25 March, 2002

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

Dear Dr Parry

IPART's Mid Term Review of Regulated Retail Tariffs

Integral Energy welcomes the opportunity to provide this submission to IPART's Mid Term Review of Regulated Retail Tariffs.

The focus of this submission by Integral Energy is that the target tariffs set by IPART in its December 2000 report on *Regulated Retail Prices for Electricity to 2004* are too low and need to be increased. It is argued that IPART has a responsibility to urgently address this situation in order to establish an appropriate commercial return for the retail electricity sector and promote wider competition in the NSW electricity market.

Integral Energy's submission and supporting information demonstrates that an increase in the level of the existing target tariffs is justified from 1 July 2002. This is primarily based on IPART's December 2000 report providing:

- An inadequate allowance for Cost to Serve (CTS);
- An inadequate provision for green energy compliance, based on an insufficient wholesale energy cost allowance

In Integral Energy's case, these factors have made the 1.5 - 2% net margin envisaged in IPART's December 2000 report unachievable. This situation must be addressed in the Mid Term Review as a matter of urgency. Integral Energy recommends that IPART address this situation by increasing the level of the target tariffs from 1 July 2002.

If you require more information on the matters raised in the submission, please contact David Neville on (02) 9853 6144 or Frank Nevill on (02) 9853 6598.

Sincerely,

Richard Powis
Chief Executive Officer

SUBMISSION TO MID TERM REVIEW

REGULATED RETAIL PRICES FOR ELECTRICITY TO 2004

22 March 2002

TABLE OF CONTENTS

1. Executive Summary

The focus of this submission by Integral Energy is that the target tariffs set by IPART in its December 2000 report on *Regulated Retail Prices for Electricity to 2004* are too low and need to be increased. It is argued that IPART has a responsibility to urgently address this situation in order to establish an appropriate commercial return for the retail electricity sector and promote wider competition in the NSW electricity market.

Integral Energy's submission and supporting information demonstrates that an increase in the level of the existing target tariffs is justified from 1 July 2002. This is primarily based on IPART's December 2000 report providing:

- An inadequate allowance for Cost to Serve (CTS);
- An inadequate provision for green energy compliance, based on an insufficient wholesale energy cost allowance.

In Integral Energy's case, these factors have made the 1.5 - 2% net margin envisaged in IPART's December 2000 report unachievable. This situation must be addressed in the Mid Term Review as a matter of urgency. Integral Energy recommends that IPART address this situation by increasing the level of the target tariffs from 1 July 2002.

In support of this primary recommendation, Integral Energy's submission also makes the following points:

- The current target tariffs do not adequately reflect Integral Energy's actual CTS. Integral Energy recommends an increase in its allowance for CTS and that uniform CTS allowances are inappropriate;

- The current target tariffs do not provide an adequate allowance for the actual cost of meeting green energy requirements. Integral Energy recommends that IPART factors realistic costs to source green energy requirements into the wholesale energy cost allowance. As a minimum Integral Energy recommends an allowance for green energy of 3%.

- Integral Energy recommends that IPART provide scope for retailers to move from current (and often under-recovering) tariffs to any new increased target tariffs from 1 July 2002. This would also entail an increase in the overall gross margin;

- In relation to specific tariffs, Integral Energy believes that the current Off Peak 2 target tariff is set too low. It is recommended that a separate Variable R factor be determined for the Off Peak 2 tariff;

* In relation to side constraints, at the very least, retail side constraints need to be increased to align with network side constraints. Integral Energy also recommends that, where necessary, retail side constraints are relaxed to enable current (and under-recovering) tariffs to efficiently transfer to any new increased target tariffs;

* The current determination on market fee allowances should remain. Integral Energy recommends that trading forecasts and inconsistent weather patterns over the last 18 months provide sufficient argument for IPART to maintain allowances for ancillary services at levels originally set;

* The cost of payment processing is an uncontrollable cost, which increase retailers' CTS. Integral Energy recommends that retailers should be able to fully recover these costs, based on the different costs associated with different payment methods;

* Integral Energy recommends that FRC costs be recovered through an increase in the "Fixed R" component of the target tariff. Integral Energy also recommends that this increase should be undertaken in a step increase of a sufficient size to recover in this regulatory period that portion of FRC costs not already recovered.

