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2004 Review of Gas and Electricity Regulated Retail Tariffs Submission

to the

Independent Pricing and Regulatory Tribunal

1 December 2003

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Dr Tom Parry
Chairman
Independent Pricing & Regulatory Tribunal
Level 2, 44 Market Street
SYDNEY NSW 2000

1 December 2003

Dear Dr Parry

2004 Review of Gas and Electricity Regulated Retail Tariffs

Integral Energy is pleased to provide its submission to the Independent Pricing & Regulatory Tribunal's (IPART) 2004 Review of Gas and Electricity Regulated Retail Tariffs.

This review represents an important opportunity to learn from the limitations of the 2001 Retail Determination and establish a more contemporary regulatory approach that is capable of supporting the continued development of the competitive electricity market in NSW.

The review process for the 2001 Retail Determination was undertaken prior to the start of Full Retail Contestability (FRC) and in the absence of the Tribunal or standard retailers having any real information or experience on the impact of competition. FRC has now been in place for almost three years and an effective market is developing. Going forward, regulated retail prices should reflect their role as safety net or default prices.

It is important that this change in context and purpose is reflected in the approach to retail price regulation from 1 July 2004.

The terms of reference (TOR) for this review reinforce the importance of the Tribunal's approach to future regulated retail arrangements. In the TOR, the NSW Government has indicated that the Tribunal must consider the Government's policy aim of reducing customers' reliance on regulated retail prices and the effect of the Tribunal's Determination on competition in the retail electricity market. The TOR also notes that the level of regulated prices for small retail customers is a crucial factor in encouraging new entrants in the retail sector.

The Tribunal has therefore been charged with a crucial responsibility in delivering a regulatory approach and making decisions that directly respond to these fundamental issues.

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Integral believes that the TOR for the review provide the Tribunal with relatively wide discretion in determining the future basis for regulated retail tariffs within the context of various policy constraints. A key decision required by the Tribunal in its Determination is the market structure that characterises electricity retailing to small customers. Integral believes that the Tribunal should seek the outcomes of a workably competitive market.

In preparing its Submission, Integral engaged the Network Economics Consulting Group (NECG) to prepare a paper on “workable competition” within the context of the Tribunal’s 2004 Retail Tariff Review.

The main conclusions from NECG’s report are that the NSW electricity retail market can be categorised as “workably competitive” and that this suggests that an invasive or aggressive form of retail price regulation is not appropriate.

This perspective suggests that the Tribunal should not be constrained by the regulatory approach that is currently in place. The current regulatory approach was established at a particular point in time to suit the prevailing market conditions and in response to the uncertainties associated with FRC. However, the market conditions have changed and there is now more information available to the Tribunal, standard retailers, second-tier retailers and, most importantly, customers, in relation to FRC.

In terms of outcomes from this review, Integral needs to have the flexibility to move to cost reflective tariffs as early as possible. This will require an adjustment to side constraints to enable this to occur. Furthermore, Integral believes that side constraints should be established on a “light-handed” basis. Integral’s submission sets out its proposal for both the structure of future side constraints and the regulatory decision-making processes that would underpin this approach.

Finally, this review is being conducted at a key period in the development of the competitive electricity market in NSW. Integral is of the view that there is enormous scope for the Tribunal to move forward on the basis that competition is the first best alternative and that the regulatory approach should support this objective. Integral urges the Tribunal to conduct the review on this basis. For further information on this submission, please contact our General Manager Regulatory Karen Waldman on 02 9853 6166.

Sincerely

R. Powis.

Richard Powis
Chief Executive Officer

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1 Overview

This section provides an overview of Integral Energy's (Integral) Submission responding to the Independent Pricing and Regulatory Tribunal's (Tribunal) Issues Paper (Discussion Paper DP70) relating to the 2004 Review of Gas and Electricity Regulated Retail Tariffs (2004 Retail Tariff Review).

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 supports the view presented in the Tribunal's Discussion Paper DP70[1] that regulated retail tariffs have a role in the transition to effective retail competition in the national energy markets. As the Tribunal notes:

> *These regulated tariffs act as a safety net or default prices for customers who choose not to participate in the competitive market.*

This observation is a starting point for the 2004 Retail Tariff Review.

The review process for the 2001 Retail Determination was undertaken prior to the start of Full Retail Contestability (FRC) and in the absence of the Tribunal or standard retailers having any real information or experience on the impact of competition. FRC has now been in place for almost three years and an effective market is developing. Going forward, regulated retail prices should reflect their role as safety net or default prices. It is important that this change in context and purpose is reflected in the approach to retail price regulation.

Based on the NSW Government's policy support for a competitive retail electricity market and the significant investments that have been made in providing for FRC capability, it also follows that the regulatory framework should support the ongoing development of the market.

The terms of reference (TOR) for this review made under section 43EB of the Electricity Supply Act 1995 (NSW) reinforce the importance of the Tribunal's approach to future regulated retail arrangements. In the TOR, the NSW Government has indicated that the Tribunal must consider the Government's policy aim of reducing customers' reliance on regulated retail prices and the effect of the Tribunal's Determination on competition in the retail electricity market. The TOR also notes that the level of regulated prices for small retail customers is a crucial factor in encouraging new entrants in the retail sector. Over the longer term, Integral proposes the elimination of the need for retail price regulation by 1 July 2007.

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[1] p.1 (IPART Discussion Paper DP70) Review of gas and electricity regulated retail tariffs – Issues Paper, October 2003

The Tribunal has therefore been charged with a crucial responsibility in delivering a regulatory approach and making decisions that directly respond to these fundamental issues.

1.1 Workably competitive market

Integral believes that the TOR for the review provide the Tribunal with relatively wide discretion in determining the future basis for regulated retail tariffs within the context of various policy constraints. A key decision required by the Tribunal in its Determination is the market structure that characterises electricity retailing to small customers. Integral believes that the Tribunal should seek the outcomes of a workably competitive market.

In preparing this Submission, Integral engaged the Network Economics Consulting Group (NECG) to prepare a paper[2] on "workable competition" within the context of the Tribunal's 2004 Retail Tariff Review. The main conclusions from NECG's report are that the NSW electricity retail market can be categorised as workably competitive and that this suggests that an invasive or aggressive form of retail price regulation is not appropriate.

In particular, Integral believes in light of the changed market dynamics since the commencement of FRC, the Tribunal has considerable scope to use the 2004 Retail Tariff Review to move the regulated retail framework in NSW forward and support the continued development of a competitive electricity market.

This view suggests that the Tribunal should not be constrained by the regulatory approach that is currently in place. The current regulatory approach was established at a particular point in time to suit the prevailing market conditions and in response to the uncertainties associated with FRC. However, the market conditions have changed and there is now more information available to the Tribunal, standard retailers, second-tier retailers and, most importantly, customers, in relation to FRC.

This review presents enormous scope for the Tribunal to move forward on the basis that competition is the first best alternative and that the regulatory approach should support this objective.

In conducting the 2004 Retail Tariff Review, Integral strongly believes that the Tribunal should place considerable weight on the fact that a workably competitive market is in place in the NSW retail electricity sector.

1.2 Outcomes from the 2001 Retail Determination

Integral has achieved poor commercial outcomes from the 2001 Retail Determination. This result has been due to a combination of the allowances permitted by the Tribunal and the side constraints. Specifically, the Tribunal did not make adequate allowances for retail cost to serve and green energy compliance.

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[2] NECG, "*Applying workable competition in the NSW electricity retail sector" – A report to IPART for Integral Energy from the Network Economics Group*," November 2003. (See Appendix A).

The mechanism for regulating retail tariffs set by the Tribunal for the current regulatory period has been overly restrictive and has not allowed Integral to price at target levels. While the Tribunal established “target tariffs” for each standard retailer, limits were also placed on the rate at which existing prices could move towards the targets. Within these constraints it was also envisaged that tariffs would move to the target levels over the 2001 regulatory period.

This mechanism has been a major problem for Integral as several of its regulated retail tariffs commenced the period below “target”. While these prices could generally be moved up annually in line with inflation, the flaw in the price-setting framework was that the target tariff also continued to move in line with inflation. This situation effectively meant that the target could never be reached.

The outcomes from the Mid Term Review of Regulated Retail Tariffs conducted in 2002 provided some relief to Integral’s regulated retail business, through changes in the application of side constraints. These changes demonstrated the Tribunal’s recognition of the issues faced by Integral and other standard retailers. However, the 2004 Retail Tariff Review presents an important opportunity to continue to learn from the flaws in the current approach.

1.3 Key issues for Integral

Integral’s objective is to work with the Tribunal and other stakeholders in the development of the 2004 Retail Tariff Review so that Integral can operate its regulated retail business on a commercial basis and manage pricing outcomes for small retail customers.

The TOR specify a number of matters for consideration by the Tribunal. Integral responds to these issues within the remainder of this submission. Based on Integral’s experience under the 2001 Retail Determination, Integral’s review of the TOR and the Tribunal’s Discussion Paper DP70, the key issues for Integral in this review are:

- Form of regulation for retail tariffs

  A change is required in the form of regulation to reflect the objectives of the review, the change in the market context and to learn from the experience of the 2001 Retail Determination.

  The current side constraints prevent Integral from achieving the regulated target tariffs allowed by the Tribunal. The amount of revenue received from Integral’s default rates is estimated to be in the order of $20m per annum less than would be received were all tariffs at the target levels.

