

Integral Energy

Draft Report: Review of Electricity Pricing and Tariff Structures – Stage 2

Submission to the Queensland Competition Authority

17 November 2009

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

Dear Gary,

REVIEW OF ELECTRICITY PRICING AND TARIFF STRUCTURES – DRAFT REPORT

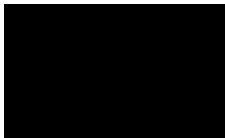
Integral Energy (Integral) welcomes the opportunity to provide comment to the Queensland Competition Authority (QCA) on its Draft Report and supporting consultant's report, regarding Stage 2 of the Review of Electricity Pricing and Tariff Structures.

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.

While Integral supports the Draft Report's conclusions that tariffs should reflect costs, through both cost recovery for retailers and cost signalling to customers, it is imperative that the Final Report contain a clear suite of recommendations and principles from the QCA to Government to guide the Government's ongoing analysis and tariff development. This should include a clear recommendation regarding the adoption of an N+R framework and the establishment of an implementation program for the introduction of a new pricing mechanism from the commencement of the 2011-2012 tariff year if this is unable to be completed for implementation in July 2010.

Please find our detailed response attached. Should you require further information or wish to discuss this matter, please contact James Shaw, State Operations Manager on (07) 3852 8303.

Yours sincerely,



Bruce Rowley
General Manager, Retail

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Executive Summary

Integral Energy (Integral) welcomes the opportunity provided by the Queensland Competition Authority (QCA) to offer comments on the QCA's *Draft Report – Review of Electricity Pricing and Tariff Structures* (Draft Report) and supporting consultant's report.

Integral is the holder of a non-area Retail Authority in Queensland and, whilst a relatively new entrant to the Queensland market, has provided energy services to Australian families and businesses for more than 50 years, including approximately 850,000 market and non-market customers in Queensland and 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.

Integral supports the Queensland Government's investigation into the current status of retail tariff regulation in Queensland, and supports the nature and content of the Minister's Direction provided to the QCA to carry out a review of electricity retail pricing structures and methodologies (Review). Integral has previously provided submissions to the QCA in response to the Stage 1 Review and the Stage 2 Request for Comments Paper.

Integral's objectives are to:

- See retail tariffs set at cost reflective levels in Queensland;
- Operate under a transparent pricing mechanism that allows retailers operational flexibility to set their own retail tariffs in the context of effective competition;
- Operate under a regulatory regime which encourages retailers to be efficient in regard to the costs that are under their direct control. Network costs (DUOS and TUOS) and externally imposed environmental costs are not within the control of retailers and retailers should not be expected to manage these costs; and
- Move to a less regulated environment, under a transitional approach, to foster greater competition.

Further to this, Integral fully supports the QCA's findings that:

- Tariffs should reflect costs, through both cost recovery and cost reflectivity;
- Fixed charges for networks should be able to be passed through to retail prices; and
- Obsolete tariffs should be removed and tariffs reflecting similar consumption patterns and / or underlying costs should be combined.

The public support of these principles by the QCA represents a significant 'step forward' in the development of sustainable retail pricing arrangements in Queensland.

It remains the case however that the Draft Report for Stage 2 and the Final Report for Stage 1, have not significantly advanced the practical development of new retail tariff and pricing arrangements for Queensland. The removal of obsolete tariffs and the goal that tariffs should be cost reflective, are not of themselves likely to drive significant change, and it appears that there is now the need for Government to take responsibility for taking the QCA's high level recommendations to reflect them into new tariff arrangements. The Reports do not contain the in-depth analysis necessary to achieve the changes envisaged by the Government's Direction to the QCA.

Integral is particularly concerned that the Stage 2 Draft Report appears to take a 'step back' from the QCA's earlier stance on retail pricing mechanisms. While the adoption of an N+R framework was strongly favoured by the QCA in earlier stages of the Review, rather than making a firm recommendation regarding its adoption in the Draft Report, this (along with many of the other issues requiring analysis of a structural nature) has been referred back to Government.

