



Electricity Supply Industry Expert Panel

Governance: Issues and Reforms

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Glossary

TERM	MEANING
AGM	Annual General Meeting
ASX	Australian Stock Exchange
CSO	Community Service Obligation
DIER	Department of Infrastructure Energy and Resource
EBITDA	Earnings Before Interest Tax and Depreciation
FRC	Full Retail Contestability
GBE	Government Business Enterprise
HEC	Hydro Electric Corporation / Commission / Department
LRMC	Long Run Marginal Cost
NCP	National Competition Policy
NEM	National Electricity Market
OECD	Organisation of the Economic Corporation Development
OTTER	Office of the Tasmanian Energy Regulator
PAYG	Pay as you Go
PCR	Price Control Regulations
SCI	Statement of Corporate Intent
SOC	State Owned Companies
SOEB	State Owned Electricity Businesses
SPM	Shareholder Policy and Markets Branch
TER	Tasmanian Economic Regulator / Tasmanian Energy Regulator
TESI	Tasmanian Electricity Supply Industry
ToR	Terms of Reference
TVPS	Tamar Valley Power Station
WACC	Weighted Average Cost of Capital

Foreword

In October 2010, the Tasmanian Parliament passed the *Electricity Supply Industry Expert Panel Act 2010* to establish an independent expert panel to conduct a review into, and provide guidance to Parliament on, the current position and future development of Tasmania's electricity industry.

The Panel's Terms of Reference states that the Panel "...shall investigate and report on any other matters that the Expert Panel considers are relevant". A range of stakeholders raised issues of governance with the Panel, in particular the Government's stewardship, as Shareholder, of the broad direction, operation and performance the State-owned Energy Businesses.

The Panel agrees that governance is a central component of the broader framework of incentives that influences the operation of the Tasmanian electricity supply industry. In short, good governance is essential for achieving both efficient prices for Tasmanian electricity consumers and driving the sustainable financial performance of the SOEBs.

This Paper explores in detail the key governance issues that have emerged during the course of the Review and outlines the Panel's draft recommendations for strengthening SOEB governance in Tasmania.

John Pierce

Chairman

Electricity Supply Industry Expert Panel

Introduction

Governance is a central component of the broader framework of incentives that influences the operation of the Tasmanian Electricity Supply Industry (TESI), which is aimed at driving both efficient prices for Tasmanian electricity customers and sustainable financial returns to the State-Owned Energy Businesses (SOEBs). In this context, 'governance' is used to describe the way in which the Government exercises its various functions of strategic energy policy-setting, economic and technical regulation and business ownership (including major capital investment decisions) within the TESI.

This Paper discusses the Panel's findings from its investigation of governance matters. The Panel has not sought to conduct a comprehensive 'audit' of all relevant governance arrangements across Tasmanian energy sector.¹ Rather, it has focused on key issues that have emerged from its investigation into the efficiency and effectiveness and financial performance of the SOEBs, as well as major infrastructure development decisions.

Most of these issues are linked, in one way or another, to the way in which the Government², in its role as Shareholder, oversees the broad direction, operation and performance the businesses. Accordingly, the Panel has focused on the current functioning of the Shareholder/SOEB relationship and has not sought to assess the internal corporate governance arrangements that are in place within each of the individual businesses.³

In simple terms, the effectiveness of current SOEB governance arrangements can be judged by how well they deliver the following outcomes:

- Confidence within the Tasmanian community - both from their perspective as electricity customers and as the ultimate owners of the businesses - that the SOEBs are being operated according to a clear and consistently applied set of goals;

¹ The Panel's Terms of Reference do not specifically require an investigation into governance matters. However, the Panel has determined that governance is directly relevant to the scope of its Review, in view of its influence on a range of observed outcomes in the TESI.

² In this Chapter, 'the Government' refers to the Tasmanian State Government in the general sense, and does not refer to the current State Labor Government specifically.

³ In this way, the Panel's analysis is focused primarily on 'external governance' arrangements. That is, the systems and mechanisms utilised by the Government in its role as shareholder to oversee the broad direction and operation of its businesses. 'Internal governance' refers to the systems of direction and control within the SOEBs, which is the responsibility of the boards and senior management of each of the businesses (see: Productivity Commission (2005) Financial Performance of Government Trading Enterprises 1999-00 to 2003-04, pp.46)

- Clearly specified roles and delegations from the Government, as custodians of public capital – both equity and debt – invested in the SOEBs, through to the SOEB Boards and senior management, such that there is a clear ‘line of sight’ between the strategic objectives set by Government and the operational and investment decisions of the SOEBs; and
- A ‘level playing field’ across the energy sector (between energy sources and market participants) where market outcomes are not distorted by virtue of the Government’s ownership of the SOEBs.

The key arrangements that formally underpin Tasmania’s SOEB governance framework are, *prima facie*, consistent with good practice principles, including those established by the OECD.⁴ Therefore, the Panel has sought to establish whether key aspects of the framework are working as intended and delivering the core governance outcomes described above. The Panel has drawn on advice and input from a range of key stakeholders, including those with practical experience of how governance and decision-making currently plays out in the Tasmanian sector.⁵

The Panel has identified the following three priorities⁶ as being critical to ensuring the robustness and transparency of SOEB governance arrangements in the Tasmanian energy sector:

- 1) Clear strategic objectives, including the transparent delivery of non-commercial activities;**
- 2) An accountability framework that drives efficient, effective and transparent performance; and**
- 3) Separation of the Government’s multiple roles of policymaker, regulator and businesses owner.**

⁴ In 2005 the OECD released its *Guidelines on Corporate Governance of State-owned Enterprises*, which are widely regarded as the ‘best practice’ benchmark against which to assess the governance of State-owned businesses.

⁵ The Secretariat, on behalf of the Panel, conducted a series of one hour semi-structured interviews with key stakeholders, including Chairpersons and senior management from the SOEBs, heads of relevant Government agencies, Shareholder Ministers, Greens and Liberal Party Energy Spokespersons, Members of the Legislative Council, representatives from the Tasmanian Chamber of Commerce and Industry and an academic with corporate governance expertise. Interviewees were provided with a schedule of interview questions ahead of time, which was used to guide the discussions. In all cases, interviews were given on the understanding that responses provided would not be individually attributed in the Panel’s report(s). The interviews were supplemented by written submissions received on governance matters from a range of stakeholders, including the SOEBs.

⁶ It is important to note that these are not intended to be a comprehensive list of ‘good governance’ principles. As noted above, the Panel has not sought to benchmark existing governance arrangements in Tasmania against best practice from a ‘top down’ or ‘first principles’ perspective. However, the Panel’s investigations and analysis have been informed by best practice guidelines, such as those published by the OECD, as well as observed good practice in other jurisdictions. Reference is made to both of these where relevant throughout the Chapter.

This Paper is divided into three sections, which examine each of these priorities in more detail. For each priority, the Panel discusses the following:

- The key guiding principles and architectural elements that good practice suggests should underpin relevant governance arrangements, and why;
- The relevant governance mechanisms that are currently in place in Tasmania, including both formal and informal arrangements;
- Issues, strengths and weaknesses identified in the practical operation of these existing mechanisms, drawing on both stakeholder feedback and the Panel's own observations; and
- Recommendations to address identified issues.

The evidence gathered by the Panel suggests a need to strengthen certain elements of the framework. Specifically, the Panel has identified six key areas, which are discussed in more detail in this Paper, in the context of the above Principles. These are:

- 1. Clearer Shareholder ownership objectives**
- 2. Transparent identification, delivery and funding of all non-commercial activities**
- 3. A greater Shareholder focus on business performance**
- 4. Effective Shareholder oversight and strategic energy policy functions**
- 5. Enhanced public reporting and accountability**
- 6. Confidence in the independence of regulatory processes**

The Panel makes a number of recommendations for strengthening SOEB governance in Tasmania. The recommendations do not call for significant changes. In most instances, the Panel believes that effective improvements to governance outcomes can be made simply by the more rigorous application in practice of principles and frameworks that are already in place. Therefore, the focus is on the incremental improvement and more closely aligning the Tasmanian governance framework with 'best practice'.

The Panel's key points and recommendations are summarised below.

Summary of Findings and Recommendations

1. Clearer shareholder ownership objectives

Key Points:

- Clear Shareholder 'ownership objectives' are important for a range of reasons, including that they provide the SOEBs with established parameters within which to operate (particularly with regard to non-commercial expectations) and send a clear message to the community about what the Government is trying to achieve through public ownership.
- The Panel endorses the view put forward by a number of stakeholders that Tasmanian Governments should more clearly, and publicly, state their overarching strategic objectives for the SOEBs – that is, the specific outcomes Government is ultimately trying to deliver through its ongoing ownership and control of the businesses.
- Without a clear set of overarching ownership objectives to guide its decision-making as a Shareholder, the Government will not have a reference point from which to consider, in a clear and consistent way, fundamental questions of strategic business direction.
- An Energy Business Ownership Policy should provide clearer direction on specific expectations with regard to the delivery of non-commercial objectives and stronger guidance on the Government's risk appetite, particularly with regard to investments in diversification and growth activities beyond the SOEBs' core business.
- The SOEBs need to be as commercially successful as possible within the parameters set by the Government, but it is critical that the scope of business activities is firstly precisely defined, with clear reference to broader strategic policy objectives.
- The Panel notes that some significant improvements to the strategic objective-setting process are already in train, primarily through the implementation by the Government of its new Reform Principles for the Oversight and Accountability of Government Businesses.

Recommendation:

- That the Tasmanian Government develops a publicly available Energy Business Ownership Policy to more clearly articulate its overarching strategic objectives for the SOEBs.

2. Transparent identification and delivery of all non-commercial activities

Key Points:

- The Tasmanian Government's CSO policy provides that the delivery of all non-commercial objectives should be explicitly provided for in legislation or regulations, formally documented and publicly disclosed so the impact on the business of delivering the activity is publicly transparent.
- The Government's policy also advocates the direct funding of CSOs from the State Budget, consistent with good practice captured in relevant intergovernmental agreements.
- However, the Panel has noted that, in practice, there is a level of non-transparency in the funding and delivery of some non-commercial activities by the SOEBs.
- The most prominent example relates to Aurora Energy's operation of the TVPS. The TVPS has not been recovering its costs from the market and its commercial viability is instead underpinned by a combination of the current regulatory regime and contractual arrangements with Hydro Tasmania for supplying the non-contestable load.
- The arrangement effectively transfers the shortfall in market value for the TVPS to Hydro Tasmania. This is not transparent or sustainable. As discussed in more detail in the Draft Report, there are alternative, more transparent means to support the TVPS on the grounds of energy supply security 'risk insurance' that the Panel's considers more appropriate.
- The Panel has also identified other examples where the CSO framework has not been applied where it would have been appropriate to do so. Acceptance of lower SOEB dividends has been used as a substitute for funding non-commercial activities from the Budget.
- The funding of non-commercial activities via CSOs rather than other mechanisms is not simply a matter of bureaucratic process. It is fundamental to good governance, performance management and ability of the Government to hold the SOEBs to account.

Recommendation:

- That the Tasmanian Government transparently identifies, endorses, costs and funds all CSO activities undertaken by the SOEBs, consistent with its existing CSO policy framework. CSOs should be directly funded through the budget process, rather than through internal transfers and acceptance by the Shareholders of reduced rates of return.

