Integral Energy

Draft Decision:

Benchmark Retail Cost Index for Electricity 2008-09

Submission to the Queensland Competition Authority

29 February 2008

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Contents

1 Overview

Integral Energy (Integral) welcomes the opportunity to provide comment in response to the Queensland Competition Authority's (QCA's) Draft Decision on the Benchmark Retail Cost Index (BRCI) for 2008/09.

Integral is the holder of a non-area Retail Authority in Queensland and, whilst a new entrant to the Queensland market, has provided energy services to Australian families and businesses for more than 50 years, including approximately 830,000 market and non-market customers in New South Wales.

Integral has actively participated in the residential and small business segments since the commencement of full retail competition (FRC) in Queensland, demonstrating a commitment to the Queensland market and establishing a significant market share in a relatively short period of time. Establishing a Queensland presence has necessitated the establishment of systems and process for what is essentially a local operation, as well as considerable expenditure by Integral on customer acquisition and retention in an environment where it is competing directly against incumbent retailers who have purchased both their customer base and Queensland service capability.

As a second-tier retailer in Queensland that is required to offer the terms and price of the Standard Retail Contract to its small customers, Integral is directly exposed to the ongoing level and stability of headroom of the Notified Prices. Integral considers that maintaining an appropriate level of headroom will be crucial to the continued development of effective retail competition in Queensland.

As a general comment, Integral believes that the Draft Decision provides a solid basis for establishing both the:

- Quantum of the increase to be applied to the Notified Prices for 2008/09; and
- Methodology to support the calculation of the BRCI index in future years, thereby mitigating the risks of step-change adjustments in future years in circumstances where the existing methodologies or simplifying assumptions fail to achieve their stated purpose or result in a material deviation between forecast and actual costs.

While Integral Energy broadly supports the methodologies and assumptions applied by the QCA to determine the cost elements of the BRCI for 2008/09, there are a small number of issues that Integral wishes to highlight for the QCA's consideration in determining both the final index to apply for 2008/09 and the calculations to be applied in future periods. In particular:

- Factors which Integral believes are placing an upward pressure on long run marginal cost (LRMC);
- The importance of fully capturing network costs, including mid-period adjustments to the distributors' revenue requirements; and
- A need to revisit the threshold for determining whether a retailer has a 'significant market share' and thereby the underlying retail cost base.

The remainder of this submission expands on these issues.

2 Purpose

This submission represents Integral's response to the QCA's Draft Decision on the BRCI for 2008/09, released in February 2008.

Integral has not sought to respond to all recommendations or to provide comment on every cost component considered by the QCA in reaching its Draft Decision. Rather, in preparing this submission, Integral has focused on those issues which it believes are key to achieving the Queensland Government's stated policy objectives of ensuring that:

- Actual increases in electricity costs are reflected in the level of tariff increases;
- Existing retail headroom in the tariff remains relatively stable; and
- The policy of permitting small market customers to revert to Notified Prices does not result in retailers providing customer retail services to non-market customers at a loss.

The key issues identified by Integral for response are addressed in the following sections:

Section	Purpose	Details
3	Cost of Energy	This section sets out Integral's view on the factors placing upward pressure on the cost of energy component of the BRCI.
4	Network Costs	This section sets out Integral's views on the way in which the QCA has reflected adjustments to the distributors' revenue requirements in its calculation of the network cost component of the BRCI.
5	Retail Costs	This section sets out Integral's views on the characteristics of a retailer with 'significant market share' and the impact that this may have on the level of customer acquisition and retention costs.

3 Cost of Energy

3.1 Draft Recommendation

In calculating the cost of energy component of the BRCI for 2008/09, the QCA has:

- Calculated the LRMC of energy based on the stand alone cost of the most efficient combination of generating technologies for Queensland, recognising the impacts of interconnection with the National Electricity Market;

- Calculated the purchase cost of energy based on a combination of the contract and spot market purchases that a prudent and efficient retailer could be expected to make; and

- Weighted the LRMC and energy purchasing cost components through an averaging of the two costs, based on a 50% / 50% weighting.

Application of this methodology has resulted in an increase in total energy costs for 2008/09 of 7.3%.