It therefore appears unavoidable that a new process will need to be scoped, resourced and then implemented by Government – jeopardising the significant momentum for reform that was intended to result from Stage 1 and Stage 2. This process is likely to result in further delays for the development and implementation of a new pricing mechanism. Further, there is a risk that once the detailed analysis on many of these issues has been undertaken, Government may come to different findings than the QCA and therefore that the Stage 1 and Stage 2 findings will be lost or become irrelevant. Integral believes that the QCA should take the lead on these changes.

Retailer risk is compounded by the fact that, until the Government completes its examination of referred issues, the Queensland market is forced to operate under the flawed Benchmark Retail Cost Index (BRCI) methodology with no certainty as to either the pricing mechanism that will ultimately apply or the level of cost recovery / cost reflectivity that will exist. Headroom will continue to be eroded under the BRCI and the development of a competitive market in Queensland will continue to be impeded as a result.

It is imperative therefore that the Final Report contain a clear suite of recommendations and principles from the QCA to Government to guide the Government's ongoing analysis and tariff development. This must include a recommendation to adopt a N+R framework and to set out clearly whether this and other changes will operate for the commencement of the 2010-2011 tariff year. The QCA must look beyond the delivery of its Final Report to Government to ensure that the next stage of work, even if completed by Government, takes advantage of the significant work that has been done to date.

1 Outcomes and Approach

1.1 Draft Report Outcomes

While the Draft Report contains a range of observations regarding the current tariffs being offered in Queensland, preferred application of principles to existing and new retail tariffs in Queensland, and summaries of views provided by stakeholders, the Draft Report lacks clear recommendations to Government in relation to retail tariffs.

Integral wishes to confirm its understanding from the Draft Report that:

- With respect to the existing tariff schedule, the QCA is proposing that:
 - Tariffs 31 and 33 should be amended to remove minimum monthly charges, to include fixed and variable charges that reflect 'cost';
 - Tariff 21 should be removed and all customers on Tariff 21 should be transferred to Tariff 20;
 - Tariff 62, Tariff 64, Tariff 65 and Tariff 66 should be consolidated into a new single Time of Use (TOU) tariff, and that customers on those tariffs should be transferred either to T20 or to a new single purpose farming tariff; and
 - Tariff 37, Tariff 63 and Tariff 64 should cease and that customers on these tariffs should be transferred to Tariff 22.

Integral's comments on these recommendations are discussed in Section 2 of this submission.

- With respect to a new tariff schedule, the QCA is proposing that:
 - All regulated tariffs should include fixed and variable components that reflect the structure of the costs faced by retailers; and
 - The fixed charges of all tariffs should be reviewed to ensure that they are aligned with network fixed charges.

Integral's comments on these recommendations are discussed in section 3 of this submission.

- There are a range of structural market and transitional issues which the QCA has considered, but upon which it has not reached a clear position. In particular:
 - Whether large customer access to notified prices should be removed, given the need for further consideration of the impact for those customers located outside the ENERGEX distribution area (discussed in section 2.2 of this submission);
 - Whether and how a new 'opt-in' time of use tariff should be introduced for residential customers, given the issue that would need to be considered (e.g. the role of seasonality and defining the number of time dependent pricing bands) (discussed in section 3.1 of this submission);

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- Whether an N+R framework should be adopted, given the potential for inconsistencies between retail tariffs and network tariffs (discussed in section 3.1 of this submission); and
 - When revised tariffs, tariff structures and pricing mechanisms might come into effect, given the additional analysis that has yet to occur. For example, it is difficult to determine which of the actions outlined above are intended to be pursued as part of changes to existing tariff structures (e.g. as part of a transition) and which are to be pursued under a new pricing methodology (discussed in Section 4.1 of this submission).

