



Electricity Supply Industry Expert Panel

**An Independent Assessment of the
Tasmanian Electricity Supply Industry
Summary Report**

December 2011

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December 2011

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Terms of Reference

The Expert Panel shall investigate and report on:

- 1) The current efficiency and effectiveness of the Tasmanian energy industry with particular reference to the existing regulatory framework and the cost and operation of the energy industry elsewhere in Australia.
- 2) The primary factors that have driven recent increases in *non-contestable* electricity prices in Tasmania including the impact of major infrastructure development decisions.
- 3) The competitiveness of *non-contestable* electricity prices in Tasmania compared with those in other states.
- 4) The financial position of the state-owned energy businesses: Transend Networks, Hydro Tasmania and Aurora Energy.
- 5) The impact of interaction between the three state-owned businesses on the effective operation of the Tasmanian energy industry and Tasmanian energy prices.
- 6) Having regards to trends in electricity prices and market developments at the national level and Tasmanian-specific circumstances, the implications of Tasmania's market and regulatory arrangement for electricity tariffs over the coming years.
- 7) Actions that would guide and inform the development of a Tasmanian Energy Strategy particularly in relation to the Government's primary objectives of minimising the impact on the cost of living in Tasmania and ensuring Tasmania's long term energy sustainability and security.
- 8) 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.
- 9) Any other matters that the Expert Panel considers are relevant to the above matters.

Drivers of reform

The Rundle Government's *Directions Statement – Tasmania's Future Energy Strategy*, released in April 1997, identified the need to re-examine Tasmania's energy policy and supply needs following the completion of the Anthony Power Development in 1994. At that time, the State's energy needs were broadly equivalent to the hydro system's sustainable output.

The Tasmanian Government embarked on major reforms to the Tasmanian Electricity Supply Industry (TESI) aligned with broader national electricity market and national competition policy reform. Since then successive Tasmanian Governments have had three primary objectives which were:

1. Securing new sources of supply to overcome energy constraints.
2. Mitigating exposure to hydrological risk.
3. Introducing greater competition and customer choice into the Tasmanian market.

The central feature was Tasmania joining the National Electricity Market (NEM), facilitated by interconnection to Victoria via Basslink and the development of competition in the wholesale and retail markets. One of the primary aims was to deliver choice to Tasmanian electricity customers:

"Tasmania's entry to the NEM will create competition and introduce choice in the Tasmanian electricity market, thereby providing benefits to Tasmanian business and household consumers."¹

While the new physical sources of supply have been delivered, and additional options for managing hydrological risk are in place, the underlying market dynamics have not developed as anticipated. Hydro Tasmania remains the principal participant in the wholesale market and Aurora Energy remains the dominant retail service provider.

The key to improving choice and creating competitive pressures for Tasmanian customers is improving the wholesale electricity market in Tasmania. The current market structure creates the potential for, and market perceptions of, high levels of risk, and a lack of choice in risk management options.

¹ Second Reading Speech for the *Electricity Supply Industry Amendment Bill 2003*, which introduced the framework for retail contestability in Tasmania.

The result is that potential entrants – both retailers and, in the future, generators – are deterred. The issue is not whether Tasmanian spot market prices are on average similar to other NEM regions. For as long as Hydro Tasmania has the ability, in certain circumstances, to raise spot prices *and* is the seller of the contracts that allow the retailer to manage these price risks, retailers will continue to judge participation in the wholesale market in Tasmania as a low commercial priority.

The evidence presented to the Panel by nationally-based retailers is that there is an attractive and viable retail market in Tasmania. What is needed are changes to the wholesale market in Tasmania that provide better options for managing wholesale market risk. The Panel considers that with such changes, the implementation of contestability for all customers, like elsewhere in the NEM, is feasible in Tasmania and this remaining aspect of the reform agenda can be delivered.

The Panel has developed three reform paths that it believes will improve wholesale market outcomes. This will, in turn, support the level of effective competition in the retail market that is necessary to underpin full retail competition. To be effective, the market reforms need to be supported with improvements to the current regulatory and governance arrangements.

Implementation details have yet to be developed. More development work and testing of implications and risks are required.² The Panel has concluded, however, that the current structural and regulatory arrangements are not economically or financially sustainable in the longer term. While there are options within these reform paths, the paths themselves cover the choices that are logically available to the Parliament and Government.