3. A greater Shareholder focus on business performance**Key Points:**

- From the Shareholder Ministers' perspective, efficiency within the SOEBs is critical as it drives financial performance and, ultimately, returns to the Tasmanian community in the form of dividends. From a customer perspective, the market and/or the regulatory framework can only go so far in driving efficiency and the longer-term trend in electricity prices.
- Shareholder oversight of the SOEBs should therefore provide a sufficient level of accountability to drive, through the SOEB Boards, continuous improvement in the efficiency, effectiveness and financial performance of the businesses.
- Until recently, however, the Panel has observed a low level of engagement between the Shareholders and the businesses, through the corporate planning process, on efficiency-related matters. Where broad expectations have been communicated, it has not always been clear how they have been incorporated into the business strategies of the SOEBs or have then in turn been monitored by the Shareholders.
- The historic absence of a strong performance focus may be symptomatic of a view that the economic regulatory environment and independent regulators will provide the dominant drivers for SOEB's efficiency and effectiveness. The Panel's view, however, is that the regulatory framework is a poor proxy for the business pressures delivered through effective competition and that effective governance of the SOEBs is also necessary to complement the incentives of economic regulation.
- The Panel notes, and endorses, recent improvements to SOEB oversight and accountability mechanisms, including the introduction of Annual Performance Agreements between the SOEB Boards and the Shareholders.
- These kinds of mechanisms need to be supported by sound and sufficiently detailed ongoing monitoring, reporting and follow-up processes. This is particularly important where the Shareholders have approved investments in non-core diversification activities that may have a higher risk profile.
- A key component of this is to ensure that the SOEBs' financial accounts continue to provide sufficient transparency with regard to the performance of discrete elements of the business.

Recommendation:

- That SOEB oversight continues to be refined and improved over time with a specific focus on putting in place accountability and incentive mechanisms that provide a clearer 'line of sight' between Shareholder expectations and the requirements of the regulatory framework on the one hand, and board management and staff performance on the other.
- In the context of the SOEB's growing complexity, reporting of financial accounts must continue to provide sufficient transparency with regard to the performance of discrete elements of the businesses in order to support effective Shareholder oversight.

4. Effective Shareholder oversight and strategic energy policy functions**Key Points:**

- The Panel's Terms of Reference (ToR 8) require it to review the "advice that was provided to the State Government by the senior management or Directors of Aurora Energy from 1 October 2009 to 16 June 2010 inclusive", in the context of the Company's changing financial position over this period.
- This example provides an insight into the practical functioning of communication channels between a SOEB and its Shareholders. The Panel has found that in this particular instance the 'continuous disclosure' process in place between Aurora Energy and the Shareholders functioned as intended. This view accords with the Auditor-General's findings, which concluded that reporting of financial issues and risks over this period was adequate.
- What was not anticipated by Aurora Energy or the Shareholders, however, was the magnitude of the financial risks. While the circumstances surrounding Aurora Energy's deteriorating financial position during 2009-10 were unusual, this example does serve to highlight the inherent risks of being an owner of merchant energy businesses in a highly complex market.
- The Government has said in broad terms that it will be considering the current distribution of its various energy responsibilities across the bureaucracy, in the context of the Panel's findings and recommendations. A strong Shareholder oversight function is clearly a fundamental role that will need to be continued, and possibly enhanced.
- Reflecting the separate but interrelated roles that government plays in the sector, the Panel highlights that SOEB oversight should also be complemented by a strategic energy policy function within the portfolio Department that is separate from the Shareholder oversight function

Recommendation:

- That the following key functions should underpin any Government review of energy responsibilities across the bureaucracy:
 - A strong SOEB ownership and oversight function, focused on driving the efficient performance of the businesses from a Shareholder perspective;
 - An expert energy policy function with the sufficient mandate, capacity and authority to provide robust advice to Government, preferably through the portfolio Minister; and
 - A strategic, 'whole of government' policy oversight capacity with the ability to weigh and consider the impacts of energy policy proposals from a more holistic perspective, taking into account broader social, economic and environmental impacts, preferably coordinated by a central agency.

5. Enhanced public reporting and accountability**Key Points:**

- As the ultimate owners of the SOEBs, it is important that the Tasmanian community can access regular information about how well the businesses are achieving their stated objectives. The Parliament plays a key 'intermediary' role in holding the SOEBs to account on behalf of the community.
- Currently, the Tasmanian public accountability framework for the SOEBs is based around the Annual Reporting process and Government Business Scrutiny Committee Hearings, with little in the way of dynamic, ongoing disclosure of performance information.
- The Panel believes that there is merit from an accountability and transparency perspective in improving the timeliness and currency of key SOEB performance information provided to the Tasmanian Parliament, consistent with good practice in other jurisdictions. Specifically, this should include a Statement of Corporate Intent, a Half-Yearly Report and an Annual Report.
- Although flagged in the Issues Paper as a possible reform, the Panel is not convinced at this time that public, continuous disclosure for the SOEBs would yield sufficient accountability benefits to justify its imposition on the businesses at this time.
- While not within the Panel's remit, it is noted that a number of stakeholders were highly critical of the effectiveness of the current Government Business Scrutiny Committee Hearings process, specifically its potential to blur the line between accountability for SOEB performance (including the oversight performance of the Shareholder Ministers) and the general performance of the

Government of the day for the delivery of other (often unrelated) policy objectives.

- The Panel's proposed improvements to the provision of relevant and timely SOEB information, proposed above, may enhance the Committees' capacity to perform its SOEB oversight function in a more informed and effective manner.

Recommendation:

- That, at a minimum, each of the SOEBs provides to the Parliament - and therefore the wider Tasmanian community - the following:
 - an annual Statement of Corporate Intent at the commencement of the Financial Year, summarising the key objectives and performance targets from the SOEB's Corporate Plan;
 - a Half Yearly Report that provides a summary of year-to-date performance against targets set out in the SCI; and
 - an Annual Report.

6. Confidence in the independence of regulatory processes

Key points:

- The primary aim of the regulatory framework should be to support the efficient operation of the energy market. Value in the SOEBs should be an outcome of efficient operations, not a core driver of policy or regulatory settings.
- When the Government is both a business owner and regulator, it is crucial that clear demarcations between these functions are, and are seen to be, maintained.
- It is important that market participants cannot reasonably form the impression that specific direction provided by the Government to the Regulator is driven by its own Shareholder value considerations.
- The Government's involvement in specific elements of recent pricing determinations – including going beyond the establishment of the broad principles and objectives that underpin the regulatory framework and, in 2007, setting the wholesale energy allowance itself - raises potential concerns about the actual or perceived level of 'functional' independence that the TER has been afforded in making certain pricing decisions.
- The Panel's view is that the Regulator should have the autonomy to determine and apply methodological approaches in the context of broad principles and objectives set by the Government.

- Complete transparency in regulatory pricing arrangements will become critically important for the new entry of private capital in the market with the introduction of full retail contestability (FRC) and attendant 'fall-back' regulatory arrangements that will apply to all retailers.

Recommendations:

- That the TER is given the discretion to independently apply appropriate approaches and methodologies, within the context of the broad principles and objectives set by the regulatory framework. If there are specific outcomes that the Government believes should be taken into account, then it may put the case to the TER in submissions to the independent regulatory process.

1. Clear strategic objectives, including the transparent delivery of non-commercial activities

1.1. Key Principles

1.1.1. Strategic objective-setting by the Shareholders

Like all State-owned enterprises, Tasmania's SOEBs face the fundamental tension inherent in being commercial entities on the one hand, and instruments of Government policy for the achievement of broader social and fiscal objectives on the other. In this sense they are 'hybrid' organisations, having the features of both private and public sector organisations.⁷

The key difference between public and private enterprises is that shareholders in a private enterprise have a broadly common purpose – to maximise risk-adjusted returns on their investment – while shareholders in a public enterprise often have conflicting objectives. This multiplicity of principals with potentially conflicting objectives can, and often does, lead to the unclear transmission of objectives.⁸

In the context of potentially conflicting objectives, it is critical that the Government, acting as the 'proxy' owner on behalf of the community, provides clear direction to the SOEBs on its expectations of the businesses.

Clear 'ownership objectives' are important for a range of reasons, including that they provide the SOEBs with established parameters within which to operate (particularly with regard to non-commercial expectations) and send a clear message to the community about what the Government is trying to achieve through public ownership, as well as how this is consistent with and contributes to the Government's broader strategic policy goals.⁹ As the Productivity Commission notes:

*"A clear definition of the public interest reasons for government ownership, and consequent ministerial control, is crucial for sound government trading enterprise governance. For ministers to be held accountable, their actions should be open and transparent. The public should be confident that the public interest has been defined, is widely known and is being served"*¹⁰

⁷ Bottomley, S (2000), *Government Business Enterprises and Public Accountability through Parliament*

⁸ Trivedi, P (2005), *Designing and Implementing Mechanisms to Enhance Accountability for State-Owned Enterprises* – Presentation to UN Expert Group Meeting on Re-Inventing Public Enterprise and its Management.

⁹ OECD (2005) – *Guidelines on Corporate Governance of State-owned Enterprises Guidelines*, pp. 24

¹⁰ *Productivity Commission (2005) Financial Performance of Government Trading Enterprises 1999-00 to 2003-04*

Good strategic objective-setting is also the 'foundation stone' upon which the accountability and oversight of the SOEBs is based. Having clear objectives enables the establishment of sound performance measurement and reporting mechanisms, based on a shared understanding of what is to be achieved.

The OECD notes that strategic direction should be provided with regard to both the Government's general expectations of its State-owned businesses from an overall 'portfolio' perspective, as well as at the individual business level. Therefore, objective-setting for the SOEBs by the Shareholders should be considered at two levels –

- the overall rationale, goals and objectives that the Government is seeking to achieve through public ownership of the businesses (within its wider portfolio of assets); and
- the more specific commercial and strategic direction that is set for each of the businesses over the short, medium and long term, within this broader context.

Like all owners, in setting high-level strategic objectives the Shareholder Ministers must manage issues around sustainable capital structures, approving major capital investment – particularly where it relates to business diversification or expansion – and maintaining a dividend policy that delivers the desired level of cash-flow from the businesses.

A State Government's approach to these issues will depend on its reasons for holding investments in these businesses in the first place. Its objectives as an investor or owner should be seen in the context of the role of State Government and the fiscal strategy needed to support that role.

At the most fundamental level, State governments can be said to have three roles:

- 1) They are in the business of supplying services, including hospitals and health care, school education, roads and public transport, public order and safety and welfare services such as child protection;
- 2) Through their legislative powers, they also regulate private sector activity. Examples include land use planning and environmental regulation, allocation of property rights for natural resources, through to occupational health and safety and workers compensation; and
- 3) They impose taxes and charges to fund these activities. In the case of Tasmania, just over 60 per cent of General Government Sector revenue comes from Commonwealth Grants, around 20 per cent from state taxation, 8.5 per cent from the sale of goods and services and just under 5 per cent from financial distributions¹¹ from State-owned businesses.

¹¹ This includes dividends, tax equivalents and guarantee fees.

Given the primary roles of State Government, the next question becomes: “what fiscal strategy or approach to financial management best aligns with these roles; and what does this imply for the management of its investments in the SOEBs?”

As a number of countries are currently experiencing, and as others have in the past, in the longer term, economic and social sustainability depends among other things on the rate of growth in government expenditure matching the rate of growth of its revenues.

The nature of State government services is such that expenditure growth on these services does not vary significantly over the course of an economic cycle. For example, the number of children enrolling in schools or people being admitted to hospital from year to year does not tend to change significantly in response to small changes to Gross State Product (GSP). Rather, State-level public expenditure growth is driven by longer-term trends in economic development, technology, demographics and the policy choices made by governments concerning the level of services that they choose to provide.¹² Revenue growth however is very much tied to short-term variations in economic conditions, particularly with respect to consumption, asset prices and private investment.

In these circumstances, it is reasonable to expect that a State governments' approach to fiscal and financial management will be targeted to delivering, as far as is reasonably possible, a sustainable and consistent rate of growth in General Government Sector services, despite the 'ups and downs' of the economy and revenue growth. The primary implications of such an objective are:

- that General Government net debt and financial liabilities will be managed to a low enough level to allow them to absorb differences between actual and trend rates of growth in revenue; and
- as an investor in assets or owner of businesses outside of the General Government Sector, the Government will have a low risk preference, preferring a steady, reliable stream of dividends and financial distributions over capital gains (i.e. the promise of future dividends or a higher, more volatile dividend stream).

