

Integral Energy

**Second Consultant's Report:
Calculation of the Benchmark
Retail Cost Index 2009-10**

**Submission to the Queensland
Competition Authority**

7 November 2008

7 November 2008

Gary Henry
Director, Electricity & Gas
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Dear Gary

Notified Electricity Prices 2009-10 - Consultant's Draft Second Report

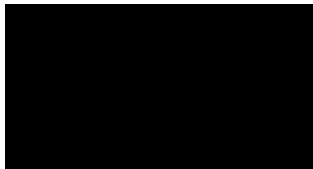
Integral Energy (Integral) welcomes the opportunity to provide comment to the Queensland Competition Authority (QCA) on the second report prepared by CRA International (CRA) to provide assistance in calculating the BRCI for 2009-10.

Integral has actively participated in the residential and small business segments since the commencement of full retail competition in Queensland, and has established a significant market share and local presence in a relatively short period of time.

The establishment and maintenance of adequate retailer headroom through the BRCI is imperative to the development of a competitive and successful retail market in Queensland. Integral supports the comments that were made by industry at the 3 November 2008 workshop and has highlighted in this submission issues arising out of the Second Draft Report and supporting material to which Integral believes the QCA must have regard, both in settling its consultants' reports and in issuing its Draft Decision.

Should you require any further information or wish to discuss this matter, please contact Steed Leonard, Manager Queensland on (02) 9853 6842.

Yours sincerely,



Bruce Rowley
General Manager, Retail

Going further for you is what we do

INTEGRAL ENERGY ABN 59 253 130 878
51 Huntingwood Drive Huntingwood NSW 2148

www.integral.com.au



The power is in your hands

Integral Energy (Integral) welcomes the opportunity provided by the Queensland Competition Authority (QCA) to offer comments on CRA International's (CRA) Second Consultant's Report (Second Draft Report) on the calculation of the Benchmark Retail Cost Index (BRCI) for 2009-10 and ACIL Tasman's estimates of new-build generation capital and fuel costs.

The QCA's commissioning of additional analysis in response to the concerns raised by stakeholders at the workshop held on 27 August 2008 and the provision of a further forum for discussion on 3 November 2008 has assisted greatly with the transparency of the 2009/10 BRCI process. That said, there are a number of data and methodological issues which continue to threaten the credibility of the BRCI outcome for 2009/10 and undermine the market's confidence that retail competition in Queensland will be sustainable.

Unless the QCA moves to:

- Reinstate the headroom that was eroded through the BRCI in 2008-09;
- Move the component elements of the BRCI in 2009-10 to levels that are reflective of retailer costs; and
- Maintain the level of these costs together with the required headroom into the future,

the shortage of market offers will continue in Queensland and retailers are likely to withdraw from the market.

This submission focuses on those new issues arising out of the Second Draft Report and supporting material to which Integral believes the QCA must have regard, both in settling its consultants' reports and in issuing its Draft Decision. Integral supports the comments that were made by industry at the 3 November 2008 workshop and also directs the QCA to its submission on CRA's First Consultant's Report (dated 22 August 2008), which is provided at **Annexure A**.

1. Certificate of Delegation

Integral acknowledges CRA's consideration in the Second Draft Report of the manner in which the Government's policy objectives of headroom in the Notified Prices and margins available to retailers can be taken into account when calculating the BRCI. It remains unclear however 'if', 'when', and 'how', this issue and the changes identified by CRA as worthy of further consideration will be assessed by the QCA and incorporated into the index for 2009/10.

In particular, Integral Energy:

- Does not consider that legislative changes are required to permit the impact on retailer headroom to be considered. While clarity regarding definitions and the manner of application of this policy intent may be 'ideal', there have been a number of other instances where CRA or the QCA have applied an interpretation, calculation or methodology that is not explicit in Queensland legislation.

Integral considers that if there is a demonstrated need for an adjustment to the BRCI to maintain headroom, an adjustment to the BRCI for 2009/10 should be made; and

- Is disappointed at the lack of discussion in Second Draft Report as to the impact on headroom of:

- the specific methodology or calculation options that are considered; and
- the six cost of energy scenarios that have been developed.

An assessment of these alternatives against the policy objectives would assist in providing a justified and defensible basis for the BRCI calculation and should be included by CRA when finalising the Second Draft Report.

2. Headroom

The QCA will need to demonstrate in its Draft Decision how it has satisfied, in the exercise of its delegated authority, that the Government's policy intents have been met for the 'efficient entity' that is contemplated for the purposes of the BRCI calculation and that the headroom that existed as at 27 March 2007 has been maintained.

Integral believes that there is a fundamental reason why these policy intents were included in the Minister's original Certificate of Delegation and have been restated in all subsequent Certificates of Delegation - namely that, if these policy intents were not met, the process of price setting will have eroded retailer profitability, thereby failing the ultimate litmus test of any price escalation formula, being that changes in prices should reflect changes in costs.

It is also unclear whether the QCA either: (a) questions whether headroom has been eroded over time; or (b) whether it accepts that headroom has not been maintained but does not know how it should be quantified:

- On the first issue, Integral believes that there are a number of clear indicators of headroom erosion in the Queensland market, including a reduction over time in:
 - the level of discount that retailers are offering (and are able to offer) customers relative to the Notified Prices;
 - the number of second tier retailers actively participating in the Queensland market (rather than merely holding a retail authority); and
 - the number of customer switches and churns.

Integral suggests that this issue is perhaps best demonstrated by the disproportionate increase in residential network tariffs relative to the increase in network costs allowed under the BRCI.