A principal purpose of the Draft Report is to expose the reforms to stakeholder input, to more fully test their implications and establish their relative merit. Input from the consultation process will lead to refinements and more fully inform the development of an Energy Strategy, as required by the Panel's Terms of Reference.

² Terms of Reference 7 request the Panel to investigate and report on actions that would guide and inform the development of a Tasmanian Energy Strategy, not the development of a strategy *per se*.

Delivery of the Tasmanian Government's Reform Framework

There have been significant reform initiatives implemented in Tasmania over the past decade involving major structural, regulatory and investment changes to the Tasmanian electricity market, including:

- securing significant new energy supply through a Tasmanian-Victorian interconnector (Basslink) and bringing natural gas to Tasmania, including the development of a large gas-fired power station;
- joining the NEM, supported by developing a competitive market within generation and retail through disaggregation of the Hydro-Electric Commission, and the application of independent national regulation of the transmission and distribution monopoly services; and
- a policy objective of introducing full retail competition to improve customer choice, which has been implemented on phased basis.

These reforms were aimed at bringing Tasmania into line with national competition and energy market reforms with positive flow-on consequences of improved investor confidence in the State.

The delivery of the National Electricity Objective³ is achieved through, amongst other things, effective competition in the wholesale market. The Tasmanian Government joined the NEM without structural separation of the State's hydro generation assets on the basis that alternative structures would have jeopardised the State's ability to secure Basslink and that security of supply would have been reduced if the hydro system was split into competing entities.

Retention of Hydro Tasmania as a single generator was raised as a significant issue by market participants leading up to Tasmania entering the NEM.⁴ Two elements of Tasmania's NEM entry arrangements required authorisation by the ACCC, and through the authorisation process, the Government implemented several 'enhancements' to its energy reform framework that were aimed at addressing some of these concerns.

³ The National electricity objective is set out in section 7 of the National Electricity Law as to 'to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to (a) price, quality, safety, reliability and security of supply of electricity; and (b) the reliability, safety and security of the national electricity system.

⁴ For example: Loy Yang observed 'The framework slows market reform in both electricity generation and retail markets as the government retains both Hydro Tasmania and Aurora Energy as single business under government ownership'. Origin Energy observed 'The proposed market structure should be of significant concern for the ACCC as it will not create an environment for competition and thus any benefits for the end user. Competition generally requires many buyers and sellers, a scenario that will be difficult to establish in Tasmania given the dominant incumbent position of both Hydro Tasmania and Aurora'. Yallourn observed 'the proposed framework will not deliver competition as it does not change Tasmania's existing electricity industry structure.'

The Government's expectations were that competition in both the wholesale and retail sectors would evolve in parallel.⁵ The expectation was that choice in the wholesale market would be delivered by market participants having choice from a range of options, including:

- contracting with Hydro Tasmania;
- contracting with the anticipated gas-fired power station;
- contracting with interstate generators across Basslink; and
- viable opportunities for spot market exposure through effective spot market competition between the above and new-entrant wind generation and Basslink operating effectively as a regulated interconnector.

The ACCC made the following observation in its final authorisation decision under the Trade Practices Act, of Tasmania's NEM entry arrangements:

"... the Commission remains concerned about the likely size of the anticompetitive detriments given the small number of Tasmanian generators and that any new entrants are likely to be small relative to Hydro Tasmania...The Commission is of the view that any anti-competitive detriments resulting from the structural arrangements will largely reside in Tasmania. Furthermore, the Commission believes that **the Tasmanian Government's on-going commitment** to addressing issues as they arise in the future will be crucial in determining the level of competition and subsequent benefits that are likely to occur in the Tasmania market."⁶ (emphasis added)

The TESI has been operating as part of the NEM for six years and the timing of the Panel's Review provides a good opportunity to consider how well the reform process has delivered on the policy objectives.

New sources of supply and the management of hydrological risk

New major sources of electricity supply have been delivered, with Basslink entering commercial service in May 2006 and the Tamar Valley Power Station (TVPS) commissioned in October 2009.

Tasmania now has substantially more electricity generation capability than is currently needed to meet peak demand, and with normal hydrological inflows, no new capacity will be needed until well after 2020.

The important difference between reform expectations and the current circumstances is that there has been a lack of diversity in ownership in the Tasmanian generator sector – the Tasmanian Government continues to own all of the material source of electricity generation in Tasmania.⁷ As a result, the Tasmanian

⁵ Meeting Tasmania's Energy Needs for the 21st Century – A Competitive Future (January 2001).