- The level of retail costs

  The “cost to serve” allowance provided for in the target tariffs is less than that allocated to regulated customers in Integral’s regulatory accounts.

  The TOR request that the Tribunal report on “appropriate” retail costs and “appropriate” retail margins. The definition of “appropriate” will be an important consideration for the Tribunal. NECG argues that the Tribunal should adopt a light handed approach in dealing with these issues:

> *"Given the error costs of regulation and the policy desire to promote competition and reduce reliance on regulated outcomes, IPART should adopt a conservative position in considering an "appropriate" retail cost and "appropriate" retail margin, as well as the various "allowances" that form part of the retail tariff."*[3]

- The level of retail margin

  The net retail margin assumed in the 2001 Retail Determination is 1.5%. This margin compares with other Jurisdictional allowances of 2.35% (Tas), 3% (ACT), 5% (SA), and 2.5 - 5% (Vic) and margins earned by publicly listed retail businesses, such as AGL of 6.3%. The primary justification for a lower margin appears to have been a lower risk due to the perceived protection offered by the Electricity Tariff Equalisation Fund (ETEF) in NSW, and government ownership not requiring a high cost of capital. Integral notes that other regulated retailers generally receive an allowance for hedging costs within their wholesale purchase costs. Therefore, Integral does not accept these arguments.

Integral provides more detailed responses to these key issues within this Submission.

1.4 Moving forward

Decisions on the form of regulation and detailed regulatory parameters will be critical to achieving competitive outcomes.

These decisions need to reflect the role of regulated retail prices as safety net prices. Further, NECG conclude that experience in the NSW electricity retail market supports categorising electricity retailing to small customers as workably competitive in nature. Therefore the Tribunal's decisions need to reflect the role of the market in "regulating" prices.

To achieve commercial outcomes and support a competitive market, Integral needs to have the flexibility to move to cost reflective tariffs as early as possible. This will require an adjustment to side constraints to enable this to occur. Furthermore, Integral believes that side constraints should be established on a "light-handed" basis.

Integral proposes that the form of regulation be improved to apply retailer specific constraints on tariff components. These constraints would be structured in line with the underlying network tariff structure, which is likely to take the form of an Inclining Block Tariff (IBT). On this basis, Integral proposes the following retail constraints:

- A maximum allowable annual increase in the fixed system access charge (the level of price constraint may differ in 2004/05 compared to other years);

[3] NECG, page 17.

- A maximum allowable annual increase in the first block of the variable energy consumption component (the level of price constraint may differ in 2004/05 compared to other years); and

- No price constraint on the second block.

Integral believes this approach supports the Tribunal's objectives of moving tariffs towards cost reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks.

1.5 Summary

The retail electricity sector has undergone significant changes since the commencement of FRC at the start of 2001. Further changes will occur as the competitive market continues to develop over future years. In parallel with these changes, the underlying network tariff structures are likely to change from 1 July 2004.

Decisions on the approach to regulation of retail tariffs need to reflect these changing dynamics. According to NECG:

> *"In such an environment, it is important to avoid an invasive or aggressive form of retail price regulation as such an approach will not accomplish the Government's objective of facilitating the emergence of a competitive market. All things being the same, the risk of sabotaging this objective increases as the regulation of retail costs and margins becomes more aggressive."*

Integral urges the Tribunal to take careful account of these issues in the conduct of its review.

2 Purpose of submission

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

The investigation and report applies to regulated retail tariff and charges for small retail customers.[4] These regulated retail tariffs act as safety net or default prices for customers who do not choose to participate in the competitive market.

The purpose of this Submission is to address issues raised by the Tribunal in its Discussion Paper DP70. This Submission is structured as follows:

Section	Purpose	Details
3	Regulation of retail tariffs	This Chapter discusses the basis for the Tribunal's approach to, and issues relevant to, the Tribunal's review of retail regulated prices, Integral's interpretation of the TOR and Integral's view on regulatory principles and objectives relevant to the review.
4	Current retail tariffs and competition	This Chapter provides an overview of Integral's current regulated retail tariff position and highlights key points on the current status of retail competition.
5	What is the most appropriate form of regulation of retail tariffs?	This Chapter sets out Integral's view on the form of regulation which will best assist in transitioning regulated tariffs to cost reflective levels over the period of review.
6	What are the appropriate levels of costs to be recovered?	This Chapter sets out Integral's position on what and how the Tribunal should consider allowances for various cost, risk and margin components
7	What is the most appropriate structure for regulated tariffs?	This Chapter sets out Integral's preferred regulated retail tariff structure of replicating the network tariff structure resulting from the 2004 Network Determination.
8	Customer assistance package	This Chapter sets out details of Integral's customer assistance package.
9	On what basis should non-tariff charges be regulated?	This Chapter sets out Integral's proposal for regulation of non-tariff charges including: - Late payment fee - Security deposit - Dishonoured bank transaction fee.

[4] 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 form customer supply contract.

3 Approach to the Retail Tariff Review

3.1 Introduction

The purpose of this Chapter is to discuss the basis for the Tribunal's approach to, and issues relevant to, the Tribunal's 2004 Retail Tariff Review.

Integral notes that the Government's TOR for the investigation and report on the setting of tariffs for small retail regulated customers raises the potentially conflicting objectives of achieving tariffs that are cost reflective and facilitate competition versus protecting customers from large price increases. In considering trade-offs between these objectives, Integral believes that the Tribunal must carefully take account of the Government's TOR in its approach to, and assessment of, submissions to the 2004 Retail Tariff Review.

3.2 The Government's TOR for the Tribunal's review

The matters for consideration by the Tribunal are as follows:

For the purposes of section 43EB (2)(a) of the Act, the matters the Tribunal is to consider in making its investigation and report on the setting of tariffs for small retail customers to apply from 1 July 2004 to 30 June 2007 include:

- *An allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation, given the characteristics of the demand of customers remaining on regulated tariffs;*
- *Appropriate retail costs;*
- *Appropriate retail margin;*
- *An allowance for retailer compliance with any Commonwealth Mandatory Renewable Energy Target (MRET) requirements and the licence requirements relating to the NSW Greenhouse Gas Benchmark Scheme;*
- *Energy losses as published by the National Electricity Market Management Company (NEMMCO);*
- *Network charges as determined by the Tribunal and the Australian Competition and Consumer Commission;*
- *Fees (including charges for ancillary services) as imposed by NEMMCO under the National Electricity Code;*
- *An allowance for expected movements in regulated components and NEMMCO fees.*

In addition, the TOR 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 TOR also state that:

The Determination should ensure, as far as practicable, that:

- *Regulated retail tariffs and regulated retail charges are at cost reflective levels for all small retail customers by 30 June 2007;*
- *The setting of any 'price constraint' should allow the further rationalisation of regulated retail tariffs and movement to full cost recovery over the Determination period with regard to the need for a smooth transition for customers; and*
- *Alternative ways be considered to facilitate transition to full cost recovery by 2007, or by an appropriate later date, such as the setting of regulated retail tariffs at cost reflective levels for all new connections and new customers.*

3.3 The Tribunal's approach to the review

Integral believes that the TOR for the review provide the Tribunal with relatively wide discretion in determining the future basis for regulated retail tariffs within the context of various policy constraints. A key consideration required by the Tribunal in its Determination is the market structure that characterises electricity retailing to small customers. Integral believes that the Tribunal should seek the outcomes of a workably competitive market.

Integral engaged NECG to review the Government's TOR and form a view on what the TOR mean for the Tribunal's approach to the 2004 Retail Tariff Review. NECG concluded that the NSW electricity market can be categorised as "workably competitive" and that this suggests that an invasive or aggressive form of retail price regulation is not appropriate.

NECG's report is included in Appendix A.

In summary, Integral believes that the Government's retail competition policy objectives set out in the TOR require that the Tribunal's Determination should be made within the context of a workably competitive market. This means that the Tribunal must adopt a conservative position when considering and making its Determination on regulated retail tariffs and charges.

3.4 Integral's proposed regulatory principles

In light of the above and given the industry context as expressed in the Overview, Integral believes that the following regulatory principles should be considered by the Tribunal in making its Determination on regulated retail tariffs and regulated retail charges:

- Consistent with the Government's TOR, the overall aim of the 2004 Retail Tariff Review should be to reduce customers' reliance on regulated retail prices. This will be achieved by:

  - Supporting the continued development of the market – competition is the best way to manage customer pricing outcomes. Invasive or aggressive retail regulation will stifle competition;

  - Ensuring an appropriate regulatory approach – this includes allowing for the proposed changes in network tariff structures, so that the price signal envisaged at the network level is also translated to the customer level;

  - Promoting efficiency and innovation – regulation should provide incentives for efficient behaviour by retailers and customers and for innovation in service delivery;

  - Allocating and managing risk – risks should be allocated to those that are best able to manage them. The costs associated with managing risks should be provided for explicitly;

  - Minimising administration and compliance costs – this is best achieved through light handed regulation and simple and clear regulatory frameworks and processes being established;

  - Encouraging commercial outcomes and financial returns – decisions need to ensure the regulated retail business receives appropriate commercial compensation and financial returns.

- There is a need to manage pricing outcomes to small customers. This outcome will be achieved by ensuring a smooth transition to cost reflective tariffs.

- The Tribunal's decision should be based on Integral's role as a "safety net retailer" and therefore consider issues associated with that role.