2. Introduction

Integral Energy is responding to a request by IPART for submissions to the Mid Term Review of Regulated Retail Tariffs. Integral Energy understands that IPART is reviewing tariff structures with the specific purpose of ascertaining whether any underlying factors have become evident that should lead to or justify a change in the level of target tariffs to apply from 1 July 2002 to 30 June 2004 (under Section 43 EB (2)(a) of the *Electricity Supply Act* 1995).

Based on the experience gained since the commencement of the current Retail Determination on 1 January 2001, Integral Energy believes there are a number of underlying factors that justify an increase in the level of the target tariffs from 1 July 2002 to June 2004.

Regulatory Principles

In its original submission to IPART's Review of Full Retail Competition (FRC) in Electricity in September 2000, Integral Energy outlined what it considered to be the regulatory principles that should guide IPART in its introduction of retail price regulation under FRC. The principles presented by Integral Energy were:

* **Protecting consumers** – where there are abuses of market power and also in relation to the more vulnerable members of the community.
* **Encouraging competition** – it should be acknowledged that robust competition is the best form of regulation and that overly intrusive regulation can stifle competition

- **Promoting efficiency** – regulation should provide for incentives for efficient behaviour by both retailers as well as consumers, and risks should be allocated to those that are best able to manage them
- **Minimising administrative and compliance costs** – simple and clear regulatory frameworks and processes are necessary to keep these costs down to a manageable level.
- **Fully commercial outcomes** – retailers are managing significant risks within their margins and any retail price controls should be calculated on a fully commercial basis. Retailers should not be required to bear risks without this being fully reflected in the price.

Eighteen months later, Integral Energy still considers these principles to be the right focus areas for effectively managing the introduction of FRC and has used these principles as the framework for addressing the specific matters requested by IPART. Integral Energy is also of the view that IPART has had some degree of success against these principles. A market is in operation, appropriate consumer protection mechanisms have been established, and there is evidence of IPART's willingness to review administrative and compliance costs and begin the process of minimising costs in these areas.

Overseas, there is support for relaxing price controls as a means of promoting market efficiency. As Professor Stephen Littlechild has noted in a recent paper "relaxing or removing price controls may be more effective in promoting the required competition, and hence in protecting customers in the longer run"[1]. He also argues that it may be more appropriate to set the initial price controls at a level that encourages new entrants into the market rather than at the estimated efficient cost level. The entry of new players into the market would then encourage existing retailers to improve their cost structures and move towards the most efficient costs.

However, in Integral Energy's case the current target tariff arrangements do not encourage competition and do not produce fully commercial outcomes. No business can sustain selling its output at a price less than the costs of running the business. For this reason, Integral Energy believes that in the interest of improving the balance between customer, business and shareholder outcomes, IPART has a responsibility in the Mid Term Review to place greater weighting on the commercial and competition issues, in order to deliver sustainable benefits for customers. This will require ensuring that an effective and efficient process for moving target tariffs to a competitive level, and removing under recovering tariffs, is introduced to improve the operation of the market and meet the objectives of FRC. The overall aim of this process should be to remove all forms of price control from the retail market beyond 2004.

Matters to be Considered

Integral Energy understands that the Mid Term Review will specifically address the following matters:

[1] Regulators, Competition and Transitional Price Controls: A Critique of Price Restraints in Electricity Supply and Mobile Telephones, Page 5, Professor Stephen C Littlechild, 20 February 2002, The Institute of Economic Affairs, London.

* An allowance for electricity purchase costs based on an assessment of the long-run marginal cost of electricity generation;
* An allowance for purchases of green energy consistent with retailer licence obligations;
* Energy losses as published by NEMMCO;
* An appropriate Retail Gross Margin;
* The allowance for annual indexation based on the Consumer Price Index and expected movements in regulated components and NEMMCO fees

Integral Energy understands that IPART is also seeking particular comment with regard to the following matters:

* The effect of side constraints in facilitating the rationalisation of existing regulated tariffs and the transition to the target retail tariffs by 30 June 2004;
* Clarification of the circumstances in which standard retail suppliers may introduce regulated retail tariffs in addition to the transitional and target retail tariffs, in particular arrangements for introducing 'green tariffs';
* Clarification of off-peak versus controlled loads including the merits of introducing a 'shoulder' target retail tariff; and
* Arrangements for the recovery of all reasonable full retail competition costs

