Executive summary

The Tasmanian Parliament established the Expert Panel to undertake a comprehensive review of the Tasmanian Electricity Supply Industry (TESI) under the provisions of the *Electricity Supply Industry Expert Panel Act 2010*.

The Final Report presents the Panel's findings and recommendations for the Parliament's consideration.

Delivering effective competition in the Tasmanian electricity market

The Panel's recommendations address fundamental structural issues within the TESI. The recommended reforms to the wholesale supply of electricity are a prerequisite for delivering genuine and sustained choice for all retail customers, including small businesses and households.

The package of reforms has been developed on the basis that it can become a central component of any new Tasmanian Energy Strategy.

The need for structural reform

One of the primary aims of Tasmania's entry to the National Electricity Market (NEM) was to deliver choice to Tasmanian electricity customers, both large and small. In 2003, the then Minister for Energy said:

> "Tasmania's entry into the NEM will create competition and introduce choice in the Tasmanian electricity market, thereby providing benefits to Tasmanian business and household consumers."[2]

Today, nearly ten years later, the vast majority of Tasmanian electricity customers are still unable to choose their supplier.

Tasmania, like other NEM regions, can support a vibrant electricity retail market. Indeed, large national retailers have indicated that Tasmania presents a potentially attractive market for them.

The Panel has concluded, based on its own analysis, experience and submissions to the Review, that competitive prices and services will not be made available to small businesses and households without structural reforms in the retail and wholesale markets. Regulatory changes to facilitate competition to so called "mass market" customers, by themselves will ultimately be ineffectual.

The necessary changes go well beyond simply 'opening up the market' by declaring full retail contestability (FRC).

[2] *Electricity Supply Industry Expert Panel Act 2010* Second Reading Speech, Hansard.

Simply removing Aurora Energy's monopoly over supply to *non-contestable* customers will not deliver competitive retail outcomes, because such a policy would lack the foundation of a competitive wholesale market in which new retail entrants could source contracts. The likely outcome would be piecemeal and unsustainable retail entry that would provide only small benefits to consumers while undermining the value of Aurora Energy's retail business.

In short, gains for customers would not be widespread and any such gains would probably be short-lived, while Tasmanian taxpayers, as the ultimate owners of Aurora Energy, would lose value.

The main barriers for large, new entrant retailers to Tasmania are the unacceptable risks posed by the structure of wholesale market in Tasmania, which are unparalleled elsewhere in the NEM.

Electricity retailing is a high-risk business, particularly for mass market customers as it involves selling at prices that are set well in advance, while having to purchase that electricity from the wholesale spot market at prices that vary widely on a 30 minute basis. Retailers manage this risk by entering into financial hedge or derivative contracts, principally with generators.

Given Hydro Tasmania's dominance, some level of generation from Hydro Tasmania is *virtually always required to meet Tasmanian electricity demand*. This provides Hydro Tasmania with the ability to set spot prices at any level, and at any time, it wishes. At the same time, Hydro Tasmania is the only party with whom retailers are able to source contract cover to manage this spot market risk. The terms and conditions of those contracts, and the degree to which they are offered are within Hydro Tasmania's control. That is, Hydro Tasmania is both the source of the price risk faced by retailers, and the monopoly seller of insurance cover against that risk.

It is this structural feature of the Tasmanian electricity market that poses a substantial barrier to sustainable retail entry.

Committed and long-term entry to the Tasmanian retail market would require retailers to make large and irreversible investments that they would not be able to recover if they had to exit the market quickly. Retailers will not make investments where there is a material risk that, after such investment is made, Hydro Tasmania could exercise its market power to the retailers' significant financial detriment.

While these conditions persist, the investment required for effective retail competition to develop can not and will not be made on the assumption that Hydro Tasmania will remain a 'benevolent monopolist' for the foreseeable future. As commercial entities, retailers would not be able to justify the risks of entering the market on a sustained basis on the grounds of simply 'trusting' Hydro Tasmania not to utilise the commercial opportunities that the current market structure provides it.