⁶ ACCC Tasmanian Derogations and Vesting Contract – Final Determinations, page 32.

⁷ While commencing as a private-sector project the Global Financial Crisis impeded the completion of the project. The TVPS was acquired by the Tasmanian Government on the basis of energy security.

community's financial exposure to the energy market, through its ownership of electricity businesses, has increased over the past decade.

The Tasmanian Natural Gas Pipeline was completed in May 2002, connecting Tasmania to the national gas network in Victoria.

The gas distribution network currently passes around 43 000 properties, as a result of combined government and private sector funding through a multi-stage Memorandum of Understanding between the Government and PowerCo Tasmania Ltd. In 2003, it was anticipated that the gas distribution network could eventually pass 100 000 properties under a third phase of these arrangements. This option was not pursued by the Tasmanian Government. There are currently around 9000 Tasmanian customers accessing the gas network and there is substantial excess capacity available to transmit more gas than is currently being utilised in Tasmania.

The development of wind resources as new entrant generation has also been partly achieved with Hydro Tasmania's construction of the 140 MW capacity Woolnorth wind farm between 2002 and 2009. Private-sector interest in developing wind resources in Tasmania has continued, with two primary projects under investigation. Hydro Tasmania's proposed Mussleroe wind farm on Tasmania's North East coast is currently the project closest to reaching commercial development.⁸

In securing new sources of electricity supply, a key objective was mitigating the State's exposure to hydrological risk.

Hydrological risk is the risk associated with the ability of hydro generation to meet output requirements in the medium to long term due to an extended period of lower than average inflows leading to low water storages and the inability to utilise installed hydro capacity.

Hydrological risk is not the same as energy supply security and reliability risk, although the two are linked. This is particularly true in Tasmania, where hydro generation accounts for over 80 per cent of total installed capacity. This means that the physical consequences of hydrological risk, at their most extreme, can extend to there being insufficient energy to meet on-island demand.⁹

⁸ On 6 December 2011, Hydro Tasmania announced the construction of Mussleroe would commence within the month.

⁹ Prior to joining the NEM, the primary response to hydrological risk was through thermal generation. In extremely dry circumstances, demand side responses were used, which in the first instance have focussed on commercial arrangements with large industrial customers to buy-back load. Where such commercial arrangements were insufficient to reduce demand, rotational load shedding was the 'last resort', but has not been required since the late 1960s. With the introduction of the NEM arrangements in Tasmania, pricing signals for reduced consumption would be expected to be the primary means of managing the energy supply/demand balance.

A primary goal of the Tasmanian Government in securing Basslink was reducing exposure to drought conditions in Tasmania. During the drought that lasted from 2007 to 2009, Basslink proved to be effective in maintaining Tasmania's electricity supply. The Panel's analysis suggests that Basslink enabled access to lower cost electricity during this period than would have been provided by on-island generation means.¹⁰

Alternative on-island generation capacity mitigates the risk of both Basslink unavailability and the combination of low storages and low inflows. As such, it can provide a benefit to Tasmanian electricity users, business confidence and the economy by avoiding the costs of sustained shortages of supply. This was the Tasmanian Government's objective for the acquisition of the TVPS in 2008.

How the cost of energy supply 'insurance' provided by the TVPS is funded and its impact on market efficiency and pricing signals, is a key issue for the Review.

The Government's energy policy reforms were also seen to provide an opportunity to capture the market value of hydro-electricity in the NEM through Basslink.

In normal hydrological conditions, Basslink has been effective in providing arbitrage opportunities between the Tasmanian and Victorian NEM regions. On the other hand, during periods of sustained below-average hydrological conditions, as was experienced in the first few years of Basslink's commercial operations, arbitrage opportunities became more limited as Basslink is used as a net supply option.

This is reflected in Hydro Tasmania's financial performance enabled by Basslink. Since its commercial operations started in April 2006, Basslink's overall cost to Hydro Tasmania has been approximately \$134 million (\$ nominal) higher than the realised direct financial benefits it has delivered. By contrast, with the return of more typical inflows, between 2010 and 2011, Basslink has generated financial returns in excess of costs for Hydro Tasmania approaching \$30 million.

Competition and customer choice for retail services

While the supply options anticipated to accompany the introduction of a market-based generation and retail sector have been delivered, the competitive dynamic that was expected has not emerged as anticipated.