This submission provides comment on the majority of these issues. In addition, Integral Energy has also raised the cost of payment processing as an issue in Section 6 of this report, under Miscellaneous Fees. The cost of payment processing is an uncontrollable cost, which increases retailers' cost to serve. Integral Energy argues retailers should be able to fully recover these costs from customers, based on the different costs associated with different payment methods. In turn, this would promote more efficient outcomes as customers could (and would) choose cheaper payment options.

3. Current Position

Retail Target Tariffs

Before addressing the matters for consideration, this section briefly discusses Integral Energy's position in relation to the Retail Target Tariffs (RTT) set by IPART in the current Retail Determination. In each case, a 3% Consumer Price Index (CPI) has been assumed and network prices have been held constant for the period 1 July 2002 to 30 June 2004. It is noted that this submission is required prior to the finalisation of Integral Energy's 1 July 2002 network pricing proposal and that the "hold constant" scenario may vary. Clearly, in the case of under-recovering tariffs, any increase in network prices will have the effect of shifting the actual retail tariff further away from the RTT. While Off Peak 2 and General Supply tariffs are above the RTTs set by IPART, Integral Energy contends that these RTTs are too low, rather than the actual tariff being too high. These points are illustrated in Attachment 1, which is provided to IPART on a confidential basis and shows Integral Energy's cumulative shortfall in cost recovery across all tariffs. This argument is further substantiated in our discussion on Cost To Serve

(CTS) issues, which demonstrates that actual CTS exceeds the CTS allowance determined by IPART.

Domestic Supply
Integral Energy's Domestic Supply tariff is below the RTT by approximately 1% for the average customer. Assuming no network price increase and a 3% CPI this tariff is expected to marginally exceed the RTT by 0.5% by 2004.

Off Peak 1
Integral Energy's Off Peak 1 tariff is below the RTT by approximately 5%. Assuming no network price increase and a 3% CPI this tariff is expected to remain below the RTT by approximately 5% by 2004.

Off Peak 2
Integral Energy's Off Peak 2 tariff is currently above the RTT by approximately 25%. Assuming no network price increase and a 3% CPI this tariff is expected to remain above the RTT by 20% at the end of 2004. It should be noted that Integral Energy considers the RTT for Off Peak 2 to be too low as it assigns the controlled load cost to all the Off Peak 2 consumption when in fact at least 30% of this load is consumed in shoulder periods at a much higher cost than the allowed off peak energy purchases.

General Supply
Integral Energy's General Supply tariff is currently above the RTT by 10.5%. Assuming no network price increase and a CPI of 3% this tariff is expected to remain above the RTT by 9% at the end of 2004.

Cost to Serve

Under the current Retail Determination, the gross margin for retailers was set at 8.5% of sales revenue from all regulated sales. The 8.5% was broken down to three areas, including 5.5% to cover CTS. Integral Energy considers this CTS allocation to be severely inadequate when compared to the actual CTS that is apparent in the retail sector. The capital and operating costs associated with the introduction of systems to support FRC, also substantially add to Integral Energy's CTS over the remaining two years of the Retail Determination and beyond. These points are illustrated in Attachment 2, which is provided as a confidential attachment to IPART. The differential between the amounts effectively allowed for CTS and the actual CTS incurred by Integral Energy, highlights the need for IPART to increase the CTS allowance within the overall target tariff. In order to deliver commercial outcomes, this inherently requires an increase in the overall target tariff.

In addition to considering the 5.5% CTS allowance too low, Integral Energy also considers the approach of a common CTS for all retailers to be flawed. Integral Energy's response to IPART's Information Request for this Mid Term Review demonstrated that the majority of our retail costs are fixed. As this is likely to be the case across all retailers, a flat return of 5.5% is not equitable, as it does not take into account economies of scale realised by retailers with larger customer bases.

Integral Energy believes that by encouraging competition the retail businesses will focus on efficient cost delivery of their services. Irrespective of any market outcomes, Integral Energy believes that it is appropriate for it to review its retail costs. A project is currently underway to look at the correct cost allocations across the business and to identify areas for efficiency gains with a particular focus on reducing variable costs. Details on this project have already been discussed with IPART secretariat staff.