For example, If FRC was declared in Tasmania *without* any reform of the wholesale market, genuine customer choice would remain absent. A small number of niche retailers might enter the market, with limited offerings to consumers. Niche retailers tend to invest less in their brands, service delivery and customer support systems and so face fewer costs and constraints to exit the retail market at short notice if they faced financial pressure. Some have indicated to the Panel that this is exactly the course they would take.

While 'hit and run' entry may provide some short-term savings to particular customers, its opportunistic character does not provide a reliable basis for the emergence of self-sustaining retail competition in the longer term.

Moreover, Aurora Energy's retail business in its current form is highly vulnerable to losses of market share and could face sustained losses from even moderately successful short-term competition from niche retailers. Taxpayers would be substantially worse off, unable to exit the retail sector and having the value of its investment in the distribution network eroded by ongoing losses by Aurora Energy's retail business.

Simply put, the Panel considers that a failure to address the current wholesale energy market structure would effectively 'lock in' an absence of effective competition and customer choice indefinitely, denying Tasmanian small businesses and households the clear benefits of competition and choice that have been delivered to consumers elsewhere in Australia.

Structural reform is necessary – and it is achievable.

The Panel's recommended reform package

The Panel's pro-competitive structural reform package comprises four measures:

1. **wholesale market structural reform** – The separation of Hydro Tasmania's physical generation operations from its financial trading functions and the transfer of these trading functions to three specialised, independent state-owned trading entities (referred to as 'GenTraders');
2. **proactive market reform** – The declaration of FRC, accompanied by the sale of Aurora Energy's retail electricity business in three similar-sized parcels to bring new retailers to Tasmania;
3. **network amalgamation** – Combining Aurora Energy's distribution business and Transend Networks into a single, State-owned network business; and
4. **the Sale** of the Tamar Valley Power Station.

1. Structural reform of the wholesale market

The GenTraders would compete against each other in the wholesale spot and contract markets and would be established from the existing trading capability of Hydro Tasmania and Aurora Energy. They would compete on the basis of energy budgets allocated with reference to Hydro Tasmania's energy generation capability and water availability. The GenTraders would not, however, control the physical generation plant.

The structural reform of the wholesale market in Tasmania will:

- result in competition in determining the spot price of electricity in the Tasmanian NEM region and deliver a choice for wholesale market participants among competing contract counterparties; and
- preserve the strengths of Hydro Tasmania's current integrated water management system, with Hydro Tasmania retaining ownership and control of the State's hydro generating assets, including control over all decisions relating to prudent water management and how much electricity can be produced over time.

2. Proactive retail market reform

The combination of repackaging and sale of Aurora Energy's retail business with the declaration of FRC will:

- provide a strong incentive to large-scale national retailers with a long-term commitment to the mass market to enter Tasmania, while not limiting the scope for organic entry strategies. The availability of significant parcels of new customers to retailers provides the fastest and surest path to genuine and sustained choice for all electricity customers in Tasmania at the lowest cost; and
- enable Tasmanians to capture the maximum value of Aurora Energy's retail business – rather than have it eroded over time - and substantially reduce taxpayers' current risk exposure to the highly volatile energy market.

3. Network amalgamation

The amalgamation of Aurora Energy's distribution business and Transend Networks into a single, State-owned network business will improve network management and capture ongoing efficiencies and cost savings, estimated to be around $8 million per annum.

4. Sale of the Tamar Valley Power Station

The Tamar Valley Power Station (TVPS) should be sold at the same time as Aurora Energy's retail business, which would increase the attractiveness of entry into Tasmania by national scale retailers. While this is the Panel's recommended course, in the event that it is not pursed, the TVPS could be established as an independent generator or allocated to one of the Gentraders, while preserving the opportunities for effective retail competition. As a last resort, the TVPS could be transferred into Hydro Tasmania and its capacity subsequently allocated across the GenTraders.

The Panel has concluded that implementation of its recommended reform package – *in its entirety* - is the only feasible way of overcoming the current structural obstacles to viable entry and meaningful rivalry in the wholesale and retail markets and promoting vigorous and sustainable retail competition and choice for all Tasmanian customers. It does this through a combination of opening up the retail market to large scale and long-term entry by experienced mass market retailers and, most importantly, eliminating the key barrier to their entry through the competitive restructuring of the wholesale market.

