

18 September 2009

Mr James Cox
Chairman
IPART
PO Box Q290
QVB Post Office NSW 1230

Dear Mr Cox,

Review of regulated retail tariffs and charges for electricity 2010-2013

Integral Energy is pleased to provide the attached response to the draft methodology paper published by the Tribunal. Broadly, Integral Energy agrees with the Tribunal that:

- the full recovery of efficient costs is necessary to ensure the development of effective competition in the State's retail electricity market; and
- in the context of regulated retail tariffs, this means appropriate allowances must be made for energy purchase costs, retail operating costs and retail margins.

In particular, Integral Energy submits that the considerable uncertainty regarding the energy purchase cost for the upcoming period make it appropriate that:

- there be greater transparency as to how the Tribunal models the allowance; and
- the Tribunal provide an additional trigger for conducting a review of the allowance during the period.

If you wish to discuss any aspect of this letter please contact Anthony Englund, Regulatory Policy Manager at anthony.englund@integral.com.au or (02) 9853 6511.

Yours sincerely,



David Neville
Acting Group General Manager
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Going further for you is what we do

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Integral Energy submission on IPART methodology paper

Greater transparency

Integral Energy welcomes the Tribunal's process to date for developing an understanding of the inputs and methodologies to be used in setting the Standard Retailers' regulated retail tariffs for the upcoming determination period.

Subject to the specific comments appearing below, Integral Energy is provisionally comfortable with the inputs and methodologies proposed noting, however, that these have only been provided at a relatively high level. In order to ensure that regulated retail prices meet the Terms of Reference for the review, Integral Energy seeks additional operational knowledge of the tools that will be used by the Tribunal and its consultants to establish the allowed costs and margins.

Given the larger risks associated with the current review arising mainly from the likely introduction of carbon pricing, Integral Energy is particularly interested in understanding the assumptions that underpin the wholesale energy purchase cost allowance to be calculated by Frontier Economics and how these assumptions flow through to generate outputs.

If proprietary considerations make the publication of the detailed workings and calculations of Frontier Economics' models impractical, then, as a minimum, Integral Energy proposes that the Tribunal provide the Standard Retailers with the results of scenario analysis to better understand how changes in key inputs affect the modelling outcomes, particularly as they relate to carbon pricing.

Addressing risks within the regulatory package

A key feature of the Tribunal's proposed regulatory approach is to distinguish between those risks that relate to "normal variations" and those that relate to "step changes" in retailer costs. The Tribunal states that the former are based on changes "that can be expected and... typically occur within a predictable range" and those that are "significant changes outside the range of normal variations"¹. Different regulatory mechanisms for addressing the two different types of risks are proposed.

Integral Energy agrees that the determination needs to provide both certainty regarding the recovery of efficient costs and flexibility in managing the associated risks. However, as a general comment, it is unclear how the Tribunal proposes to evaluate the difference between "normal variations" and "step changes" on a case by case basis. For example, Table 2.1² in the Tribunal's methodology paper sometimes requires the demonstration of a causal link (for example, systemic versus non-systemic changes) and other times refers to an unspecified quantum of change (for example, a "significant" change in wholesale electricity prices). Without clear criteria, there is a risk that the Tribunal's methodology will not adequately provide for the relevant risks.

Addressing the risk of "step changes" in wholesale energy purchase costs

Integral Energy's main concern is the way that the Tribunal proposes to apply the framework to the risk of changes in wholesale electricity purchase costs. The Tribunal proposes to manage the risk as follows:

¹ IPART, *Review of regulated retail tariffs and charges for electricity 2010-2013 draft methodology paper*, page 7.

² IPART, p 9.

- address “normal variations” through a volatility allowance and “step changes” through a periodic review of that allowance conducted by the Tribunal, six monthly during 2012-2013 when the Federal Government’s CPRS is expected to be in full effect; but
- *not* to allow either a pass through or retailer-led tariff adjustments (with an ex-post Tribunal review) where energy purchase costs rise significantly between those reviews.

The missing scenario

In its comments justifying the first limb of this approach, the Tribunal stated³ that:

[i]f average wholesale prices were significantly higher than assumed but this was signalled in advance, there should be sufficient time to adjust regulated tariffs to avoid adverse impacts on the retailers’ financial positions.