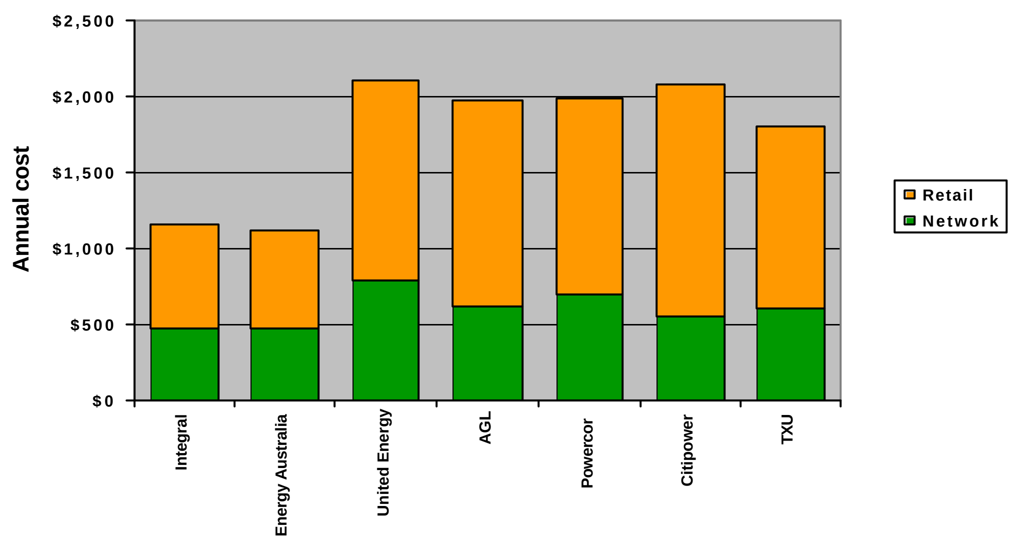
4. Improving Target Tariff Outcomes

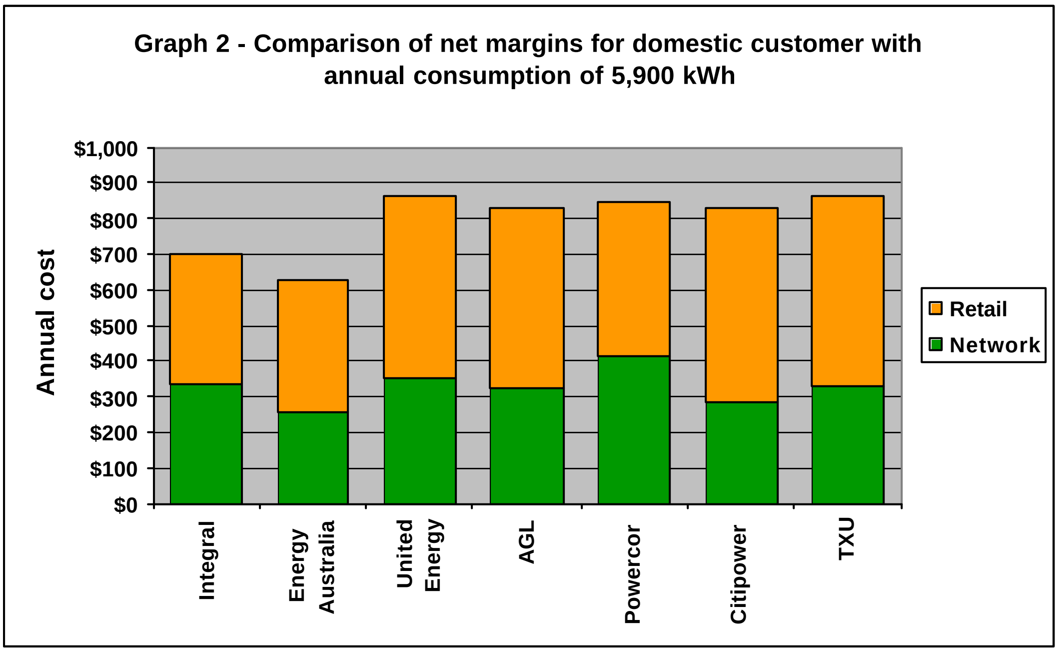
Current Retail Tariffs

Analysis of retail margins for retailers within the National Electricity Market (NEM) shows that Integral Energy currently has the smallest net margin. Integral Energy also notes that the current level of pricing effectively removes 150,000 of our customers from the competitive market, as they are unlikely to be commercially attractive to another retailer. This is a result of these customers not producing enough margin at current prices to cover their CTS.