A Government may wish to manage its General Government Sector balance sheet to minimise the extent to which it needs to reduce health, education and other services due to cyclical downturns in, for example, property transactions. In the same way, it would be appropriate for the Government's decisions with respect to its governance and ownership of SOEBs to be driven by the impact on General Government Sector service provision.

¹² This can be contrasted with Commonwealth expenditure which is dominated by transfer payments, a significant proportion of which is directly linked to economic cycles, for example unemployment benefits.

A key differentiating feature of government businesses that has a significant influence on strategic direction setting (particularly when compared to their publicly listed counterparts) is the community's inability – as 'captive' shareholders - to access the value of capital growth in the same way that the shareholders in a publicly listed company can (i.e. through trading their shares). This means that the main way in which the community as owners can benefit financially is by way of regular dividend flows to the Government.

1.1.2. Identification of Non-Commercial Objectives

A related, but fundamental, component of the SOEB objective-setting process is clearly defining the way in which the SOEBs are to undertake non-commercial activities and/or community service obligations. While the Board is ultimately answerable to the Shareholder Ministers, it is also obliged to act commercially in the interests of maximising shareholder value. Good practice therefore dictates that non-commercial activities should be undertaken on the formal direction of the Shareholders and be accompanied by appropriate and transparent compensation – usually in the form of specific 'Community Service Obligations' (CSOs). In this way, social policy objectives achieved through CSOs are funded by the taxpayer rather than the electricity consumer.

As the Productivity Commission notes:

"The mandatory identification of CSOs and the transparent costing and funding methods...not only promotes good governance, but also reduces the incentive to underfund CSOs. It helps clarify what constitutes appropriate funding, as both the public and intended service recipients are made aware of the cost to society of pursuing social objectives through [government businesses]"¹³

The OECD recommends that CSOs or similar arrangements should be explicitly provided for in legislation or regulations, formally documented (for example in service contracts between the Government and the SOEB) and publicly disclosed so the impact on the business of delivering the CSO is publicly transparent.¹⁴

1.2. Summary of Current Arrangements

The high-level objectives and strategic direction for the SOEBs are currently set by Government through a series of key governance instruments that operate at three main levels, namely:

- 1) At the statutory level through relevant legislative instruments;
- 2) At a general level through guidelines, parameters and expectations that are set for all Government businesses; and

¹³ Productivity Commission (2008) *Financial Performance of Government Trading Enterprises 2004-05 to 2006-07*, p. 41

¹⁴ OECD (2005) – *Guidelines on Corporate Governance of State-owned Enterprises Guidelines*, p. 20

- 3) At a more specific level through expectations and directions for each of the individual SOEBs, primarily via the annual Corporate Planning process.

The key documents that currently operate under each of the above headings are summarised briefly below.

1.2.1. Legislation

The legislation under which the SOEBs are established provides very high-level guidance and direction with regard to the scope and broad direction of the businesses.

For Hydro Tasmania, this broad direction is provided under:

- The *Government Business Enterprises Act 1995*, (the GBE Act) which specifies that the 'principal objectives' of the business are to "perform its functions and exercise its powers so as to be a successful business by operating in accordance with sound commercial practice and as efficiently as possible" and "achieving a sustainable commercial rate of return that maximises value for the State in accordance with its corporate plan and having regard to the economic and social objectives of the State". The Act also lists as a principal objective "to perform on behalf of the State its community service obligations in an efficient and effective manner". The GBE Act provides for the establishment and prescribes the contents of a Ministerial Charter for each of its GBEs that outlines the broad expectations of the Shareholder Ministers; and
- The *Hydro Electric Corporation Act 1995* (the HEC Act), which defines core functions and powers of Hydro Tasmania with regard to electricity generation, the operation of Basslink, participation in the NEM and the delivery of consultancy services.

For Aurora Energy and Transend, strategic direction at the statutory level is limited to the following:

- The *Electricity Companies Act 1997* (the Electricity Companies Act), which states that the 'principal objectives' of the Companies are to: operate its activities in accordance with sound commercial practice; and to maximise its sustainable return to its shareholders. These same objectives are mirrored in each of the Companies' Constitutions; and
- The *Corporations Act 2001* (Commonwealth).

1.2.2. General expectations of all Government-owned businesses

The Government provides general direction on its expectations for all of its businesses through the *Guidelines for Tasmanian Government Businesses*. The Guidelines are an administrative document only and do not have any formal legislative status. As well as general guidance on matters such as the Government's low risk appetite as an investor, the Guidelines provide policy direction on the following:

- Board appointments, induction and performance assessment;
- The establishment of subsidiary companies and joint ventures; and
- Government Business borrowings and dividends.

The *Treasurer's Instructions*¹⁵ cover the principles, practices and procedures to be observed in the financial management of Government Business Enterprises. Some Treasurer's Instructions (specifically with regard to tax equivalents and guarantee fees) are also applicable to State-owned Companies through their Portfolio Acts. The Instructions cover application of tax equivalent regime, guarantee fees and dividends, CSO framework, corporate planning, and financial reporting (including the application of accounting standards).

The Existing Guidelines and Treasurer's Instructions have recently been supplemented by new *Principles for Strengthening the Oversight and Governance of Government Businesses*. The Principles provide an updated view the Government's expectations relating to:

- The level of strategic control by Government over business activities;
- How objectives for the businesses are set and reflected in core governance documents;
- Its broad risk appetite as an investor, particularly in relation to 'non-core' business activities;
- Efficiency measures; and
- Accountability and reporting mechanisms.

1.2.3. Specific expectations of the individual SOEBs

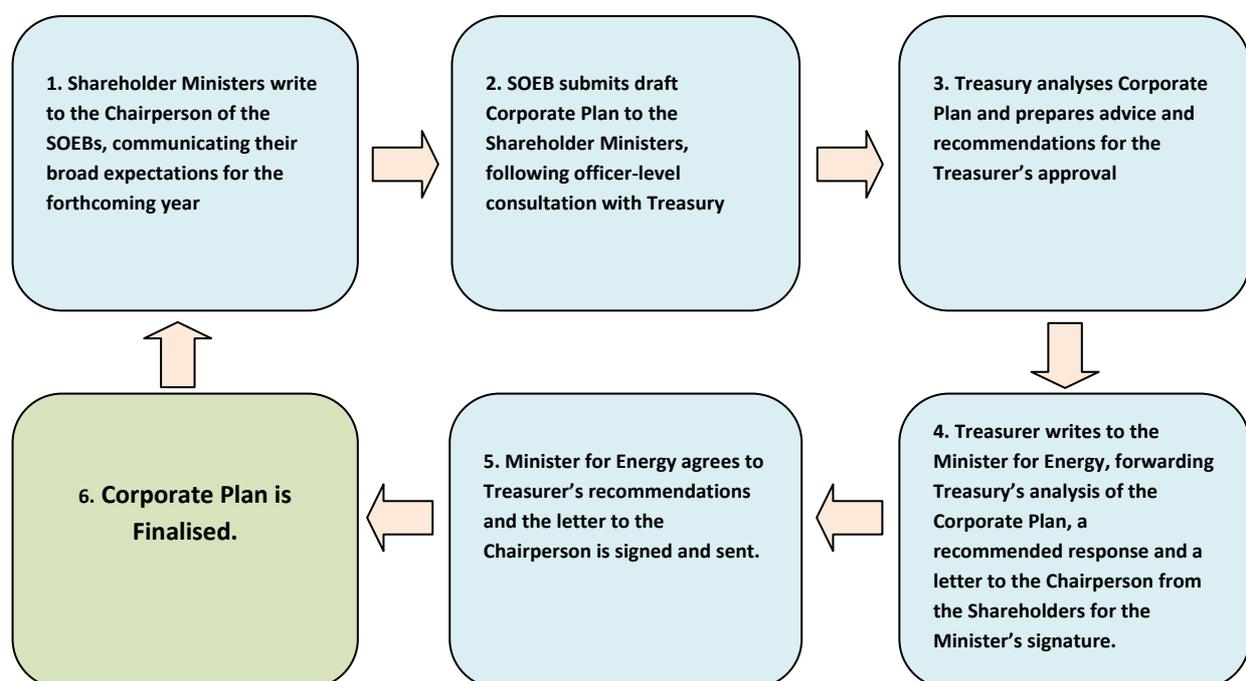
The most substantive and specific direction at the individual business level is provided via the annual Corporate Planning Process. Currently, each of the SOEBs must submit to the Shareholder Ministers an annual Corporate Plan for a period of four years. For Hydro Tasmania, the Corporate Plan must be approved by the Shareholders; however there is no such formal approval requirement for the SOCs.

¹⁵ Treasurer's Instructions are issued under section 23 of the *Financial Management and Audit Act 1990*

Prior to the annual planning cycle (usually December), Shareholder Ministers will write to the SOEBs outlining the strategic priorities and broad expectations of the businesses in the development of the Corporate Plan. The letters have historically been limited to two to three pages and focus on setting high-level parameters around the content of the Corporate Plan on matters such as financial performance and risk identification and mitigation. The Government will also generally use the letters to provide direction on its dividend policy.

After developing their Corporate Plans, taking into account the broad strategic direction provided by the Shareholder Ministers, the SOEBs submit them by the end of March. Treasury then undertakes analysis of the Plan and provides advice with regard to whether or not the Plan is consistent with the broad expectations issued at the beginning of the planning process and provides recommendations regarding the approval of the Plan, which may include conditional approval of some elements. Advice is provided to the Treasurer, who in turn advises the Minister for Energy on the content of the Plan and the Shareholders' proposed response. In the recent past, the Panel understands that separate advice has not typically been sought by the Minister for Energy from the portfolio agency, with Ministerial advisers instead providing support in this capacity. The corporate planning process is summarised in Figure 1, below.

Figure 1 - Development and Approval of the SOEBs' Corporate Plans



1.2.4. Framework for the delivery of non-commercial objectives

With regard to non-commercial objectives, the Government retains the power to direct the SOEBs to undertake various activities. For the SOCs (Aurora Energy and Transend) a wide power of direction exists under the Electricity Companies Act, whereby the Shareholding Ministers may give a lawful direction to Company on any matter and the directors must comply. The direction power for GBEs, on the other hand, is limited under the Government Business Enterprises Act to the following matters:

- Long-term objective-setting for the business;
- Financial performance objective setting;
- The requirement to undertake a community service obligation; and
- The payment of income tax equivalents and dividends.

The Tasmanian Government also has in place a framework, provided for under the Treasurer's Instructions, for managing the delivery of specific non-commercial policy objectives through the SOEBs. Again, there are some minor differences in the arrangements that apply to Hydro Tasmania (as a GBE) and Aurora Energy and Transend (as SOCs)¹⁶, however, as Treasury notes, the principles of the framework applying to both SOCs and GBEs are 'effectively identical'.¹⁷

The Treasurer's Instructions note that "the main objectives of the CSO policy are to ensure that the Government's economic, social and other objectives are achieved without impacting on the commercial performance of GBEs and to improve the transparency, equity and efficiency of CSO service delivery".

If the Government requires one of the SOEBs to undertake (by either directive or statute) an activity or service that the business would not ordinarily choose to provide on a commercial basis, or would provide at a higher price, then this product or service must be clearly purchased by the Government from the SOEB under a contractual arrangement with the relevant portfolio agency.¹⁸

¹⁶ One of the key differences between GBES and SOCs in this regard is that the *Government Business Enterprise Act 1995* makes specific reference to the delivery of broader objectives beyond the commercial operation of the company, including the objective of "...achieving a sustainable commercial rate of return that maximises value for the State in accordance with its corporate plan and having regard to the economic and social objectives of the State". It also makes specific mention of the delivery of CSOs as a principle objective of GBEs.