1.2 Draft Report Approach

The Draft Report could provide greater clarity for recommendations.. The status of the QCA's conclusions from Stage 1 of the Review and the Draft Report should therefore be confirmed in the Final Report, through:

- The development of a concise set of recommendations addressing:
 - Proposed changes to the existing tariff schedule;
 - The pricing methodology and structural changes proposed to apply to a new suite of tariffs; and
 - The transitional arrangements that should apply in moving from existing tariff arrangements to modified tariff arrangements (e.g. moving from the 2009-10 to 2010-11 tariff years) and from the existing pricing methodology to a new pricing methodology (e.g. from the BRCI to a N+R framework).
- The development of a concise set of principles to guide the process of recommendation implementation. The QCA should identify a series of tariff 'objectives' to guide the process of Government implementation, for example:
 - Tariffs should reflect costs;
 - Fixed charges for networks should be able to be passed through to retail prices;
 - Obsolete tariffs should be removed and customers transferred; and
 - Ergon Energy's distribution area should be opened up to competition over time.

This will ensure that the QCA's criteria for assessing structural reforms are not 'lost' through the process of implementation and that any subsequent analysis by Government is conducted on a basis that is consistent with that undertaken by the QCA.

It is noted that the principles for the short-term amendment of existing tariffs (e.g. as part of any transitional arrangement) may be different from those required to achieve the preferred medium-term 'end state' for pricing.

The Final Report should also confirm that, while the QCA is making high level recommendations to Government, it does not propose to work through the detail of how these recommendations would be brought into effect. Integral believes that the QCA should work with the Government for this current review and then continue to take the lead on future changes.

1.3 Recommendations – Outcomes and Approach

Integral believes that, with respect to the outcomes and approach, the Final Report should contain:

- A concise set of recommendations addressing, changes to the existing tariff schedule, structural changes in the form of new tariffs, the new pricing methodology, transitional arrangements, and additional analysis required by Government;
- A concise set of principles to guide the process of recommendation implementation by Government; and
- Confirmation that while the QCA is making high level recommendations to Government, it does not propose to work through the detail of how these recommendations would be brought into effect.

2 Improving Existing Tariff Structures

2.1 Changes to Existing Tariff Structures

Integral supports the QCA's finding that existing tariff structures could be improved by removing obsolete tariffs and combining or aggregating tariffs where the customers currently on those tariffs have similar consumption patterns and / or underlying costs.

It is understood that the Draft Report supports the following changes to the existing tariff schedule:

- Tariffs 31 and 33 should be amended to remove minimum monthly charges, to include fixed and variable charges that reflect 'cost';
- Tariff 21 should be removed and all customers on Tariff 21 should be transferred to Tariff 20;
- Tariff 62, Tariff 64, Tariff 65 and Tariff 66 should be consolidated into a new single TOU tariff, and that customers on those tariffs should be transferred either to T20 or to a new single purpose farming tariff; and
- Tariff 37, Tariff 63 and Tariff 64 should cease and that customers on these tariffs should be transferred to Tariff 22.

Integral supports these changes and believes that they should be progressed as a matter of priority, for implementation at the commencement of the 2010-11 tariff year, noting that a minimum period of three to four months would be required by retailers from finalisation of the reforms (including customer notification requirements) to support system changes, testing and customer communications.

Any proposed changes to the existing tariff schedule must be accompanied by a recommendation that the customer impacts of structural changes (e.g. for low consumption and vulnerable customers), should be addressed through explicit Government support. That is, customer impacts should not be addressed through the pricing regime, nor should retailers be left to manage any increased incidence of financial stress through their payment management or hardship programs.

Since the commencement of FRC, Integral has also worked closely with DEEDI and its predecessor Departments in the implementation of a range of Government rebates and concessions including the Home Energy Emergency Assistance Scheme and the Queensland Government Solar Bonus Scheme. No administration fee is currently payable for a number of these schemes.