3.2 Comment

Integral supports the QCA's examination of the relationship between the long-run cost of energy and the actual energy purchasing costs of a prudent retailer, in particular its recognition that these are influenced by a range of factors including supply and demand conditions, internal risk management policies and the market's perception of risk.

Given that the QCA is required to calculate the cost of energy for the BRCI based on its view of the long run marginal cost of energy, Integral supports the 50% / 50% weighting that has been applied by the QCA to LRMC and energy purchase costs in its Draft Determination for the purposes of deriving a single energy cost. Integral considers that this weighting provides an appropriate recognition of the extent to which actual costs in the short-term continue to deviate from LRMC, and reasonable book building behaviour in the market.

While Integral is supportive of the methodology applied by the QCA to determine total energy costs, there are several issues which the QCA could consider in refining the analysis, being:

- The proposed downward adjustment in LRMC. The impact of year-on-year changes in the NEM load shape on the calculation of LRMC should be balanced against a range of factors placing upward pressure on the LRMC, including the value that participants will be attributing to water resources, an increasing penetration of gas-fired generation, and increasing cost of coal fired generation due to shorter-term purchasing arrangements.

  As noted in its submission on the Interim Consultation Notice, Integral believes that these factors represent a fundamental shift in both the market's approach to contracting and its future physical composition, increasing the cost of energy in the long-term through higher capital and operating costs of generation.

- While Integral supports the QCA's recognition of 'other' energy costs, including GECs, RECs, participant fees and ancillary services, there is the potential for significant ongoing movement in the cost of RECs, with shortages in supply likely to lead to a greater upward pressure in prices than is reflected in the Draft Determination. As noted by Integral in its submission on the Interim Consultation Notice, the Australian Financial Market Association weekly market prices are not an accurate determinant of retailers' compliance costs in the event of any unanticipated separation between spot and forward prices.

4 Network Costs

4.1 Draft Recommendation

In calculating the network cost component of the BRCI for 2008/09, the QCA has:

- Accounted for adjustments to the distributors' revenue requirements, including the pass-through of additional capital expenditure and FRC costs, the exclusion of non-DUOS services from the distributors' revenue caps and re-smoothed revenue requirements where required; and

- Based its assessment of transmission costs on the AER's Final Decision on Powerlink's revenue cap.

Application of this methodology has resulted in an increase in total network costs for 2008/09 of 10.9%.

4.2 Comment

Integral accepts that network costs are rising steadily in Queensland and will continue to do so beyond the term of ENERGEX and Ergon Energy's current regulatory determinations. This is a "cost of doing business" in Queensland that Integral accepts.

Integral notes that the QCA's 2005 Determination significantly increased the amount of network revenue that can be charged by ENERGEX and Ergon Energy over the 2005/06 to 2009/10 period. These amounts are being reflected by the QCA into the BRCI.

As well as this, however, Integral is aware that both entities are currently spending far in excess of even these "capital expenditure building blocks", implying that large step changes will be required in the next regulatory period commencing 2010/11. This means that the costs that the QCA is allowing still do not represent the true increases in network costs over the longer term and that therefore, there is still some way to go before the BRCI is reflective of the true underlying costs of supplying electricity.

This, and the use "pass-through" mechanisms to grow the allowed Annual Aggregate Revenue Requirements (AARRs), emphasises the importance of the QCA continuing its current method of fully incorporating network costs into the BRCI. If this does not occur, then the costs borne by retailers in paying for these network costs will not be represented in retail tariff increases. This would in turn create a revenue 'shortfall' for retailers, directly impacting the sustainability of market offers and thereby the ongoing development of competition in Queensland.

In this context, Integral supports the QCA's recognition of recent adjustments made (or likely to be made) to ENERGEX and Ergon Energy's AARRs, in its calculation of the network cost component for 2008/09. Integral suggests that, in light of recent Government announcements and concerns in relation to the BRCI, that the QCA comment in its Final Decision about its long term views on electricity prices, specifically that the likelihood of upwards movement greatly exceeds the likelihood of downward movement in the foreseeable future.