Comparisons between NSW and Victoria demonstrate that prices in the NSW regulated market are set too low. While wholesale prices in Victoria are approximately 10% higher than NSW, their regulator has allowed retail regulated prices to be set 20-30% higher than NSW. Graph 1 and Graph 2 provide comparisons on retail prices in NSW and Victoria in the General Supply and Domestic tariffs, as at July 2001 and not including the December 2001 price increases approved for Victorian retailers.

Graph 1 - Comparison of net margins for business customer with annual consumption of 9,900 kWh





As can be seen from these graphs, there is considerable variation in the retail component between Victoria and NSW. The larger retail component in Victoria provides greater scope for competition than the NSW prices. This is reflected in the number of completed transfers of small customers in Victoria when compared to NSW. According to the NEMMCO web site, as at 14 March 2002, there had been 3748 completed transfers in Victoria and only 337 in NSW.

Integral Energy considers the current restrictions on electricity margins in NSW will limit competition in the NSW market to only the top 20% of the market. Based on the current level of the RTTs, this is the only section of the market that will have sufficient margins to allow effective price competition. In addition to limiting competition in the mass market, a continuation of current RTT levels also has the potential to further distort the commercial viability of the remainder of the market. A likely outcome is that as the top 20% of the market churns to negotiated contracts, the profitability of the remaining regulated supply contracts will become more unprofitable as the 150,000 customers who do not cover CTS become a larger proportion of the regulated supply.

While Integral Energy's commercial objectives will ensure that it continues to focus on driving costs down in relation to regulated supply, there are other factors that will limit this focus. In particular, regulations requiring Integral Energy to provide Retailer Of Last Resort (ROLR) facilities and the requirement to create a formal regulated supply contract will continue to add to Integral Energy's CTS on both a fixed and variable basis.

Integral Energy's cost structure provided in the Information Request to IPART showed an increasing CTS as a result of FRC costs and system development to ensure an ability to service these customers. The majority of these costs are defined as fixed. Furthermore, the majority of

FRC costs are fixed as they relate to depreciation costs associated with system enhancements and managing regulated customers.

This information supports Integral Energy's view that the existing RTTs need to be increased in order to establish an appropriate commercial return for the retail electricity sector and promote wider competition in the NSW Electricity Market.

Off Peak 2 Tariff

Integral Energy believes that the current Off Peak 2 target tariff is set too low. As per IPART's determination the retail component of the target tariff is based on the controlled load Variable R factor of 3.61 c/kWh. The load supplied under the Off Peak 2 tariff straddles both the off peak and shoulder periods and at least 30% of the consumption on this tariff occurs in the shoulder period.

Integral Energy recommends that a separate Variable R factor be determined for the Off Peak 2 tariff. This Variable R factor should incorporate the costs of supplying the energy in the shoulder as well as the off peak periods. Integral Energy believes the current Variable R factor understates that component of the Off Peak 2 tariff by approximately 1.05 c/kWh.

New Retail Tariffs

Under the current Determination, there is no provision for the introduction of new regulated retail tariffs. This is an unnecessary limitation. Integral Energy recommends the establishment of a mechanism by IPART to allow for the introduction of new tariffs.

Integral Energy notes that some of our competitors price on the basis of shoulder tariffs and include a stepped price structure. Integral Energy believes that there may be market circumstances that favour the introduction of a wider range of retail tariff options in the interests of encouraging competition and protecting consumers.

Side Constraints

The current side constraints place a restriction on increases beyond CPI or $25. However, a number of Integral costs are labour dependent and therefore are increasing at above CPI levels. This is highlighted in the Information Request that Integral Energy has provided to IPART. The $25 side constraint also limits Integral Energy from achieving a profitable outcome over its customer base.

