

Mr James Cox
Chief Executive Officer
Independent Pricing and Regulatory Tribunal of NSW
PO Box Q290
QVB Post Office
Sydney NSW 1230

10 April 2008

Dear Mr Cox

Regulated Electricity Retail Tariffs - Review of Market Based Electricity Purchase Cost Allowance

I refer to the Tribunal's draft report dated March 2008 on the review of the market based electricity purchase costs allowance to be included in the regulated electricity retail tariffs for 2008/09.

Integral Energy notes that the Tribunal has decided to base the allowance on Frontier Economics' models rather than market data and that the draft decision is to not change the allowance as allowed in the original Determination. This is of concern to Integral Energy as the 2008/09 year is the year in which the first tranche of ETEF load rolls off. Integral Energy's recent experience in the market indicates that there is limited opportunity to obtain hedge cover at prices that are below the IPART regulated allowance for the ETEF load as it rolls off.

ETEF covers all volume risk associated with the small regulated retail customer segment. Without ETEF and without any long term hedging in place Integral Energy's market risk will increase and therefore greater capital at risk must be allocated. The margins associated with this segment must therefore increase to fully cover the increase in risk capital, which will be required to maintain Integral Energy's regulated retail customers. Integral Energy believes that maintaining the energy purchase cost allowance at the level set in the Determination will not allow this to occur and will in fact reduce the retail margin.

Integral Energy's inability to obtain suitable market instruments to provide hedge cover below the IPART allowance has also impacted on our ability to conduct recruitment and retention

Going further for you is what we do

Contact: Mike Martinson Direct Phone (02) 9853 4375 Fax (02) 9853 6376
INTEGRAL ENERGY ABN 59 253 130 878
51 Huntingwood Drive Huntingwood NSW 2148
www.integral.com.au

par12/061553924



The power is in your hands

- Rainfall across south east Australia has been above average since the 2007 Retail Determination was released, resulting in the easing of water restrictions on power stations in Queensland.

Integral Energy does not question the methodology adopted by Frontier Economics as it appears consistent with that required as outlined in the 2007 IPART Retail Determination. However, in comparing its own modelling outcomes with market data sourced from d-cypha¹, Frontier Economics states that:

*The premium of d-cypha prices over Frontier Economics' price estimates in 2009/10 is about 14 per cent.*²

Frontier Economics outlines the reasons why the d-cypha market data should be discounted, as it is relatively thinly traded and that the current price is likely to over-represent past prices, volatility and uncertainty, and concerns over the nature of policies that influence power prices across the NEM.

The discounting of the d-cypha market data by the Tribunal based on advice by Frontier Economics is important as it has effectively led to the threshold for revisiting electricity purchase cost allowance prices not being met.

Background

Integral Energy notes that the terms of reference for IPART's 2007 Retail Determination included the overarching aim 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.

Integral Energy is concerned to ensure that the regulated retail tariffs it offers are fair and reasonable and reflect the costs of operating in a volatile wholesale market. The impact of regulated retail prices that are set below cost reflective levels would be twofold:

- The impact on retail competition; and
- The financial impact on Integral Energy and its shareholder.

These concerns are addressed below.

Retail competition in NSW

If regulated retail prices are set below cost reflective levels, customers will have the incentive to remain on regulated prices as the prices will be lower than what a retailer is able to offer through a competitive offering. This has significant implications for both the level of retail competition in NSW and ability to signal the costs of new generation.

¹ d-cypha is the official product sponsor of the d-cypha SFE Australian Electricity Futures market. See <http://www.d-cyphatrade.com.au>

² See Frontier Economics March 2008 report titled "Annual energy cost review", page 19.

Integral Energy's inability to obtain suitable market instruments to provide hedge cover below the IPART allowance has impacted on our ability to offer competitive contracts for small customers both within the Integral Energy area and within the EnergyAustralia and Country Energy franchise areas.

Integral Energy has not been able to maintain a retention campaign for customers coming off retail supply contracts within the Integral Energy area since the end of July 2007. This has been as a result of Integral Energy being unable to obtain wholesale energy costs that would allow the customers to receive prices lower than the IPART regulated retail prices. Since the implementation of the 2007 Retail Determination, Integral Energy has transferred approximately 1,850 customers back to regulated retail prices. Integral Energy is still unable to mount a retention campaign for customers within the Integral Energy area.

For customers on Integral Energy contracts in the EnergyAustralia and Country Energy franchise areas, a similar situation has arisen. Integral Energy customers whose retail supply contract has expired since July 2007 have not been offered new contracts as Integral Energy has not been able to source competitively priced electricity at or below the levels underpinning current regulated retail prices. These customers have been referred back to their host retailer and have been charged contract extension rates until such time as the host retailer arranges the transfer. Approximately 6,730 customers have been affected in this way. Integral Energy has only just been able to commence a campaign to attract new customers and retain existing customers on contract in both the EnergyAustralia and Country Energy areas.

Integral Energy considers that regulated prices that are below cost reflective levels is a contributing factor to the slowdown in competitive retail activity and the increased reliance on regulated retail tariffs by customers. If this trend is to continue, Integral Energy considers that the terms of reference with respect to reducing reliance on regulated retail tariffs by customers would not be met.

Impact on financial risk

Integral Energy and its shareholder are exposed to the risk that actual electricity purchase costs may exceed the level at which Integral Energy is obliged to sell the electricity to regulated customers. This financial risk would be borne solely by Integral Energy and its shareholder.

Integral Energy's recent experience in the market indicates that there is limited opportunity to obtain hedge cover at prices that are at the IPART regulated allowance for the ETEF load as it rolls off.

ETEF covers all volume risk associated with the small regulated retail customer segment. Without ETEF and without any long term hedging in place Integral Energy's market risk will increase and therefore greater capital at risk must be allocated. The margins associated with this segment must therefore increase to fully cover the increase in risk capital, which will be required to maintain Integral Energy's regulated retail customers. Integral Energy believes that maintaining the energy purchase cost allowance at the level set in the 2007 Retail Determination will not allow this to occur and will in fact reduce the retail margin.

As Integral Energy is obliged to offer regulated retail prices, the inability to obtain suitable market instruments to provide hedge cover at the IPART allowance will result in increased financial risk to Integral Energy and its shareholder.

The decision on the electricity purchase cost allowance for 2008/09 will be critical to achieving competitive outcomes. The decision needs to reflect the role of regulated retail prices as safety net prices and the role of the market in "regulating" prices. To achieve commercial outcomes and support a competitive market, Integral Energy believes that the Tribunal should review its decision to not consider market data in addition to the modelling provided by Frontier Economics when making its decision on whether the threshold has been met to trigger a review of the energy purchase cost allowance.

Should you require any additional information or if you have any questions on the above please contact Mr Mike Martinson on (02) 9853 4375.

Yours faithfully

A handwritten signature in black ink, appearing to read "Vince Graham". The signature is fluid and cursive, with a large initial "V" and a long, sweeping tail.

Vince Graham

Chief Executive Officer