



**17 February 2012**

Electricity Industry Panel - Secretariat  
GPO Box 123  
Hobart TAS 7001

Dear Secretariat,

## **An Independent Assessment of the Tasmanian Electricity Supply Industry**

AGL Energy welcomes the opportunity to provide a submission on the Electricity Supply Industry Expert Panel Independent Assessment of the Tasmanian Electricity Supply Industry Report. As the leading investor in renewable energy and one of the largest energy retailers in Australia, AGL Energy (AGL) is well placed to comment on the Report. AGL operates across the supply chain and has investments in coal-fired, gas-fired, renewable and embedded electricity generation. AGL is Australia's largest private owner, operator and developer of renewable generation in Australia. AGL is also a significant retailer of energy with over 3 million electricity and gas customers.

### **Overarching Comments**

AGL agrees with the statement on page 5 of the Summary Report: "The key to improving choice and creating competitive pressures for Tasmanian customers is improving the wholesale electricity market in Tasmania. The current market structure creates the potential for, and market perceptions of, high levels of risk, and a lack of choice in risk management options."

The wholesale market in its current form does disincentivise participants from entering the Tasmanian market. However, there are other key issues preventing the entry of non-incumbent participants relating to: ongoing regulation of retail electricity tariffs; and the lack of regulatory consistency with other jurisdictions. This submission is therefore divided into three sections: wholesale market reforms; retail price regulation; and the need to create a uniform national regulatory framework for non-price energy regulation.

### **Wholesale Market Reform**

AGL notes that the Panel has found that: "Under the current structure of the wholesale market, Hydro Tasmania has the ability to profitably influence the Tasmanian spot price in a far wider range of scenarios than generators elsewhere in the National Electricity Market (NEM)." The panel also noted that this ability has not been regularly exercised. This may be due to the political risk of doing so, with economic incentives being blunted by the fact a single government is the owner of both energy production (Hydro Tasmania) and energy retail (Aurora). However, if the retail component of the supply chain was no longer owned by government (e.g. through selling parcels of retail customers), the conditions which otherwise seem to constrain profit-seeking behaviour would be removed, thus raising the potential for the exercise of any latent market power that might exist.

As such, it is logical to conclude that in the absence of structural reform, there is relatively little incentive for retailers to enter the Tasmanian market to compete for customers that are currently contestable (more than 50 MWh per year) or for retailers to consider entering the market should currently non-contestable customers (less than 50 MWh per year)

become contestable. This is an important conclusion of the Panel which AGL agrees with. While there has been mild activity in the contestable market, the notion that such activity might continue under a Full Retail Contestability scenario should be treated with caution by the panel in the absence of structural reform. Retail products offered to large contestable customers in small markets can be matched with suitable wholesale hedge contracts, albeit with considerable transaction costs involved. However, with a larger base of small (e.g. residential) customers, this is considerably more difficult to achieve because they tend to be stickier. As a result, when an entrant retailer needs to re-contract in the wholesale market, they need a high degree of confidence that the market will behave in a reasonably predictable manner (i.e. to avoid the risks of cliff-edge recontracting). In the absence of structural reform, no such confidence could reasonably exist amongst retailers, despite recent history. A change in policy, strategy or management would always remain more than a theoretical possibility, and hence a risk to entrant retailers.

In relation to the reform options presented by the Panel, AGL has provided comments on the three options in Table 1 below:

**Table 1: Comment on Reform Options**

<b>Reform Option</b>	<b>AGL Comment</b>
An independent, regular auction of standard contracts from Hydro Tasmania to provide retailers with confidence that appropriately priced hedging contracts will be available in the Tasmanian market on an ongoing basis on reasonable terms, so that they can build a viable retail business	This option does not provide long-term certainty for retailers entering the Tasmanian market.
Creating competition in the trading of energy produced by Hydro Tasmania's generation assets by establishing three independent trading entities to compete in the wholesale market and provide choice in the supply of wholesale contracts	This option has been successfully utilised in both privatisation processes (e.g. NSW generation trading rights sale) and by private sector participants (e.g. AGL's investment in trading rights for the Oakey and Yabulu power stations in Queensland). This option provides more certainty for retailers by creating competing entities in the wholesale market.
Increasing competition for Hydro Tasmania by combining the Victorian and Tasmanian NEM regions	This option is likely to be significantly more difficult for the Tasmanian Government to implement given the need for consent to be obtained from other jurisdictions.