IPART has indicated that tariffs should be cost reflective, and more particularly, accurately reflect the underlying network tariff. However, there is an obvious lack of alignment in the side constraints set by the Tribunal. Network side constraints have been set at $30pa or CPI + 2%, while retail side constraints have been limited to $25pa or CPI. This asymmetry has created inevitable distortions in the cost-reflectivity of network and retail tariffs and, over the medium term, has the potential to produce perverse outcomes, as it encourages the transfer of costs from retail to the network business.

Integral Energy asserts that a more flexible position should be taken with regards to side constraints. Where above CPI increases can be justified these should be permissible. Integral Energy also contends that the $25 side constraint places a severe restriction on attaining target tariff levels in those cases where tariffs are below target. This can only be addressed by IPART allowing retail side constraints to be relaxed to enable current (and under-recovery) tariffs to efficiently transfer to any new increased target tariffs.

At a minimum, IPART should utilise the Mid Term Review to address the lack of parity between retail and network side constraints in the current arrangements and allow the retail side constraint to match the network side constraint.

It is also noted that the current side constraints state that for residential customers the total amount of bills issued must not exceed the greater of;

i. for the period 1 July 2001 to 30 June 2002 - $25.00; or
ii. for the period 1 July 2002 to 30 June 2003 – CPI

It is presumed that IPART's intent was that the $25.00 limit would also apply for the 2002/03/04 years as well and that point (i) above should read;

i. for the period 1 July 2001 to 30 June 2004 - $25.00.

The same issue arises for the business customer's side constraint. The Mid Term Review will provide IPART an opportunity to correct these anomalies and Integral Energy would recommend IPART amend the side constraints as above.

5. Retail Gross Margin

Integral Energy is of the view that the Retail Gross Margin allowance is not equitable to retailers and does not foster competition as it does not allow sufficient returns to be made on investment to attract new entrants to the Retail market. The current allowable margin is a total of 8.5%, comprising a 1.5% renewable energy component and a 7% standard retail margin, being 5.5% to recover cost to serve and 1.5% as net profit margin.

Based upon assessment of the risk in energy purchase and review of international markets, it is Integral Energy's position that a Retail Gross Margin at least double the current allowance is appropriate and sufficient to provide economic efficiency and a competitive contestable market (allowing up to a 4% margin for energy purchase risk to incentivise market entry and recognise the real "cost" of ETEF).

Cost to Serve Recovery

IPART's report on Regulated Retail Prices For Electricity to 2004 stated that:

> *…the standard retail suppliers projections are similar on a per customer basis, irrespective of the standard retailer's size.*[2]

Integral Energy has reviewed the break down of its costs and found that the majority of these costs are fixed. If this was the case across all standard retailers then the larger retailers should have a reducing cost to serve per customer. Furthermore, the application of a flat 5.5% across all retailers could allow for inefficiencies to be built into the larger retailers or not reflect actual costs in the smaller retailers.

It is also arguable that the base of default customers across which to spread fixed costs will decline over time, while those costs will remain static or increasing. Integral Energy has forecast a 3% decline in default Integral Energy customer base from 2002 to 2004 with a 12% decrease in revenues over the same period. The current Retail Gross Margin does not take into consideration adequately this increasing cost base per customer.

It is Integral Energy's position that the Retail Gross Margin should be increased to allow for the increasing level of fixed costs and for smaller competitors in the regulated energy market that it should be higher to allow for demonstrable scale inefficiencies.

Retail Net Margin

As mentioned previously, Integral Energy believes that price controls for the retail business should be set at a level that encourages new entrants into the market. The existing retail net margin allowance of 1.5% is not considered sufficient for a new entrant.

The risks that a new commercial player in the market would face include the wholesale market price risk and demand volatility particularly in the small business and residential classes. The new entrant would also be required to make a significant capital investment in putting systems in place to allow for the trading function and would also need to have sufficient prudentials in place to satisfy the NEMMCO registration requirements.

It is estimated that to service a regulated customer base similar to Integral Energy's would require a minimum capital investment of $200 million. The minimum return on this capital investment that a potential investor would seek would be approximately $40 million per annum (5.6% of current revenues). In the United States for instance, regulated net margins commence at 3%. It should be noted that this net margin is based on higher prices and customer numbers than exist in Australia and generally in most parts of the United States the consumption per customer is much higher than in Australia.

