Contact: Jane Hyland
Phone No: (03) 6233 5671
File No: 1959
Our Ref: 11/2961 HCJH

office of the tasmanian economic REGULATOR

Mr John Pierce
Chairman
Electricity Supply Industry Expert Panel
GPO BOX 123
HOBART TAS 7001

Dear Mr Pierce

INDEPENDENT REVIEW OF THE TASMANIAN ELECTRICITY SECTOR: ISSUES PAPER JUNE 2011

Thank you for the opportunity to provide input into the Expert Panel's consideration of the issues facing the electricity supply industry in Tasmania. The Office of the Tasmanian Economic Regulator (OTTER) would like to comment on some specific matters raised in the Issues Paper. Please note that the comments are those of OTTER, not the Regulator, and seek to clarify certain aspects raised in the Issues Paper. They do not touch upon matters of governance and value considerations of major investments as these are matters of Government policy.

1. *The extent to which the commercial structure of Aurora Energy as an integrated retail and distribution entity is a material barrier to new entry, such as through access to information from its distribution business or its ability to absorb thinner retail margins supported by the cash generated by its distribution business.*

The Regulator recognised that information exchange and misallocation of resources between Aurora Network (Aurora Energy's distribution business) and Aurora Retail (Aurora's retail business) were significant risks in a contestable retail market.

To mitigate these risks, the Regulator issued a *Guideline for ringfencing in the Tasmanian electricity supply industry, October 2004*, which specifies that any information held by Aurora Network must not be generally accessible by Aurora's retail business segment. However, this does not preclude Aurora Network from providing information to retail businesses and customers on a non-discriminatory basis. The Regulator monitors compliance with its guideline through periodic reviews conducted by an independent third party.

Aurora Network is price regulated to ensure that it operates efficiently, does not make monopoly profits, and sets its prices at economically efficient levels with no inherent cross subsidies. Aurora Retail is also price regulated to ensure that it does not make monopoly profits on its sales to non-contestable customers. Therefore, any "thinner" retail margins on contracts with contestable customers would be reflected in lower than commercial rates of return to the business as a whole, as would any of Aurora

Energy's other business activities that may deliver less than commercial rates of return.

2. *Is there a difference in the cost to serve Tasmanian customers in relation to customers in other NEM jurisdictions?*

   The regulated cost to serve Tasmanian non-contestable customers is lower than that in other NEM jurisdictions for customers on standing offer tariffs.

   In setting the cost to serve for non-contestable customers, the Regulator looks at the cost to serve allowed by other jurisdictional regulators for standing offer tariffs. However, this does not mean that the Regulator sets a benchmark cost to serve without taking into account the specific circumstances that apply in Tasmania. In setting the cost to serve allowance for Tasmanian non-contestable customers, the Regulator reduces the benchmark allowance to remove costs borne by retailers in other states associated with the implementation of full retail contestability and costs associated with acquisition and retention of customers (principally additional marketing and promotion costs). As Aurora is a relatively small retailer, some recognition is also given to economies of scale effects in setting the cost to serve.

   However, while the Regulator considers that this is an adequate allowance to meet Aurora's cost to provide retail services to the non-contestable customer base, the Regulator recognises that Aurora's actual cost to serve may differ from the regulated cost to serve during the period.

3. *In what ways has the regulatory framework delivered retail costs that are higher than would be delivered by a fully competitive retail market in Tasmania?*

   A retailer in a fully competitive retail market in Tasmania would be faced with costs associated with the acquisition and retention of customers, including marketing and promotion costs. The retailer's retail margin would also reflect energy price risk. The *Electricity Supply Industry (Price Control) Regulations 2003* prescribe how the wholesale energy price for the regulated non-contestable customer segment is to be determined which effectively removes the energy price risk. The absence of energy price risk is reflected in the regulated net retail margin of 3.8 per cent.

   So in a fully competitive market, a new retailer would have acquisition, retention and marketing costs factored into its cost to serve, and energy price risk factored into its retail margin – factors that are excluded from Aurora's regulated retail costs and margin. If a new retailer can meet these additional imposts and be more efficient than Aurora Retail, then retail costs in a fully competitive retail market may be lower than those regulated.

   Retail cost to serve and margin aside, the retail price seen by the consumer would also depend on the wholesale energy price that a new retailer could negotiate compared to the wholesale energy allowance provided in the regulated retail tariffs.