4 Current retail tariffs and competition

This Chapter discusses issues related to current retail tariffs and competition as input to the Tribunal's review.

As stated in Chapter 1 of this Submission, it is important that the Tribunal's determination takes account of:

- Experience in the 2001 retail determination, particularly the adverse commercial outcomes resulting from overly restrictive side-constraints;

- Developments in the competitive retail market and Integral's experience with customer churn.

The following sections will demonstrate that:

- During the 2001 regulatory period, the side constraints established as part of the current regulatory approach have meant that Integral has not been able to achieve the Tribunal's target retail tariff levels, nor cost reflective tariffs.

  Therefore, the approach to the setting and regulation of regulated retail tariffs needs to be amended in the 2004 Retail Tariff Review;

- Since 2001 the competitive retail market has developed considerably. Competition is strongest where the opportunities for savings are greatest and where the regulated retail price provides "headroom" for competitive offers.

  The Tribunal's consideration of cost allowances and the approach to regulating tariffs needs to take account of the relationship between the level of regulated tariffs and the churn outcomes. This factor is also noted in the TOR for the review.

4.1 Current retail tariffs

The current form of retail price regulation and the level of the side constraints prevent Integral from achieving the regulated target tariffs as allowed by the Tribunal.

Table 4-1 compares Integral's regulated retail tariffs effective from 1 July 2003 with the Tribunal's target tariffs.

Tariff class	Regulated tariff compared with the Tribunal target tariff
Domestic Supply	Integral's Domestic Supply tariff is below the retail target tariff by approximately 3.2%
Off Peak 1	Integral's Off Peak 1 tariff is below the retail target tariff by approximately 9.1%
Off Peak 2	Integral's Off Peak 2 tariff is currently above the retail target tariff by approximately 5.8%
General Supply	Integral's General Supply tariff is currently below the retail target tariff by approximately 1.4%
General Supply Time of Use	Integral's General Supply Time of Use tariff is above the retail target tariff by approximately 6.3%

Table 4-1 – Regulated tariffs compared to target levels

As a result of the outcomes highlighted in Table 4-1, the amount of revenue received from Integral's default rates is estimated to be in the order of $20m per annum less than what would be received were all tariffs at the target level for the 2003/2004 financial year.

The reduction in revenue reduces the profitability of the regulated retail business and adversely affects the financial sustainability of the business. The inability to move tariffs to target levels is contrary to the Government's objectives to facilitate effective retail competition.

If the current form of retail price regulation continued, and similar side constraints were set, the under-recovery would increase over the coming years, particularly given the proposed network price increases submitted to the 2004 Network Determination which would flow through to the target tariff.

Integral's experience in the 2001 Retail Determination highlights the difficulties in designing and implementing a regulatory approach based on target tariffs and tight side constraints and points to the need to change the form of regulation. Integral's proposal on the form of regulation is discussed in Chapter 5.

4.2 Retail competition

FRC has now been in place for three years and the competitive retail market has developed during this time:

- Customers have a choice of retailer;
- Customer have better awareness of their choices of retailer and supply options;
- FRC systems and processes facilitate transfer;
- Customer churn is occurring where there is a price incentive.

As noted in the TOR for the review, the levels of regulated tariffs have a significant effect on competition in the retail market.

A recent paper by Ofgem on electricity supply competition[5] noted that price is a significant issue in a customer's decision to switch. The paper refers to research which found that 69 percent (domestic) electricity customers that switched did so in pursuit of savings.

Statistics published by the National Electricity Market Management Company (NEMMCO) demonstrate that although NSW has a much larger customer base than Victoria, the number of customers transferring retailers in Victoria is more than 75% greater than in NSW. Integral considers that the prime reason for the lower churn in NSW is the lower relative levels of regulated tariffs.

Integral's experience in customer transfer during 2002/03 is summarised in Table 4-2:

Tariff class	Regulated tariff compared with the Tribunal's target tariff in 2002/03	Churn experience
General Supply	In 2002/03 Integral's General Supply tariff was above the target tariff in both fixed and variable components	A significant proportion of customers on this tariff moved from regulated rates within the year.
Off Peak 2	Integral's Off-Peak 2 tariff was over-recovered on the variable rate.	A significant proportion of the larger customers on this tariff moved from regulated rates.
Off Peak 1	In contrast to Off-Peak 2, the Off-Peak 1 tariff was significantly under-recovered.	Almost all customers on this tariff remained on regulated rates.
Domestic Supply	Domestic Supply tariff was below the retail target tariff	Lower levels of churn have occurred relative to General Supply and Off Peak 2.

Table 4-2 – Customer churn during 2002/03

Integral's experience in 2002/03 was that customer churn was greatest where regulated prices provide opportunities for lower competitive offers.

[5] Electricity supply competition: An Ofgem occasional paper, 16 Dec 2002

5 What is the most appropriate form of regulation for retail tariffs?

The Tribunal seeks comment on:

> *What form of regulation will best assist the Tribunal in meeting its objectives of moving all regulated tariffs towards cost-reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks.*

The Tribunal's decision on the form of regulation needs to consider the trade-offs between the benefits of moving relatively quickly to cost-reflective tariffs versus the need to protect customers from "unacceptable price shocks". These trade-offs need to be considered in the context of:

- The existing regulatory approach based on target tariffs and side constraints; the current regime places tight limits and constraints on retail prices;
- The timeframe for implementation of the form of regulation by 1 July 2004;
- The objective of facilitating a smooth transition to a competitive retail market.

Integral proposes that the most appropriate form of regulation for the 2004 regulatory period be based on the regulatory approach outlined in Table 5-1.

Issue	Comments
Form of regulation	Constraints[6] on tariff components: • A maximum allowable annual increase in the fixed system access charge (the level of price constraint may differ in 2004/05 compared to other years); • A maximum allowable annual increase in the first block of the variable energy consumption component (the level of price constraint may differ in 2004/05 compared to other years); and • No price constraint on the second block.

Table 5-1 – Form of regulation proposal

Integral considers that there are strong merits to this approach, as it is consistent with the Tribunal's objectives, recognises the role of the competitive retail market, does not entrench regulated outcomes and supports tariff innovation.

[6] Constraints would be retailer specific.

Further, the approach is consistent with NECG's findings:

> *"Given the balance of costs and errors, it is therefore important that regulatory errors do not strangle the emergence of the competitive retail market. In such an environment, it is important to avoid an invasive or aggressive form of retail price regulation as such an approach will not accomplish the Government's objective of facilitating the emergence of a competitive market."*[7]

This section discusses:

- Shortcomings of the current approach to regulation of retail tariffs;
- The objectives affecting the decision on the form of regulation;
- Why the decision on the form of regulation should have regard to the "safety net" nature of the tariffs being regulated;
- The interaction between the form of regulation and the level of allowed costs;
- Integral's proposed form of regulation;
- Timing for completion of detailed design of the form of regulation;
- Provision for Determination reopeners and pass-through events.

5.1 Shortcomings of the current regulatory approach

Integral supports the Tribunal's consideration of alternative forms of regulation. Integral considers a change in the form of regulation is required to meet the Tribunal's objectives.

Integral has undertaken preliminary analysis of the implications of alternative regulatory approaches on customer outcomes and tariff transition paths. This analysis confirms that the current approach of constraints on average prices in combination with individual bill constraints is overly restrictive and does not support the objectives of the TOR.

In particular, the current target tariff approach significantly limits the ability to transition to cost reflective tariffs within a reasonable time frame.

5.2 The Tribunal's objectives for the form of regulation

Section 3 of the Discussion Paper DP70 notes that:

[7] NECG, page 18.

> *The Tribunal considers that the primary objective in setting the form of regulation for both sectors should be to move all regulated tariffs towards cost reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks.*

While Integral understands and accepts the importance of ensuring that customers are not exposed to unacceptable price shocks as a consequence of transitioning under-recovering regulated tariffs to cost reflective levels, it is important that this objective does not unnecessarily hinder the development of a more competitive retail market for electricity.

Integral understands that customer impacts need to be managed responsibly and that the role of regulation in achieving a smooth price transition is explicitly considered.

Moving to cost reflectivity may adversely impact bills for some customers. Regulation can facilitate a smooth transition and mitigate, but not eliminate, the impact. Customer impacts can be managed in a variety of ways:

- Integral has commercial and risk management objectives that support it managing customer impacts. Integral also needs to balance recovery of its costs against setting prices too high and exposing itself to adverse customer sentiment and competitive pressure;

- Social policy and Government have a role in managing services to low income customer groups.

Integral recognises that in making a decision on the form of regulation, the Tribunal will inevitably need to trade-off the elements of its “primary objective.” Integral believes that the Tribunal needs to make this decision with regard to:

- The role of the form of regulation in managing social outcomes;

- The role of the retail business in making detailed decisions about balancing customer pricing and service levels against commercial interests; and

- The potential role of Community Service Obligations in protecting disadvantaged customers.

5.3 Tariffs subject to regulation

The Tribunal’s review and report relates to regulated retail tariffs for small retail customers.

All small retail customers have the ability to enter into market contracts for supply of retail electricity. The regulated retail tariffs are default prices for customers who do not choose to participate in the competitive market. Integral believes that it is important that these default tariffs reach cost reflective levels as soon as possible.

Nevertheless, Integral understands and accepts that the transition to cost reflective prices must be undertaken in a socially responsible manner given the important role that these tariffs play to protect customers that are unable to benefit from participating in the competitive market, at this stage.