For example, with respect to Network Tariff Code 8400: Domestic (Lighting, Power and Continuous Water Heating) in ENERGEX's distribution area, which broadly maps to Tariff 11: Domestic (Lighting, Power and Continuous Water Heating) in the Notified Prices, the following increases occurred in 2008/09:

2008/09	Fixed Charge	Energy Charge
Allowance in BRCI for increase in network costs	2.68%	2.68%
Increase in NTC 8400	5.2%	13.26%

The effect of this is the removal of headroom for residential customers, further reducing a retailer's ability to compete for the very customers to whom the Notified Prices are intended to apply and illustrates the type of outcome that the policy intent on headroom was intended to redress.

- On the second issue, Integral suggests that a distinction should be drawn between 'actual' (i.e. retailer-specific) headroom and the headroom of an 'efficient retailer'. Retailers should not be penalised by an inability to provide public evidence of the impact of the BRCI on their headroom given the commercial sensitivity of this information. Accordingly, it is the headroom of an efficient retailer which should be considered by the QCA.

While an efficient retailer may have characteristics that are similar to the retailer considered for the purposes of the BRCI calculation (e.g. scale and a cross-section of customers) the costs of this retailer should not be tied to the BRCI's methodology for the calculation of costs.

Further to this, Integral does not support the suggestion in the Second Draft Report that the costs of any theoretical efficient retailer could be assumed to be the costs that are included in the BRCI and that therefore, headroom is always maintained. This assumption does not hold in light of the obvious disconnect between the BRCI's theoretical framework and the actual costs faced by retailers (as demonstrated above). Clearly, it cannot be the Minister's policy intent to equate these costs as this would in fact make the policy direction meaningless.

3. Energy Purchasing Costs

Integral supports the concerns that were raised by industry at the 3 November 2008 workshop regarding the data and assumptions that have been applied by CRA in its modelling and the downward pressure that this has placed on energy purchasing costs. It is understood that several of these issues (e.g. the marginal loss factor, the demand price correlation and the relatively high number of cap payouts) will be re-examined by CRA in the finalisation of its Second Draft Report. The early release by CRA of its findings and any accompanying revisions to data sets would greatly assist industry in developing its response to the QCA's Draft Decision.

Integral also supports the use of broker forward price curve data for less frequently traded instruments such as caps and peak swaps, as an alternative to the use of the d-cypha Trade data. Although there is a high degree of correlation in the forward price curves published by brokers, an average should be derived across major brokers (e.g. ICAP Energy, TFS Energy and Newedge) in preference to any attempt to identify a data set from a 'preferred' broker. Although material price anomalies between brokers would be unusual, this approach would assist in mitigating any such impacts should they occur.

4. Capital and Fuel Costs

Integral supports the use of a step-change scenario as the only realistic representation of recent installed costs and consideration of factors which have (and continue) to influence generation capital and fuel costs over the period of the LRM analysis. Any future moderation of capital and fuel costs as a consequence of economic conditions can be adequately addressed through subsequent BRCI determinations.

5. Environmental Costs

In relation to environmental costs:

- It is suggested that, as the Renewable Power Percentage (RPP) is set on a calendar year basis, the RPP for 2010 would need to reflect a ramp-up of the renewable target under an expanded MRET from 2010/11. That is, the impact of the revised MRET will likely be felt from the beginning of 2010, not 2011 as suggested. A ramping-up of REC targets prior to 2011 would appear to be consistent with the targets implied in the COAG Working Group on Climate Change and Water's consultation paper *Design Options for the Expanded National Renewable Energy Target Scheme*; and
- Clarification is required as to whether, when calculating the shortfall charge for GECs for 2009/10, the shortfall charge for each of 2009 and 2010 has been rounded to the nearest five cents following the CPI escalation, consistent with the methodology prescribed in section 135FA of the *Electricity Act 1994* (Qld).

6. Customer Churn

The assumed level of customer churn for 2009/10 should reflect active competition and should not be derived from historic market activity as this has been directly influenced by the level of headroom in the Notified Prices which, as noted above, has been materially eroded over time. Using the number of switches projected for 2008/09 in 2009/10 further entrenches this loss.

Integral does not accept that the reference to "likely costs" in section 94(1) of the Electricity Act precludes consideration of the levels of switching that would occur if there were stronger competitive forces than may otherwise be observed in 2009/10¹. Such an approach would materially impede the reinstatement of competition in the Queensland market. This is a clear example of where the Government's policy intents should be used as objectives to guide 'choices' regarding the level of market activity that should be assumed to apply in 2009/10.

Although not supported by Integral for the reasons stated above, if historic data on customer switching is to be used, it should be reflected as a percentage of the customer base to capture growth in customer numbers from one year to the next.

7. Network Costs

Integral welcomes the information on network costs made available by the QCA at the 3 November 2008 workshop and encourages the QCA to update these figures as necessary between its Draft and Final Decisions to reflect current information on cost pass-through applications, any other relevant adjustments to the AARR and the pass-through of transmission-related costs.

It remains critical that the network costs captured in the BRCI for 2009/10 be as closely aligned to true network costs as possible given that:

- There is already a material disconnect between the annual percentage change in network costs allowed under the BRCI and the annual percentage change in network

¹ Second Draft Report, page 127.

charges faced by retailers as a consequence of Ergon Energy's and ENERGEX's price setting process; and

- It is clear that there will be significant upward pressure on the BRCI for 2010/11 as a consequence of the Po factor at the commencement of Ergon Energy's and ENERGEX's next regulatory control period. Any under-costing of network costs for 2009/10 will only exacerbate the impact of the step-change that will occur.

Given that network costs represent a high proportion of total costs under the BRCI and will continue to do so, Integral also supports the provision of a reconciliation by the QCA in its Draft Decision of the network cost calculations and adjustments that have been applied over time under the BRCI.

**ANNEXURE A:
INTEGRAL SUBMISSION TO FIRST CONSULTANT'S REPORT**