The Tasmanian Government introduced customer contestability under a phased approach beginning on 1 July 2006, starting with the largest customers and progressively extending competition through to electricity users of 50MW/pa¹¹ and above from 1 July 2011. Customers below this annual consumption limit, namely small businesses and residential customers, remain *non-contestable* and must purchase their electricity from Aurora Energy under regulated tariffs.

¹⁰ Hydro Tasmania has undertaken separate analysis that also supports this conclusion – see the Panel's Information Paper *Basslink: Decision Making, Expectations and Outcomes*

¹¹ Customers with an annual electricity bill of around \$10,000.

There has been some new entry into Tasmania's retail market. There are currently five licensed retailers in Tasmania, but only two – Aurora Energy and ERM Power Retail -are active in the market and Aurora Energy remains the dominant retailer in the contestable market.¹²

This is in large part due to the risk involved in entering a region with a single dominant wholesaler, Hydro Tasmania. This has created a 'chicken-and-the egg' conundrum for the introduction of full retail contestability. Without a vibrant retail market it will not be possible for *non-contestable* customers to achieve superior outcomes from competition. However, without access to the full retail market, and with the current wholesale market architecture in place, new entrant retailers find the Tasmanian retail market commercially unattractive, relative to other retail opportunities in the NEM.

Summary

The reforms implemented by successive Tasmanian governments have had limited success in achieving the policy objectives and expectations established over the past decade.

The principal 'gap' between reform expectations and observed outcomes is the degree to which the wholesale market in Tasmania has failed to deliver the choices for risk mitigation that are required to underpin participation in that market. This has in turn prevented the development of effective retail competition and the introduction of customer choice for all customers.

¹² AGL Sales Pty Ltd, TRUenergy Pty Ld and Essential Energy have indicated to the TER that they do not intend to offer market contracts to customers that consume less than 4GWh/pa (ie large industrial users).

Competition in the Wholesale and Retail Markets

While past actions have gone some way to delivering the objectives of the TESI reform framework, the current market structure does not support the policy objective of introducing effective competition and customer choice to all Tasmanian customers, particularly households and small businesses. This objective remains paramount and, in the Panel's view, is achievable.

National retailers have indicated to the Panel that the Tasmanian market presents an attractive potential commercial opportunity, particularly with regard to customer numbers and consumption levels. However, the Tasmanian market represents only one of a number of growth opportunities in a national setting, and with the current architecture, it presents a low priority, relative to opportunities elsewhere.

The NEM model, which Tasmania committed to in the late 1990s, is based on competition at the wholesale level between generators offering to supply electricity to retailers and competition at the retail level between retailers offering to supply electricity to end customers.

Under the current structure of the wholesale market, Hydro Tasmania has the ability to profitably influence the Tasmanian spot price in a far wider range of scenarios than generators elsewhere in the NEM. Though this ability is not often exercised, its presence alone creates risks and costs for other market participants. Importantly as the principal supplier of wholesale risk management products in Tasmania, Hydro Tasmania has a high degree of discretion regarding the extent to which these products are offered to the market and their terms and conditions, including price.

The fundamental requirement is to provide wholesale market participants greater confidence that wholesale market risks in Tasmania are commercially manageable. Other measures that relate to the retail market directly will also be important to provide the right framework to attract new participants to the Tasmanian market. Without these reforms, the relative commercial attractiveness of participation in the Tasmanian market for retailers will remain low.

The central challenge is to create a structure that would allow retailers more options in the wholesale market and create a more competitive environment for spot and contract market trading in the future. As discussed in Chapter 11 of the Draft Report, the need to reform the wholesale market in Tasmania is primarily driven by concerns about latent market power. Given this, the objective is to deliver change that provides confidence that Hydro Tasmania either is not able to exploit latent market power, or does not possess it in the first instance. The objective is to provide confidence that the wholesale market in Tasmania will routinely deliver efficient outcomes.

The Panel has identified three reform paths which would create a more competitive environment for spot and contract market trading in the future. They can be represented firstly as a regulatory path, secondly, a means of introducing effective competition within the Tasmanian region and thirdly, as a means of increasing the size of the market available to Tasmanian consumers. These are:

1. An independent, regular auction of standard contracts from Hydro Tasmania to provide retailers with confidence that appropriately priced hedging contracts will be available in the Tasmanian market on an ongoing basis on reasonable terms, so that they can build a viable retail business;
2. Creating competition in the trading of energy produced by Hydro Tasmania's generation assets by establishing three independent trading entities to compete in the wholesale market and provide choice in the supply of wholesale contracts; and
3. Increasing competition for Hydro Tasmania by combining the Victorian and Tasmanian NEM regions.

