Tasmanian Electricity Supply Industry Reform

Executive Summary

The aim of this submission is to promote the establishment of a truly competitive and open retail electricity market for all Tasmanians.

A competitive retail market will:

- Provide retailer choice for all customers;
- Promote pricing at a commercially competitive rate;
- Allow for a more accurate split between the fixed and variable component of a given account;
- Demand a review of the unfair developer charges now facing our members.

I am in agreement with the Panel that the only way in which to promote the creation of a competitive retail market is the reform of the wholesale electricity market in the state.

Introduction

The reform of the Tasmanian Electricity Supply Industry (TESI) and alignment with the national electricity market commenced following the release of *Directions Statement – Tasmania's Future Energy Strategy* in early 1997.

The key drivers of the reform were to secure new sources of generation in order to overcome future energy generation constraints, mitigate the hydrological risk, secure new sources of generation to meet future energy demands and introduce greater competition and choice into the Tasmanian electricity retail market.

The success of the reforms to date has been mixed. The acquisition of the Tamar Valley Power Station and opening of Basslink have secured additional supply capacity and insured against hydrological risk however, a competitive and open retail market has not been fully established for all customers. The latter is the result of the lack of a truly organic and competitive wholesale generation market in Tasmania.

The draft report prepared by the Electricity Supply Industry Expert Panel provides insight into the major challenges facing the TESI however there are other opportunities available for the establishment of a truly low cost and efficient electricity retail market for all Tasmanians.

The following discussion aims to address my key concerns of the current TESI. Some of these issues have been explored in the Panel's draft paper however I have also identified a number of issues yet to be sufficiently addressed.

RETAIL MARKET

The draft report explores the rationale behind the apparent lack of competition in the Tasmanian retail market and the hurdles that stand in the way of the establishment of retailer choice for all customers. Currently only large customers are provided with a choice of preferred retailer and the opportunity to negotiate a better rate per kilowatt hour (kW/h).

By way of comparison, I conducted a review of the cost of electricity for Victorian and Tasmanian private retail customers. The results are depicted graphically below:

It is evident that the lack of a competitive retail market, such as that afforded to Victorian customers is having a marked influence on the relative pricing of electricity for Tasmanian consumers. During the drafting of this submission it was found that Tasmanian consumers were paying an average of 40% more than their Victorian counterparts.

It is also worth noting that the price of electricity for non contestable customers has more than doubled since 2000 with a further increase of 45% forecast in the next 5 years.

Tasmanians require and demand and truly low cost, competitive electricity retailer. The only way to achieve this is to create an environment in which retailers are required to be commercially competitive and accountable.

BARRIERS TO ENTRY

The current Tasmanian Energy Supply Industry (TESI) model allows for only one principal generator of electricity in the state – Hydro. A sole generator and sole participant on the Tasmanian electricity spot market provides little incentive for prospective retailers to enter the Tasmanian retail market. Without a truly competitive retail electricity market, the cost to the end consumer cannot and will not reflect the cost of production. A competitive market is the critical element required for the provision of a truly low cost provider to all customers.

I concur with the Panel's opinion that Hydro exhibits latent market power which, whether exercised or not, has the potential to influence the spot price of electricity and consequently the decision of potential retailers seeking to enter the retail supply market.

This perceived power and the Hydro's apparent ability to influence spot prices, whether directly or indirectly, is evident in review of the history of Tasmanian spot price. The spot price on the National Electricity Market (NEM) typically follows the economic supply and demand model – at times of peak energy load the spot price of electricity is at its highest and conversely the spot price is traditionally at its lowest during times of low demand. The Tasmanian generation market does not, by its own admission, follow this model with unexplainable spikes in the spot price prevalent in the spot price history. Research indicates that there were 27 of these off peak low load spikes in the Tasmanian market during the 6 years to 2011. In isolation this figure may not seem material however when compared to the next highest occurrence in the NEM of 7, it becomes clear that Hydro's trading behaviour is not consistent with generators operating in a competitive NEM jurisdictions.

The significance of this latent power and the effective monopoly over the State's power generation is clearly a barrier to entry upon review of discussions with potential retailers considering entering the Tasmanian market. The panel found that until retailers have the ability to hedge their spot price risk through a choice of generator contrac.0ts, the Tasmanian market's risk is too great to attract these potential retailers. The frequent spot price movements will erode any profit achieved by a new retailer who aims to spread their risk through exposure to a number of supply contracts. It is worth noting that given access to the non-contestable customers, potential retailers feel that the Tasmanian market represents a real opportunity to establish a competitive, rewarding retail market.