¹⁷ Department of Treasury and Finance (2008) *Guidelines for Government Businesses*

¹⁸ *Ibid*

The two CSOs currently undertaken by the SOEBs are:

- The delivery by Aurora Energy of electricity concessions to health care and pensioner card holders under an agreement with the Department of Health and Human Services; and
- The delivery of subsidised electricity supply by Hydro Tasmania of electricity to Bass Strait Island customers and the provision of concessions to pensioner customers on the Bass Strait Islands, under an agreement with the Department of Treasury and Finance.

The Tasmanian Government's CSO policy advocates the direct funding of CSOs from the State Budget. This is consistent with good practice captured in relevant intergovernmental agreements. Direct funding is preferred for several reasons, including:

- **Efficiency** – prices for non-CSO functions can be set to reflect the cost of the commercial services supplied by the government business;
- **Transparency and Accountability** – the level of funding is publicly notified and subject to scrutiny in the budget process; and
- **Equity** – funding is sourced from general tax revenue so the cost of social policy is shared by the whole community.¹⁹

1.3. Issues and Recommendations

1.3.1. Clearer Shareholder ownership objectives

The Tasmanian Government, as a Shareholder, has not always communicated its overarching strategic objectives for the SOEBs in a clear and consistent way.

This issue has manifested itself in two key areas:

- 1) *The Shareholders' expectations with regard to the delivery of broader non-commercial outcomes through the businesses, particularly where these objectives are not specifically prescribed in CSOs* - Stakeholders from the SOEBs indicated that they have difficulties in resolving the inherent tension between their obligations under legislative and other instruments to act commercially in one hand, and the expectations that the Shareholders may or may not have explicitly stated with regard to delivering broader policy objectives (for example reducing the impact on cost of living for customers or the retention of members of the local Tasmanian workforce as employees of the businesses). SOEB feedback indicated that, outside the established CSOs, there is an element of 'second guessing' involved in determining what the Government's broader policy expectations of the Businesses were, and therefore how these should be delivered.

¹⁹ Productivity Commission (2008) *Financial Performance of Government Trading Enterprises, 2004-05 to 2006-07*

2) *The Shareholders' views on whether the SOEBs should be pursuing growth opportunities in national and international markets or whether they should be focused on the delivery of core, on-island services to Tasmanians* - There has at times been a lack of consistency with regard to the Government's risk appetite as a Shareholder and what this means at a practical level for the expansion of the businesses into areas beyond 'core business'. Despite the Government identifying itself as a 'risk-averse shareholder',²⁰ it has nonetheless approved the SOEB corporate objectives of pursuing business diversification opportunities, often outside of the Tasmanian market.²¹ As a consequence, the SOEBs are now operating in areas that are well outside their traditional core business. While some of these diversification activities have been pursued primarily as defensive, risk mitigation measures, others have been sought as value-creating in their own right, often with relatively high levels of attendant risk. Examples include Hydro Tasmania's national and international expansion of its interests in wind farms (through Roaring 40s) and its pursuit of retail growth opportunities on mainland Australia (through Momentum) beyond the level that can be backed by its existing generation portfolio. Similarly, Aurora Energy has recently diversified into the wholesaling and retailing of gas, in Tasmania and elsewhere.

Fundamentally, the Government's position on these high-level, strategic issues should be guided by its overall ownership objectives for the businesses - the fiscal, wider economic and broader social policy outcomes that the Government is seeking to ultimately achieve through its ongoing public ownership of the SOEBs.

The Panel agrees with the observation made by a number of stakeholders that, instead of being maintained for the achievement of clear policy goals, the policy of public ownership of the SOEBs has become a 'default position' or 'an end in itself', for all three parties in the Tasmanian Parliament. Consequently, there is a policy gap at the strategic level around what the *outcomes* of public ownership are, or should be.

Currently, the only public, high-level statement of Government policy intent with regard to ongoing business ownership is contained within the Guidelines for Government Businesses, which notes that:

"Government ownership continues for various reasons including historic ownership, the need to ensure the continued provision of important and/or essential services that may not otherwise be provided by the private sector, and a greater ability to regulate services through public ownership."

²⁰ Department of Treasury and Finance (2008) *Guidelines for Government Businesses*

²¹ See *A Review of the Financial Position of the State Owned Electricity Businesses* –and The Panel's Draft Report

This statement does not provide sufficiently clear direction on what specific public interests or benefits the Government is trying to achieve through ownership of the SOEBs. Further, the Panel questions the above statement's relevance to the network businesses, where the regulatory environment is such that ownership (whether it be public or private) should in practice be largely irrelevant.

Without a clear set of overarching ownership objectives to guide its decision-making as a Shareholder, the Government will not have a reference point from which to consider, in a clear and consistent way, fundamental questions of strategic business direction. Further, the SOEBs, other stakeholders and the broader Tasmanian community will be left with a degree of uncertainty with regard to the Government's policy intentions. This is a less than ideal outcome from a governance perspective.

The Panel is of the view that the Government should return to 'first principles' and establish a set of clear ownership objectives - including an explanation of how and why these objectives are best delivered through ongoing public ownership - through the development of an Energy Business Ownership Policy (Ownership Policy). The Ownership Policy should be revised and updated with changes in government to reflect shifting direction, priorities and business drivers.

The Ownership Policy should provide clear answers to key questions relevant to setting long-term strategic business direction. For example, to what extent does the Government need or wish to expose its ability to maintain a steady rate of growth in General Government Sector services to the commercial success or otherwise of its SOEBs? And does the Government wish to forgo short-term returns from the SOEBs in the form of dividends, which could be used to fund other policy priorities for the benefit of the community, in pursuit of potentially higher returns from commercial investments that have attendant risk?

These are particularly important questions when considering major new investment decisions by the SOEBs, such as business acquisitions (e.g. Momentum) or the construction of new generation capacity (e.g. wind farms), neither of which is required to maintain security of supply or serve to deliver lower electricity prices to Tasmanian consumers.

Irrespective of how these kinds of investments are funded, be it any combination of retained earnings from the business or additional debt - or, as has been observed, the direct provision of equity by the Government - the capital has an opportunity cost in terms of its ability to support General Government Sector service delivery.

Such investments may or may not be commercially successful or have an acceptable level of earnings volatility. In making these investments, the Government may have a reasonable expectation of earning a commercial return. However, it may also be asked whether such investments and activities are appropriate investments for government at all, given that, in making them, the Government is also accepting that General Government Services will need to be adjusted in the event that they are not successful.

These issues are germane to the scope of the businesses activities that the Government specifies or, in other words, the boundaries of the field on which it allows the SOEBs to 'play'. The SOEBs need to be as commercially successful as possible within the parameters set by the Government, but it is critical that the scope of business activities is firstly precisely defined, with clear reference to broader strategic policy objectives. This is a primary function of the Shareholders. Significant input from the SOEBs is both necessary and appropriate in understanding the consequences and trade-offs involved in strategic policy direction-setting.

An Ownership Policy would also improve transparency and accountability, by making clear which objectives for the SOEBs are set by the Shareholders and which are set by the businesses themselves. This would allow more public scrutiny of who is accountable for the ultimate delivery of each of the various objectives.

The Panel notes that improvements to the strategic objective-setting process for Government Businesses are already in train. The Government's February 2011 release of its Reform Principles for the Oversight and Accountability of Government Businesses²², has re-opened the discussion between the Government and the SOEBs on the Government's overarching ownership objectives, particularly in the context of what constitutes core and non-core business activities for each of the entities.

For example, the Principles now explicitly refer to the need for clear objectives to be set by the Shareholder Ministers, including core activities of the businesses and any public policy objectives. The Principles also reinforce the Government's low risk appetite as an investor and suggest a focus on 'on-island' activities, unless the businesses can provide a strong, risk-based business case.

While the Principles have been broadly welcomed, some stakeholders from the SOEBs raised questions about how they will be applied in a practical sense, and in particular how they will interact with existing legislation, where it appears in some instances there may still be the potential for ambiguity or conflict, particularly with regard to the Board and management's businesses' legal obligations to operate commercially.

²² Department of Treasury and Finance (2011) *Operation of Government Businesses: Principles for Strengthening the Oversight and Governance of Government Businesses*

The new Principles must therefore be cognisant of director's duties and the intent and objectives of the relevant Acts in order to resolve potential confusion or ambiguity. Specifically, clear guidance should be given as to how Boards are expected to prioritise objectives provided via the new Principles in relation to their existing legislative and other responsibilities. As noted above, there is a need to specify the scope or 'reach' of business activities, thereby setting the boundaries within which their commercial performance will be judged.

Recommendation:

That the Tasmanian Government develops a publicly available Energy Business Ownership Policy that more clearly articulates its overarching strategic objectives for the SOEBs.

1.4. Transparent identification, delivery and funding of all non-commercial activities

The Tasmanian Government has in place a clear framework through which the SOEBs may undertake non-commercial activities for the achievement of broader policy objectives. In the case of the electricity concession and Bass Strait Island CSOs, the cost of delivering these activities is transparently recorded through the annual State Budget process.

The CSO process is a key component in minimising the potential disconnect between directors' duties and the legislative framework on the one hand and the delivery of broader policy objectives on the other. The treatment of CSOs in this way also enables the SOEBs to be held accountable for efficient delivery of the service and for the Government to be held accountable for the policy itself and its overall cost.

However, the Panel has observed a level of non-transparency in the funding of some non-commercial activities.

The most prominent example relates to Aurora Energy's operation of the TVPS. As noted in Chapter 9.2 of the Draft Report, the TVPS has not been recovering its costs from the market. Rather, the current commercial viability of the TVPS is underpinned by a combination of current regulatory arrangements and contractual arrangements with Hydro Tasmania for supplying the non-contestable load. The arrangement effectively transfers the shortfall in market value for the TVPS to Hydro Tasmania. This is not transparent or sustainable

As discussed in more detail in Chapter 9.2 of the Draft Report, there are alternative, more transparent means to support the TVPS on the grounds of energy supply security 'risk insurance'.

There are other examples where the CSO framework has not been deployed where it would have been appropriate to do so. For instance, in 2009 the Government wrote to Aurora Energy to express a desire for tariff increases charged under the Aurora Pay as You Go (APAYG) billing system to be effectively 'capped' for concession cardholders at a rate below that at which Aurora Energy was intending to charge.²³

The Panel understands from its discussions with Aurora Energy that an agreement was subsequently reached with the Shareholders through a negotiated process, which resulted in the Shareholders accepting a commensurately lower dividend in order to cover the cost of delivering the price cap for these customers.²⁴ While the APAYG 'price cap' was publicly announced by the Government and Aurora Energy, its actual cost was only ever captured in confidential Corporate Plans, rather than transparently as a line item in the State Budget, as would be expected for an activity of this kind.

The Panel has also viewed evidence²⁵ that shows the Government had also planned to deliver its 'five per cent price cap' promise through an arrangement where it would accept reduced dividends from the relevant SOEBs.

The practice of accepting a lower rate of return from businesses in return for the internal funding of a CSO runs contrary to the agreed policy of operating government businesses on a fully commercial basis and reduces the businesses own retained earnings.²⁶ The practical consequence of reducing dividends to fund non-commercial activities is that it undermines government's ability to be an effective business owner and sends mixed messages to Boards and management as to what the owner regards as success. Businesses without clear, unambiguous lines of accountability to their owner or where the owner sets mixed or contradictory objectives invariably begin to be run in the interests of the management, with consequences for both customers and owners.

²³ As a 'product of choice' for Tasmanian customers, APAYG tariffs are not set by the Regulator, but at commercial rates determined by Aurora Energy.

²⁴ On 8 July 2009, Aurora Energy announced that APAYG prices would be increased by an average 12 per cent in 2009-10, largely as a result of "...the product's higher technology costs, higher than expected transmission charges and inflation" (Aurora Energy Media Release, 26 July 2009). Following intervention from the Government, average price increases for eligible APAYG concession customers were subsequently brought down to the rise approved for customers on regulated tariffs – 7.2 per cent. The reduction was achieved by the abolition of the daily standing charge and a reduced increase in the standard and off-peak winter prices in the 11am to 4pm, 4pm to 8pm and 8pm to 6.30am time-slots.