Because the components of the package are interdependent and reinforcing, to try to implement only selected parts of it would undermine and place at risk achieving improved outcomes for customers. The benefits from each part of the reform package depend on the other parts also being implemented.

Reforms of this type are not new or novel. Similar models to the proposed GenTrader arrangements have worked successfully elsewhere in Australia and overseas, and on a long term basis.

However, this reform package is not an 'off the shelf' reform package from another jurisdiction. The Panel has done significant preliminary work with a range of stakeholders to ensure that its proposed model is compatible with the technical and commercial features of the Tasmanian region. The reforms <u>will</u> work, provided there is genuine and sustained commitment to their implementation.

The one-off design and implementation cost of implementing the GenTrader model would be modest in both an absolute sense and, particularly, in relation to the benefits arising from the structural reform model and from the implementation of the Panel's governance recommendations.

The economy-wide benefits of effective competition demonstrate a compelling case for reform. The Panel has adopted a highly conservative approach to estimating the economic gains from reform by examining the impacts of change on currently *non-contestable* customers only. On this most narrow of measures, economic benefits in the range of $150 million to $240 million are achievable over an eight year period. This leaves aside the dynamic efficiency benefits driven by competition in the retail market, and the direct benefits of reform on currently contestable customers.

Consultation on the Panel's Draft Report found that national retailers and other stakeholders – including the Australian Energy Market Operator and the Australian Energy Regulator - support structural reform of the wholesale market as the best way to address the current wholesale market issues. The only significant opposition comes from Hydro Tasmania.

In the Draft Report, the Panel identified two other reform paths that could potentially address the issues in the wholesale market:

1. **a regulatory option based on an auction by Hydro Tasmania of standard wholesale energy contracts; and**

2. **the creation of a single Victoria–Tasmania NEM region.**

Following further development, analysis and consultation with stakeholders, the Panel does not recommend the implementation of either of these options.

A regulatory approach without structural reform is likely to be ineffective – it would not meet the entry requirements of national mass market retailers, although it could provide further encouragement for some opportunistic entry by niche retailers. Nonetheless, absent structural reform, a regulatory approach would be preferable from an energy policy perspective to no reform at all on the basis that FRC were to be implemented in Tasmania.

The Panel does not recommend the 'VicTas' single region option for a range of reasons, foremost among these being that it would require considerable coordinated work by numerous decision-makers outside Tasmania over an extended timeframe. Reliance on bodies and interests external to the Tasmanian Government is a major risk and drawback for this option, particularly when both the GenTrader and contract auction models could be implemented unilaterally.

Figure 1 presents a summary of the outcomes for each sector of the TESI under the status quo, structural reform and regulatory reform models.

Immediate Priorities for Change

In addition to the recommended market structure reforms, the Panel has also identified three issues that should be addressed by the Tasmanian Government as a priority*, independent of the approach taken to reforming the wholesale and retail markets*.

These are:

1. **Changing the regulatory framework for determining the wholesale energy allowance for *non-contestable* customers.**

   The current pricing arrangements are referenced to the stand-alone costs of a hypothetical new entrant generator. Given that this is calculated as if the new capacity was required today, such an approach sends the wrong pricing signals to *non-contestable* customers. Prices should better reflect: the efficient cost of the generating plant that is actually supplying those customers; hydrological storage levels; and the prevailing supply/demand balance in Tasmania.

   This change will result in prices for *non-contestable* customers that are more in step with market prices faced by contestable customers.

2. **Restructuring the TVPS' financial arrangements so that it is put on a commercially sustainable footing.**

   Under its current cost structure, the TVPS cannot compete and operate efficiently in the market, at current or expected market prices in the Tasmanian and Victorian regions of the NEM under normal water levels.

   The TVPS' commercial viability is underpinned by arrangements between Aurora Energy and Hydro Tasmania. This is not sustainable. The TVPS should be placed on a transparent and commercially sustainable footing.