Integral considers that the decision on the form of regulation needs to be consistent with the role of regulated retail prices as "safety net" or default prices.

Integral believes that this means that a more lighted handed form of regulation is justified as the Tribunal's objective is to ensure that appropriate safety net prices are in place for customers that are not able to benefit from competition. It is important that the objective of providing a safety net price does not hinder the further development of competition in the retail electricity market.

5.4 Interaction between cost levels and form of regulation

Chapter 3 of this Submission analyses the TOR for the Tribunal's review and highlights the importance of adopting *"a conservative position in considering an "appropriate" retail cost and "appropriate" retail margin, as well as the various "allowances" that form part of the retail tariff."*[8]

It is important that the regulatory approach adopted provides flexibility for Integral to manage its tariff levels in relation to the detailed design of the form of regulation.

The benefits of a conservative approach when considering the costs to be allowed for in the retail tariffs could easily be removed by imposition of restrictive tariff controls which could prevent tariffs from reaching cost reflective levels.

5.5 Proposed form of regulation

The Tribunal identified a range of alternatives for the form of regulation in the Discussion Paper DP70.[9]

Integral has considered the various options in light of the objectives of the retail review, the network tariff proposals and the wider competition objectives. Integral considers there are significant merits in a form of retail regulation that applies side constraints to selective tariff components. The key features of this proposed option are set out in Table 5-2.

Issue	Comments
Form of regulation	Constraints[10] on tariff components: • A maximum allowable annual increase in the fixed system access charge (the level of price constraint may differ in

[8] NECG, page 16.

[9] The Tribunal 2003, Review of Gas and Electricity Regulated Retail Tariffs, Issues Paper, p.8

[10] Constraints would be retailer specific.

Issue	Comments
	2004/05 compared to other years); • A maximum allowable annual increase in the first block of the variable energy consumption component (the level of price constraint may differ in 2004/05 compared to other years); and • No price constraint on the second block.
Regulatory decision-making	• The Tribunal considers the costs to be recovered from regulated customers as part of the 2004 Retail Tariff Review; • The Tribunal calculates price levels[11] needed to recover costs, taking account of the potential churn outcomes and the fixed nature of Integral's retail operating costs (estimated to be 90% fixed at the customer level); • The Tribunal determines side constraints for the the fixed system access charge and the first block of the variable energy consumption component which reflect an appropriate transition path from current tariffs to the cost reflective price levels; and • Integral develops and submits default retail tariffs to the Tribunal for approval; these proposed tariffs could be submitted to the Tribunal for consideration as part of annual price change process. The Tribunal considers these proposed tariffs for compliance against side constraints.

Table 5-2 – Form of regulation proposal

While this option was not explicitly mentioned in the Discussion Paper DP70, it is very similar to other options identified.

Integral believes that this option:

- Supports the Tribunal's objectives of moving tariffs towards cost-reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks;
- Recognises the important role that the Tribunal plays in setting price constraints to ensure that pricing outcomes will be socially responsible;
- Results in greater transparency in the formulation of side constraints ensuring that all stakeholders understand the basis of the Tribunal's decision on the level of side constraints; and
- Provides retailers with more flexibility in setting default tariffs, whilst ensuring that the important role that these tariffs play as a "safety net" is not undermined.

[11] Note that these price levels would not be part of the retail price regulation

5.6 Timing and detailed design issues

Integral believes that the success of the form of regulation depends on decisions on the detailed design issues and parameters. These decisions need to be made on the basis of detailed analysis and taking account of the range of potential customer churn outcomes.

Integral will provide the Tribunal with its detailed analysis on these issues. However, Integral considers that the outcomes of the 2004 Network Determination have a significant impact on the retail prices. Therefore, Integral's detailed analysis of its proposed form of regulation will commence immediately following release of the Tribunal's draft 2004 Network Determination and release of the Tribunal's consultant's report on electricity costs.

5.7 Provision to re-open the Tribunal's 2004 Retail Determination

Integral believes that the decisions resulting from the 2004 Retail Tariff Review should include the provision to be re-opened in the event of significant changes outside the retailer's control including for example:

- A decision by Government to restructure the industry or change the nature of the regulated retailer's business (including any changes to the current Electricity Tariff Equalisation Fund); and
- Changes to the national regulatory framework or market arrangements which impact the regulated retail business (such as the introduction of full nodal pricing, changes to the NSW greenhouse gas abatement scheme or the Commonwealth Government's MRET scheme).

Integral requests the Tribunal allow for the above re-openers when making its Determination.

5.8 Pass-through of other specified costs

Integral believes that the following events should be allowed by the Tribunal as a pass-through event given that they are outside Integral's direct control or influence:

- Change in taxes event - changes in the way or rate at which a government imposed tax, fee, levy or charge (Relevant Tax) is calculated, or the imposition of a new tax to the extent that the change (such as the introduction of carbon tax), removal or imposition results in a change in the amount Integral is required to pay or is taken to pay (whether directly or under any contract) by way of Relevant Taxes.
- Insurance events - this includes the following events:
  - changes in the availability and extent of cover that result in material increases in the cost of insurance relative to the forecast included in the retail operating expense;

  - payment by Integral of a deductible premium in connection with a claim under an insurance policy; or

  - an event which is outside Integral's prudently determined risk management policies and is not insured and causes Integral to suffer material loss or damage.

- Regulatory changes - changes to the scope, standard or risk of Integral's retail services as a result of changes to the National Electricity Code, decisions by NECA, NEMMCO, the Tribunal, the NSW Government, or the courts or changes to legislation (such as environmental certificate requirements), regulation, licence conditions or other legally binding instruments that Integral is required to comply with which result in Integral incurring materially higher or lower costs associated with the retail services than it would have incurred but for that change.

Integral requests the Tribunal to allow for the above pass-through events, outside any price side constraints, when making its Determination.

6 What are the appropriate levels of costs to be recovered?

The Tribunal seeks comment on:

> *The most appropriate treatment of the various cost components to ensure that retail charges are at, or close to, cost reflective levels for all small retail customers by 2007.*

Integral's view is that the Tribunal needs to consider this issue in two stages:

- What is the level of retail costs that need to be recovered and what factors affect the level of costs?
- How should the regulatory parameters be set to ensure that retail charges can move to cost reflective levels?

This section considers issues related to the question of the level of costs and the factors affecting these costs.

Chapter 5 of Integral's submission discusses issues related to setting regulatory parameters.

Integral considers it is imperative that, in making its decision on the regulatory mechanism and parameters, the Tribunal makes appropriate allowances for all costs associated with providing the regulated retail service.

In addition, it is critical that these allowances for costs and gross margin are reflected in the NSW ETEF arrangements.

Integral is concerned that the Tribunal's information request and Discussion Paper DP70 appear to exclude important cost elements. Cost reflectivity requires that the Tribunal:

- Takes account of all cost components relevant to Integral meeting its statutory services to customers;
- Considers an appropriate allowance for each cost component element;
- Gives careful consideration to the nature of costs and how costs are affected by customer churn; this is particularly important given the role of the regulated retailer as "safety net" supplier.

Table 6-1 summarises Integral's position on the cost and risk matters identified in the TOR and set out in the Tribunal's Issues paper.

Cost and risk matters to be considered in retail tariffs (Minister's reference under s43EB)	Tribunal Issues Paper cost areas	Integral comments and position
Electricity purchase costs based on: • Long run marginal cost of electricity generation • Demand characteristics of customers remaining on regulated tariffs	In s4.1 the Tribunal confirms application of LRMC against each retailer's actual load profile for regulated customers.	Refer section 6.2 – Electricity Purchase Costs Integral is concerned that the Tribunal must also make a separate allowance for hedging costs including any residual energy purchase costs arising from load shape variations between forecast and actual.
"Appropriate" retail costs	In s4.4 the Tribunal states that the Tribunal "aims to ensure that retail operating cost benchmarks represent efficient retail operating costs to provide appropriate incentives for retailers to operate efficiently."	Refer section 6.4 - Appropriate Retail Opertaing Costs The Tribunal should adopt a conservative position in considering "appropriate" retail costs. Any benchmarking undertaken by the Tribunal must include all operating and maintenance costs incurred by Integral in meeting its statutory services including other quantifiable risks (such as residual energy purchase costs and residual energy loss risks). The Tribunal should also consider the nature of the retail costs, including the extent of fixed costs associated with supplying regulated customers.
"Appropriate" retail margin	In s4.5 the Tribunal states that the retail margin represents return on capital employed and the risks associated with the business.	Refer section 6.5 – Appropriate Retail Margin The Tribunal should adopt a conservative position in considering an "appropriate" retail margin.The retail margin should reflect a return on capital employed commensurate with risk associated with the retail business. In addition, if the Tribunal does not make specific allowance in considering the retail costs areas for all business risks then the Tribunal must make allowance for such risks in the retail margin.
Renewable energy and greenhouse gas (Commonwealth mandatory renewable energy target (MRET) and NSW Greenhouse Gas Benchmark Scheme)	It is unclear where the Tribunal intends to include an allowance for renewable energy and greenhouse gas costs	Refer section 6.2.4 – Green Costs Integral notes that the information request does not have a line item for renewable energy and greenhouse gas costs. The total retail costs must include a separate allowance for Integral's forecast renewable energy and greenhouse gas costs as set out in section 6.2.4.