Having addressed the key barrier to greater participation in the wholesale market creates the opportunity for reform at the retail level to deliver genuine customer choice. This would be enhanced through the direct introduction of new retailer operators through the packaging and sale of Aurora Energy's retail business to private investors. This would also enable the risks inherent in energy retailing to be transferred from the taxpayer to the private sector.

In addition to delivering diversity in retail, this approach would capture the value inherent in the customer base. Retailers can be expected to be attracted by the immediate access to a large tranche of customers and compete to retain them, rather than a drawn-out process of acquiring them over time from a dominant incumbent.

This proposed reform of the Tasmanian retail sector could be implemented under each of the three wholesale market reform paths. Allowing retail competition to develop 'organically' over time is not well matched to reform paths 2 and 3 – given the nature of the reforms proposed. To commit to the level of reform involved in these options without proactively refining the retail sector would be a missed opportunity.

While 'organic' FRC¹³ could be implemented with reform path 1, it would most likely see new entrant retailers 'cherry picking' Aurora Energy's customer base and leaving it with the less profitable customers, which would see the Tasmanian community's value in Aurora Energy eroded over time.¹⁴

Given the commercial and physical constraints inherent in the Tasmanian wholesale sector, the reform options are necessarily constrained, and approaches utilised in other jurisdictions for creating competition and choice are less practicable. These constraints shaped Tasmania's initial NEM entry architecture and as noted by the ACCC in its authorisation of some of Tasmania's NEM entry arrangements:

*"Whether or not the proposed energy framework will deliver the purported outcomes is uncertain and ultimately **depends on the policy choices made by the Tasmanian Government.**"¹⁵*

The Panel's reform paths present a revised set of policy choices for the Parliament to consider.

Each reform path gives rise to trade-offs. Accordingly, the Panel considers that each should be assessed for its relative merit. The implementation of any of the reform paths will involve the resolution of a range of detailed implementation measures, and each varies in its degree of complexity and cost of implementation.

Ultimately, the extent to which each of these reform paths would deliver the objective of creating the basis for genuine and sustained customer choice in Tasmania depends on the confidence NEM participants have on the options delivering effective wholesale market outcomes on a consistent basis. This is the key issue on which the Panel is seeking input through submissions and participation in public hearings.

The Panel's current view is that the preferred mechanism to deliver these reforms is the establishment of a number of independent competing trading entities that would trade energy produced by Hydro Tasmania.

The potential to physically disaggregate Hydro Tasmania to form a number of competing physical generators has been canvassed in the past.¹⁶ A central argument for the retention of Hydro Tasmania as a single integrated generator is water management. The primary argument is that physical optimisation of water use requires integrated planning and decision making regarding which catchment and generation assets are used to meet the desired level of dispatch from the hydro system.

¹³ That is, full retail contestability declared and competition to emerge over time, as has been the case in the previous retail contestability tranches in Tasmania.

¹⁴ Analysis undertaken by the Panel indicates that the value of Aurora Energy's retail business is likely to be materially exposed to modest levels of loss of market share in Tasmania because of its lack of scale.

¹⁵ Tasmanian Derogations and Vesting Contract – Final Determination p.6

¹⁶ For example, physical disaggregation of the hydro-generation system was proposed in the 'National Competition Policy Review of the Structure of the Hydro Electric Corporation's Generation & System Control Function's' (the Garlick Report), May 1999.

The reform path the Panel is proposing would introduce competition into trading decisions. It would do this by creating a number of independent trading entities, each with rights to trade contracted amounts of Hydro Tasmania's available energy output. Hydro Tasmania would remain responsible for water management and determining how best to operate the generation system to provide output consistent with the trading decisions of these entities.¹⁷ Under this structure, all responsibility for physical operation of the generation system would remain with Hydro Tasmania, allowing it to retain its integrated planning and decision making regarding which catchment and power schemes are used to meet the desired level of output from the hydro system.

The establishment of up to three trading entities that would trade output of the hydro-system into the market would provide competition and choice in the wholesale market, with the intention of removing the latent market power that exists under the current arrangements.

Given enhanced market discipline and pressure, it is also important that effective governance complements and motivates business performance.