3. **Ongoing governance improvements, building on actions already in train.**

   The Panel's governance recommendations are aimed at ensuring greater focus on State-owned Energy Business (SOEB) objectives, efficient performance and accountability. Clearer objectives for the SOEBs - and improved accountability for their achievement – will lead to more efficient operations and, in turn, the capacity of SOEBs to return higher dividends than have historically been delivered. If implemented, the Panel's recommended governance reforms will also provide a more transparent picture to the Parliament and the Tasmanian community of the SOEBs' direction and performance.

The recent performance of the TESI

The other key aspect of the Panel's task has been to review the historical performance of the TESI and in doing so, to address a number of issues that have been matters of public discussion in Tasmania for some time.

These issues include how major investment decisions, major industrial customer pricing and the performance of the SOEBs have impacted on household electricity prices.

This analysis has informed the Panel's reform recommendations, particularly in the areas of governance and strategic oversight of the SOEBs.

Electricity pricing trends (ToR 2 and 3 - see Chapter 14)

Household customer prices have more than doubled since 2000. Small business customer prices have not increased at the same rate, but have grown from a higher base.

About half of the increase in prices has been due to distribution and transmission network (the poles and wires) costs, with about 40 per cent due to increases in the wholesale price of energy factored into regulated prices.

Prices are expected to increase in the foreseeable future in every region of the NEM, including Tasmania. A driver of changes in delivered energy costs to Tasmanian customers will be the impacts of carbon pricing. The slowing growth in capital spending of the network business will ease some, but not all, of the price pressures that have recently been experienced from the network businesses.

While 'hydro-industrialisation' may have been used by previous Tasmanian governments in the past as an economic development tool, contemporary major industrial customer pricing does not reflect cross subsidies from other electricity users.

Financial and technical performance of the State-owned energy businesses (ToR 1, 3 and 5 – See Chapter 15)

The technical performance, including overall reliability, of the electricity supply industry in Tasmania is generally comparable to that in other states.

Each of the SOEBs generates sufficient cash to fund operating activities and to have available an amount of 'free cash' to utilise for capital investment in core business assets or diversification/growth activities, repay debt or return dividends to shareholders/taxpayers.

However, the SOEBs' financial performance has been relatively weak, particularly with regard to dividends distributed to the Government. Over the period 2003-04 to 2009-10, the SOEBs returned $309 million in dividends.

A feature of the SOEBs' performance has been the investment in business activities that are not required to meet Tasmanian energy demand, including national and international ventures. Between 2003-04 and 2009-10, $100 million has been invested outside Tasmania, which to date has yielded very little financial return directly to the community. Indeed, one of the reasons that dividends have been so poor has been the retention of capital for investment in these non-core activities.

The SOEBs' financial performance has also been affected by both Aurora Energy and Transend's tendency to overspend regulated allowances for both operating and capital expenditure. Aurora Energy's retail costs have also been significantly above its regulated allowance. More recent performance, which has accompanied higher allowances, shows the regulated businesses spending in line with, or less than, regulated allowances. Aurora Energy, in particular, has placed an unprecedented focus on driving costs out of its business across a range of areas.

Governance changes that drive accountability for performance are starting to emerge which, if sustained, can be expected to improve the financial performance of the SOEBs. In the Panel's view there is significant scope for improvement however, particularly in regard to the clarity and consistency with which the objectives of the businesses are set and implemented.

Major infrastructure projects (ToR 2, 4 and 8 – See Chapter 16)

Basslink has proven to be an effective and cost-efficient means of securing the State's energy supply during times of drought. It has enabled Tasmanian demand to be met at a materially lower cost to Hydro Tasmania than would have been the case under alternative scenarios.

Because of the 2006 to 2008 drought, Hydro Tasmania has not, until recently, been able to use Basslink to profitably trade electricity at the levels or value expected prior to Basslink's commissioning. With inflows returning to more typical levels, Basslink is proving to be a profitable opportunity for Hydro Tasmania.

Tasmanian *non-contestable* customers are <u>not</u> subsidising Basslink through their electricity prices.