While Integral accepts that the level of reimbursement for the administration of concessional and community schemes is a matter for Government to determine, it remains the case that cost recovery and cost reflectivity necessitate that the pricing methodology must reflect the costs associated with operation as a retailer in Queensland. New or expanded Government requirements to provide certain services are not optional as they are imposed on retailers via licence and legislation and directly contribute to retailers' cost to serve. Any ongoing failure to explicitly recompense retailers for these costs will further erode headroom and undermine the principles of cost recovery and cost reflectivity in tariffs.

For this reason alone, it is appropriate and necessary for the QCA to make a recommendation supporting the management of customer impacts through explicit Government support.

2.2 Access to Notified Prices

Integral supports the removal of regulated price protections for all 'large' customers (i.e. those consuming >100MWh per annum) and notes comment by the QCA in the Draft Report that¹:

As the Authority noted in its Stage 1 report, the continued availability of regulated tariffs designed for large (business) customers in the post-FRC environment is difficult to justify... Similarly, most customers who operate public lamps and traffic signals should be well able to manage in the competitive market without requiring the existence of notified price safety net.

While the removal of access to notified prices for large customers appears to be supported in principle by the QCA, the Draft Report does not contain a firm recommendation to Government regarding the removal of price protection or progress discussion in the Stage 1 Report, as to:

- The customers to whom this would apply (e.g. all large or large non-residential only);
- The scope of application (e.g. existing customers or new customers only); and
- The date from which price protections should be removed (including transitional arrangements as appropriate).

The QCA appears to view itself as constrained in making a recommendation on this issue by the perceived need to give further consideration to the impact for customers operating outside the ENERGEX network prior to the removal of protections within ENERGEX's network²:

¹ Draft Report, page 12.

² Draft Report, page 13

...However in both cases [large (business) customers and unmetered supplies] some further consideration would be required for those operating outside the Energex network area where competition and the availability of market contract offers may be limited even for these customers.

Integral does not believe that resolution of issues regarding the availability of competitive market offers in Ergon Energy's distribution area should delay the removal of access to notified prices for large customers ENERGEX's distribution area. Existing protections should be removed in ENERGEX's distribution area as a matter of priority – no later than 1 July 2010, supported by appropriate transitional arrangements.

A period of differing application for customers in ENERGEX and Ergon Energy's distribution areas would not be dissimilar to the transitional arrangements that the Queensland Government has put in place for streetlight loads, whereby State or local government streetlight loads in ENERGEX's distribution are classified as 'market' while equivalent loads in Ergon Energy's distribution area are classified as 'non-market', with the option of moving to a negotiated supply arrangement as a matter of choice.

It is also noted that the Government, through DEEDI, is currently pursuing a change to the *Electricity Act 1994* to impose an obligation on the Financially Responsible Retail Entity to offer a market contract to large customers at premises that have been de-energised. This would ensure that customers at premises who have moved to market can secure a future supply arrangement if they are indeed otherwise unable to secure an offer of supply from the market. That is, adequate default arrangements are proposed such that large market customers will not be left without an offer of supply. This should further assist in mitigating the QCA's and Government's concerns regarding an extension of the non-reversion policy to all large customers.

2.3 Recommendations – Existing Tariffs

Integral believes that, with respect to existing tariffs, the Final Report should contain firm recommendations by the QCA to Government regarding:

- The structural changes that are proposed to existing tariffs (i.e. as outlined in the Draft Report);
- The timeframe for their implementation (i.e. commencement of the 2010-11 or 2011-12 tariff year);
- The provision of explicit Government support (as required) to manage the impacts for low consumption and vulnerable customers of tariff changes; and
- The removal of price protection (i.e. access to notified prices) for 'large' (i.e. consuming >100MWh per annum) customers in ENERGEX' distribution area.

3 Proposals for New Tariff Structures

3.1 Development of New Tariff Structures

Integral supports the QCA's findings in Stage 1 of the Review that objectives such as cost recovery, the promotion of competition, and sending appropriate price signals to customers will all be achieved if better cost reflectivity can be achieved, and further that³:

The adoption of the N+R pricing methodology recommended in Stage 1 of this review would provide an opportunity to introduce a new set of regulated retail tariffs designed to meet the objectives set out in the Direction Notice for this review and not restricted to amending the existing set of tariffs.