4. *Whether it is the principle of a fixed daily charge or its level that is the major issue?*

   The Regulator regularly receives enquiries, complaints and submissions (not just during its price investigations) in relation to the fixed daily charge. Most frequently it is about its level and that it is relatively higher than other jurisdictions, rather than its existence *per se*.

   The Regulator, in both the 1999 and 2003 price determinations, capped increases in fixed daily charges, reducing the proportion of revenue received from these. In 2007, the Regulator did not impose any specific constraint on fixed charges, but requested that Aurora Energy constrain increases in these charges. Since that time Aurora Network has increased its daily fixed network charge at, or close to, CPI, although the daily meter charge has increased slightly above CPI.

Aurora Retail has, for the last three price increases, chosen to increase all charges by an equal percentage. Its arguments for doing so are set out in its 2011-12 Pricing Proposal which was submitted to the Regulator in June 2011. In summary, Aurora Retail contends that constraining the increases on the daily fixed charge would increase the amount by which consumption charges would have to increase. This would put undue pressure on high consumption customers, noting that low income households can also be high consumption customers.

5. *The validity and usefulness of a new entrant LRMC pricing indicator as a measure of the effectiveness of the wholesale energy market in Tasmania.*

OTTER notes that, in the long term, market prices should equal the LRMC. However, where there is no capacity constraint (ie supply exceeds demand), market prices are likely to be below LRMC. On the other hand, where there is a shortfall in the supply market then market prices will exceed the LRMC (providing an incentive for new suppliers to enter the market). The Tasmanian electricity supply is energy constrained; it is not capacity constrained. Therefore, the use of the LRMC of a new entrant may not be the best indicator or measure of efficiency in the Tasmanian market.

6. *Wholesale pricing for non-contestable customers, and in particular the application of new entrant long run marginal cost (LRMC) pricing in setting the energy allowance for non-contestable customers.*

The Price Control Regulations set out the principles that the Regulator must apply in setting the wholesale energy allowance in retail tariffs for non-contestable customers. In effect, the Price Control Regulations require the allowance to be at least the LRMC of a notional new generator supplying electricity to non-contestable customers.

In jurisdictions where greater flexibility is given to the relevant regulatory body, other methods are applied. For example, the Independent Competition and Regulatory Commission in the Australian Capital Territory chose to apply market-based prices and the Queensland Competition Authority applied a weighted average of the market-based price and LRMC.

During the Regulator's 2010 Retail Price Investigation, the Regulator sought expert advice on the long run marginal cost to supply and the market-based cost for the three year period commencing 1 July 2010. The expert's cost estimates (exclusive of the forecast CPRS impacts) are reproduced in the table below.

Table 1-1 Cost Estimates – real 2009-2010 dollars

Year	2010-2011	2011-2012	2012-2013
Market Cost Approach	$66.23	$65.13	$66.04
LRMC Approach	$73.50	$73.16	$74.33

The expert's recommended allowance arising from the LRMC approach was tested against allowances in other jurisdictions that used a similar methodology. The Regulator concluded that the allowance recommended by the expert was:

> .. an appropriate value to be adopted as the electricity supply cost allowance in accordance with the requirements set out in regulation 32 of the Price Control Regulations.

Details of the process and rationale for adopting the expert's advice are set out in the Final Report of the 2010 Tasmanian Electricity Retail Price Investigation.

7. *When reliability standards are being proposed, how are pricing consequences considered?*

The Regulator had a key role in the setting of performance standards both in the transmission and distribution sectors. Network service providers are expected to deliver these performance outcomes in return for the levels of expenditure allowed them by regulators.

Transmission standards

In the transmission sector, the minimum network performance requirements that Transend must meet in order to satisfy the reliability limb of the regulatory test in the National Electricity Rules are set out in the *Electricity Supply Industry (Network Performance Requirements) Regulations 2007*.

These standards were developed in 2006 by the Regulator's expert advisory panel, the Reliability and Network Planning Panel (RNPP), and largely reflected the level of security within the transmission system prevailing at the time. In testing the transmission network against these standards, Transend Networks concluded that it was meeting most identified deficiencies through projects that had already been factored into Transend's five year work program. The cost of those projects was, therefore, factored into the prices that customers were then paying. However, several new projects were identified at an estimated total cost of $31 to 38 million which translated to an increase of around 0.5 per cent in average tariff charges based on the general load at the time, excluding energy intensive customers. Note that:

- the costs of these projects were based on transmission solutions to the deficiencies; lesser cost distribution network or non-network solutions may have resulted from Transend's application of the processes specified in the regulatory test; and
- the RNPP acknowledged in its report that there were limitations in estimating costs and forecasting loads too far into the future.