¹⁷ A model similar to this was proposed in the Structural Review of Hydro Tasmania by Peter Garlick in 1997. That proposal entailed the establishment of three trading entities that would have dispatch rights over parts of the hydro system. That linkage between trading rights and physical aspects of the system was perceived to have the effect of removing the ability of the physical generator to optimise water usage. The Panel's proposal does not have that linkage.

The Price Setting Framework for *Non-Contestable* Customers

The current regulatory framework for the determination of wholesale energy allowances for *non-contestable* customers is in need of change so that it delivers efficient pricing signals to these customers.

The wholesale cost of energy makes up 40 per cent of the overall regulated price of electricity.¹⁸ It is the growth in this cost over the past decade that, of the four building blocks, has had the biggest impact on the prices paid by *non-contestable* customers.

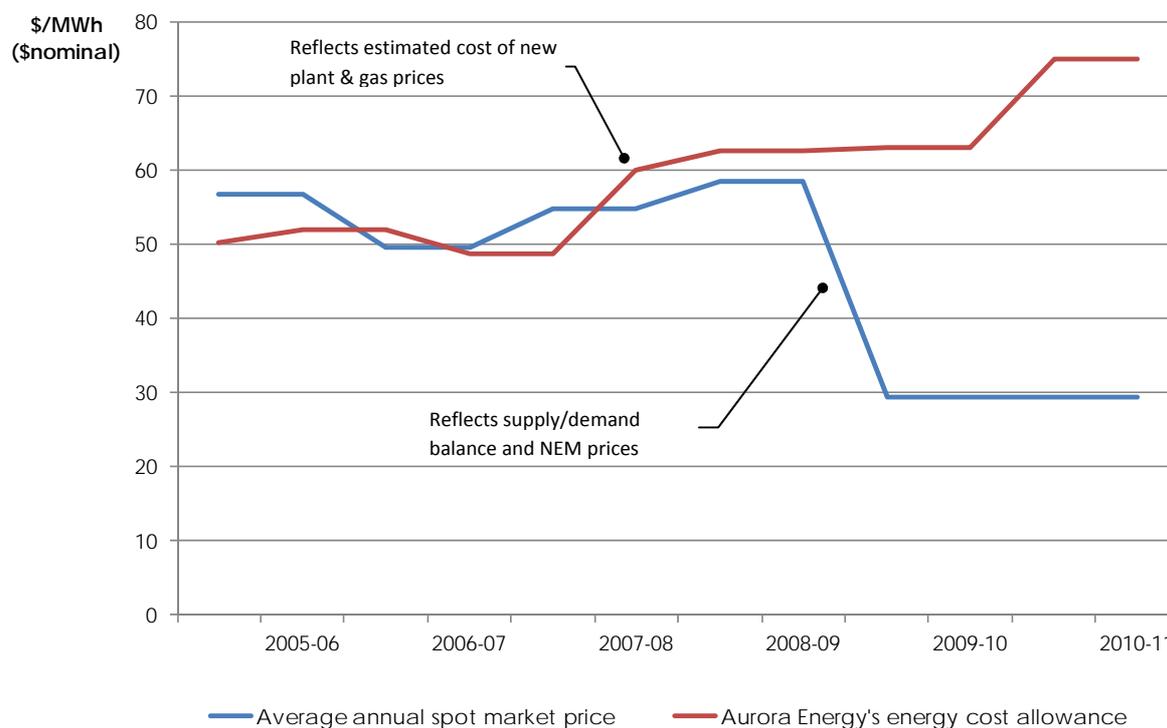
Since 2007, the wholesale energy component of regulated tariffs for *non-contestable* customers has been based on the cost of a notional new generator located on mainland Tasmania and supplying electricity to *non-contestable* customers. The application of this approach has resulted in energy prices for *non-contestable* customers that are implicitly based on the assumption that new generation capacity is required in the very near future to meet the load of *non-contestable* customers. Because this approach has not reflected the Tasmanian supply/demand balance, there has been a divergence in the trends in the wholesale energy allowance and actual market prices in Tasmania over this period, as shown in Figure 1.

Utilising an LRMC-based framework as an indicator for wholesale energy allowance is appropriate when it:

- recognises the existing Tasmanian generation system and the sources of energy that will actually be utilised over time 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 level of hydrological risk 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.

¹⁸ Distribution charges and transmissions charges have both increased by around 25 per cent each, and increases in retail costs have contributed around 10 per cent to price increases. The remaining 40 per cent of the increase is as a result of the changes in the wholesale energy allowance.