Cost and risk matters to be considered in retail tariffs (Minister's reference under s43EB)	Tribunal Issues Paper cost areas	Integral comments and position
Energy losses	In section 4.6 the Tribunal includes energy losses as "other costs."	Refer section 6.2.3 – Loss Factor Integral notes that the information request does not have a line item for energy losses. The Tribunal must also make allowance for increases in losses over time and energy loss costs arising from market settlement processes.
Network charges	In s4.3 the Tribunal that network costs should be treated as a pass-through.	Refer section 6.3 – Network Charges Network charges should be passed through to customers with no risk to Integral of a mismatch between recovery from customers and the network charges incurred by Integral Retail. The ability to pass-through will depend on the Tribunal's decision on the form of regulation (see Chapter 5).
Market fees (including charges for ancillary services)	In s4.6 the Tribunal includes market fees as "other costs."	Refer section 6.2.2 – Market Fees and Ancillary Charges Integral's forecast market fees and ancillary charges are set out in section 6.2.2.
An allowance for expected movements in regulated components and NEMMCO fees	No specific mention is made by the Tribunal in its Issues Paper.	The Tribunal must give consideration to the inclusion of a mechanism for changes outside the control of the business (see Chapter 5).

Table 6-1 – Cost and risk matters

6.1 Approach to decision-making on the appropriate level of costs

In relation to the level of costs allowed by the Tribunal, Integral agrees with NECG's conclusions that the Tribunal should adopt a conservative position in considering an "appropriate" retail cost and "appropriate" retail margin, as well as the various "allowances" that form part of the retail tariff.

However, Integral notes that the Tribunal proposes to decide on the level of operating costs based on benchmarks that represent efficient retail operating costs.

Integral does not agree with the Tribunal's proposed approach to deciding on the level of retail operating costs. Integral believes that this approach is inconsistent with the Government's TOR in that it risks focussing on a precise and theoretical ideal cost level that has the potential to suppress competition by setting regulated tariffs that are too low to encourage entry by efficient retailers.

6.2 Electricity purchase costs

6.2.1 Allowance for costs associated with electricity purchase

The Government's TOR require that the Tribunal include an allowance for electricity purchase costs based on an assessment of the Long Run Marginal Costs (LRMC) of electricity generation, given the characteristics of the demand of customers remaining on regulated tariffs.

Integral believes that the total allowance for electricity purchase costs needs to take account of all costs associated with supplying electricity to the regulated customer base. These costs include the "base" wholesale energy costs (that is, LRMC under the Government's TOR) and the suite of costs associated with managing changes in volume and shape (or hedging costs).

It is important to note that the allowance for LRMC is separate from the allowance for hedging costs and green costs, such as the MRET and the NSW Greenhouse Gas Benchmark Scheme. These costs are not settled under the ETEF and so must be allowed for separately from the cost of energy.

6.2.1.1 Long Run Marginal Costs (LRMC)

In determining an allowance for the LRMC of electricity purchases, Integral believes that:

- The LRMC should be reflective of the expected load shape and volume. This raises issues about the changing mix of customers over the 2004 regulatory period, particularly if actual customer churn is different from that included in the LRMC analysis.

- Integral considers that one option to partially address the changing mix of customers is for the LRMC cost to be calculated at peak and off-peak times (as defined in the ETEF settlement arrangements). The costs of energy for each individual tariff would then be load weighted based upon the amount of energy used in the peak times compared to off-peak times. This method will take into account the expected change in energy costs of the regulated customers with the change in mix of these customers.

Integral notes that the Tribunal has commissioned a consultancy to develop a model for calculating the future LRMC of electricity generation and for this consultancy to consider whether it is appropriate to include hedging costs in the calculation of energy costs.

Integral reserves the right to make further comments on the LRMC once the consultant report is released.

As an over-riding principle, however, from a retail perspective the energy purchase cost should be treated as a full pass through within the overall regulated retail price.

6.2.1.2 Hedging Costs

Integral is concerned that there are misconceptions that the ETEF arrangements could provide Integral with a perfect electricity purchase cost hedge during the 2004 regulatory period. This is not the case; Integral incurs costs associated with changes in shape relative to the forecast underpinning the setting of retail tariffs.

Therefore, an explicit allowance for additional hedging costs needs to be made by the Tribunal to cover changes in shape relative to the forecast underpinning the setting of retail tariffs.

As noted above the calculation of LRMC at peak and off-peak times will partially address this by addressing the change in mix of customers within Integral's portfolio, however, this will not address the changes in the proportion of peak/off peak usage within tariff categories.

In order to convert LRMC rates into $/MWh tariff rates, the Tribunal will need to make an estimation of the relative volumes of peak and off peak usage of customers in each tariff category. Integral can provide the Tribunal historic calculations of these relativities, however, these may change depending upon weather, changes in customer behaviour, changes in appliance mixes (particularly the penetration of air conditioners) or the introduction of interval metering.

In order to make an allowance for these likely changes Integral recommends that a risk premium is included, either by adjusting the historic weighting more towards peak prices or by adding a margin to the final figure. Integral is presently modelling the potential impacts of these matters and will provide details of Integral’s findings to the Tribunal.

6.2.1.3 ETEF

The TOR state that the ETEF arrangements will continue during the 2004 regulatory period. Integral understands that the ETEF rates will be set based on the LRMC electricity purchase costs established by the Tribunal. If this does not occur then Integral believes the 2004 Retail Determination will need to be re-opened to include the market cost of energy (see section 5.7).

It should be noted that ETEF is settled using peak and off-peak energy rates. The Tribunal therefore needs to determine a peak and off peak LRMC. In addition, it should be noted that ETEF does not include an allowance for green costs.

6.2.2 Market fees and ancillary costs

There is considerable uncertainty regarding the national electricity market (NEM) regulatory arrangements and market outcomes during the regulatory period. There is current debate on the introduction of a national energy regulator (which may impact market fees) and there is uncertainty and volatility associated with the frequency control in the ancillary markets. This uncertainty needs to be included in the forecast market fees and ancillary costs over the regulatory period.

Integral's projected NEMMCO market fees and ancillary costs over the 2004 regulatory period are outlined in Table 6-2.

Period	2004/05	2005/06	2006/07
Market fees and ancillary costs	$1.237/MWh	$1.317/MWh	$1.407/MWh

Table 6-2 – Market and Ancillary cost projections

The current actual market fees and ancillary costs are based on:

- The causer pays percentages remaining static;
- Integral's exposure to system restart ancillary services, network control ancillary services and frequency control ancillary services being determined in line with the current market settlement mechanism;
- Spot costs with associated volatility.

Integral engaged Tavis Consulting to review its forecast market fees and ancillary costs. Tavis Consulting concluded that Integral's forecasts were reasonable.

6.2.3 Loss factors

The Government's TOR for the review requires the Tribunal to consider energy losses as published by the NEMMCO.

Energy losses comprise transmission loss factors (TLFs) and distribution loss factors (DLFs).

Integral's weighted average TLF approximates unity. The TLFs are not calculated by Integral, and are therefore difficult to forecast. Therefore, Integral has assumed that there will be no significant changes over the 2004 regulatory period and that the TLF will remain at unity.

The TOR requires that the relevant NEMMCO distribution loss factor (DLF) for "customers taking supply at low voltage from the Integral low voltage network". NEMMCO's published DLF for 2003/04 is 1.0832.

However, DLFs vary over time and are a function of a number of variables, particularly load. Integral's main concern is that the Tribunal recognise the increasing trend of losses, which is correlated to the increase in load.

In order to make sufficient allowance for network losses the Tribunal will need to take into account the effect of increased load over the period of the 2004 Retail Tariff Review.

The calculation of loss factors is a complex exercise with a large number of variables including system configurations, loadings, etc.

However, as losses increase in proportion to the square of the load passing through any electrical equipment, it is reasonable to assume that the loss factors will increase with the increase in load over the regulatory period. This has been the case for the last four years.

Integral submits that the Integral Network DLFs (which are increased consistent with forecast load) shown in Table 6-3 should be used for the 2004 Retail Tariff Review:

Integral Network	2004/05	2005/06	2006/07
LV loss factors	8.50%	8.69%	8.86%

Table 6-3 – Proposed LV Distribution Loss Factor forecasts

In addition to the DLFs tabled above, the manner in which the DLFs are applied presents a financial burden to Integral. This is discussed further in section 6.4.3 below.

6.2.4 Green Costs

There are currently two separate greenhouse gas abatement obligations that apply to Integral; the national MRET scheme ($/REC or $/MWh), and the NSW Greenhouse Gas Abatement Certificates (NGAC) scheme ($/NGAC or $/tonnes CO2 equivalent). For ease of use and comparison Integral has converted both Greenhouse obligation costs to $/MWh.

Integral's forecast green costs over the 2004 regulatory period are shown in Table 6-4.

Green Energy Transfer Costs	2004/05 $/MWh	2005/06 $/MWh	2006/07 $/MWh
MRET forward cost curve	0.69	0.94	1.25
NGAC	1.16	1.71	2.27
Total forecast green costs	**1.85**	**2.65**	**3.52**

Table 6-4 – Forecast green costs

The forecast green energy costs shown in Table 6-4 do not include costs for the risk associated with a regulatory change impacting on the certificate requirements for environmental products. If this occurs Integral requests the Tribunal to allow for pass-through of any additional costs that result from the change over the regulatory period (see section 5-7).