The commissioning of the TVPS in October 2009 achieved a long-standing government objective of securing on-island gas-fired generation in Tasmania. However, ownership of the TVPS by Aurora Energy, and its use to back *non-contestable* customer load, has not achieved the original policy objective of promoting more effective competition in the Tasmanian wholesale market for contestable customers.

Since the Tasmanian Government directed Aurora Energy to acquire the TVPS in 2008, the TVPS has proven to be a financial burden for Aurora Energy. The current cost structure of the TVPS means that it cannot compete in the market, given current market prices and water levels, and prevailing prices in the remainder of the NEM.

As noted above, the TVPS needs to be placed on a transparent and commercially sustainable footing.

Figure 1

	Customer Outcomes	Retail Market	Energy Trading
Status Quo	**Partial Contestability**	**Limited Retail Participation**	**Market Dominated by Integrated Hydro Tasmania**
	• FRC not declared • Small business and residential customers remain non-contestable on a regulated tariff • Tranche 5a deregulated – Aurora Energy only retailer offering services in this market • Ineffective wholesale price outcomes for non-contestable customers	• Limited competition outcomes - Aurora Energy retaining 89% of market share (by volume) of Tranche 1 to 4 customers • New entrant retailers do not have access to small business and household customers • Commercial and industrial retail position of based on back-to-back wholesale arrangements with Hydro Tasmania • Aurora Energy retail business financially vulnerable • Aurora Energy unable to meet retail regulatory allowance	• Single 'Hydro Tasmania' view drives key decisions that deliver Tasmanian market outcomes • Demonstrated transitory market power in the spot market and sustained market power in contracting for *non-contestable* customers • Aurora Energy over-hedged (OCGT) - estimated cost $14 million per annum • Barrier to rigorous retail competition rotail competition on Hydro Tasmania's terms
Structural Reform	**Full Contestability with Durable Retail Choice**	**Proactive Retail Participation Providing Customer Choice in the Short Term**	**Competing Trading Entities**
	• Small business and residential customers contestable. • Tranche 5a and 5b customers have the choice of market based contract or standing offer (regulated) contract • Delivers several large competing new retailers into the market to provide durable choice and effective price outcomes for customers	• Delivers several large competing new retailers into the market though the sale of Aurora Energy's retail business • Preserves ability for niche entry • Greater likelihood of sustained retail competition • Realises Shareholder value in Aurora Energy retail rather than have it eroded over time • Removes Government from risky sector	• Diversity in views on the Tasmanian market - not single • Hydro Tasmania view • Competition between entities drives trading decisions bidding and contracting • Spot market outcomes more predicable • Provides multiple contracting counterparties • Provides wholesale energy market structure to support sustained retail competition • Some additional costs from multiple traders and one-off implementation costs
Regulatory Reform	**Full Contestability with Limited Retail Choice or Durability**	**Organic Retail Market and Delayed Customer Choice**	**Regulated wholesale contracting arrangements**
	• Small business and residential customers contestable. • Tranche 5a and 5b customers have the choice of market based contract or standing offer (regulated) contract • Hit and run' retail competition • Limited competition to provide durable choice and offerings for customers	• Smaller retailers enter on 'hit and run' basis • Notional large-scale retailers unlikely to enter the market • Cost-plus approach to retail competition - price competition on cost to serve only • Government 'trapped' in sector • No realisation of Shareholder value in Aurora Energy's retail business - erosion over time with consequences for returns from distribution business	• Further deviation from the notional market adding costs to prices • Regulatory design stymies the NEM competitive market dynamic • Regulation rather than trading drives wholesale outcomes • High levels of regulatory and sovereign risk - demonstrated in Tasmania through Government involvement in regulated tariffs • Does not address spot market issues high risks remain • Does not provide basis for entry of first-tier retailers