Figure 1 - Average spot market price v Energy Cost Allowance in regulated tariffs (nominal)



Sources: Australian Energy Market Operator (*Average annual prices*), Office of the Tasmanian Economic Regulator

The Panel has proposed a refinement of the application of the LRMC methodology that more closely reflects the current Tasmanian electricity market conditions by taking into account the prevailing supply demand balance under normal hydrological conditions. This alternative approach would result in the regulated energy allowance being more closely aligned to market prices than is currently the case.

The current Price Determination is in place until 30 June 2013.

It is not possible to provide a definitive estimate of the difference in wholesale allowances and retail prices that would apply for the next pricing determination under the Panel's recommended methodology, relative that which would result from the continuation of the existing methodology. Nonetheless, if the current supply/demand circumstances were to continue and existing hydrological circumstances existed at the time of the next determination, retail prices could be in the order of 5 per cent to 10 per cent lower than if the current framework were applied at that time.

Tamar Valley Power Station - Funding energy supply security

The consequences of potential electricity shortages for the economy and investor confidence in the State have been a long-term driver of Tasmanian Government support for additional capacity in Tasmania.¹⁹ A notable feature of the development of the Tasmanian electricity sector is that the Government has made investment decisions based on securing energy supply in the event of a prolonged drought.

In 2008, the Tasmanian Government directed Aurora Energy to acquire, complete and operate the TVPS on the basis of energy security.

The Tasmanian Government's decision to acquire the TVPS to avoid potential supply shortages from the loss of Basslink and/or on-island generation in light of very low water storages was an understandable hydrological risk management strategy. The implementation of that strategy inevitably shifted costs and risks from the private sector to the public sector – in the first instance, to Aurora Energy - and has not been without cost.

The effective supply security premium arising from the TVPS acquisition was around \$150 million, which represents the difference between the acquisition and completion cost of the TVPS and its estimated enterprise value from market trading at the time that it was acquired.

The TVPS is not commercially viable at market prices during extended periods of normal and above normal rainfall and inflows, given the degree to which generation capacity exceeds demand.

Currently, the revenue that TVPS receives from its tolling arrangement²⁰ with Aurora Energy's energy business covers all of the TVPS' costs, including fixed costs, gas costs, debt management and the delivery of a small return on equity. This results in a unit cost to Aurora Energy's energy business that is higher than market prices and without offsetting cost reductions or higher revenues, Aurora Energy would not be able to fund the tolling arrangement.

¹⁹ This has included the oil fired Bell Bay Power Station in the early 1970s following the drought and electricity restrictions in the late 1960s; support by successive Governments for Basslink; and endorsement for Hydro Tasmania's purchase of additional peaking capacity in 2005.

²⁰ Aurora Energy has a tolling arrangement with AETV, the entity which owns the TVPS, under which it pays all of the costs of the TVPS in return for the output of the power station.

As the wholesale energy allowance Aurora Energy is entitled to recover through *non-contestable* customers most closely aligns with the cost of operating the TVPS, Aurora Energy utilises the output of the TVPS capacity to back its *non-contestable* customer load. Output from the TVPS covers around half of the energy demands of *non-contestable* customers, with the remainder of Aurora Energy's *non-contestable* customer contract requirements purchased from Hydro Tasmania. The effect of these contractual arrangements is that the value difference between the tolling agreement and the wholesale energy allowance is offset by Hydro Tasmania. This is not transparent and is not sustainable.

As discussed above, the Panel believes that changes to the method for calculating the wholesale energy allowance will more appropriately reflect the economic cost of *non-contestable* customers consumption decisions. Alternatively, if all customers face market prices under effective retail competition, the current gap between the regulated wholesale energy allowance and market prices can be expected to be crystallised.

Either change will mean that the sources of revenue available to Aurora Energy to fund the operation of the TVPS, which was acquired to provide energy security insurance, will be curtailed.

Given that the investment in TVPS was driven in part by policy considerations, the Panel considers that the financial arrangements for the TVPS should be restructured with the intention of placing Aurora Energy on a more sustainable commercial footing.