Integral is concerned to ensure that the Final Report firmly recommends the adoption of an N+R framework as the preferred control mechanism for achieving the objective of 'end state' cost reflectivity.

The Draft Report also leaves unresolved a number of practical and implementation issues for further analysis by Government. For example:

- How tariffs will be aligned with cost – other than this is a high level objective to be pursued;
- How fixed and variable components of tariffs will be calculated;
- How the network components of tariffs will be passed through, including how cycles of network price determinations and retail price determinations are to be reconciled;
- How network tariffs in ENERGEX and Ergon Energy's distribution areas are to be reviewed or changed;
- How the process of establishing and removing the cross-subsidies between tariffs will occur and when the final form of tariffs will be available;
- How to ensure the availability of retail options in Ergon Energy's distribution area; and
- How the BRCI or ongoing tariff review process will be conducted.

Rather than comprehensively examining these issues and providing recommendations and a clear set of guiding principles to Government for its consideration, the QCA appears to have instead referred these questions back to Government for further analysis and review. Industry may therefore face the prospect of yet further delays in the implementation of a revised pricing control mechanism and a move to cost recovery and cost reflectivity.

³ Draft Report, page 24.

Integral has concerns with this approach, given that these are the very issues that were hoped to have been resolved from the Review. As it stands, the outcomes of the Review have not yet yielded tariffs nor a process to achieve them. The outcomes are high level recommendations that were present in the Government's directive – alignment of costs with prices and removal of obsolete tariffs.

Further, while effect is given to the outcomes of the Reports and further analysis by Government, the market will be compelled to continue to operate under the existing, flawed, BRCI methodology, despite clear statements from Government that the outcome of the Review was to inform the setting of regulated retail tariffs from 2010-11. The ongoing failure of the BRCI to capture and reflect the upward pressure on network charges will create a revenue 'shortfall' for retailers and directly impact on the sustainability of market offers.

Integral considers that, wherever practicable, the QCA's preliminary findings on these issues should be clearly identified in the Final Report for consideration by Government. Where preliminary findings cannot be made, a guiding principle should be developed to support the next phase of tariff and pricing development.

While the QCA may feel constrained by the perceived need for further analysis when making recommendations with respect to the 'N' component of an N+R pricing methodology, it should not be similarly constrained in its consideration of the 'R' component, given its experience in administering the BRCI and the conclusions of the Stage 1 review. Issues upon which guidance should be provided include:

- The method of calculating retail costs and margin;
- Whether there should be a movement away from the Long Run Marginal Cost approach to a purely market based approach to estimating wholesale costs; and
- The level to which customer acquisition costs will be included in the calculation of retail costs.

Integral believes that the establishment of effective and sustainable electricity retail competition and the removal of retail price controls should be the Queensland Government's medium-term goal, as well as the end-state against which any retail pricing framework is structured.

3.2 Recommendations – New Tariffs

Integral believes therefore that, with respect new tariff arrangements, the Final Report should contain firm recommendations by the QCA to Government identifying:

- An N+R framework as the preferred control mechanism for achieving the objective of 'end state' cost reflectivity;
- The principles to guide the process of recommendation implementation by Government of an N+R framework;
- The additional analysis that the QCA believes is required to ensure the effective development and implementation of an N+R framework for commencement of the 2011-12 tariff year; and
- The framework for 'R' that should apply.

4 Timing for Introduction

4.1 Introduction and Transitional Issues

The ability of interested parties to provide detailed comments on issues of implementation are hindered by the fact that the Draft Report appears to conclude that another entire process of review and recommendation is necessary before structural changes are made to the tariffs⁴:

These measures should be accompanied by a thorough review of the notified prices applying in each remaining tariff with the objective of moving these to a fully cost reflective basis and, where possible, aligning prices with underlying network costs.