Integral also engaged Tavis Consulting to review its forecast green costs. The main findings from their review were:

- As the renewable power percentage increases over time, the price of RECs required to meet this will increase as supply tightens. The increase above the $40/MWh penalty price that is shown in the forward curve supports this expectation. It also reflects the taxation effects from the purchase of RECs. However, Integral has not priced the increased scarcity of RECs into its cost estimates.

- It is realistic to expect that as with RECs, the availability of NGACs will decrease as the requirements for certificates increase. The resultant price increase should be factored into Integral's cost forecasts. There is considerable regulatory risk that either (or both) of the Greenhouse gas abatement schemes will be amended at any time. The review of the MRET has concluded and has been presented to the government, but currently there is no indication of the outcomes of this review. Therefore there needs to be a pass through provision in the event of a major change to the Greenhouse gas abatement schemes.

Tavis Consulting concluded that Integral's estimate for Greenhouse related fees were reasonable, if not slightly conservative given the potential for increased scarcity as abatement requirements increase. Tavis also considered it reasonable for Integral to request a pass through provision in the event of a major change to the Greenhouse schemes.

6.3 Network charges

In compiling this Submission, Integral has assumed that network charges will be passed through. Integral believes that it is inappropriate for the incumbent retailers to be exposed to potential network differentials for the safety net retail tariffs. However, Integral fully supports innovation in contract offerings where the retailers can consider alterative options for the bundling and recovery of costs, including network charges.

To the extent that the Tribunal does not allow for pass through of network charges, then the incumbent retailers must be given an opportunity to assess the residual risk that they might bear under an alternative approach proposed by the Tribunal. This may require the need for an allowance to be made by the Tribunal to provide an appropriate contingency in prices for any risk that might arise.

6.4 Appropriate retail operating costs

This section provides comments on:

- The level of retail costs to serve (including depreciation);

- Allowance for "other" retail costs;

- The nature of the costs (fixed versus variable).

In summary, Integral believes that:

- The Tribunal should take a conservative approach in considering an allowance for retail operating costs;

- The level of retail costs to serve should be based on Integral's forecast costs;
- Other costs associated with managing specific risks (ie. being a default retailer) should also be explicitly identified but grouped and recovered separately to retail operating costs;
- The Tribunal should consider the impact of customer churn.

6.4.1 Level of retail costs to serve

Integral's forecast for retail operating costs (including depreciation) has been provided to the Tribunal in the Information Request.

The projections for the financial years 2005-2007 are based upon Integral's business planning process and have been subject to internal review and approval.

Integral's current organisation structure is shown in Figure 6-1. This figure identifies the business units that are referred to in the following discussions on retail costs.

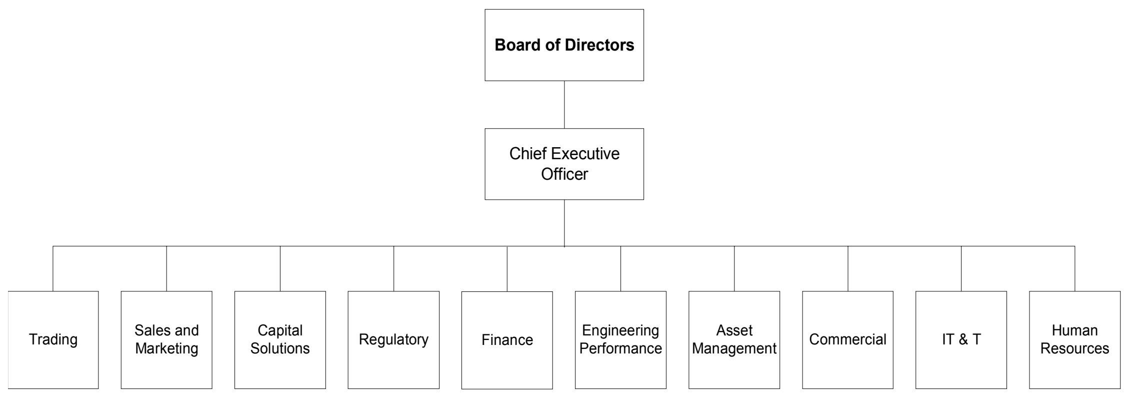

Figure 6-1 – Integral's organisation chart

The total costs incurred by Integral Retail have been assessed as direct costs of Integral's Sales & Marketing and Trading business units plus an allocation of Corporate costs based upon the same methodology as that presented in the 2002-03 regulatory accounts.

In allocating costs to the regulated business, Integral reviewed the direct costs associated with its Sales & Marketing and Trading business units. Customer numbers, revenue and consumption (MWh) costs were allocated to the regulated business where appropriate. Costs such as contract sales commissions have been excluded from the regulatory allocation, as they are directly attributable to deregulated activity.

Corporate costs including Human Resources, Finance and Regulatory, were allocated to the regulated business based upon key cost drivers identified. The cost drivers utilised were revenue and customer numbers. These cost drivers have been utilised for the allocation of projected costs for the proposed Determination period. The customer numbers and revenues are based upon the outcomes of churn and switching models developed by Integral for the purposes of the Retail Determination assuming increases in current tariffs of CPI for the next four years as required by the Tribunal. As churn and switching fluctuates with each regulated tariff scenario, whilst the variable costs adjust accordingly, the total fixed costs remain constant.

Integral's forecast retail cost to serve as provided in the Information Request compares favourably with allowances in past decisions in other Jurisdictions of $76 (Tasmania excluding FRC costs), $85 (ACT), $80 (SA) and $50 - $80 (Victoria).

6.4.2 Nature of retail operating costs

In considering the nature of operating costs the Tribunal needs to take into account both the manner in which retail costs change with increase or decrease to a retailer's customer base, and the manner in which costs change with increase or decrease in customer usage.

The former is important in determining a retailer's operating cost allowance, the latter in determining a cost reflective tariff. These two issues are addressed below.

6.4.2.1 Retailer operating cost allowance

In making a decision on the detailed regulatory parameters the Tribunal needs to consider the level of retail costs to be recovered and the way in which these costs vary with customer churn. This is particularly important given the desire to facilitate retail competition.

Integral's operating costs are 65% fixed and depreciation is 100% fixed; this high level of the fixed costs reflects the nature of the retail business and the need to maintain capacity as a retailer of last resort.

The Tribunal will therefore need to give careful consideration of the effect competition will have on the average cost of servicing a customer. For example, Integral estimates that if prices move to cost reflective levels there would be 25% less customers on regulated tariffs by June 2007 than under a CPI price constraint. This 25% reduction in the regulated customer base due to competition would require a 22% increase in the operating costs per regulated customer and a 33% increase in depreciation cost per regulated customer, in order to continue recovering costs.

Therefore, the Tribunal must allow a real increase in cost allowances based upon a competitive outcome that is consistent with the TOR. This will require a significantly higher allowance for retail operating costs than would occur under a CPI tariff increase scenario.

6.4.2.2 Cost reflective tariffs

In making a decision on customer pricing the Tribunal will need to consider the most cost reflective manner in which to recover the retailer operating costs from customers.

Integral submits that there is very little variation in costs between a small or large customer. Of the 35% variable costs noted above, 70% are related to costs such as billing etc that are similar costs between customers irrespective of their consumption level. Therefore, only 10% of retail operating costs would alter depending upon the consumption level of the customer.

To achieve a cost reflective price signal, the Tribunal should therefore allow 90% of retail operating costs to be recovered through the fixed system access charge component of the regulated tariffs.

6.4.2.3 Industry structure

This Submission and analysis has been prepared on the current industry structure and Integral's retail activities. If, however, there are any structural changes during the 2004 regulatory period, these costs may alter significantly. For example, given Integral's largely fixed cost structure, if Integral were to only operate as a safety net retailer, the existing costs which are borne by Integral's contestable customer base would need to be spread across regulated customers, greatly increasing the average cost to serve these customers. Integral requests that the Tribunal make provision to re-open the determination if any such structural change occurs (see section 5.7).

6.4.3 Other retail costs

6.4.3.1 Allowances for residual DLF settlement risks

The National Electricity Market (NEM) is settled by subtracting the loss-adjusted loads of non-local retailers from the total energy entering the local retailer’s franchise area (termed settlement by differencing).

The NEM accounts for distribution losses using a static DLF to account for losses. Given that losses are non-linear, increasing in proportion to the square of the load, there are great variations in any half-hour through the year. Therefore, this form of settlement presents significant risk for the local retailer.

Although a static DLF may account for energy lost in total over the year, the losses will be under or over estimated in some half-hours. When the energy price within the half-hour is applied to these over and under-recoveries, the net impact on the local retailer’s wholesale energy cost can be significant.

As a simplified example, assume losses are 8.33% in total and system load is 50 MWh during off peak times (half the year) and 100 MWh during peak times. The losses during peak time would be 10 MWh and during off peak time 2.5 MWh. If peak energy costs are assumed at $60/MWh and off peak energy costs $30/MWh, the total cost of losses is $675 (10*$60 + 2.5*$30). However, the amount that would be allowed using a static loss factor would only be $625, (100*8.33%*$60 + 50*8.33%*$30). The difference of $50 is borne by the relevant incumbent retailer.

Therefore, although a static loss factor will account for the total MWh losses across the year (ie 8.33% x 150 MWh = 12.5 MWh), the variation during different half-hourly times will result in a difference between the true cost of the losses and that allowed for by the static loss factor. Given that losses are proportional to the square of the load (ie they are higher when load is high and lower when load is low), and price is higher when load is high, there is a systematic bias towards losses costing more than is allowed for by a static loss factor.