In order to reconcile the issues facing the TESI an outcome-based approach must be adopted. The 'result' of the issue is the lack of a truly thriving and competitive retail market with Tasmanians generally paying more for power than their mainland counterparts however the 'cause' of this lack of market diversity begins with the latent power and monopolistic generation market. Until a choice of generators is introduced into the Tasmanian market there is little incentive for potential retailers to enter the market.

WHOLESALE MARKET

I concur with the Panel's concerns over the current Tasmanian wholesale market. Hydro, as the only significant participant in the Tasmanian spot market, has significant scope to influence the spot price of electricity through its trading activities. The long-range average spot price is one of the key factors considered by the regulator in setting the current prices charged to consumers.

The Panel's report explores three options for consideration:

- <u>Reform Path 1 – Auction of Contracts</u>

  This reform option would see the regular auction of generation contracts to the market. The premise being that if Hydro are largely contracted at a certain price point, they have very little to gain from strategic trading in the spot market.

  It is thought that these regular auctions would encourage more retailers to enter the Tasmanian market on the basis that they will be better placed to hedge their market risk. It is also thought that such a move would erode Hydro's market power and force them to engage in commercially competitive negotiations with retail market participants.

  There appears to be far too many variables and considerations to overcome in order for path 1 to be a workable solution.

  These include:

  - Frequency of auctions;
  - The manner in which a reserve price is derived;
  - The volume of the contracts;
  - The necessity for an independent body to organise, oversee and police the auctions and participants.

  It is my conclusion that this reform path structure would fail to achieve the intended outcomes of the market reform.

- <u>Reform Path 2 – Creation of Competition in the trading of energy produced by Hydro</u>

  The concept behind this reform is the partial dissolution of the consolidated Hydro business and the creation of a number of wholesale retailers who would actually sell the electricity generated by Hydro onto the wholesale market.

  Hydro would remain as the sole generator and retain their ability to manage the water stores; capacity and actual volume of electricity generated which would overcome any concerns over mismanagement of infrastructure and resources if a second or third generator were to be formed.

  The newly formed entities would then be able to contract with retailers and as the market would be a competitive environment it is anticipated that the cost a given supply contract would reflect this. The competitive wholesale market and the choice of wholesale retailer would then entice potential retailers into the market – thus overcoming a key shortcoming of the current Tasmanian market.

There are however a number of key considerations:

- § The newly formed entities must be privately owned and free from State Government directive;
- § The energy generated by Hydro is made available to the new entities at the cost price of production. A further profit layer in the TESI would erode any potential savings to the customer;
- § An independent watchdog be implemented to ensure a fair and equitable trading environment;
- § Cost containment and efficiency be key considerations during the reform.

After consideration, this reform path is the most likely to succeed. Furthermore it is my preference that three entities be formed as the intermediary wholesale market participants. It is felt that this number is reflective of the market size and will likely produce savings through economies of scale for market participants.

A cautionary note is attached to this endorsement – in order to achieve a truly commercially competitive and viable market solution, the trading entities must be a private enterprise free of State Government ownership and control. The entities must have the freedom to trade within the normal constraints of a business operating in an open market.

– <u>Reform Path 3 – Creating Competition by Combining the Victorian and Tasmanian Regions</u>

Of the three reform proposals, this option is be far the most dramatic. The proposal would see the Tasmanian NEM region absorbed into the Victorian market – the Tasmanian and Victorian spot price would be merged.

This would remove Hydro's market dominance as they would be forced to compete with the Victorian based generators and their pricing behaviour would need to reflect this competitive environment. This option would create the most organic competitive environment.

There are a number of serious concerns arising from this option:

- § Hydro will struggle to be commercially competitive during low load periods and may simply withhold supply during these times;
- § There is the potential for situations to arise where the supply and market demand to severely mismatch causing wild fluctuations in spot pricing;
- § Hydro's management of water stores would be compromised by their inability to accurately model supply demands;
- § The inflow/outflow of electricity may exceed the capacity of Basslink in extraordinary trading circumstances;

- § The generators do incur a transmission loss for energy transferred across Basslink. Currently the generator effectively funds these losses. A higher volume of energy being transferred translates to high transmission loss factors, which will be inevitably factored into future spot prices.

