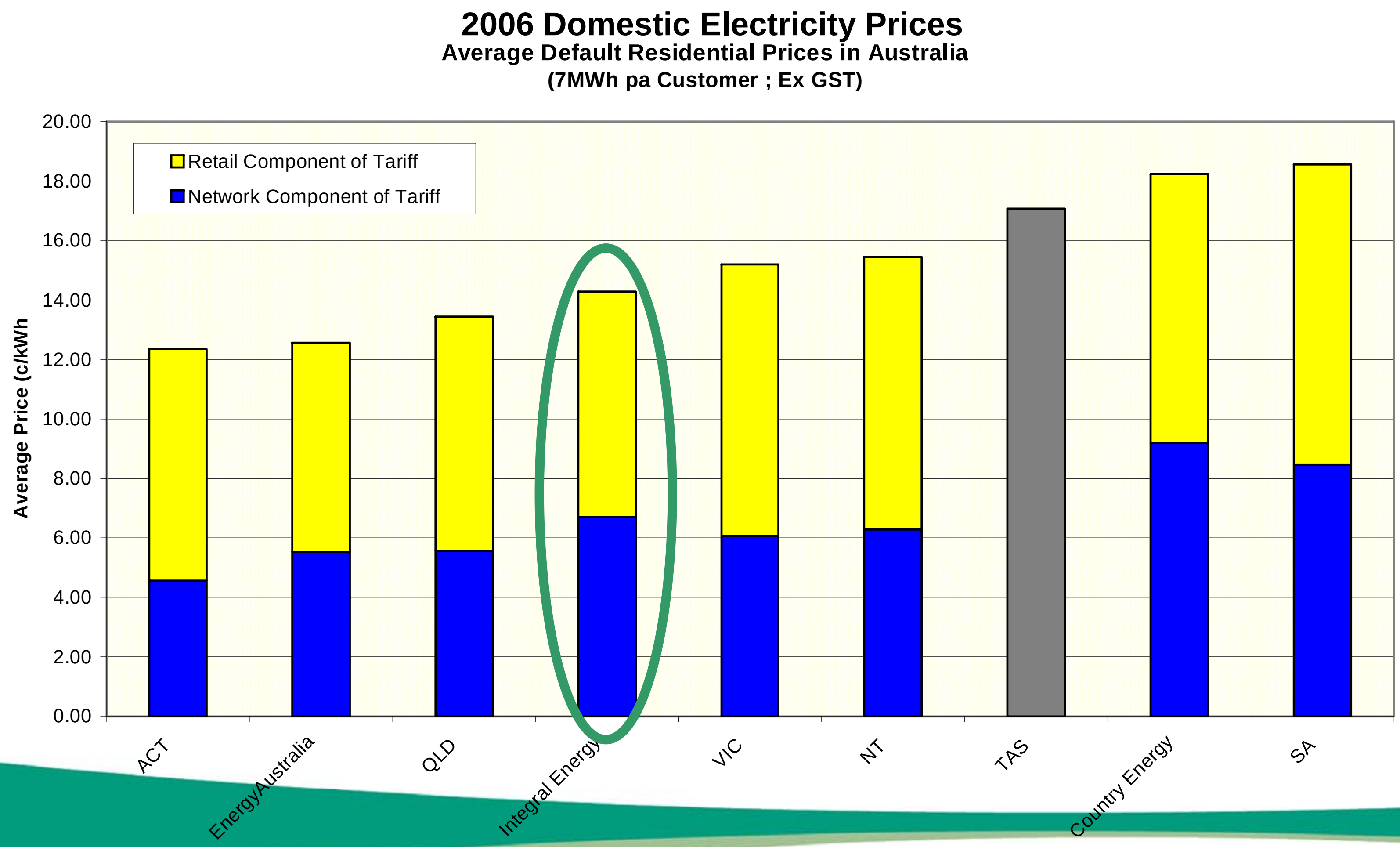
Context for the 2007 Retail Review

Integral's residential customers have seen significant real price reductions



Source: ABS CPI data, Integral Energy

Integral's regulated retail tariffs are at the lower end of the Australian market



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Source: Various Public Retailer and Network Websites

Changes from the 2004 Retail Review

- Significant changes between the TOR for the 2007 Retail Review and the TOR for the 2004 Review are that the Tribunal:
  - Must ensure that regulated tariffs are at cost reflective levels by 30 June 2010
  - Is now required to recognise retailers' hedging, risk management and transaction costs (against a background of the cessation of ETEF)
  - Must consider an allowance for electricity purchase costs based on LRMC of new entrant generation
  - Must recognise the Net System Load Profiles (NSLPs) of each standard retailer
  - Must consider retail operating costs and margin based on a "mass market new entrant"

