12th February 2010

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

Dear Mr Henry

Draft Decision - Benchmark Retail Cost Index for Electricity: 2010-11

Integral Energy (Integral) welcomes the opportunity to provide comment in relation to the Queensland Competition Authority's (QCA's) Draft Decision for the Benchmark Retail Cost Index (BRCI) for Electricity: 2010-11 which was released in December 2009.

In the absence of any major restructuring of the current methodology utilised to determine Notified Prices in Queensland as discussed in the recent review on Queensland Pricing and Tariff Structures, Integral Energy generally supports this Draft Decision released by the QCA. Longer term, Integral supports a restructure of tariffs including an N+R approach to reduce the erosion of retail margin.

Integral sees 13.83% as a minimum increase and we raise three points for consideration to support this position: the allowances in relation to the cost of energy; the retail margin; and the costs of customer acquisition.

<u>Cost of energy</u>

The QCA proposes to allow retailers to recover an energy purchase cost of $59.95/MWh for 2010-11. This is based on the QCA's estimate of an equal weighting of a Long Run Marginal Cost (LRMC) of $58.13/MWh and energy purchase cost of $61.80/MWh.

Integral notes that IPART, in its recent draft decision to set the regulated retail margin for the three standard retailers in NSW (EnergyAustralia, Integral and Country Energy), proposed to base the cost of energy for 2010-11 on an LRMC of $69.40/MWh[1]. This is significantly above the QCA's proposed allowance. Both, however, utilise the input costs

1 IPART, *Review of regulated retail tariffs and charges for electricity 2010-2013: Electricity — Draft Report and Draft Determination* (December 2009), p 80.

MCM-0709-4D2047-LTR-QLD-E

INTEGRAL ENERGY ABN 59 253 130 878
Locked Bag 2 Milton Business Centre, Milton QLD 4064
www.integral.com.au

contained in ACIL Tasman's April 2009 report to the Inter-Regional Planning Committee[2] and are based on broadly similar methodologies[3].

Retail margin

Integral submits that the 5% retail margin proposed by the QCA is conservative and that consideration should be given to the methodology proposed by IPART in its draft decision in setting retail margin. IPART's methodology was based on taking an average of the three approaches used by SFG, IPART's consultant[4].

However, Integral has also submitted to IPART that the 5.4% retail margin proposed is too low. This is because the IPART margin fails to adequately allow for the depreciation associated with the assets needed to run an efficient retail electricity business of the size and type the subject of the review.

IPART's 5.4% margin is drawn from an EBITDA range of 4.8 to 6.1% provided by SFG. This itself is based on an EBIT range of 4.0 to 5.1%[5]. The implicit depreciation allowance therefore lies between 0.8 and 1.0%. This range is lower than Integral's estimate of its own long term, sustainable depreciation trend.

SFG used three methods to generate the retail margin range: an expected returns analysis, benchmarking with comparable retailers and a bottom-up analysis. In the first and last case, it is clear in SFG's report to IPART that the consultant has used a depreciation allowance between 0.8 and 1.0%[6].

However, in relation to the benchmarking method, Integral notes that SFG states that the businesses that form the most appropriate comparison with the Standard Retailers are that broader class of retailers that have an average depreciation of 2.2% of revenues[7]. SFG then goes on to state on the next page of its report that the observed profit margins of Australian retail energy businesses "are not materially different from the observed profit margins of the broader class of retailers"[8]. This suggests that, unless there is evidence to conclude that the Australian businesses have a materially different cost structure to those of the broader class, the local retailers also have an average depreciation of 2.2% of revenues.

---

2 See Frontier Economics, *Energy Purchase Costs — a Draft Report Prepared for IPART* (December 2009), p 8.

3 See, for example, p 10 of the QCA's draft decision.

4 IPART, p 110.

5 SFG Consulting, *Estimation of the regulated profit margin for electricity retailers in New South Wales* (30 November 2009), p 2.

6 See, respectively, Tables 3 (p 13) and 12 (p 33) of the SFG report.

7 SFG, p 25.

8 SFG, p 26.

Given this information, Integral submits that the QCA should consider IPART's approach along with a more realistic depreciation treatment and then raise that margin to a range of 5.5% - 6.5%. This is, based on applying the appropriate depreciation allowance of 2.2% to all three SFG methods, noting this gives at least an impact of 0.5% over the IPART proposed retail margin.

Customer acquisition costs

Integral Energy agrees with the QCA in relation to the difficulties in forecasting the total numbers of customers switching and transferring between retailers.

Integral notes that high and volatile wholesale prices and low retail margins, may in fact have limited competition in the first two years of Queensland FRC and that the recently softer wholesale prices and QCA's recognition of the previous low retail margin which was reflected in last year's increase, may lead to an increase in competition in the next 12-18 months.

In addition, many of the customers who signed up on Negotiated Retail Contracts at the commencement of FRC will be rolling off those two and three year contracts during the 2010-11 period and may choose to shop around. As such, this activity will, in Integral's view, increase the potential number of customer switches to levels equal to or even greater than the activity at the commencement of the market.

Taking this into consideration, Integral believes that the estimated 22.7% (some 461,000 of total customers) churn rate used by the QCA should be reviewed

In summary, Integral generally supports the proposed 13.83% increase as a minimum level for 2010-2011 but would welcome the QCA's consideration of the above points

Should you require further information or wish to discuss this matter, please contact James Shaw, State Operations Manager Queensland on (07) 3852 8303.

Yours sincerely

[redacted]

Bruce Rowley
General Manager Retail