Whilst this option would most likely result in the greatest cost savings to the customer, the potential for serious implications for the matching of generation and market demand requirements. This solution may also impose a substantial load on the Basslink infrastructure, which in turn may cause reliability issues – negating the key justification for its existence.

TWO PART PRICING

The current two part pricing structure adopted for the calculation of a customer's account provides very little scope for a given customer to control their electricity expenditure. As with the proposed water and sewerage pricing model, it is difficult to accept that the breakdown of fixed and variable cost truly reflects the actual cost of production and distribution.

Furthermore, there is little incentive for customers to invest in green energy solutions such as solar generation when reduction in usage does not correspond to significant saving on their electricity accounts.

Media and anecdotal reports indicate that while consumer consumption is decreasing, their net cost is actually increasing. This infers that a fundamental and fatal flaw exists in the current two part-pricing model. Again, in a truly competitive and open retail market, a retailer would be forced to price according to the true cost of production in order to remain commercially competitive. It is expected that such competition would place downward pressure on pricing behaviour.

Failure to address this fundamental underpinning of the TESI will lead to similar consternation and controversy as experienced during the water and sewerage reforms. The adoption of any of the market reform paths provides the industry with a unique opportunity to assess the key considerations and failings in the current pricing structure. Failure to capitalise on this opportunity will be a seen as a significant missed opportunity to engage in holistic market reform.

DEVELOPER CHARGES

A developer was traditionally eligible for a subsidy for new connections however Aurora has now rolled back this subsidy. New developments may now incur 100% of the cost of a new installation. This cost, in conjunction with the skyrocketing cost of new water and sewerage connections will place significant financial pressure on the developer of any new dwelling, building or subdivision. The most likely outcome will be that these projects are simply no longer economically viable, stifling further investment and growth in the state's economy.

Development is a cornerstone of property industry and indeed the State's economy. Artificial barriers such as profiteering on developer charges serve no purpose other than to drive investment, employment and funds out of the State and must be reviewed to ensure they represent a fair and justifiable cost.

NATURAL GAS ROLLOUT

Whilst it is noted that the investment in natural gas infrastructure is strictly beyond the scope of the Panel's report, I feel that it should be considered in any discussions relating the to future generation and supply of energy sources for the State.

During the preparation of this submission, it was extremely difficult to compare the cost of energy between the Tasmanian market and the remainder of the NEM. This difficulty is caused to the lack of a readily available gas supply network to the majority of consumers. This source of alternative energy provides mainland consumers with a cheaper option for their heating, hot water and cooking requirements and whilst it was noted that the average cost per kW/H for a private consumer on the mainland was approximately 40% less than the equivalent Tasmanian customer, the net savings may be even more than this when the use and cost of natural gas is factored into this equation.

The initial gas rollout has not reached the majority of Tasmanian population. It should be a key consideration. A common theme amongst justification for price rises is the requirement to fund futures upgrades and expansion of electricity infrastructure. Conversely, a common justification for the limited gas rollout is the cost of creating the infrastructure to support it. It can be inferred that discretionary spending on the roll out on the gas infrastructure would negate the need for power grid expansion. The increased availability and use of natural gas throughout the state would correspond to a decrease in the demand on the electricity supply network. Furthermore, customers would have the option of using the cheaper alternative energy to meet much of their energy demand requirements.

RECOMMENDATIONS

With consideration of the Panel's findings, I recommend the following actions:

1. The model recommended by the independent review panel be implemented and three independent retailers created to trade in the wholesale electricity supply market. The following provisions should be noted:
    - The wholesale participants be privately owned commercial entities free from State Government ownership;
    - The electricity generated by Hydro is made available to the entities at a price reflective of the cost of production. A profit margin on the generation would erode any savings made by the end user in a competitive, open market;
    - Cost containment and equality be the key consideration during the reform.
    - An industry watchdog be introduced to oversee market activity and prevent anti-competitive market behaviour.

2. The two part-pricing model by restructured to ensure the cost to a given customer is reflective of the actual cost of generation, transmission and use.

This is critical to ensure customers have the sufficient ability to control their cost through a change in consumption.

3. Developer charges be reviewed and adjusted to ensure the fees are reasonable and not imposing unnecessary obstacles for property investors and developers in the state.

4. Further investment is made in the rollout of natural gas to business and residential areas. It is suggested that the capital funds set aside for the expansion of the electricity grid be considered for re-allocated to the provision of an alternative energy source instead.