Further, the static loss factor risk is exacerbated by differencing upon settlement which results in the regulated load bearing the difference between the losses allocated by the static loss factor and the actual losses for all customers, not just regulated customers. Integral estimates that the static loss factor risk costs $1 million per annum. Therefore, Integral submits that the Tribunal should make allowance in Integral’s forecast costs for this risk in its 2004 Retail Tariff Review.

6.5 Appropriate retail margin

The Tribunal states that:

> *The net retail margin (or profit margin) is the margin on energy sales before interest and tax but after all other costs (including retail costs) have been accounted for. 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 submits that the Tribunal’s allowance for retail margin should consider the following points:

- The need to adopt a conservative position as discussed in section 6.1 to encourage competition.

- The fact that NSW regulated electricity retailing businesses are not low risk businesses and have a similar risk profile to other Australian retailers. There is a general misconception than the NSW ETEF arrangements make the incumbent NSW retailers less risky that other retail businesses. However, although the ETEF arrangements provide certainty over peak and off peak cost of energy, the arrangement does not prevent shape risk. Integral also notes that other regulated retailers generally receive an allowance for hedging within their wholesale purchase costs. Therefore, Integral believes that it is incorrect to assert that the net margin for the NSW incumbent retailer should be lower than that of other retailers.

- The level of the capital employed in the business and the margin required to ensure an appropriate return on this capital.

The net retail margin assumed in the 2001 Retail Determination is 1.5%. This margin compares with other Jurisdictional allowances of 2.35% (Tas), 3% (ACT), 5% (SA), and 2.5 - 5% (Vic).

The primary justification for a lower margin appears to have been on the false assumption that there is lower risk due to the perceived protection offered by the ETEF in NSW, and government ownership not requiring a high cost of capital. As stated above, Integral notes that other regulated retailers generally receive an allowance for hedging costs within their wholesale purchase costs. Therefore, Integral does not accept these arguments.

In reviewing the capital invested in the retail business Integral has examined three categories that it considers as standard requirements for a regulated retailer. These categories are:

- Working capital;

- Fixed asset investment; and

- Prudential capital requirements;

Integral's position is that a retailer would seek a return on the total capital invested reflective of the risk involved in the business. In assessing this position Integral has calculated a Weighted Average Cost of Capital (WACC) for its regulated retail business which it considers appropriate. This is higher than the WACC utilised in calculating returns for the network business and is comparable to other retail businesses.

In assessing the appropriate level of capital invested, Integral considers it important that the Tribunal take account of regulated requirements such as Retailer of Last Resort (ROLR) which are imposed by legislation on the regulated retailers in NSW, and ensure sufficient allowance is made in the area of net margin to ensure ongoing returns to the retailers.

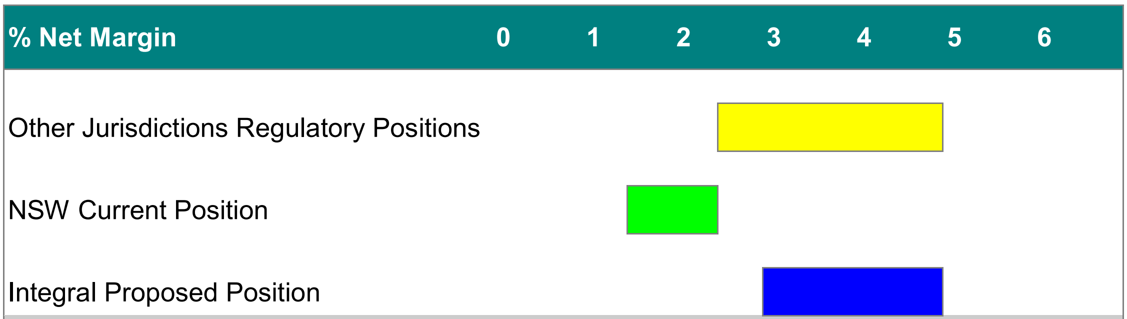

Figure 6-2 – Net Margin proposal compared to current position

Taking account of these points, Integral considers that a net retail margin of 3% to 5% as shown in Figure 6-1 represents a return on capital employed and the risks associated with the business.

7 What is the most appropriate structure for regulated tariffs?

The Tribunal seeks comment on:

> *Issues regarding the structure of regulated retail tariffs, including whether an inclining block structure is a proxy for cost reflectivity and the implications of allowing more complex price structures for the objective of rationalising the number of regulated retail tariffs.*

The Tribunal's Discussion Paper DP70 seeks comment on tariff structure issues, particularly those relating to an IBT. Integral's submissions to the Tribunal under the 2004 Electricity Network Review consider the need for tariff reform and discuss the rationale for IBTs.

Integral considers that the key issue affecting the structure of regulated retail tariffs is the network tariff structure. This Chapter considers the issues associated with the network tariff reform and the implications for retail tariffs:

- Section 7.1.1 summarises Integral's preferred network tariff reform strategy including the proposal to introduce IBTs.
- Section 7.1.2 sets out the implications of the network tariff reform for retail tariff reform.
- Section 7.1.3 summarises Integral's analysis of an IBT retail tariff structure.

This chapter also considers the question posed by the Tribunal on whether regulated tariffs should be based on vanilla tariff structures.

In summary, Integral's position is that the regulated retail tariff structures should reflect the underlying network tariff structure.

On the question on whether customers should have choice in regulated tariffs, Integral agrees with the Tribunal's preferred position set out in section 5.2 of its Discussion Paper DP70, that regulated tariffs should be a basic option without special features.

7.1 Appropriateness of Inclining Block Tariffs

7.1.1 Proposed Integral Network tariff reform

In its various submissions to the Tribunal under the 2004 Network Pricing Review, Integral Network has stated that its current network tariffs do not provide customers with efficient pricing signals during peak periods, particularly given the increased cost impact that peak demand has on network investment. Customers who are not contributing to the network peak are bearing the costs associated with those that are.

Modelling undertaken by Charles River Associates[12] for Integral Network estimated that the inherent cross subsidy associated with capital investment required to meet peak demand is in the range of $80 million to $110 million per annum.

To address this inherent cross subsidy Integral Network's preferred tariff reform strategy package for default network tariffs is to:

- Reform the structure of the default residential tariff and the default general supply tariffs to an IBT, subject to quantitative analysis of revenue and tariff design outcomes;
- Offer the default residential and small general supply tariff customers a Time of Use (ToU) tariff option to reward customers with a good load profile (or who are willing to change their electricity consumption behaviour to minimise disproportionately high electricity consumption during peak periods);
- Offer residential and small general supply default customers a controlled air-conditioning tariff option (in addition to the existing controlled heating tariff) to reward customers that are prepared to offer interruptible capacity; and
- Incentivise the small general supply ToU default tariff customers to move onto a demand tariff. This will ensure that customers with a good load profile (or who are willing to change their electricity consumption behaviour) are rewarded.

Integral Network is currently evaluating different IBT tariff design scenarios from a revenue risk, equity and efficiency perspective to determine its preferred position. It is expected to finalise its analysis by the end of 2003.

Integral Network's proposed network tariff reform is aimed at:

- Achieving cost reflective network tariffs consistent with network investment drivers (that is, better alignment of revenues and costs over time);
- Influencing customer behaviour to reduce consumption during peak times (including through demand side management initiatives), and hence reduce the cost of network investment.

For Integral Network's proposed tariff reform to influence customer behaviour to reduce consumption during peak times, Integral Network believes that retail customers need to receive pricing signals consistent with the network tariff reform[13].

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[12] "Impact of Air Conditioning on Integral Energy Networks", Charles River Associates, May 2003.

[13] The responsiveness of customers in Integral's franchise area to a more efficient price signal, which will lead to improved network utilisation, is unknown. Nevertheless, studies on price elasticity suggest that the customers do respond to price signals, particularly over the longer term when customers have been given sufficient time to change their behaviour and to upgrade to more energy efficient household appliances.

Therefore, Integral Retail needs to reform its retail tariffs consistent with any reformed network tariffs. This is consistent with the TOR which require the Tribunal to take account of options for restructuring tariffs to promote demand management.

7.1.2 Integral's evaluation of retail IBTs

From Integral Retail's perspective, the following criteria need to be considered in evaluating an IBT structure:

- Equity – that customers are not exposed to an unacceptable "price shock;"
- Revenue at risk – that any network tariff reform does not expose the retail business to unacceptable revenue risk;
- Consistency - that there is default retail price consistency in the Sydney basin.

Integral's evaluation against these criteria is shown in Table 7-1:

Evaluation criteria	Integral Retail assessment
Equity	The IBT structure provides an inherent price discount to small users. Integral Network believes that the majority of low income households will be beneficiaries of this inherent price discount. The IBT structure could result in price increases for large customers. However, Integral Network's voluntary ToU tariffs will enable large users with a good load profile to reduce the price impact.
Revenue at risk	There are two element to retail business risk: Volume risk – if the proposed IBT structure is not passed through to customers, Integral Retail will be exposed to more margin risk via volume risk; that is, significant growth in second block consumption will decrease Integral's retail margin. Margin risk – if the proposed IBT structure is not passed through to retail customers, the current uniform retail tariff structure will change the distribution of retail margin across the customer base. This presents a potential unacceptable risk to Integral Retail.
Consistency	EnergyAustralia has already implemented a retail IBT structure effective from 1 July 2003. Therefore, the introduction of an IBT structure will provide consistency in tariff structures within the metropolitan parts of NSW.