[2] Report Regulated Retail Prices For Electricity to 2004, Final Report, Appendix 3: The cost of Supplying electricity, p.50

Based on these observations, Integral Energy recommends that IPART increase the retail net margin within the range of 3 – 6%.

Renewable Energy Component

In the original IPART determination there was an allowance for compliance with renewable energy targets in the wholesale energy cost allowance. This allowance was set in the absence of firm information as to the precise make-up of the Mandatory Renewable Energy Target (MRET) at that time and so it was acknowledged that the allowance may require a review.[3] Indeed, MRET was excluded altogether.

The targets for MRET are designed to increase to 2% of consumption by 2010, to meet these targets, pressures are being placed upon retail suppliers, with the Renewable Energy Credit (REC) quota for 2002 increasing fourfold over the previous year. While Integral Energy is currently exceeding its Greenhouse reduction targets and is expected to meet its MRET target for 2002, the supply of green energy is likely to place upward pressure on these costs.

As an example, a 1.5% allowance provides Integral Energy with approximately $10m pa to cover our mandatory Greenhouse Gas (GHG) abatement requirements. In NSW Treasury's review of licence requirement amendments the cost has been identified of between $7-$16 per MWh based on the form of abatement techniques utilised. Furthermore, ABARE states that cost of abatement will range between $10-$30/MWh over the next 3 years.

Integral Energy's current GHG abatement costs are approximately $17/MWh. At this level, and on the assumption that Integral Energy has to reduce GHG emissions by 15% of total consumption, this would require a total cost of $2.55/MWh spread across the regulated customer base.

The cost of meeting the requirements of the 2% Renewables Act will bring additional costs to the retailers of $0.25/MWh by the end of the current Retail Determination period increasing to $2/MWh by 2020.

This will see the total of green costs increase to $3.18/MWh by 2003/04 – equating to approximately 3% of revenue.

Table 1 summarises Integral Energy's position and the deficiency in a 1.5% green allowance. This shows how the amount allowed in 2001/02 of $10.63M was not sufficient to meet Integral Energy's actual green costs of $20.41M. A similar situation is forecast in 2003/04 based on the current arrangements.

[3] Appendix 3: The cost of supplying electricity, p.33, Report Regulated Retail Prices For Electricity to 2004, Final Report, stated that:

Table 1 – Greenhouse Allowance vs Actual Costs

Year	Revenue	Allowable Recovery	Actual Costs	Breakdown of Costs
2001/02	$709m	$10.63m	$20.41m	$1.2m to meet MRET +$19.2m for GHG reduction
2003/04	$653m	$9.79m	$18.30m	$3m for MRET & $15.3m for GHG Reduction.

Based on these facts, it is apparent that the allowance is not enough to cover costs. Integral Energy is prepared to provide costing details on energy purchases to the Tribunal on a confidential basis as it is important that IPART factors realistic costs to source green energy requirements into the wholesale energy cost allowance.

Integral Energy is of the view that a 1.5% allowance is not sufficient and that the Renewable Energy component of the Retail Gross Margin should increase to a minimum of 3% to the end of this Determination period. Furthermore, Integral Energy strongly recommends an annual review of the Renewable Energy component of the Retail Margin in light of the volatility of renewable energy supply.

6. Fees

Ancillary Services

Under the current determination market fees have been set at $1.30/MWh. These fees are made up of NEM participants' fees and ancillary service fees.

On a YTD these fees have averaged lower than the level set in the Determination. It is important to bear in mind however, that the weather pattern over the last summer and since the introduction of a wholesale market for ancillary service has been relatively mild compared to previous years and hence the need for ancillary services has been somewhat reduced. This is likely to be a short-term trend. Also, the introduction of a wholesale market for ancillary costs has only allowed a partial reduction in the risk associated with these fees especially against a bundled tariff as the wholesale market only trades in certain types of ancillary fees leaving the risk of the other fee movements upon the retailer.