²⁵ Cabinet documents

²⁶ Productivity Commission (2008) *Financial Performance of Government Trading Enterprises 2004-05 to 2006-07*

The central issue is not whether the Government should utilise the SOEBs to deliver wider policy objectives – this is one of the core reasons that governments continue to own businesses. Rather, it is the way in which the Government implements these policy outcomes that is central. The funding of non-commercial activities via CSOs rather than through the acceptance of lower than otherwise dividends, is not an accounting ‘nicety’ or a reflection of the technocrats’ desire to tie things up in neat boxes. It is fundamental to good governance, performance management and ability of government to hold the businesses to account.

Recommendation:

That the Tasmanian Government transparently identifies, endorses, costs and funds all CSO activities undertaken by the SOEBs, consistent with its existing CSO policy framework. CSOs should be directly funded through the Budget process, rather than through internal transfers and acceptance by the Shareholders of reduced rates of return.

2. An accountability framework that drives efficient, effective and transparent performance

2.1. Key Principles

2.1.1. Accountability to the Shareholders

The Shareholder Ministers' oversight of SOEB performance should provide a sufficient level of accountability to drive continuous improvement in the efficiency and effectiveness of the businesses. The economic regulatory framework will only partly drive efficiency in the businesses. There is, therefore, a clear responsibility on the Shareholders, through their interaction with the Boards, to provide additional impetus for efficiency.

However, the Shareholders' role in driving SOEB performance needs to be tempered by the general principle that Government should not seek to interfere with the day-to-day management of the SOEBs or step over the important line between the roles of 'owner' and 'director'.²⁷

In this way, the Panel agrees with Transend's view that, with regard to the SOEBs, "[t]here needs to be a balance between giving Shareholding Ministers control over the businesses so that they can be properly answerable to Parliament and taxpayers for its performance and ensuring that the 'control' is not so intrusive that it usurps the legitimate and strategic role of the board or becomes in effect another layer of quasi-regulation".²⁸

Striking this balance relies on a number of key governance elements working together effectively, including:

- Clear²⁹, performance-based agreements between the Shareholders and the Board based on the achievement of agreed objectives, including appropriate sanctions and rewards. Rewards and sanctions should be applied to Boards by the Shareholder Ministers, in turn Boards (in consultation with the Shareholders) should reward and discipline CEOs and management;
- Arrangements that allow for the Shareholders to act as informed owners, including dynamic reporting systems that give the Government's ownership entity a true and timely picture of the SOEB's ongoing performance and financial situation; and

²⁷ See OECD (2005), *Guidelines on Corporate Governance of State-Owned Enterprises* – Principle No. 2

²⁸ See Transend Networks' submission to the Issues Paper

²⁹ Clear in the sense that, ex-post; it is easily discernable whether or not objectives have been achieved.

- The capacity and expertise within Government to then interpret information provided to it by the businesses and provide good advice to the Shareholders, without seeking to duplicate key SOEB management functions in the bureaucracy.

The relative lack of capital market-based discipline on State-owned businesses means that the Shareholder Ministers (and ultimately the Parliament and the broader community) are largely reliant on administrative monitoring procedures as the main accountability mechanism for the SOEBs.³⁰ In broad terms, the Panel notes that such a performance monitoring regime should adhere to the following principles:

- Formal contact between the Shareholders and the SOEB Boards should be kept to a broad strategic level in order to preserve management autonomy and facilitate accountability;
- The monitoring process should concentrate primarily upon overall commercial performance. However, targets and measures for non-financial performance, including the efficiency and effectiveness of the SOEBs, should also be used; and
- There needs to be regular provision of quality information from the SOEBs to enable effective assessment of performance against all set targets. Reporting should comprise both regular publicly available information and the provision of commercially sensitive information solely to the Shareholders.

2.1.2. Accountability to the Parliament and the Community

In addition to the critical Shareholder/Board relationship, the other key element of the SOEB accountability framework is the transparency and public disclosure of key performance information. As the ultimate owners of the SOEBs, it is important that the Tasmanian community has the ability to access regular information about how well the businesses are achieving their stated objectives. The Parliament plays a key intermediary role in holding the SOEBs to account on behalf of the community.

However, the Panel notes that the principle of public disclosure again needs to be balanced against a range of other important considerations, including commercial confidentiality and the burden of reporting on the SOEBs. It is also important that performance reporting is genuinely informative, particularly given both the inherent complexities of the energy market and the public's inability to 'trade' their shares in the SOEBs³¹.

³⁰ NSW Auditor-General (2005), *Performance Audit – Oversight of State Owned Electricity Corporations*.

³¹ It is important to remember in this context that, because the community's shares in the SOEBs are held in trust by the Shareholder Ministers, they cannot utilise information about business performance to inform trading activities. Ultimately, they can only act on this information in forming a judgement of the Government's performance in managing its portfolio in their capacity as electors.

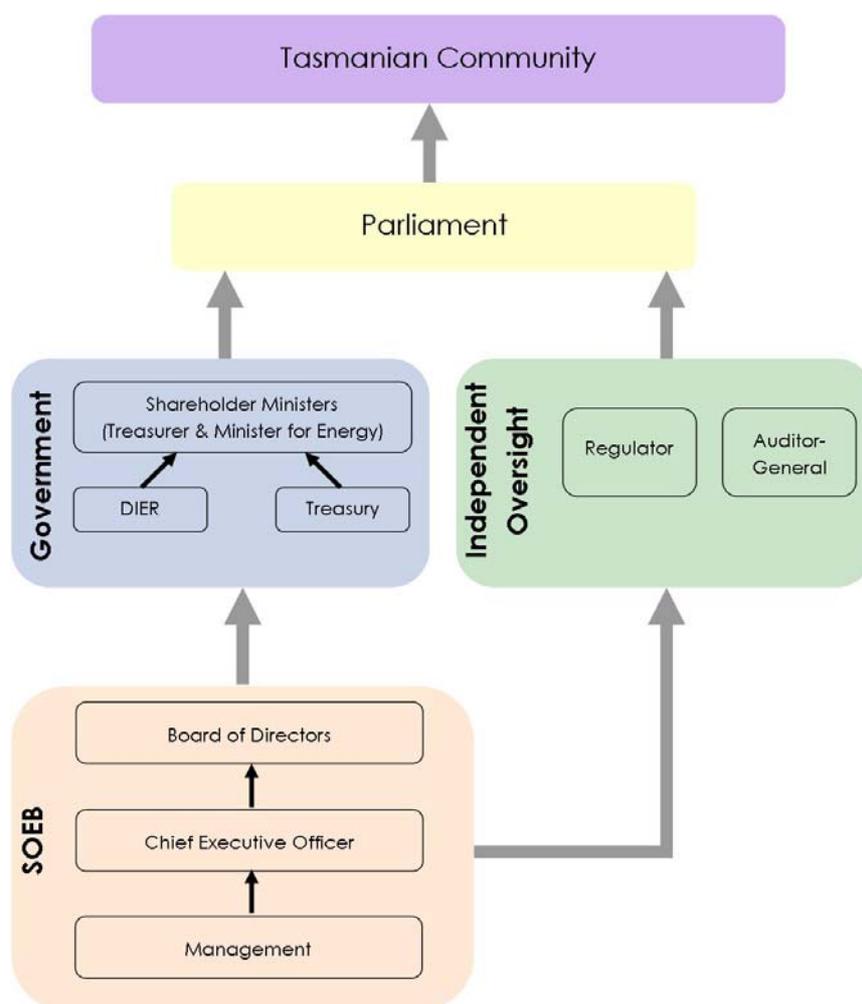
2.2. Summary of Current Arrangements

The current SOEB accountability framework is underpinned by the relationships between the following entities:

- **The Parliament**, which plays a broad monitoring and accountability function on behalf of the Tasmanian community;
- **The Shareholder Ministers**, who are responsible for assessing and monitoring the financial performance of the businesses. The Shareholder Ministers also play a key role in appointing directors;
- **The Board of Directors**, which is responsible for both business performance and ensuring that the management undertakes its functions in the best interests of the business and in accordance with relevant laws. The Board sets relevant performance targets for the business and reviews and approves strategy and policies designed to achieve the Shareholders' objectives. The Board is responsible for the long-term viability of the business by monitoring business and senior executive performance and continually refining the system of internal controls, liability management practices and solvency level of the business; and
- **The CEO and Management**, who are responsible for the business achieving its goals in accordance with the strategies, policies, programs and performance requirements that are approved by the Board. The CEO and Management have legislative obligations to perform their duties in the interest of the business, including acting in good faith for a proper purpose, exercising due care and diligence and preventing insolvent trading.

The chain of accountability that links these entities is summarised in Figure 2, below.

Figure 2 - SOEB Accountability Framework



The SOEB reporting regime is at the centre of the accountability framework. Reporting by the SOEBs is structured around two main lines of accountability:

- 1) To the Shareholder Ministers; and
- 2) To the Parliament and the community.

The SOEBs must also report to the independent Tasmanian Energy Regulator and the Auditor General with regard to their technical performance and compliance respectively. The SOEBs also have 'parallel' reporting obligations to the Australian Energy Regulator with regard to relevant performance measures. The key mechanisms through which the SOEBs currently report to each of these specific audiences are described briefly below.

2.2.1. Reporting to the Shareholder Ministers

The SOEB Board/Shareholder Minister accountability relationship is underpinned by a range of performance reporting mechanisms, ranging from specific, legislative-based requirements through to less formal, officer-level interactions. The current reporting arrangements comprise the following:

Ongoing Disclosure – The Shareholder Ministers have expressed through a range of documents – including the annual letters of expectation and more recently the revised Principles for SOEB Oversight and Governance – that they expect that the Boards of the SOEBs to promptly advise them and Treasury, as their principal financial advisor, of any material risks or issues within the businesses, particularly where this has the potential to impact on the State and its balance sheet. In these instances, the SOEB Chairman will generally arrange for a special briefing with the Shareholder Minister.

Monthly Meetings with the Minister – The Chairman and the CEO of each of the SOEBs meets with the Energy Minister monthly, following the regular Board meeting. The Treasurer attends these meetings quarterly, but is generally represented at the monthly meetings by an advisor.

Quarterly and Half-Yearly Reports - Quarterly reporting to the Shareholders is required under the GBE Act, while SOCs are required to report half-yearly, under their Corporations Act obligations. In practice, however, Treasury requires that all the SOEBs report quarterly. The content of quarterly reports includes commentary on the business' operations and key financial information. Issues may include full year performance expectations, changes in risk factors, progress with major capital projects, strategic issues and any other issues likely to impact on business performance.

After receiving the Reports, Treasury prepares a summary report for the Shareholder Ministers, which includes a 'traffic light' assessment of how the businesses are tracking in relation to their key corporate plan objectives and targets. Neither quarterly nor half-yearly reports – nor a summary thereof - are currently tabled in the Parliament or made publicly available.

Ongoing Interaction between SOEB Management and Treasury Officials – As the designated financial advisors to the Shareholder Ministers, the Shareholder Policy and Markets (SPM) Branch within Treasury maintains an ongoing dialogue with the management teams in each of the SOEBs. SPM nominates individual officers within the Branch as designated 'contact points' for each of the SOEBs to ensure a level of coordination and consistency in its interactions with the businesses.

Annual General Meeting – SOCs are required to hold an Annual General Meeting by 30 November each year, unless approved otherwise. Hydro Tasmania, as a GBE, is not required under legislation to hold an AGM. The AGM is a formal mechanism to appoint the directors and the chairperson, consider the dividend recommendation and consider the financial results for the year.

2.2.2. Reporting to the Parliament and the Public

Public performance reporting is primarily through the Annual Report and Government Business Scrutiny Committee Hearings, which both focus on end of financial year results. These are described briefly below.