The Government's adoption of the QCA's draft recommendations and the likely outcome of the additional pieces of analysis flagged in the Draft Report for Government consideration remain significant unknowns and continue to create material risks for retailers in their ability to effectively contact and operate in the Queensland market.

While the Minister's Direction Notice states that:

The Government intends that any new retail electricity price setting arrangements and tariff structures arising from the Review... should be implemented in deciding the 2010-11 notified electricity prices...

... this is not likely to be the case. The likelihood of further analysis by Government, or by third parties such as ENERGEX, and the lack of adequate lead-time to manage the complexities of system, process and billing changes as well as customer communications, preclude significant structural changes being achieved by the 2010-11 tariff year.

As noted in Sections 2 and 3, Integral supports the introduction of changes to the existing tariffs in 2010-11 and structural changes to the tariff schedule, including the adoption of an N+R pricing methodology, in 2011-12. Integral believes that this would appropriately balance the need to move towards more cost reflective pricing with the time required to practically implement a new, better designed tariff structure and pricing methodology.

Realising these changes and the goals of cost recovery and ultimately, cost reflectivity, is however premised on:

- Government undertaking the additional analysis required to support the structural reform of tariffs and the removal of price protections for large customers.

The QCA should recommend that Government, as a first step following the Final Report, develop and publish a detailed program setting out its understanding of the QCA's recommendations, its objectives and timeframes. This would:

- Provide stakeholders will an opportunity to comment on the way in which the Government has interpreted the QCA's recommendations; and

⁴ Draft Report, page 23.

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- Assist in providing the necessary transparency and discipline to all parties (Government, QCA, retailers, distributors and end-users) to ensure that: outstanding issues are resolved in a timely manner; adequate consultation occurs; and retailers are provided with sufficient lead-times for process changes, systems changes and customer communications.

A detailed implementation program will be of particular importance where reform is reliant upon analysis that is not directly within the control of Government, e.g. the proposed review by ENERGEX of its network tariff range, to determine whether its existing network tariffs should be modified to better reflect network priorities⁵; and

- Government directly addressing the ongoing impact of the BRCI on the development of a competitive retail market in Queensland. Until the Government completes its analysis of issues referred by the QCA, retailers will be forced to continue to operate under the existing BRCI methodology with no certainty as to either the pricing mechanism that will ultimately apply or the level of cost recovery / cost reflectivity that will exist. Headroom will continue to be eroded and the development of a competitive market in Queensland will continue to be impeded.

It is incumbent upon the QCA, as the party charged with administering the BRCI and with responsibility for its review, to provide firm recommendations regarding the future adoption of an N+R framework and to propose mechanisms by which cost recovery and cost reflectivity can be improved under the BRCI for the 2010-11 tariff year.

Integral also believes that the QCA would need to consider allowing retailers a limited moratorium on the payment of GSLs under the Retail Billing Code, in circumstances where insufficient lead-times were provided for system changes, testing and customer communications, i.e. between finalisation by Government of the required changes and effective implementation by retailers.

4.2 Recommendations – Introduction

Integral believes therefore that, with respect to the timing for introduction, the Final Report should contain firm recommendations by the QCA to Government regarding:

- Changes to existing tariffs should be implemented for the e 2010-11 tariff year;
- New tariffs (e.g. time of use) should be developed and implemented for the commencement of the 2011-12 tariff year;
- A new pricing methodology, in the form of an N+R framework, should be developed and implemented for the commencement of the 2011-12 tariff year;
- The introduction of structural reforms (tariff and pricing) for the 2011-12 tariff year must be supported by a transparent process of consultation with impacted parties and adequate lead-times to enable retailers and distributors to implement reforms;
- The development and publication by Government a detailed program setting out its understanding of the QCA's recommendations, its objectives and timeframes; and
- Mechanisms to ensure the restoration and maintenance of headroom under the BRCI for the 2010-11 tariff year.

⁵ Draft Report, page 27.