In an attempt to minimise this risk, Integral Energy's trading desk has reviewed the wholesale market and found that forward costs for ancillary fees, where tradeable, are priced in line with the regulated rate. The remaining risk would be borne by the retailer as these fees are not passed through as they are for the contestable market.

Miscellaneous Fees

The cost of payment processing is an important issue for Integral Energy, which also needs to be addressed by IPART in the Mid Term Review. The cost of payment processing is an uncontrollable cost, which increases retailers' cost to serve. As has been strongly argued in other parts of this submission, Integral Energy is already significantly under-recovering on its

CTS allowance compared to actuals. The cost of payment processing is an uncontrollable cost, which increases retailers' CTS. Attachment 3, which is provided to IPART on a confidential basis, details the variation in these costs on a per customer/transaction basis. These range from $0.31 per transaction to $3.64 per transaction, depending on the payment channel used. Attachment 3 also details how these payment channels impact on Integral Energy's CTS.

Integral Energy recommends that retailers should be able to fully recover these costs from customers, based on the different costs associated with different payment methods. In turn, this would promote more efficient outcomes as customers could (and would) choose cheaper payment options. This is the most cost effective way of encouraging customers to transfer to alternative and lower-cost payment methods, as they would see the immediate benefit on their accounts. Integral Energy does not consider offering discounts to already unprofitable customers to change payment channels to be an effective approach as the discount would not be sufficient to induce conversion to other payment methods without substantial cost to the retailer.

In support of this recommendation, Integral Energy proposes that only the actual costs associated with payment processing would be passed through to customers. Integral Energy also proposes that these costs be subject to annual review to ensure that these costs are adjusted for any increases or reductions in payment channels.

7. FRC Recovery

It is acknowledged that IPART is currently undertaking a review of the appropriate level of FRC costs and the recovery of those costs for the retail businesses is an important part of the mid term review. It is also acknowledged that IPART has allowed $5 per customer per annum in the existing retail CTS.

If the review of FRC costs indicates that additional costs need to be recovered, over and above the current allowance, then Integral Energy recommends that recovery of these additional FRC costs should be through an increase in the "Fixed R" component of the target tariff. This is consistent with a large proportion of the Retail FRC cost drivers being transaction based and therefore not load dependent.

Integral would further submit that this increase should be undertaken in a step increase of sufficient size to recover in this regulatory period that portion of FRC costs not already recovered. In order to ensure these costs are recovered the corresponding increase in the actual tariffs should not be subject to side constraints.

Integral believes this would be a more efficient approach than having the issue of FRC cost recovery continue on through a number of smaller increases over an extended period.

Integral would also like to raise the issue of potential increases to the NEM Fees.

It is Integral's understanding that the costs of introducing MSATS will be recovered in the next NEMMCO fee determination, which commences in 2003/2004. As the level of this fee recovery is uncertain at present Integral Energy would recommend that the recovery of these fees be an actual pass through.

IPART's original report did not take this into consideration, and so a corresponding increase for NEM Fees is required in the final year of the regulatory period. Integral would request that this be treated in a similar manner to the FRC costs, ie a step increase in tariffs not subject to side constraints. It should be noted that these costs are not included in the FRC cost recovery submission as they were separated out in the original IPART report.

8. Process Issues

Integral Energy notes that IPART intends to finalise any Determination resulting from this Mid Term Review by 15 May 2002 and release its report by 31 May 2002. Integral Energy also notes that 1 July retail pricing proposals are required to be submitted to the Tribunal by 1 June 2002. In order to ensure practical outcomes from the Mid Term Review, Integral Energy urges IPART to provide the industry with timely information on any proposed amendments or change in arrangements so that these changes can be factored in to 1 July pricing retail submission.

Due to the variety of un-finalised issues at this time, including FRC cost recovery arrangements and 1 July network pricing proposals, Integral Energy also urges IPART to adopt a highly consultative approach in the Mid Term Review. Beyond this public submission and the Round Table Forum, Integral Energy welcomes the opportunity to meet with IPART and discuss the pricing options that need to be considered to address the issues raised in this submission.

Attachment 1 - Cost Recovery by Tariff

CONFIDENTIAL

Attachment 2 - Cost to Serve Issues

CONFIDENTIAL

Attachment 3 – Payment Processing Costs

CONFIDENTIAL