Higher but well signalled prices could result from changes in the design of the proposed CPRS, particularly the timing and scope of the scheme.

However, the case the Tribunal does *not* identify is where average wholesale prices are significantly higher than those assumed but those movements are *not* signalled sufficiently in advance to allow the Tribunal to complete its review and adjust the retailers’ allowance.

If a price spike larger than the Tribunal’s volatility allowance occurred between the six monthly reviews and there was no “failsafe” mechanism, the financial viability of one or more retailers could very quickly be put in serious jeopardy. For example, based on the Tribunal’s previous determination⁴, a rise in wholesale energy costs of approximately six per cent would halve the current five per cent retail margin. A ten per cent rise would virtually eliminate any margin for a Standard Retailer. Therefore, building in a mechanism that requires a Standard Retailer to virtually lose money before a review is initiated is likely to have serious consequences for retailers, customers and the market.

The Tribunal has already identified that the energy purchase cost risk has the potential to be the most volatile and material risk faced by retailers during the upcoming regulatory period. This is reinforced by the fact that, at present, very few market participants appear willing to sign contracts to purchase energy during 2012-2013, the year that the CPRS is expected to be in full operation. It remains unknown whether the current level of market uncertainty will reduce enough for the Tribunal to be confident that it can decide on an appropriate allowance at the time without also providing a failsafe mechanism.

Integral Energy supports the Tribunal’s decision to review energy purchase costs on a six monthly basis. However, since the Tribunal must make its determination in the next few months, Integral Energy submits that it would be prudent to include a failsafe mechanism to ensure that a Standard Retailer does not incur significant losses in the period between reviews. Indeed, given the terms of reference that require the Tribunal to ensure that CPRS-inclusive energy costs *are in fact recovered*, it is necessary to include such a mechanism.

³ Id.

⁴ IPART, *Regulated electricity retail tariffs and charges for small customers 2007 to 2010, final report and final determination*, p 87.

Failsafe mechanisms

Integral Energy identified two potential failsafe options in its submission on the Tribunal's issues paper. These were that the Tribunal either:

1. extend the pass through mechanism to allow a fast track Tribunal review to occur between the six monthly reviews; or
2. as proposed by the Australian Energy Market Commission (AEMC)⁵, allow retailers the scope to reasonably adjust their own tariffs subject to an ex-post review by the Tribunal.

Regarding Option 1, and as was pointed out during IPART's methodology hearing, individual retailers have an incentive not to avail themselves of a pass through mechanism unnecessarily as they not only face additional administrative costs associated with frequent price changes, but they also face the risk of having any increased allowances competed away in the wider marketplace if they are set above efficient costs.

With respect to Option 2, the Tribunal listed a number of objections it had to AEMC's proposed mechanism in its methodology paper⁶, in particular allowing a Standard Retailer to implement its own price change and then seek to "rebate" any potential overcharging at some future time. Integral Energy recognises that a rebate approach to adjusting regulated retail tariffs may be problematic from a number of perspectives.

However, Integral Energy also notes the effect of the AEMC's approach could also be met by having clearly established criteria in place that, should a Standard Retailer believe one or more required criterion have been met, it could apply to the Tribunal for a review of the energy purchase cost allowance at any time between the six monthly reviews. For this approach to be effective, the Tribunal would be obliged to accept the Standard Retailer's application and initiate a review if the Tribunal was satisfied that the pre-defined criteria had been met. Integral Energy understands that the Tribunal may be willing to consider this option if suitable trigger criteria could be identified.

In effect, Option 1 and Option 2 may be identical if criteria for the review are specified in advance and the Standard Retailer is required to apply to the Tribunal for the review to be initiated (with the Tribunal obliged to conduct the review if the criteria have been met).

If it is considered appropriate that a review mechanism is to be contained in the regulatory framework, which Integral Energy believes is required for the Terms of Reference to be met, then the appropriate trigger mechanism should bear a relationship to the size of the retail margin allowance. As discussed earlier, Integral Energy considers that the current 10 per cent trigger mechanism, whereby a Standard Retailer's retail margin is virtually eliminated before a review is conducted, is too high a threshold.

On balance, Integral Energy considers that a five per cent increase to the energy purchase cost allowance is an appropriate trigger mechanism, given the uncertainties over carbon pricing and the impact on retail margins of "getting it wrong" on the energy purchase cost allowance.