	Distribution	Transmission	Generation
Status Quo	**Integrated distribution/ retail business**	**Stand-alone Transmission Business**	**Dominant Hydro Generator**
	• Some concerns for retail competition from integration of Aurora Energy retail and distribution businesses • Aurora Energy Board required to focus on two fundamentally different businesses • Small cost savings available from co-operation between distribution and transmission businesses • Unable to capture cost savings from network integration	• Small cost savings available from co-operation between distribution and transmission businesses • Unable to capture cost savings from network integration	• Wholesale market structure results in broad wholesale market issues • Hydro generation 81% installed capacity (Hydro Tasmania) • Wind generation 5% installed capacity (Hydro Tasmania control) • Basslink 500 MW import (up to 630 MW import) (Hydro Tasmania control) • TVPS 10% installed capacity (Aurora Energy control)
Structural Reform	**Integrated Network Business**	**Integrated Network Business**	**Integrated Generation Portfolio**
	• Integration of transmission and distribution network businesses into one entity • Pure network focus • Market confidence in arms-length dealings with networks • Integration delivers savings of around $8m annually • Greater scope for operational synergies to be implemented • Some implementation costs	• Integration of transmission and distribution network businesses into one entity • Pure network focus • Integration delivers savings of around $8m annually • Greater scope for operations synergies to be implemented • Some implementation costs	• Hydro Tasmania retains ownership and operation of hydro generation assets and responsibility for prudent water management • *Trading entities have rights to generation output* • Hydro Tasmania offers traders dispatch to AEMO • Hydro Tasmania retains key existing relationships with Basslink, MI customers for energy and SPS • IRRs allocated to trading entities to facilitate inter-regional trading
Regulatory Reform	**Integrated distribution/ retail business**	**Stand-alone Transmission Business**	**Dominant Hydro Generator**
	• Aurora's retail not viable as a stand alone entity – needs balance sheet and cash flows from DB to remain viable	• Unable to capture cost savings from integration	• Wholesale market structure results in broad wholesale market issues • Hydro generation 81% installed capacity (Hydro Tasmania) • Wind generation 5% installed capacity (Hydro Tasmania control) • Basslink 500 MW import (up to 630 MW import) (Hydro Tasmania control) • TVPS 10% installed capacity (Aurora Energy control)

Key findings and recommendations

Key findings

Competition – the wholesale and retail markets in Tasmania

- Tasmania is a potentially attractive market for both large national retailers and smaller niche retailers in the event that the entire retail market, including small business and households, is opened to competition.
- The main barrier is a Tasmanian wholesale market structure that poses unacceptable risks for retailers, which are unparalleled elsewhere in the NEM.
- Hydro Tasmania can control the Tasmanian spot price and is also the only counterparty with which retailers can enter into contracts to manage the risks of spot price volatility.
- Hydro Tasmania has not exercised its market power in a sustained way. Nonetheless, the risk that it could act on its incentives to do so is sufficient to deter most retailers. A 'benevolent monopolist' in the wholesale market cannot be the basis for building a sustainable retail business in Tasmania.
- The strategies of retailers differ depending on their business models, but all must manage wholesale market risks.
    - Those that have a flexible and opportunistic entry and exit approach may be more prepared to enter the Tasmanian retail market based on short-term risk management arrangements. They will also be prepared to exit the market if margins are squeezed.
    - The national-scale retailers take a long-term focus and are not prepared to make substantial investments in building a sustained retail presence in Tasmania without wholesale market risks in Tasmania being reduced through structural change.
- The market structure on which retailers will base their entry to the market is fundamental to the ***nature*** and ***quality*** of retail competition that is likely to emerge.
- The declaration of FRC alone, or with 'light handed' regulation of the wholesale market, will not deliver effective and sustainable competition.
    - Competition will likely be limited to a small number of niche retailers adopting an opportunistic, 'hit and run' approach to Tasmanian market.

  - This may provide some short-term savings to particular customers, but it will not promote the emergence of self-sustaining retail competition in the longer term. Under this scenario, the costs of FRC would outweigh the benefits for most consumers.

- The only way to entrench ***genuine and sustained*** retail competition in Tasmania is by changing the underlying wholesale market structure so that large, nationally-based retailers will not be 'locked out' of the market on the basis of unacceptable risk.

- The Panel remains convinced that structural reform is best achieved by the separation of Hydro Tasmania's physical generation operations from its financial trading functions and by then transferring these functions to a number of specialised, independent State-owned trading entities, which could compete against one another in the spot and contract markets.