Principles underpinning Integral's submission [1]

- An effective competitive market is in place in NSW
- To facilitate competition and support a viable retail business, regulated retail prices must:
    - ➢ Be at cost reflective levels within a reasonable time frame
    - ➢ Incorporate an allowance for hedging, risk management and transaction costs associated with the phase out of ETEF
    - ➢ Include a reasonable allowance for retail costs and margin
    - ➢ Allow for the full pass through of network charges
    - ➢ Support demand management by not unduly restricting retailers from rebalancing tariffs

Principles underpinning Integral's submission [2]

- The retail electricity market is already competitive with regulation beyond 2010 for customer protection purposes
- Regulated tariffs should be simple and provide maximum flexibility to eliminate obsolete tariffs
- The approach must appropriately balance commercial and customer outcomes

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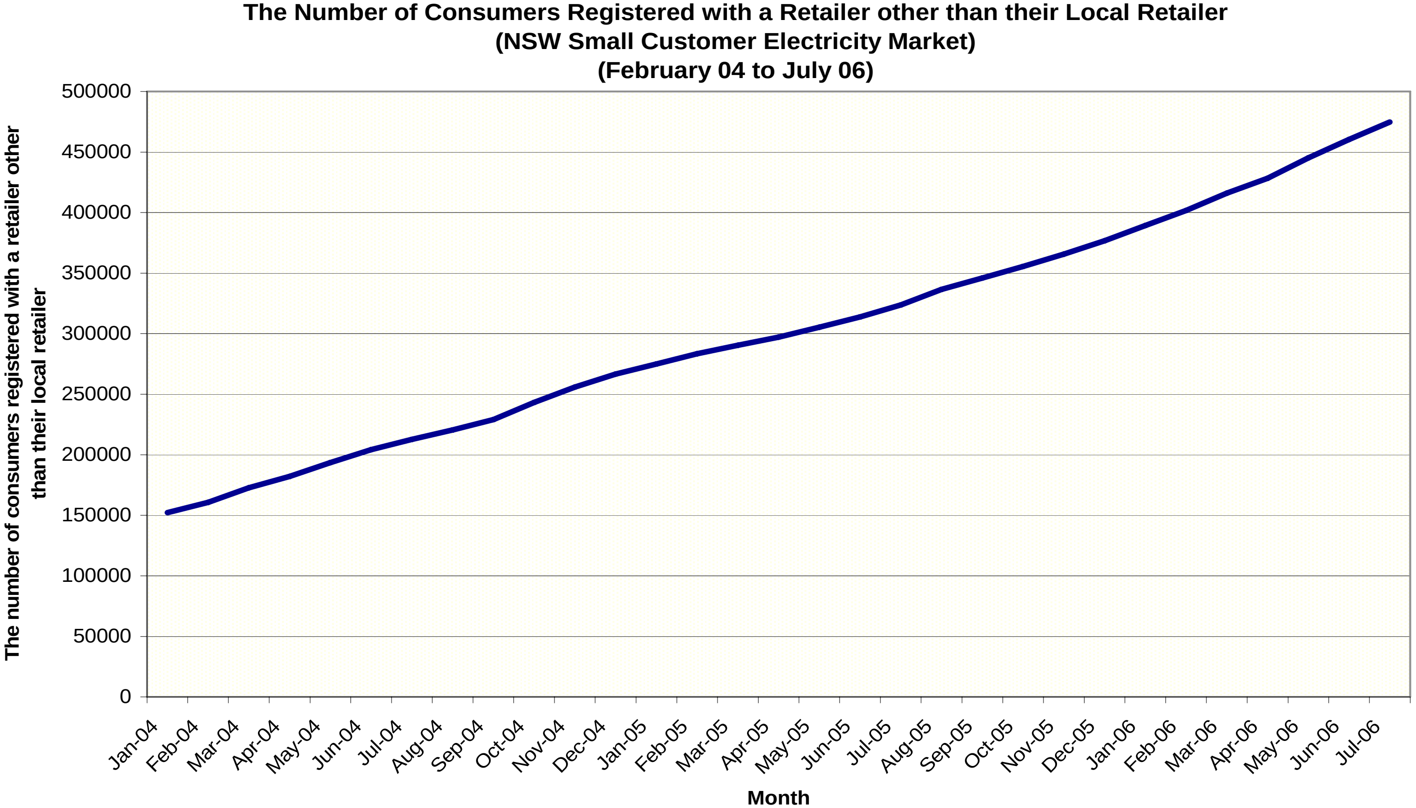
Integral's experience under the 2004 Retail Determination