Table 7-1 – Integral IBT evaluation criteria

Based on its analysis above, Integral Retail believes that the structure of the regulated retail tariff should reflect the underlying network tariff structure to ensure that:

- The desired outcomes of the network tariff reform are clearly signalled to customers so that customer behaviour is influenced and the expected benefits of any network tariff reform are realised;

- The current business risk position is maintained; non-alignment of network and retail tariff structures is likely to lead to increased volume and margin risks.

7.2 Customer choice or plain vanilla?

Integral agrees with the Tribunal's preferred position set out in section 5.2 of its Discussion Paper DP70, that regulated tariffs should be a basic option without special features. Integral believes that this approach is consistent with the Government's intention that the regulated retail tariffs act as a safety net for those customers that do not choose to participate in the competitive market.

Integral believes that special features for retail price offerings are best developed by the competitive market where retailers are fully responsible for their pricing; that is, retailers are able to control the pricing and associated risk of any innovation and/or tariff options offered.

8 Customer assistance package

The purpose of this section is to set out Integral's customer assistance package available to customers with difficulties paying their electricity accounts.

Integral recognises that from time to time some customers have financial problems because of unexpected events in their lives. Integral is committed to assisting these customers to meet the financial obligation of paying their electricity accounts and to consider disconnection as the last resort.

Integral's aim is to have an integrated approach to customer assistance, designed to address the issue of customers who, due to low income and wealth, regularly cannot pay their electricity bills. Integral's customer assistance package is also designed to assist customers who experience financial problems due to unforeseen circumstances. The package is not intended to apply to customers who have the means to pay, but choose to avoid or delay payment.

Integral's customer assistance package is based on the principle that Integral has a responsibility to correctly charge and collect revenues from all customers, but in some cases there is a need to recognise the circumstances of low-income customers.

Integral already provides assistance to customers by extending payment terms. At any one time Integral has approximately 14,500 customers with payment arrangements in place. Integral also offers payment options such as direct debit and Centrepay arrangements.

In addition to the above, Integral is soon to trial a new approach to its customer assistance package to better manage customers deemed to be in hardship. The approach involves Integral staff identifying customers in hardship early in the overdue payments process and, after providing any assistance they can, referring them to select welfare agencies for Energy Account Payment Assistance (EAPA) assessment, budgeting assistance or financial planning. Consultation with Integral's Customer Consultative Committee has already commenced, and will occur with Pubic Interest Advocacy Centre (PIAC) before the trial commences.

Indicators of customers in hardship include (but are not limited to):

- Known medical or mental illness affecting capacity to pay;
- Previous outstanding debt or disconnections;
- Death in the family affecting capacity to pay;
- Change in the family unit affecting capacity to pay;
- Sudden loss of income or substantial reduction in income;
- Referrals from community groups;
- Total reliance on Centrelink payments.

Integral expects that customers referred to welfare agencies for assistance will receive assistance with their electricity account and general advice relating to their specific circumstances, that is, cases will be managed by the welfare agencies. Integral will work closely with the agencies to determine the best solution for the customer and Integral, while being mindful of privacy requirements.

The plan is that customers referred to the welfare agencies will not be included in the normal overdue payment process unless they are unwilling to participate in the program or accept the recommendations made. Regular monitoring of the customer's account will occur to ensure arrangements made are adhered to. Where customers default on arrangements, follow up will occur. Customers who, for any reason, fail to comply with Integral's customer assistance package following best efforts from Integral and the welfare agency will then revert to the overdue payment program for follow up.

Integral's new approach to delivering its customer assistance package will include the following steps/processes:

- Ensuring that all customers in the delinquency process are receiving appropriate government rebates, pension, disability allowances etc;
- Offering customers a payment plan suitable for their needs;
- Encouraging customers to sign up for the Centrepay arrangement;
- Providing energy efficiency advice and/or energy audits for those customers whose consumption is greater than their ability to pay;
- Referral for EAPA assistance and, if necessary, budgeting/financial planning (case management);
- Removing customers from the normal delinquency process.

Integral believes that its customer assistance package will enable customers to better manage their obligations and hence reduce the number of customers listed for disconnection.

9 On what basis should non-tariff charges be regulated

The Government's TOR for the electricity review require the Tribunal to consider and report on the basis for regulating miscellaneous charges and security deposits. In section 6 of its Discussion Paper DP70, the Tribunal has asked for:

> *Submissions relating to the regulation of non-tariff charges including where possible the incidence and cost of different types of charges.*

This Chapter sets out Integral's proposal to change the basis for charging various non-tariff charges.

9.1 Current non-tariff charges

The Electricity Supply Amendment Act 2000 establishes a list of electricity non-tariff charges that the Tribunal may regulate by determining the charges, or the specific methodology for determining the charges. These charges are limited to:

- late payment fees
- fees for dishonoured bank cheques
- security deposits.

These charges are discussed below.

9.1.1 Late Payment Fee

Late payment fees are aimed at encouraging behavioural change among late paying customers to reduce the significant costs associated with administering reminder and disconnection notices and to ensure those customers bear the cost of their actions.

Integral's policy for late payment fees is:

- Late payment fees will not be levied on outstanding invoice payments:
  - during the period of an extension payment time agreed between Integral and the customer;
  - where a customer has made a billing related complaint to the Energy and Water Ombudsman NSW, or another external dispute resolution body, and where that complaint is unresolved; or
  - during the period of an instalment arrangement agreed with Integral.

- A late payment fee will be waived:

  - where the customer has contacted a welfare agency/support service for assistance;
  - where payment or part payment is by EAPA voucher; or
  - on a case by case basis as considered appropriate by Integral or the electricity industry ombudsman under an approved electricity industry ombudsman scheme under the Act.

- A late payment fee will only be levied:

  - on or after the date which is at least five business days after the due date shown on the invoice that is the subject of the late payment; and
  - after the customer has been notified in advance that the late payment fee will be charged if the invoice is not paid, or alternative payment arrangements entered into, within five business days of the due date.

Integral's current late payment fee for each overdue invoice was set in the 1999 Retail Determination and is $5.45 (inc GST). Since then there has been an increase in delinquency compliance requirements and hence costs.

Integral estimates that its current cost of managing late paying customers is approximately $7.60 (inc GST). Integral notes that AGL currently charges customers a late payment fee of $11.00.

Integral proposes that the allowance for the late payment fee increase to $7.60. A late payment fee at this level will:

- Be more cost reflective;
- Encourage Integral's customers to settle their accounts within Integral's existing payment terms rather than incur a late payment fee;
- Be more consistent with competing energy providers. This level will encourage customers to give equal priority to payment of their electricity account with other energy bills.

9.1.2 Security Deposit

Integral requests that the Tribunal review the current requirement to request a security deposit at the commencement of the supply agreement. Integral believes that the option of charging a security deposit during the life of the supply agreement should be introduced based on the customer's credit rating and payment history. This has the advantage of providing:

- Greater flexibility in managing credit risk during the life of the agreement;
- The ability to use the security deposit as an alternative to disconnection;
- Timely collection of outstanding debt whilst managing customer debt exposure.

The flexibility created by the above may also lead to Integral offering more of its customers the option of commencing their supply agreement without the need for a security deposit upfront.

Integral therefore believes the security deposit should be able to be charged during the life of the supply agreement.

In addition, Integral currently charges less than the allowed 1.5 times the average bill. However, Integral requires the flexibility to charge up to this level, as there may be a future requirement to increase the level of security deposits to minimise the impacts of bad debt associated with customer churn.

9.1.3 Dishonoured Bank Transaction Fee

Currently, Integral is only able to charge fees associated with dishonoured cheques. However, with the additional payment channels (such as Direct Debit and Credit Card Payments) offered by Integral, this definition needs to be expanded.

Integral therefore submits that the Tribunal expand the definition of dishonoured fees to include other payment channel such as Direct Debit and Credit Card Payments.

10 Glossary

Term	Definition
ACT	Australian Capital territory
CGEY	Cap Gemini Ernst & Young
CPI	Consumer Price Index
DLF	Distribution Loss Factor
EAPA	Energy Account Payment Assistance
ETEF	Electricity Tariff Equalisation Fund
FRC	Full Retail Contestability
GST	Goods & Services Tax
IBT	Inclining Block Tariff
IPART	Independent Pricing and Regulatory Tribunal of NSW
LRMC	Long Run Marginal Cost
MRET	Mandatory Renewable Energy Target
MWh	Megawatt Hour
NECA	National Electricity Code Administrator
NECG	Network Economics Consulting Group
NEM	National Electricity Market
NEMMCO	National Electricity Market Management Company Ltd
NGAC	NSW Greenhouse Gas Abatement Certificate
NSW	New South Wales
Ofgem	Office of Gas and Electricity Markets (UK)
PIAC	Public Interest Advocacy Centre
REC	Renewable Energy Certificate
SA	South Australia
Tas	Tasmania
TLF	Transmission Loss Factor
TOR	Terms of Reference
ToU	Time of Use
Tribunal	Independent Pricing and Regulatory Tribunal of NSW
Vic	Victoria

11 Appendix A – NECG report on workable competition

"*Applying workable competition in the NSW electricity retail sector - A report to IPART for Integral Energy from the Network Economics Consulting Group*," November 2003.