- Regulatory approaches to the wholesale market are unlikely to deliver effective retail competition. The contract auction model proposed by the Panel in its Draft Report will not meet the entry requirements of national mass market retailers, and is arguably not required to attract opportunistic entry by niche retailers.

- After further consultation, the 'Vic/Tas' single NEM region option proposed in the Draft Report is also not favoured for a range of reasons.

- The small size of the Tasmanian retail electricity market means that the entry of private capital in the retail market is likely to be limited if the market is left to develop on an 'organic' basis, even where the proposed wholesale structural reform is undertaken.

- FRC is best implemented with a pro-competitive structural reform of the Tasmanian retail market to bring nationally operating retailers to Tasmania.

- The amalgamation of the distribution and transmission businesses would deliver efficiencies in the order of $8 million per annum. The only path to obtaining these efficiences is through the structural reforms of the wholesale and retail market. These savings would more than offset any additional costs in the wholesale market arising from structural reform.

The price-setting framework for *non-contestable* customers

- The current arrangements for setting the wholesale energy allowance that can be charged to *non-contestable* customers send the wrong pricing signals to these customers.

- As noted in the Draft Report, the wholesale energy allowance should better reflect the efficient cost of the generating plant that is actually supplying *non-contestable* customers, as well as dam storage levels and the prevailing Tasmanian supply/demand balance.

Electricity price trends

- *Non-contestable* customer prices have more than doubled since 2000.
- About half of the price increase has been due to costs incurred in running the distribution and transmission networks. Some 40 per cent of the increase has been driven by the wholesale energy allowance factored into customer prices.
- Tasmanian price rises have been broadly consistent with increases experienced across Australia. Tasmanian prices continue to be somewhere in the 'middle of the pack' when compared with prices in other jurisdictions.
- While 'hydro-industrialisation' may have historically been used by previous Tasmanian governments as a tool for economic growth, contemporary major industrial customer pricing does not reflect cross subsidies from other electricity users.
- Electricity prices are expected to increase into the foreseeable future in every region of the NEM, including Tasmania. Carbon pricing being a new driver. While the rate of growth in network costs is expected to moderate, network charges will continue to also be a major driver of higher electricity costs.

The technical and financial performance of the TESI

- The technical performance, including overall reliability, of the electricity supply industry in Tasmania is generally comparable to that in other states.
- Each of the State Owned Electricity Businesses (SOEBs) generates sufficient cash to fund their operating activities and to have available an amount of 'free cash' to utilise for capital investment in core business assets or diversification/growth activities, repay debt or provide a return to shareholders.
- The SOEB's financial performance has been relatively weak, particularly with regard to returns to the Government.
- Poor returns have been partly due to the SOEBs investing available capital in non-core business activities rather than returning it to Government. Between 2004 and 2010, $100 million has been invested outside Tasmania, and, to date, has yielded very little in the way of direct financial returns to the Tasmanian community.
- Until recently, Aurora Energy and Transend have regularly overspent their regulated allowances for both operating and capital expenditure. Aurora Energy's retail costs are also significantly above its regulated allowance. These over-expenditures have impacted on the financial performance of the business and have been borne by taxpayers, rather than electricity customers.

- More recent performance, which has accompanied higher allowances, shows the regulated businesses spending in line with, or under their regulated allowances.

- Governance changes that improve accountability for performance are also starting to emerge which, if sustained, can be expected to improve the financial performance of the SOEBs.

- In particular, clearer objectives for the SOEBs - and improved accountability for their achievement – will lead to more efficient operations and, in turn, the capacity of SOEBs to pay higher dividends than have historically been delivered.

Major infrastructure projects

<u>Basslink</u>

- Tasmanian *non-contestable* customers are <u>not</u> paying for Basslink through their electricity prices.

- Basslink has proven to be an effective and cost efficient means of securing the State's energy supply during times of drought. It has enabled Tasmanian demand to be met at a materially lower wholesale energy cost to Hydro Tasmania than would have been the case under alternative scenarios.

- Since 2006, Hydro Tasmania's financial returns from Basslink's have been around $134 million less than its Basslink-related costs. This largely reflects the drought directly following commissioning. With the return to more typical inflows, between 2009-10 and 2010-11 Basslink has enabled Hydro Tasmania to generate positive net returns approaching $30 million.