Learnings from the 2004 Retail Determination

- Tribunal allowances for Integral's energy costs, operating costs and retail margin are below the levels set by regulators in other states in recent decisions
- The current form of regulation is not appropriate given a competitive environment:
  - Too prescriptive with requirement to transition tariffs to target and to introduce new tariffs at target
  - Too restrictive with side constraints applied at individual tariff level, limiting the ability to:
    - Move to cost reflective levels
    - Rationalise obsolete tariffs

Lessons from Full Retail Competition



- Few barriers to customers accessing the benefits of the retail electricity market
- Customers across Integral's customer base as a whole are being offered competitive contracts

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Appropriate form of regulation

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Reducing reliance on regulated tariffs

- A key aspect of the TOR for the 2007 Retail Review state that:

  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.

- The Government's aim of reducing reliance on regulated tariffs is a key consideration for the Tribunal in its approach to the form of regulation

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Updating the form of regulation

- Overall aims should be to:
  - Recognise this Determination is a step to removing retail price regulation
  - Achieve full cost reflectivity of regulated retail tariffs and charges by the end of determination
  - Allow the rationalisation of regulated retail tariffs, particularly removal of obsolete tariffs
  - Ensure full pass through of network tariffs and other costs outside Integral's control
  - Facilitate demand management

Proposed Form of Regulation

- The Tribunal should modify the current regulatory approach by:
  - In an ‘N+R’ approach, regulating the ‘R-component’ only, as ‘N-component’ already regulated
  - Relying on “weighted average price” cap, rather than individual Target Tariffs
  - Removing side constraints at the individual tariff level
  - Adopting a pass through mechanism for unforeseen events
  - Using forecast quantities

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Costs to be recovered

Integral's proposal for recovery of costs

- There are three broad categories of retail costs that the Tribunal should recognise in forming its Determination:
  - Energy costs
  - Retail margin
  - Retail operating costs