Annual Report – The Annual Report is the main public accountability document prepared by the SOEBs. For Hydro Tasmania, the GBE Act requires the preparation by the Board of an Annual Report to be submitted to the Shareholder Ministers and the Auditor-General. The content of Hydro Tasmania’s Annual Reports is prescribed in the Treasurer’s Instructions. Aurora Energy and Transend’s annual reporting requirements are prescribed under the Commonwealth Corporations Act. The Annual Reports of all the SOEBs must be tabled in the Parliament by no later than 30 October in any given year.

While GBEs and SOCs have differing requirements in relation to the prescribed content of their Reports, they generally all include the following information:

- Financial statements for the year, including a copy of the Auditor-General’s opinion on the financial statements;
- A report on performance indicators against those outlined in the Corporate Plan;
- A report on the general operations of the business; and
- Details of CSOs delivered.

One key difference between annual reporting requirements for GBEs and SOCs is that GBEs are required under the GBE Act to provide a Statement of Corporate Intent for the next financial year, whereas SOCs are not.

Government Business Scrutiny Hearings – the Tasmanian Parliament has established the annual Government Business Scrutiny Committee Hearings to ask questions and require answers by Ministers, Chairpersons, CEOs and other managers of Government Businesses “...so as to ensure Government Businesses and their shareholders (Ministers) remain accountable to the Parliament”.³² Effectively, the Hearings are designed to provide the opportunity for Members to inquire in more detail about information provided in the SOEBs’ Annual Reports.

³² Legislative Council (2009) *GBE Scrutiny Committee A Report 2009*

The Hearings are similar in structure and process to those of the annual Budget Estimates Committees, and are generally held in December of each year. Businesses appear before either the House of Assembly or the Legislative Council on an alternating basis from year to year. For the SOEBs, the Hearings are generally attended by the Energy Minister (as Shareholder Minister), the Chairperson, the CEO and senior management. The Committees generally produce a summary report of proceedings for publication. Committee proceedings are also published 'verbatim' in *Hansard*, which is publicly accessible.

Legislative Council Sessional Committees – in 2010 the Legislative Council approved a motion to establish two Government Administration Sessional Committees whose functions are to inquire into and report on any matters relating to "...the administration, processes, practices and conduct of any ... Government Business Enterprise, State-owned Company..." The Panel understands that intention of these Committees is for the Legislative Council to be able to apply more scrutiny to SOCs and GBES on an 'as needs' basis, rather than be restricted to the annual Government Business Scrutiny Hearings. The Committees have to date been used to investigate various operational aspects of both Forestry Tasmania and TasRacing.

2.2.3. Reporting to the Regulator and the Auditor-General

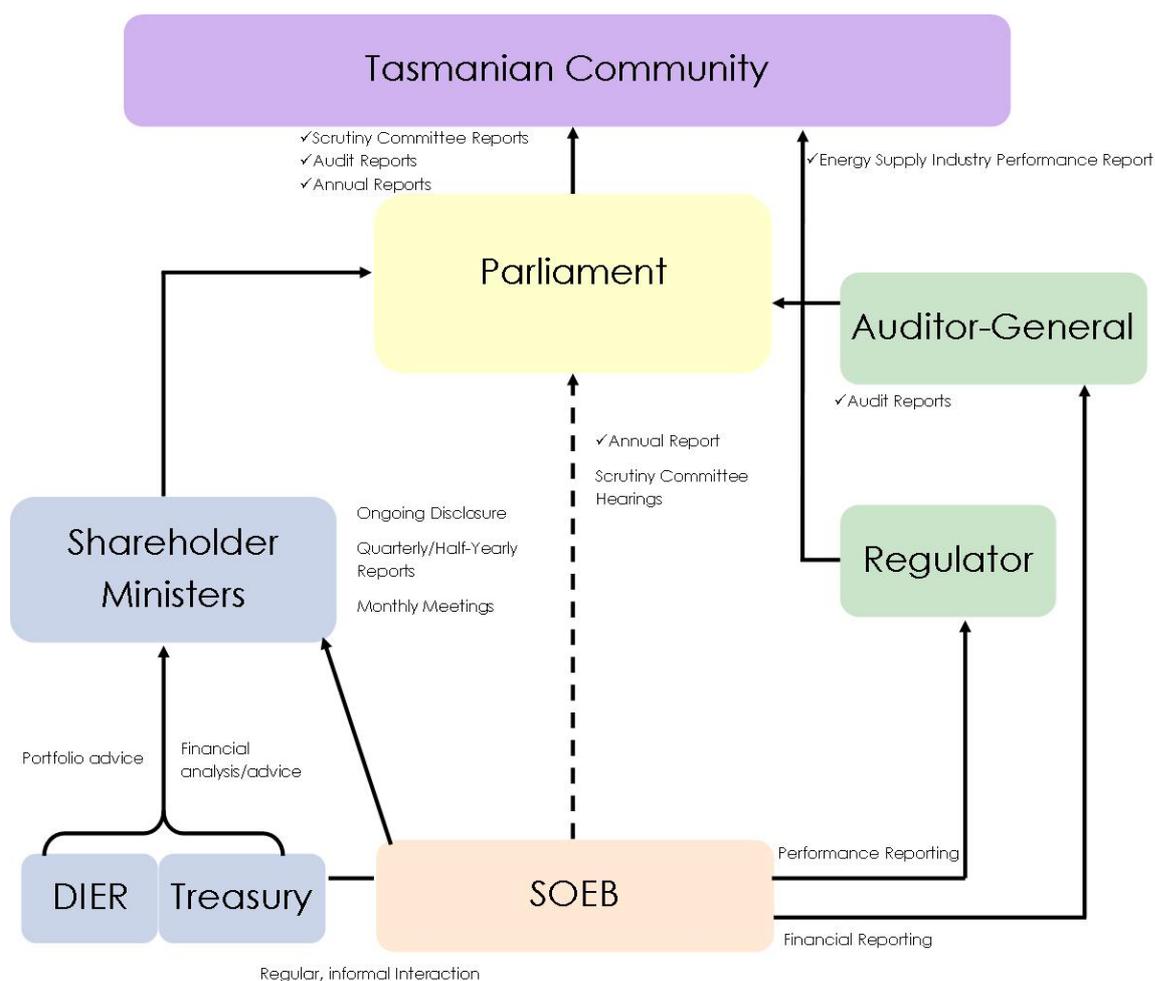
As part of its functions provided for under the ESI Act, the Tasmanian Energy Regulator prepares an annual report on the performance of the Tasmanian electricity industry, covering service standards, quality, reliability and pricing of the energy supply industry in the State across generation, transmission and retail. The Report is publicly available and is intended to provide a key accountability mechanism through which the Tasmanian community can assess the performance of the SOEBs. As part of this process, the SOEBs are required to provide annual reports to the Regulator across a range of technical and other performance measures.

The Auditor-General is appointed by the Governor³³ as the auditor for all Government businesses, including the SOEBs. Under the *Audit Act 2008*, Auditor-General must audit the financial statements of all Government businesses and issue reports on compliance with relevant legislation and accounting standards. The Auditor-General also has the power to conduct both performance audits examining the efficiency and effectiveness of a Government business and compliance audits to examine compliance by the business with relevant laws or internal policies. As the Auditor-General's 'client' is the Tasmanian Parliament – and not Government - the results of all audits conducted reported to the Parliament and are also publicly available.

The SOEB Performance Reporting Framework is summarised in Figure 3, below. Where items that are 'ticked', this indicates information that is publicly available.

³³ On the recommendation of the Treasurer – see the *Audit Act 2008*

Figure 3 - SOEB Reporting Framework



2.3. Issues and Recommendations

2.3.1. A greater Shareholder focus on business performance

From the perspective of the Shareholder Ministers, efficiency within the SOEBs is critical as it drives financial performance and, ultimately, returns to Government in the form of dividends. From a customer perspective, the market and/or the regulatory framework can only go so far in driving efficiency and the longer-term trend in electricity prices.

Responsibility for initiating and driving efficiency improvements primarily falls to the SOEB Boards. However, the Shareholders also have a key role to play in ensuring that the Boards remain clearly focused on high levels of productivity and efficiency to achieve sustainable financial returns. The Shareholders must then subsequently hold the Boards accountable for the achievement or otherwise of relevant efficiency and financial performance targets.

The Panel has observed³⁴ a trend that where efficiency-based expectations have been communicated to the Tasmanian SOEBs via the corporate planning process, these have often been at a high-level, and Corporate Plans have consequently lacked specific targets or performance measures that can be used to monitor the effectiveness of productivity or efficiency efforts.

One possible view is that the economic regulatory environment and independent regulators will provide the dominant drivers for SOEB's efficiency and effectiveness. The Panel's view, on the other hand, is that the regulatory framework can, at best, provide a level of assurance that business not exposed to strong and sustained competitive disciplines are not able to routinely operate at generally inefficient levels. A culture of performance must come from within the business – it cannot be effectively imposed by regulation.

In Tasmania, there are two key reasons why the Shareholders must be even more active in driving the efficient performance of the SOEBs. Firstly, both the wholesale and retail markets lack effective competition, being dominated by Hydro Tasmania and Aurora Energy respectively. Secondly, because the SOEBs under public ownership they are not subject to the same market discipline as private sector entities.

Responsibility for embedding an efficiency-based business culture must start 'from the top' by ensuring robust accountability measures exist between the Shareholders and the Boards. The relationship between the parties should recognise that optimising business performance within the broad parameters established by the economic regulatory environments remains the domain of management and Boards, but that Shareholders provide the ultimate incentives and sanctions for efficiency and effectiveness.

In recent times, efficiency has become more of a focus in the governance arrangements between Boards and Shareholders of the SOEBs. For example, Letters of Expectation have become more specific with regard to the Shareholders' expectation that the SOEBs will develop efficiency improvement programs.

Representatives from the SOEBs have also noted an increase in the level of detail more generally in the most recent Letters of Expectation, compared to previous years. This represents a shift towards oversight that is seeking to better understand and actively engage with the strategic direction of the SOEBs. For example, from this year the SOEB Boards and the Shareholder Ministers will be required to put in place a formal agreement which sets out key performance measures based on agreed objectives, including target dividends and end of year financial results.

³⁴ See 'A Review of the Efficiency and Effectiveness of the State Owned Electricity Businesses and Chapter 8.1 of the Panel's Draft Report

The Panel endorses the recent improvements in SOEB accountability and oversight. However, it is crucial that these arrangements continue to be refined and improved over time, given that it has not always been clear in the past how expectations are being incorporated into the business strategies of the SOEBs or are then in turn being monitored by the Shareholders. It is also important that, where possible, these improvements are reflected and enshrined in formal and enduring mechanisms (e.g. legislation or subordinate regulations).

Of prime importance are the development of specific accountability and incentive mechanisms that provide a 'clear line of sight' between Shareholder expectations and the requirements of the regulatory framework on the one hand, and Board, management and staff performance on the other. The Panel notes Transend's Employee Regulatory Incentive Scheme as good example of this kind of approach in action.³⁵

However, these kinds of mechanisms need to be supported by sound and sufficiently detailed ongoing monitoring, reporting and follow-up processes. This is particularly important where the Shareholders have approved investments in non-core diversification activities that may have a higher risk profile.

It is also important given the growing diversity and complexity of the SOEBs. The intra-entity financial linkages within Hydro Tasmania and Aurora Energy means that there is significant scope for value to be shifted within different parts of the business, either by explicit design, or by changes in one part of the business impacting on another.

For example, there have been implications for the financial performance of Aurora Energy's distribution business arising from the debt levels required to be held by Aurora Energy as a result of the TVPS acquisition. In relation to Hydro Tasmania, as an integrated generation-retail business in the NEM, there are opportunities to shift value between the retail and generation arms.