The transmission standards are due for review in 2012.

Distribution standards

The present distribution service standards were considered in the lead up to the Regulator's 2007 Distribution Price Investigation noting that these standards formed a key component of the resultant price/service package that is specified in the 2007 Determination.

As is commonly used in other jurisdictions, Tasmania applies 'postage stamp pricing' in charging for use of the electricity network. This means that customers pay the same unit charge for network services no matter the level of their usage or their location on the network. However, this also means that customers in low density rural areas can expect to receive a lower level of reliability than their urban counterparts. In developing the standards, it was found to be eight times more costly to provide a unit of electricity to lower density rural areas than to urban areas.

The present reliability standards were developed on the basis that the average performance of the network was adequate, although recognising that there were some areas where reliability was poor.

One of the basic tenets underpinning the present standards was that like communities should receive a similar level of service. One hundred and one communities were identified and categorized and standards of reliability applied to each of the five resulting categories.

Aurora Energy estimated in 2007 that capital expenditure of $13.3 million would be required to meet the '101 communities' standards which equated to around a 0.69 per cent increase in the distribution tariffs (or roughly $2 per customer per annum).

8. *How prescriptive should the regulatory arrangements for determining prices be?*

Regulatory arrangements should be consistent with national arrangements to the largest extent possible. OTTER considers that a balance needs to be struck between being prescriptive in relation to the high level framework and policy, as well as for more detailed outcomes or matters important to the Government, but permit the Regulator to administer the framework with sufficient flexibility to respond to developments in the industry.

OTTER recognises that responsibility for the regulatory policy framework is vested with the Government. However, it also believes that consistency in policy between regulatory periods is essential to ensure that risk allocations are not unduly shifted between regulatory periods. On this point, the OECD Joint Transport Research Centre noted in 2010 that:

> Regulators should work within that policy framework, but the framework should not be altered frequently or arbitrarily. To do so would be to destabilise the integrity of the regulatory system, raise legitimate concerns on the part of industry players, and therefore raise the cost of investment and prejudice service quality and the development of the industry.[1]

9. *What alternative arrangements for setting the energy supply cost allowance might be more appropriate than those currently specified in the current Price Control Regulations?*

OTTER notes that other jurisdictions apply alternative approaches to the one currently set out in the Price Control Regulations. Queensland has taken an approach that shares the risks between retailers and customers by using a weighted average of market and LRMC. The Australian Capital Territory has taken the approach that a market-based price is the preferred methodology as it is transparent and reproducible (for mainland NEM jurisdictions at least). South Australia has applied LRMC. Only NSW has taken a similar approach to Tasmania (that is, a price that is the higher of market or LRMC).

[1] 'Effective regulatory institutions: the Regulator's role in the policy process, including issues of regulatory independence', Tony Winsor, OECD Joint Transport Research Centre Discussion Papers, 21, 2010, p7

10. *Are there other aspects of the 'standard' NEM model that appear inconsistent with the underlying market architecture in the Tasmanian region and evidence to support this view?*

    There is a question as to whether the existing systems and arrangements in Tasmania under the 'standard' NEM model are able to support the increasing penetration of low inertia renewable generation into Tasmania's generation mix.

    In raising this issue, OTTER draws your attention to the findings of the Tasmanian Inertia Issues Working Group (IIWG) in its Discussion Paper submitted as part of the Department of Infrastructure and Energy's response to the AEMC's consultation on a proposed change to the National Electricity Rules.[2] (The objective of the Rule change was to improve arrangements for the planning and acquisition of network support and control services.) The IIWG Discussion paper raises concerns that impact on both system and market efficiency that have yet to be resolved and which should be brought to your attention.

If you would like to discuss any of the above, please contact Ms Jane Hyland on (03) 6233 5671 or by email to jane.hyland@economicregulator.tas.gov.au in the first instance.

Yours sincerely

Jane Hyland
DIRECTOR
OFFICE OF THE TASMANIAN ECONOMIC REGULATOR

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[2] 'Inertia Issues Working Group Discussion Paper, Version 1.3' can be accessed at http://www.aemc.gov.au/Media/docs/Binder2-b11fd1b1-d62f-4a1f-811f-4a82927e7dd7-1.PDF