Energy costs

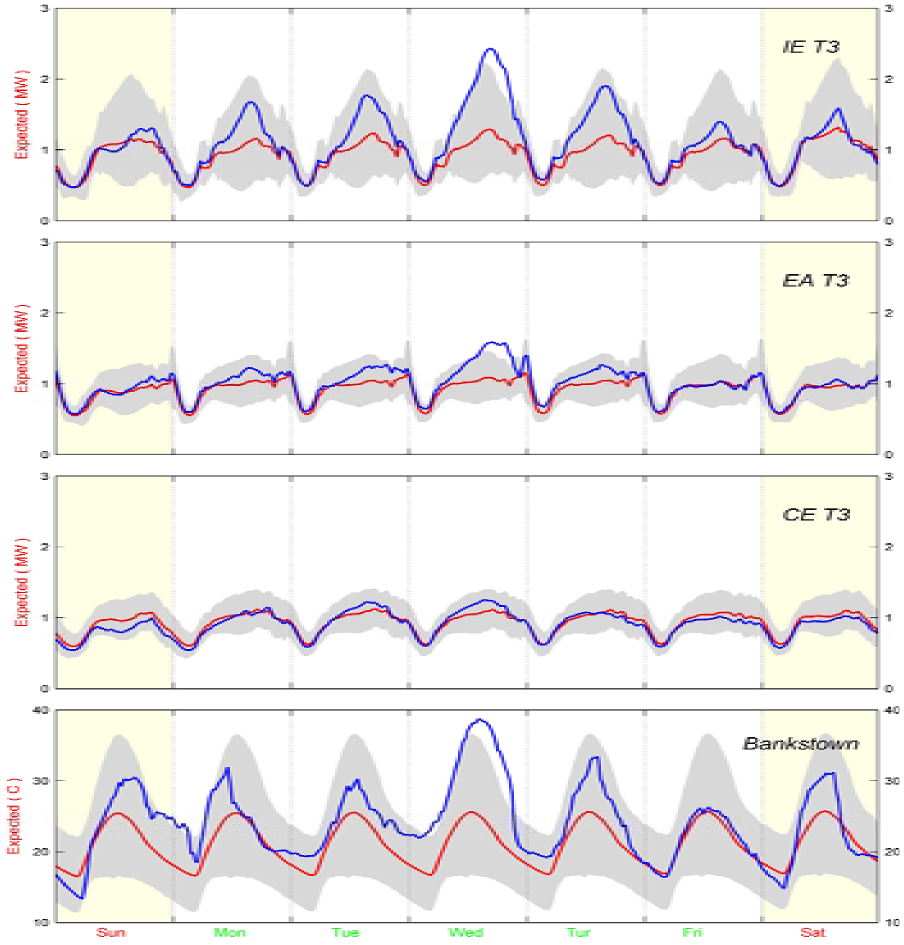
Integral’s position on energy costs

- Integral believes that an increase in the Energy Purchase Cost Allowance (EPCA) is required due to:
  - LRMC used in current retail determination based on conservative assumptions
  - Terms of Reference for this review require Tribunal to recognise the higher volatility and higher ratio of peak energy contained in Integral’s Net System Load Profile (NSLP)
- No adjustment to the EPCA to reflect gradual removal of ETEF

Wholesale Transfer Price (WTP)

- Reliance on LRMC alone is not consistent with full cost reflectivity or effective retail market competition
- The appropriate method for estimating the energy purchase cost allowance for a standalone new entrant retailer is a WTP
- The three main determinants of the WTP are:
  - The NSLP of a representative customer with cost determined by shape X price
  - The estimated cost of purchasing a portfolio of hedges corresponding to each trading period for the forecast NSLP (LRMC used as a proxy)
  - An additional margin to cover energy risk management and transition costs

Integral's NSLP



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Retail margin and operating cost allowance

Integral's positions on appropriate retail margin

- Integral believes that the retail margin must rise
- The increase in retail margin is due to:
  - The Tribunal is required to determine appropriate margin for 'mass market new entrant'
  - Therefore, margin must now reflect customer acquisition costs
  - Margin must cover residual hedging risks from ETEF phase out
  - Current margin well below the level allowed in other states

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Retail margin comparison across jurisdictions

	Electricity			Gas		
	IPART	ESCOSA	Vic	IPART	ESCOSA	Vic
Margin	2%	4 to 6.5%	5-8%+ (CRA) 7-9% (Govt)	2-3% (NERA)	3.4 to 4.3%	2-3%+ (CRA)
Return on capital (physical assets)	✓	✓	✓	✓	✓	✓
Depreciation	✗ (incl. in op costs)	✓			✓	
Return on capital (working capital)	✗	✓	✓		✓	✓
Energy purchase risk	✗	✗	✓	✗	✗	
Riskiness of customer base Competition from energy substitutes	✓	?				
Headroom Uncertainty of operating cost estimates	✗	✗	✓	✗	✗	✓
Other		✓			✓	

Other: includes Return on capital (intangible assets); Amortisation and Interest and taxes.

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Contribution to retail margin

Assumption/contribution to margin	Low	Medium	High
Customer acquisition costs	300	524	700
WACC	6%	8%	10%
Average customer life in years (new entrant)	7	10	13
Working capital	1mth revenue	1mth revenue	1mth revenue
Contribution of customer acquisition costs	4.1%	5.9%	7.5%
Contribution of working capital	0.5%	0.7%	0.8%
Contribution for asymmetric risk	1%	2%	3%
Contribution for return on tangible assets	0.5%	0.7%	0.8%
Contribution for return of tangible assets	0.8%	0.8%	0.8%
Total	**6.9%**	**10.0%**	**12.9%**

Margin sensitivity analysis

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Integral's position on retail operating costs

- Current allowance of $70 per customer is below levels in recent regulatory decisions, including $92 per customer in Victoria

- Tribunal is required to consider retail costs for a 'mass market new entrant', rather than standard retailer. Retail costs for new entrant are higher due to:
  - Costs of establishing the physical infrastructure necessary to operate a retail business

- Integral has included customer acquisition cost in retail margin, rather than operating cost

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Customer Protection

Customer assistance program

- Integral's INpower hardship program has been in place since 2004

- INpower provides the following customer assistance:
  - A dedicated case manager – one representative to allow for consistency
  - Tailored payment plans that best suit the customer's needs
  - No disconnections while the customer is on the program
  - Energy audits by phone or home visit