5 Retail Costs

5.1 Draft Recommendation

In calculating the retail cost component of the BRCI for 2008/09, the QCA has:

- Adjusted the 2007/08 benchmark retail operating cost up, to reflect inflation and wages growth;
- Adjusted retail operating costs associated with customer acquisition and retention down, due to an expected reduction in customer churn; and
- Maintained the retail margin of 5% that was applied in 2007/08.

Application of this methodology has resulted in an increase in total retail costs for 2008/09 of 1.4%.

5.2 Comment

Section 94(1) of the *Electricity Act 1994* (Act) states that the cost of providing customer retail services is to be calculated based on an efficient entity carrying on an electricity retail business that meets the criteria that it:

- Is carried on separately from any other business;
- Has a significant market share of the State's electricity retail market;
- Provides customer retail services to a cross-section of customers; and
- Earns a reasonable retail margin.

Additional guidance on the characteristics of the retail entity for the purposes of section 94 of the Act is provided by:

- Section 109(2) of the *Electricity Regulation 2006* (Regulation) which states that it is to be assumed that the retailer has a proportion of customers, separated into customer types defined by their consumption level within particular consumption bands, that is substantially the same as the proportion for the bands for the whole Queensland customer base; and
- The Minister's Delegation of 16 March 2007, which is accompanied by explanatory material that states that: *"The retailer will have a reasonable customer base, **for example** to be determined as 500,000 customers, and the customer types will be in the same proportion as the entire Queensland customer base"* [emphasis added].

The suggested example of 500,000 customers contained in Attachment B to the Delegation has been adopted by the QCA as representative of "significant market share", for the purposes of calculating retail operating and customer acquisition costs.

Integral is concerned that this assumption overstates the number of customers that represent a significant market share and thereby, understate retail operating and customer acquisition costs. In particular:

- There are only two competitive retailers in Queensland that are likely to maintain a market share of this size for the foreseeable future (i.e. the incumbent retailers AGL and Origin Energy). Although the total Queensland customer base is around 1.8 million customers, 600,000 of these customers are serviced by Ergon Energy Queensland and effectively remain outside the competitive market as a consequence of the economies of supply to rural and regional Queensland;

- Under an alternative methodology, unconstrained by a threshold of 500,000 customers, a number of second-tier retailers may be considered to have a significant market share. In this context it is noted that:

  - The example provided in the Delegation is illustrative rather than definitive. Put simply, it is up to the QCA to determine the meaning of ‘significant’;

  - Unlike other aspects of the retail cost calculation (e.g. composition of the customer base), clarification has not been provided through the Regulation, although a clear head of power to do so exists in section 94(1) of the Act. This suggests that Government intended the QCA to form its own view; and

  - The threshold for classifying a retailer as having a ‘significant’ or ‘large’ market share is significantly lower under other aspects of the Queensland FRC framework. For example, the Office of State Revenue (OSR) applies a ‘2% rule’ to the classification of retailers as ‘large’ for the purposes of administering the Community Ambulance Cover – i.e. *“a minimum of 2% of electricity customers participating in the Queensland electricity market”*. A classification of ‘large’ obliges a retailer to remit any ambulance cover levies that are received to OSR on a daily, rather than monthly, basis; and

- An alternative methodology may impact the characteristics of the retail costs that are recognised. As noted in Section 1 of this submission, establishing a sizeable Queensland presence has necessitated the establishment of systems and process for what is essentially a local operation, as well as considerable expenditure by Integral on customer acquisition and retention in an environment where it is competing directly against retailers who have largely purchased both their customer base and Queensland service capability.

Therefore, while Integral recognises that retail costs are a small component of total costs within the BRCI:

- Customer acquisition and retention costs are currently understated because second-tier retailers must invest considerably against incumbent retailers to win and retain market share. That is, the acquisition and retention costs of a retailer with significant market share do not equate to the costs of an incumbent retailer. An incumbent retailer’s costs may be lower - for example, it already has the customer’s information and is thereby in a stronger position to retain the customer or move the customer to a market contact;

- The assumed level of customer churn for 2008/09 should reflect active competition. This would be consistent with the Government’s and market’s expectation regarding the development of competition; and

- Costs should be amortised over a period that is consistent with active competition – i.e. in a competitive market, customers on average can be expected to be retained over a shorter period.