Detailed reporting of disaggregated or segmented financial information – and a clear explanation and interpretation of this information – is important to ensure that Shareholders and their advisers are in a position to understand core value drivers and how the financial targets established for parts of the SOEBs are being achieved³⁶. For example, Aurora Energy's energy business now comprises wholesale electricity trading, wholesale gas trading, Tasmanian retailing of gas and electricity and retailing activities in the wider NEM. While there are strong commercial reasons for this structure to be adopted, including efficiency rationales, the potential trade-off is that it is more difficult to understand what is driving overall performance – what aspects are generating genuine value and what areas are underperforming.

³⁵ See *'A Review of the Efficiency and Effectiveness of the State Owned Electricity Businesses* and Chapter 8.1 of the Panel's Draft Report

³⁶ This is not to suggest that the management and Boards of the SOEBs do not adequately monitor the financial performance of the various aspects of their businesses.

In this context, Shareholders and their representatives need access to sufficiently detailed and disaggregated financial information that allows them to determine how well individual aspects of the businesses are performing in relation to clear expectations and targets that have been set. Aggregation of financial results should not be used as a way of obfuscating the identification of value drivers of the business.

The Panel has reviewed a range of information provided by the SOEBs to Shareholders, including Corporate Plans and ongoing performance reporting. It has also reviewed monthly management accounts and board reporting within the SOEBs and notes that segment reporting is provided. While not identifying any material deficiencies, the Panel emphasises that access to information at an appropriate level of detail is a cornerstone of the SOEB accountability framework and must be preserved and, where possible, enhanced.

Recommendation:

That SOEB oversight continue to be refined and improved over time with a specific focus on putting in place accountability and incentive mechanisms that provide a clearer 'line of sight' between Shareholder expectations and the requirements of the regulatory framework on the one hand, and Board, management and staff performance on the other.

In the context of the SOEBs growing complexity, reporting of financial accounts must continue to provide sufficient transparency with regard to the performance of discrete elements of the businesses in order to support effective Shareholder oversight.

2.4. Effective Shareholder oversight and strategic policy functions

The ability for the Shareholder Ministers to effectively monitor and drive efficient SOEB performance through the Boards relies in large measure on the ability of the Shareholder's agent (in this case Treasury) to access and interpret performance information. Equipped with good information, the Shareholders should be in a position to respond to emerging issues in a timely and effective manner.

The Panel's Terms of Reference (ToR 8) require it to review the "advice that was provided to the State Government by the senior management or Directors of Aurora Energy from 1 October 2009 to 16 June 2010 inclusive", in the context of the Company's changing financial position over this period. This example provides a good insight into the practical functioning of communication channels between a SOEB and its Shareholders.

From its analysis of the relevant documents, the Panel has observed that senior management in Aurora Energy and officers within Treasury were in regular dialogue throughout 2009 (beginning in February 2009) with regard to the significant financial impact of the TVPS acquisition on its balance sheet, particularly in relation to the likelihood that the asset would need to be impaired or 'written down' in its financial accounts.

Further, when the wider financial issues in Aurora's energy business began to fully emerge late in 2009 and early 2010³⁷, the Panel notes that the Board took urgent and appropriate action in informing the Shareholders of these developments by firstly writing to the Shareholders and then tasking a special Board sub-committee to hold extraordinary Shareholder briefings in January 2010. These briefings were followed up with presentations in April 2010 (upon the return of the Government after the 2010 State Election) that contained more detailed financial projections of the severity of Aurora Energy's position, once this was known.

These observations support the Auditor-General's findings from his investigation into the circumstances around the Government's 'five per cent price cap' promise, that reporting by Aurora Energy to the Shareholders with regard to its financial circumstances over this period was adequate.³⁸

The Government's Principles for Strengthening the Oversight and Governance of Government Businesses reinforce the requirement that the businesses notify the Shareholding Ministers and Treasury as their principal financial adviser, of any business specific issues and risks that have the potential to impact on the State and its balance sheet'. The Panel supports this 'continuous disclosure' approach and notes that in this particular instance the process functioned as intended.

However, this example highlights a broader issue. While the nature of the financial risk exposure itself was known (and had been communicated to the Shareholders), what was not anticipated was its potential (and subsequently realised) magnitude. As noted in Chapter 9.2 of the Draft Report, the large and sustained falls in the financial performance of Aurora Energy's Energy business was not anticipated by the Company, although a number of ongoing revisions to expected earnings were conducted throughout 2009-10. In other words, it was not known in advance what Aurora Energy's financial position would be at June 2010 (which saw actual EBIT of some \$50 million below the original Budget, at -\$31m), as unanticipated losses continued to emerge as late as May 2010.

While the circumstances surrounding Aurora Energy's deteriorating financial position during 2009-10 were unusual, this example does highlight the inherent risks of being an owner of merchant energy businesses in a highly complex market.

³⁷ Chapter 8 discusses how and why Aurora Energy's financial difficulties deteriorated so rapidly over this period. Further detail can be found in *Tamar Valley Power Station: Development, Acquisition and Operation*

³⁸ Tasmanian Auditor-General (2010) Special Report No.94, *Election promise: five per cent price cap on electricity prices*, pp.i

In its submission to the Panel on governance matters, the Government noted in broad terms that it will be considering the current distribution of its various energy responsibilities across the bureaucracy, in the context of the Panel's findings and recommendations. A strong Shareholder oversight function is clearly a fundamental function that will need to be continued, if not further enhanced.

The Panel has not undertaken a detailed review of the resourcing or operation of key functions relevant to the TESI across the Tasmanian bureaucracy. However, reflecting the separate but interrelated roles that government plays in the sector, the Panel highlights that SOEB oversight must also be complemented by an effective strategic energy policy function within the portfolio Department.

Currently, despite having a legislative basis³⁹ DIER's energy policy function appears to have a relatively broad but indistinct mandate. Stakeholder feedback indicates that in practice, DIER's limited energy resources are currently heavily committed to the support of Tasmania's involvement in national energy policy forums (e.g. the Ministerial Council on Energy), and leaving little opportunity to focus on State-based strategic policy development.

Treasury has held a central coordinating role in the delivery of a number of major energy reform projects over the past ten years, including NEM entry and Basslink, and retains formal responsibility for managing the progressive roll-out of retail contestability. This has led to the accumulation of expertise and credibility by Treasury in the eyes of decision-makers.

However, if Treasury holds the major responsibility for strategic energy policy advice – in addition to SOEB oversight - this can potentially blur the lines between these two functions, as well as adversely impact on the diversity of perspectives being brought to bear in advice to Executive Government on major energy policy decisions.

Recommendation:

That the following key functions should underpin any Government review of energy responsibilities across the bureaucracy:

- A strong SOEB ownership and oversight function, focused on driving the efficient performance of the businesses from a Shareholder perspective;
- An expert energy policy function (separate from the ownership and oversight function) with the sufficient mandate, capacity and authority to provide robust advice to Government, preferably through the portfolio Minister; and
- A strategic 'whole of government' policy oversight capacity with the ability to weigh and consider the impacts of energy policy proposals from a more holistic perspective, taking into account broader social, economic and environmental impacts, preferably coordinated by a central agency.

2.5. Enhanced public reporting and accountability

The Panel suggested in its Issues Paper that, *prima facie*, there appear to be limitations on the extent to which SOEB performance could be driven by 'external' accountability mechanisms (which includes answering to both the Parliament and the broader Tasmanian community). It should be noted that in many instances these limitations are not unique to the Tasmanian context, but instead reflective of the State-owned enterprise model more generally, where the focus tends to be on executive accountability (i.e. to the Shareholder Ministers) rather than broader Parliamentary or 'public' accountability.⁴⁰

As the ultimate owners of the SOEBs, however, it is important that the Tasmanian community, as well as the Shareholders, can access regular information about how well the businesses are achieving their stated objectives. In this way, the Parliament plays a key 'intermediary' role in holding the SOEBs to account on behalf of the community.

The principle of transparent public disclosure needs to be balanced against a range of other important considerations, including commercial confidentiality and the compliance burden of reporting. It is also important that performance reporting is genuinely informative, particularly given both the inherent complexities of the energy market and the public's inability to trade their shares in the SOEBs.

Currently, the Tasmanian public accountability framework comprises the Annual Reporting process and Government Business Scrutiny Committee Hearings, with little in the way of more dynamic, ongoing disclosure of performance information. In this way, public accountability of the SOEBs is largely static and focused on end-of-year performance.

In their submissions to the Panel, the SOEBs noted their existing reporting burden, with some suggesting that they already face a higher level of scrutiny than listed companies due to their status as State-owned enterprises.

It is certainly true that the SOEBs, by virtue of being owned by the State, face different kinds of scrutiny to publicly listed private companies, including the unique requirement to appear before Parliamentary Committees. However, publicly listed companies face their own - and in some cases more stringent - accountabilities, both more broadly through their exposure to the discipline of the share market and under the various reporting requirements specified under the ASX's Listing Rules.⁴¹

⁴⁰ Bottomley, S (2000) *Government Business Enterprises and Public Accountability through Parliament*.

⁴¹ For example, the requirement to immediately disclose to the ASX any matter that in the view of a reasonable person would have a material impact on the share price of the company – see ASX Listing Rules, Chapter 3.

In this context, the publication of annual financial statements and annual appearances by the SOEBs before the Government Business Scrutiny Committees are a relatively weak substitute for the kind of close market scrutiny that continuous public disclosure places on listed companies.

The existing public reporting regime for the SOEBs attracted extensive comment from Members of Parliament, a number of whom expressed the view that the current level of information available to the Parliament in particular was insufficient for it to perform its accountability and oversight function on behalf of the Tasmanian community.

The Panel believes that the most significant barrier to more effective public accountability is the inherent (and growing) complexity of the energy sector and information asymmetry between the SOEBs and those seeking to understand their business activities.⁴² However, the Panel also acknowledges concerns that some key information, such as the Government's and SOEBs' business objectives for forthcoming year, is often not available, which makes it difficult to determine if relevant goals had been met, even at a very high level.

In a number of other jurisdictions⁴³, public reporting by State-owned Enterprises comprises a combination of 'ex-ante', 'process' and 'ex-post'⁴⁴ reporting mechanisms, which provide a more dynamic picture of business performance throughout the financial year. This typically comprises the publication of a summary of the corporate plan at the start of the financial year, a half-yearly report and a final annual report.

The Panel believes that there is merit from a public transparency perspective in improving the timeliness and currency of key SOEB performance information provided to the Tasmanian Parliament, consistent with good practice arrangements in other jurisdictions. Specifically, this should include a Statement of Corporate Intent, a Half-Yearly Report and an Annual Report.

⁴² A number of interviewees made the observation that without a background in energy markets, Members of Parliament and the general public would (and indeed did) find it very difficult to understand important contextual information about the operation of energy markets relevant to scrutinising the performance of the businesses.

⁴³ For example, the New South Wales *State Owned Corporations Act 1989* requires SOCs to provide to the Parliament a Statement of Corporate Intent (SCI), Half-Yearly and Annual Reports (within specified timeframes), as well as any directions issued to the SOCs by the Shareholder Ministers. Similarly, New Zealand State-owned Enterprises are required under statute to lay before the House of Representatives a copy of their SCI and both half-yearly and annual reports. The Commonwealth Government also applies a very similar reporting framework to its Government Business Enterprises.

⁴⁴ See Bottomley, S (2000) *Government Business Enterprises and Public Accountability through Parliament*. Bottomley notes the typology developed by John Goldring and Ian Thynne, which usefully describes three kinds of public accountability that can generally be applied to Government Business Enterprises – 'ex-ante', 'process' and 'ex-post' accountability. Examples of the first include the publication of statements of corporate intent, the second could be used to describe reports provided during the financial year ('ongoing disclosure') and the third generally applies to mechanisms such as Annual Reports and end-of-year Parliamentary scrutiny.