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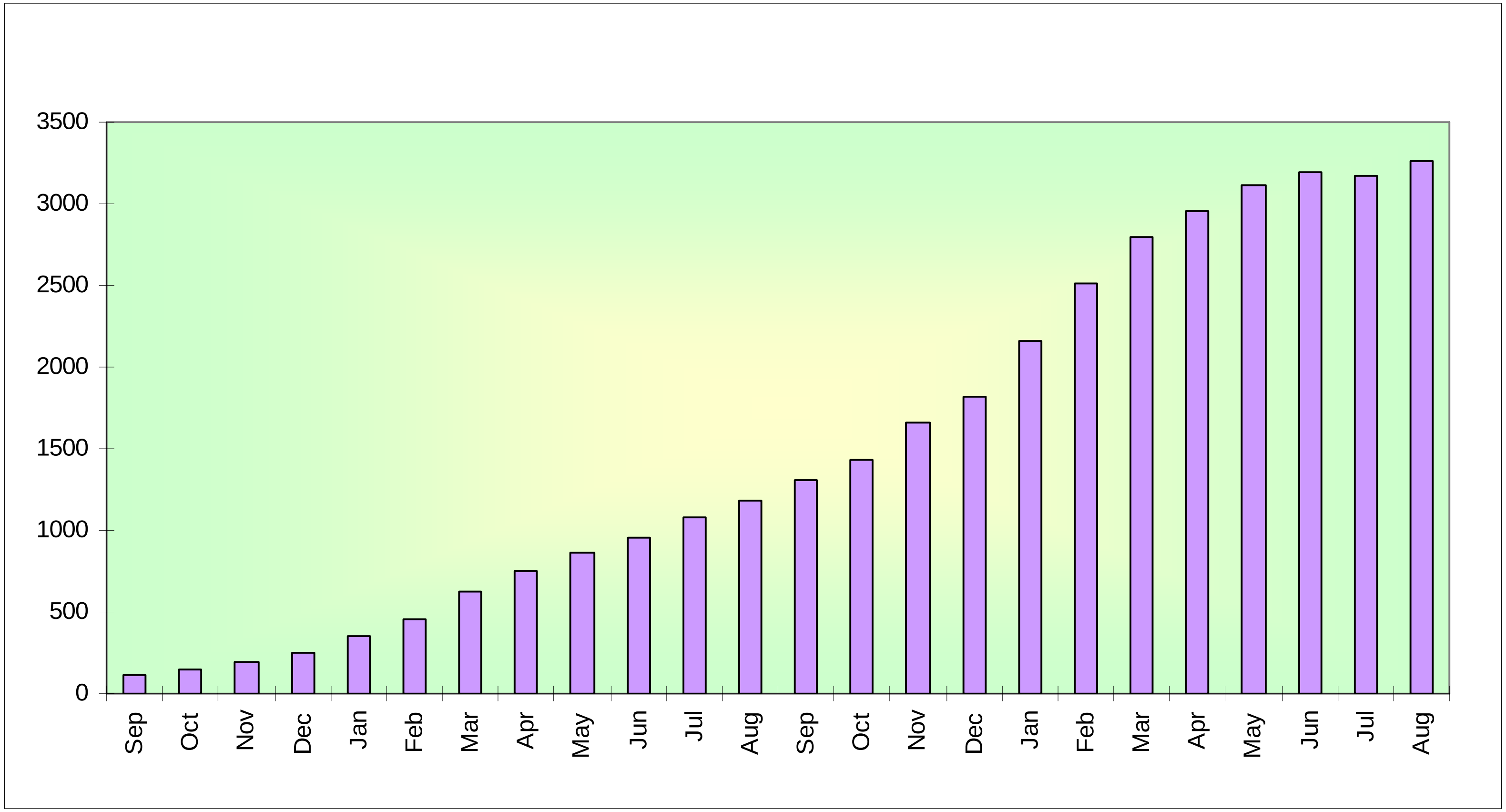
Recent improvements in INpower

- Now one of the largest programs in NSW with over 3200 customers enrolled
- Research conducted in May with customers and welfare groups had positive feedback particularly in relation to:
  - Accessibility
  - Flexibility
  - Relationships with Community Welfare Organisations
  - Feelings of safety, relief, hope, calm, respect and patience for customers
- Incentive program for most needy customers – Integral will make an equivalent payment for every 6th payment made on time

INpower enrolments



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Summary

- The 2007 Retail Review is being undertaken at a critical time in the ongoing development of retail competition in NSW
- Decisions on the form of regulation and detailed regulatory parameters will be critical to achieving competitive outcomes
- The relationship that IPART develops between the LRMC and the allowance for energy costs under the phase out of ETEF will be critical aspect of this review
    - A reliance on LRMC alone is not consistent with full cost reflectivity or effective retail market competition
- 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