⁵ AEMC, *Review of Energy Market Frameworks in light of Climate Change Policies: 2nd Interim Report*, June 2009, p 55

⁶ IPART, p 31.

Integral Energy considers that a market based trigger mechanism, whereby a five per cent increase in actual costs compared to the spot market prices modelled by Frontier Economics and used as the starting point for calculating the Tribunal's allowance should form one of the criteria for the review to be initiated.

One approach may be to measure any change by reference to the quarterly average of spot market prices per "tick" (trading interval). This measure provides a suitable balance between too few observations triggering an unworkable number of reviews and too many observations being affected by seasonal variations.

Changes in industry structure

The Tribunal indicated in its methodology paper that it intends to assume the current ownership and industry structure will remain in place for the first year of the determination period and that, if changes occur as the result of the NSW Government's industry reform plan, these could be considered as part of the annual periodic review proposed for the second year of the determination.

At the recent public hearing, the Tribunal clarified that it would not be the change of structure itself that would trigger a review. Rather, a review would be appropriate only if the reforms had an impact on the Standard Retailers' efficient costs of doing business. Integral Energy is comfortable with this approach only to the extent that it applies to a change in the wholesale energy purchase costs as the result of consequent changes in market structure (not the change of structure per se).

Other concerns

Bundled black and green energy purchase cost

Frontier Economics argues in its methodology paper that:

- given that the purchase cost will almost certainly eventually be a bundled market price; and
- separating out the wholesale and carbon elements in the short term would require the making of as many assumptions as would be required for the bundled price,

then there is little value in calculating those elements separately for the purposes of the current determination.

Integral Energy is comfortable with this position provided that the modelling assumptions regarding the extent to which generators pass through the value of government provided carbon permits into wholesale prices are made transparent and, as discussed earlier, scenario analyses are provided to Integral Energy for review. This is important given the likely magnitude of the free carbon permits that the generators will receive.

Use of Net System Load Profiles (NSLPs) to forecast load

Integral Energy notes that the Tribunal has proposed using NSLPs as a proxy for, or in addition to, retailers' own regulated load forecasts. The Tribunal's terms of reference make it clear that it is the costs of each Standard Retailer that are to be provided for. This must include using those load forecasts that accurately reflect the position of each such retailer. Integral Energy has provided detailed load forecast information to the Tribunal and expects that, were that information not to be used or were any public data incorporated, the Tribunal would provide Integral Energy with

the opportunity to review the appropriateness of the specific forecast data proposed to be used.

Customer acquisition and retention costs

The Tribunal has noted that it expects that the transfer from contract to regulated (and vice versa) of a customer that already forms part of a Standard Retailers' existing customer base would involve "negligible" transfer process costs. Integral Energy submits that this should not necessarily be assumed. Rather, it expects that the Tribunal will review the cost information provided as part of the Standard Retailers' information responses to determine an appropriate allowance.

Retail margin benchmarks

Integral Energy considers that the approaches set out in SFG Consulting's paper for estimating the profit margin to apply to the Standard Retailers' regulated business is broadly sound. However, as indicated at the outset of this submission, the appropriateness of the resulting outputs depends critically upon the assumptions and judgements that underpin the analysis and the appropriateness of the cost base to which the margin is applied.

To provide a suitable level of confidence in the outcomes, Integral Energy submits that the Tribunal must make the following explicit as part of its process:

- details and the supporting rationale for the cost of capital parameters used by SFG Consulting in its analysis — in particular, it should be stated what specific parameter assumptions (rather than specifying a range) will be mandated by IPART and the basis for those assumptions as well as details regarding the assumptions made by SFG Consulting itself;
- details regarding how the benchmarking approach is implemented including:
 - the weightings applied to the various benchmarks considered by SFG and an articulation of the rationale supporting these weightings; and
 - any adjustments or normalisation applied to benchmark partners to account for differences in the international markets, including the composition of the markets, industries in which the businesses operate and the business activities which they undertake; and
- details of any analysis and assumptions provided by Frontier Economics to SFG Consulting and used in the latter's analysis, such as any assessments of market risks.

Retail margin as a rate

Finally, Integral Energy supports the retail margin allowance being assessed as a percentage applied to a cost base, rather than a fixed dollar allowance, to ensure consistency should other cost elements be revised during the determination process or ensuing period.