<u>Tamar Valley Power Station</u>

- The TVPS has proven to be a financial burden for Aurora Energy since it was directed by the Tasmanian Government to acquire the partially-built power station in August 2008.

- Under its current cost structure, the TVPS cannot compete and operate viably in the market, at current market prices in the Tasmanian and Victorian regions of the NEM and assuming normal water storage levels.

- Currently, commercial arrangements between Hydro Tasmania and Aurora Energy, which emanate from the regulatory framework relating to *non-contestable* customers, effectively transfer the shortfall in the market value of the TVPS from AETV (the subsidiary of Aurora Energy that owns the TVPS), through Aurora Energy and on to Hydro Tasmania. This is not sustainable and needs to be addressed. The TVPS needs to be placed on a commercially-viable footing.

- The valuation advice provided to the Government when it decided to acquire the power station indicated a difference between its acquisition and completion costs and its market value, under normal hydrological conditions, of around $150 million. The Panel has interpreted this as an energy supply risk 'insurance premium' paid by the Government to avoid what it believed would be significant potential economic damage in the event of a supply shortfall.

Governance

- The arrangements that underpin Tasmania's SOEB governance framework are generally consistent with good practice principles.
- The evidence supports the Auditor-General's previous finding that reporting by Aurora Energy to the Shareholders with regard to its financial circumstances between 1 October 2009 and 16 June 2010 was "adequate".
- There is scope to improve the way the Government, as Shareholder, communicates its strategic objectives for the SOEBs, particularly with regard to the delivery of non-commercial objectives and the scope of business activities.
- In some instances, the Government's Community Service Obligation (CSO) policy has not been appropriately or consistently implemented, including the practice of accepting a lower rate of return from businesses in exchange for the internal funding of a CSO.
- Public accountability of the SOEBs is largely focused on end-of-year performance. There is currently little in the way of ongoing disclosure of performance information.

Recommendations

The Panel makes the following recommendations:

1. That the Tasmanian Government amend the Price Control Regulations with regard to the setting of the wholesale energy allowance for *non-contestable* customers so that the Tasmanian Economic Regulator is able to:
    - recognise the efficient costs of the existing and future sources of energy that will actually be utilised in delivering the energy that is used by *non-contestable* customers, rather than basing prices solely on estimates of a notional new entrant;
    - take into account the prevailing storage situation and the likely level and volatility of hydrological inflows over the period for which the allowance is to be set; and

- consider the likely supply/demand balance over the period for which the allowance is to be set and the timing of any new investment needed to meet growth in the *non-contestable* customer load in the future.

2. That the TVPS be put on a transparent and commercially sustainable footing by re-valuing and recapitalising AETV to reflect the TVPS' current place in the market and the sustainable revenues available to it. All debt that cannot be supported by market revenues should be transferred from the Public Non-Financial Corporate Sector to the General Government Sector.

3. That the Tasmanian Government pursue a pro-competitive, structural reform package comprising all of the following components:

   - the separation of Hydro Tasmania's physical generation operations from its financial trading functions and the transfer of these trading functions to three specialised, independent state-owned trading entities;
   - the declaration of full retail contestability, accompanied by the sale of all Aurora Energy's retail electricity business in three similar-sized parcels;
   - the amalgamation of Aurora Energy's distribution business with Transend Networks to create a single, State-owned network business; and
   - the sale of TVPS at the same time as the sale of the Aurora Energy retail business or, alternatively, its transfer into Hydro Tasmania, where its capacity can be allocated across the three new trading entities.

4. That the Tasmanian Government implement a package of governance reforms to improve the strategic oversight and governance of the SOEBs, including:

   - the development of a publicly available Energy Business Ownership Policy that more clearly articulates the Government's overarching, strategic objectives for the SOEBs;
   - specific accountability and incentive mechanisms for the SOEBs 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;
   - the more transparent and consistent application of the Government's existing CSO policy; and
   - more dynamic and transparent SOEB public reporting arrangements.