This kind of reporting regime is unlikely to result in any significant additional compliance burden for the SOEBs, given the existing Corporate Planning process, and the fact that more detailed half-yearly reports are already provided by the SOEBs to the Shareholders. It is noted that Treasury suggested that a very similar reporting regime may improve public accountability in its 2010 Position Paper on the conversion of Government Business Enterprises to State-owned Companies.⁴⁵

Through its Issues Paper, the Panel also sought stakeholder views on whether there might be some accountability benefits in exposing the SOEBs to public 'continuous disclosure' requirements, analogous to those that currently apply to companies listed on the ASX. This was met with mixed responses from stakeholders, most notably from the SOEBs themselves.

After further analysis of similar arrangements in other jurisdictions⁴⁶ and discussion with stakeholders, the Panel is not convinced that public, continuous disclosure for the SOEBs would yield sufficient accountability benefits to justify the burden of its imposition on the businesses at this stage.

While not within the Panel's remit, it should also be noted that a number of stakeholders were highly critical of the effectiveness of the current Government Business Scrutiny Committee Hearings process, specifically its ability to provide a genuine forum for the discussion of the SOEBs' operational and financial performance. Many stakeholders thought the Hearings had become unduly politicised, which was seen by some as having the unhelpful effect of blurring the line between accountability for SOEB performance (including the oversight performance of the Shareholder Ministers) and the general performance of the Government of the day for the delivery of other policy objectives (which are often unrelated to the operations of the businesses).

The conduct of Scrutiny Committee hearings is a matter solely for the Parliament to determine and the Panel makes no further comment or recommendations in relation to this specific aspect of SOEB oversight and accountability. However, the Panel considered it appropriate to make mention of stakeholders' concerns given the strong feedback received during consultation.

The Panel's proposed improvements to the provision of relevant and timely SOEB information, proposed above, may enhance the Committees' capacity to perform its SOEB oversight function in a more informed and effective manner.

⁴⁵ Department of Treasury and Finance (2010) *Conversion of Government Business Enterprises to State-owned Companies: Position Paper*

⁴⁶ The Panel looked specifically at New Zealand, where continuous public disclosure requirements for State-owned entities were introduced in 2010. The Panel was sufficiently convinced by an early analysis - see Howell, Bronwyn E., Heatley, Dave and Talosaga, Talosaga, (2011) 'Can Continuous Disclosure Improve the Performance of State-Owned Enterprises?'. Available at SSRN: <http://ssrn.com/abstract=1856287> - that because of the inherently 'distant' nature of the SoE/community relationship, this kind of arrangement would be unlikely in and of itself to deliver any significant accountability benefit. It is noted, however, that a number of New Zealand's SOEs have recently been part-privatised, which increases the relevance and likely effectiveness of continuous disclosure requirements in that country.

Recommendation:

That, at a minimum, each of the SOEBs provides to the Parliament and the wider Tasmanian community the following:

- an annual Statement of Corporate Intent (SCI) at the commencement of the Financial Year, summarising the key objectives and performance targets from the SOEB's Corporate Plan;
- a Half Yearly Report that provides a summary of year-to-date performance against targets set out in the SCI; and
- an Annual Report.

3. Separation of the Government's multiple roles of policymaker, regulator and businesses owner

3.1. Key Principles

A fundamental governance challenge in the Tasmanian energy sector, as in a number of jurisdictions, is that the State Government is both a major business owner and one of the main arbiters of the policy and regulatory framework within which the businesses operate. This gives rise to the potential for confusion, or possibly conflict, between these roles, whereby outcomes in one area, for example business performance, are delivered by changes or compromises in another.

In the absence of clear institutional and operation lines of demarcation between Government's roles, it becomes difficult to hold state owned businesses accountable for the outcomes under their control or management. Further, where the perception of potential ownership/regulatory conflict exists, this can have the effect of undermining the confidence of market participants in the independence of the regulatory framework. It can also drive the perverse outcome of government withdrawing from its obligations under its legitimate shareholder oversight role for fear of being accused of regulating or making policy to benefit its own businesses.⁴⁷

The issue of an ownership/regulatory tension was raised by a number of stakeholders in submissions to the Panel. TasGas Networks, for example, suggested that there is currently a 'fuel bias' (either inadvertently or deliberately) towards electricity over gas because of the State's position as owner of the SOEBs. This issue was also highlighted during the stakeholder interviews, where examples were provided that suggested that important gas interests had, at times, been seen to be excluded from key strategic energy infrastructure planning forums established by Government.

There were also some more general concerns raised with regard to the ability of the SOEBs to influence energy policy because of their superior level of access to Ministers and Government when compared to other, privately-owned market participants.

In order to manage these potential conflicts, accepted good practice is that there should be a clear distinction between the State's ownership function and its regulatory and policy-setting function. Even in the absence of private sector competition, governments have favoured the separation of the roles of Ministers as a means of improving discipline for efficient use of State resources, minimising distortions arising from government ownership and increasing the responsiveness of State-owned businesses to their customers.

⁴⁷ OECD (2010) *Accountability and Transparency: A Guide for State Ownership*.

As the OECD notes, "...full administrative separation of responsibilities for ownership and market regulation is a fundamental pre-requisite for creating a level playing field for [State-owned Enterprises] and private companies and for avoiding distortion of competition".⁴⁸

The outcome from this separation should be a regulatory framework that does not discriminate in any way between public and private sector entities, so that ownership effectively becomes irrelevant to the regulatory decision-making process.

This separation is achieved through the following key mechanisms:

- Independent industry regulation (including prices, technical and service standards etc.);
- Exposing State-owned businesses to the same laws and regulations as their competitors, with no special exemptions (including payment of all applicable taxes);
- Minimising benefits associated with State-owned businesses' access to state-backed debt finance (typically through the payment of 'guarantee fees'); and
- The separation of portfolio ministerial responsibilities from shareholder minister/business ownership and oversight responsibilities.

3.2. Summary of Current Arrangements

The separation of State-owned entities from the regulatory roles of government is a central tenant of the corporatisation concept that has been pursued by Australian governments, including Tasmania, since the late 1980s and formalised in the National Competition Policy (NCP) reforms of the mid-1990s.

For example, the NCP agreements signed by all States and Territories in 1995 specifically required, among other things:

- the separation of policy development and regulation from the operation of industry;
- that regulation of prices for monopoly services and access to networks should be independent of government; and
- that government-owned and private sector businesses should be afforded the same treatment under policy and regulatory arrangements (i.e. the principle of competitive neutrality).

⁴⁸ OECD (2005) *Guidelines on Corporate Governance of State-owned Enterprises*, pp. 18

Consistent with the NCP agreements, and in recognition of the important principle of transparent regulatory and ownership separation, there are currently a suite of governance mechanisms in Tasmania to ensure an appropriate demarcation between Government's different roles in the sector, the key components of which include:

- Independent economic and technical regulation of the sector, jointly undertaken by the Tasmanian Economic Regulator and the Australian Energy Regulator;
- The payment by the SOEBs of tax equivalents and guarantee fees; and
- The administrative separation of policy and SOEB ownership functions between the Minister for Energy and the Treasurer (and consequently between the Department of Infrastructure, Energy and Resources the Department of Treasury and Finance).

In the broad, existing governance mechanisms are both consistent with good practice and provide a sound 'baseline' framework for appropriately reconciling the ownership/regulatory tension. However, the Panel has made some observations in the course its investigations, which it believes have the potential to weaken their intended outcomes.

3.3. Issues and Recommendations

3.3.1. Confidence in the independence of regulatory processes

It is the Panel's position that financial value in the SOEBs should be an outcome of efficient operations, not a core driver of policy or regulatory settings. Given the sector's economic and social significance to the State, policy and regulatory settings should be primarily focused on economically efficient outcomes in the energy market.

Economically efficient prices may or may not be consistent with good financial outcomes for the SOEBs at a particular moment in time. As electricity consumers, the Tasmanian community's interests are best served through economically efficient pricing. As the ultimate owners of the major electricity businesses, the community's interests are also in achieving good financial outcomes as dividends paid by SOEBs, relieving the pressure on the need to raise Budget revenue through other means.

Achieving both of these objectives *simultaneously* depends on a range of variables, including the efficacy of decisions around the scope of the businesses activities and investments, the incentives for productivity improvements provided by the way shareholder oversight works in practice and the overall demand and supply balance. It is vital that a framework is established that clearly allocates risk and reward between owners/taxpayers on the one hand and electricity users on the other.

In the Tasmanian framework, the TER is responsible for the setting of the Maximum Allowable Revenue that Aurora Energy may recover from its non-contestable retail customers through regular (typically three-yearly) pricing determinations. In determining maximum prices, the TER is required to take into account all cost components of the supply chain, including the wholesale price of energy, which is the single largest component.⁴⁹

Under the *Electricity Supply Industry Act 1995* (the ESI Act), the TER is independent of Ministerial direction in carrying out its functions, including the setting of retail prices for non-contestable customers. The Act provides the TER with a high level of flexibility in how it undertakes its key functions. However, Parliament remains responsible for defining the framework within which the TER operates, including through the State-based Price Control Regulations (PCRs). Within this framework, government appropriately provides for the consideration and balancing by the TER of a range of broad objectives, including the quality and efficiency of services, the financial sustainability of the businesses and the 'public interest' (among others).

In its investigation of recent pricing trends, the Panel has observed that the Government has provided additional, specific direction to the TER with regard to either prices themselves (as in 2007), or the methodology that should be used for arriving at these prices. Chapter 13.5 describes in further detail the process through which wholesale energy allowances have been set under recent Pricing Determination processes.

Under the 2007 Determination - where the Government, not the TER set the wholesale allowance - , one of the key principles applied Government was that the price should contribute to the sustainability of Hydro Tasmania and Aurora Energy to ensure sufficient revenue capacity to earn a commercial return.⁵⁰ This ultimately resulted in an 'adjustment factor' of approximately \$3MW/h⁵¹ being applied to the price that had been recommended by independent consultants based on the application of a long-run marginal cost methodology.

⁴⁹ For a detailed description of how the Regulator determines prices for non-contestable, see the Panel's Pricing Discussion Paper '*Tasmania's electricity pricing trends*'

⁵⁰ See Department of Treasury and Finance, (May 2007) *Energy Pricing for Non-Contestable Customers – Report to the Treasurer*

⁵¹ The Panel understands that the adjustment was justified in part based on Hydro Tasmania's weakened revenue raising capacity while it rebuilt its storages during a period of drought but has found no evidence or clear explanation of how the \$3 MW/h figure was derived.

Regulatory frameworks must be adaptive and responsive to change where it is demonstrated that they are not delivering the objectives they have been primarily established to achieve. However, given the primary aim of the regulatory framework is to support the efficient operation of the energy market, it is important that market participants cannot form the impression that specific direction provided by the Government to the Regulator, through changes to the regulatory framework, is driven by Shareholder value considerations. When the Government is both a business owner and regulator, it is crucial that clear demarcations between these functions are, and are seen to be, maintained.

The Government's involvement in specific elements of recent pricing determinations – beyond the establishment of the broad principles and objectives that underpin the regulatory framework - raises potential concerns about the actual or perceived level of 'functional' independence that the TER is afforded in making pricing decisions.

The PCRs are designed to provide a high-level of flexibility in the mechanisms that the TER uses in achieving the objectives set out in the regulatory framework.

The Panel endorses the Office of the Tasmanian Economic Regulator's (OTTER) view⁵² that the high level regulatory framework - once appropriately set by Government - should remain consistent between regulatory periods as far as is possible. Crucially, it should also permit the TER sufficient independence, particularly with regard to the application of technical and methodological approaches.

Complete transparency in regulatory pricing arrangements will become critically important for the new entry of private capital in the market with the introduction of full retail contestability and attendant 'fall-back' contract arrangements. A number of electricity retailers have raised this as an issue in their discussions with the Panel.

Recommendation:

That the TER is given the discretion to independently select and apply appropriate approaches and methodologies, within the context of the broader objectives set by the regulatory framework.

Where there are specific outcomes that the Government believes should be taken into account, then it may put the case to the TER in submissions to the independent regulatory process.

⁵² See OTTER's submission to the Issues Paper