AGL agrees with the Panel's view that the preferred mechanism to deliver these reforms is the establishment of a number of independent competing trading entities that would trade energy produced by Hydro Tasmania. This model has been utilised by public and private sector market participants in other jurisdictions and is likely to create sufficient competition to incentivise retailers to participate in the Tasmanian market, all other things being equal.

### **Retail Price Regulation**

Ongoing retail price regulation in all jurisdictions except Victoria remains a key risk for retailers operating in the NEM. AGL believes governments should adhere to obligations entered into with the signing of the *Australian Energy Market Agreement*: namely that prices should be deregulated where the Australian Energy Market Commission (AEMC) has found competition to be effective. AGL would encourage the Tasmanian Government to move to full retail contestability for all customers with a longer term goal of deregulating prices once competition is effective.

In relation to the Panel's commentary on the existing form of price regulation, AGL agrees with the principle of using "the higher of long-run marginal cost or market prices". AGL believes that the Panel should also consider the following principles:

- Regulators should be moving toward light-handed forms of regulation in light of intergovernmental agreements to promote retail competition, since price regulation is considered a very material market risk.
- The risks of determining retail costs are asymmetrical. If costs are set too low, retail competition is likely to be stifled and second tier retailers will be disincentivised from entering the Tasmanian market.
- In assessing appropriate retail pricing, regulators should estimate costs for a new entrant retailer servicing a small customer load as opposed to incumbents with a blend of customers.

With specific regards to the methodology for determining LRMC used in Tasmania:

- In the past, the Tasmanian Economic Regulator (TER) has calculated LRMC using the total system load with the marginal system price applied to non-contestable load. AGL believes that modelling LRMC should be based upon non-contestable (mass market or NSLP) load on a greenfield basis. This provides long term stability for default pricing and is a relevant benchmark in relation to wholesale energy costs (WEC) for a new entrant retailer with a small customer load.
- The proposed 'incremental' LRMC has the potential to change over time depending upon hydrological assumptions. Retailers need certainty to develop competitive products and setting the WEC using an LRMC approach that could change materially within the regulatory period would undermine retailer confidence.

Above all, under full retail contestability, the purpose of any regulated tariff should be to ensure a suitable safety net tariff or 'price-to-beat' exists, and allow the market to distribute the benefits, rather than attempting to distribute the benefits of competition through regulatory force. Once the market is sufficiently competitive, the need for price regulation should be reviewed in line with AEMC processes.

### **National Regulatory Consistency (Non-Price Energy Regulation)**

AGL notes the Panel's conclusion in relation to the packaging and sale of Aurora Energy's retail business to private investors. AGL agrees that such an approach would enable the risks inherent in energy retailing to be transferred from the taxpayer to the private sector, freeing up valuable capital for the Tasmanian Government to spend on public services such as schools and hospitals.

However, there is a critical hurdle related to non-price energy regulation which would need to be overcome for participation in organic market development or a privatisation process. Due to the relatively small number of customers within the Tasmanian market, any specific rules or regulations imposed upon retailers operating in Tasmania are likely to present a significant barrier to participation. Transaction costs and costs of regulatory compliance (e.g. specific State-based regulatory requirements on retailers) incurred in Tasmania would be spread across a much smaller number of customers than in other states, lifting the individual customer cost to serve relative to other States.

AGL therefore cautions that without proper consideration of the need to ensure national regulatory consistency (for non-price energy regulation), a sale of customers to private sector participants may not capture the value inherent in the customer base. While various retailers can be expected to be attracted by the immediate access to a tranche of customers and compete to retain them (rather than a drawn-out process of acquiring them over time from a dominant incumbent), such a statement is dependent upon Tasmania adopting a non-price regulatory framework that is consistent with other States and minimises Tasmanian specific rules and regulations, because the customer parcels will be inherently small by NEM standards.

### **Concluding Remarks**

Assuming the reform options identified are implemented (including the supplementary suggestions in this submission), NEM retailers are likely to emerge as participants in the Tasmanian industry, although given the small size of the Tasmanian market, relying on an organic customer acquisition approach would clearly run the risk of low activity. Given the primary roles of State Government are the provision of services such as hospitals and

schools, AGL believes that the Tasmanian Government could realise significant improvements in services by redirecting capital away from inherently risky retailing of energy to the provision of other services such as education and health.

Should you have any questions in relation to this submission, please contact me at [tanelson@agl.com.au](mailto:tanelson@agl.com.au) or on (02) 9921 2516.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Tim Nelson', written in a cursive style.

Tim Nelson  
Head of Economic Policy and Sustainability