Detailed modelling in conjunction with Aurora Energy, AETV and Treasury would be required to accurately quantify the nature of the financial restructuring that would be required under this approach. The key elements of the Panel's proposal are:

- That the tolling agreement between AETV and Aurora Energy be adjusted to reflect the market value of all energy that the TVPS produces.
- The TVPS is re-valued to reflect its market value. This is likely to be considerably lower than the current carrying value of \$353 million (as at 30 June 2011), but will be necessary to establish a sustainable financial position for the business going forward.
- The debt associated with the TVPS that cannot be funded by Aurora Energy on a sustainable basis should be transferred from the Public Non-Financial Corporation Sector to the General Government Sector. The Tasmanian Government could offset the budget effect of this portion of debt by making use of improved dividend returns available from Hydro Tasmania resulting from the price on carbon.
- In the event that the market value of the TVPS is negative, the Government may also wish to give consideration to a transparent supplementary funding mechanism, that is essentially an electricity supply insurance premium, that could be levied within the market and paid to Aurora Energy as a CSO reflecting the Government's policy decision to acquire the power station.

Ownership and the Governance Framework

Public ownership of the SOEBs, given their dominant role in the TESI, affects confidence within the market and more broadly in relation to the underlying drivers of energy policy and regulatory processes.

The central issue in relation to ownership of the SOEBs is which objectives are being sought through public ownership.

Clear and unambiguous Shareholder 'ownership objectives':

- provide the SOEBs with established parameters within which to operate, particularly with regard to non-commercial activities and investments not directly related to supplying services to the Tasmanian community;
- send a clear message to the community about what government is seeking to achieve through public ownership, including how this is consistent with and contributes to broader strategic policy goals; and
- are the 'foundation stone' for the accountability and oversight of the SOEBs, particularly given the absence of the normal capital market disciplines.

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 of SOEBs 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. to impose taxes and charges to fund these activities. In the case of Tasmania, just over 60 percent of General Government Sector revenue comes from Commonwealth Grants, around 20 percent from state taxation, 8.5 per cent from the sale of goods and services and just under 5 percent from financial distributions from State-owned businesses.

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, 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 very nature of State Government services is such that *expenditure growth* on these services does not vary significantly over the course of an economic cycle. 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 the normal 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.²¹ *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 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, such as those in the electricity 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 financial assets and liabilities 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.

²¹ 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.

Therefore, another core question for Government when setting objectives for the SOEBs is: “to what extent does it 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?”

Business Boundaries

This is a particularly important question when considering major new investment decisions, 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, nor do they lower electricity prices to Tasmanian consumers.

Irrespective of how such investments are funded, be it any combination of retained earnings from the business or additional debt, the capital has an opportunity cost in terms of its ability to support General Government Sector service delivery.²²

Such investments may or may not be commercially successful and have 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 reasonably be asked whether such investments and activities are appropriate investments for a government at all, given that in making them government is also accepting that General Government services will need to be adjusted in the event that they are not successful.

Such issues are germane to the scope of the businesses activities that the Government specifies, or in other words, the ‘field on which it allows its business to play on’. The businesses need to be as commercially successful as possible within the boundaries set by government, but it is critical that the scopes of business activities are precisely defined.

Non-commercial activities

The Tasmanian framework for transparent funding of non-commercial activities by the SOEBs is consistent with good practice and similar to arrangements in other jurisdictions. The Panel has observed examples of where these arrangements have not been implemented.

The practice of accepting a lower rate of return from businesses in exchange for the internal funding of a Community Service Obligation (CSO) runs contrary to the agreed policy of operating government businesses on a fully commercial basis and reduces the businesses’ own retained earnings. 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.

²² Noting that retained earnings can be returned in government via capital restructure).

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 commercial entities. Rather, the way in which the Government implements these policy outcomes is central. The funding non-commercial activities via CSOs rather than through the acceptance of lower than otherwise dividends, is not simply a matter of process. It is fundamental to good governance, performance management and ability of government to hold the businesses to account.

Improvements to the strategic objective-setting process for Government Businesses are already in train, as flagged in the Government's 2010-11 Mid-Year Financial Report.²³

²³ See pp. 9-10 "Operations of Government Businesses".

Electricity Price Trends

Drivers of current electricity prices

The Terms of Reference ask the Panel to investigate and report on a range of matters that essentially pose the question 'what explains the current level of Tasmanian end customer prices?'

For *non-contestable* customers, prices have more than doubled since 2000.

About half the price increase has been due to costs incurred in running the distribution and transmission networks with about 40 per cent driven by the wholesale price of energy.

- The key driver of network charges has been investment in the transmission and distribution networks over the past decade. Much of this investment has been put forward as necessary to replace aging assets and improve reliability. In this sense, Tasmania's experience matches that in other Australian jurisdictions over recent years.
- The other primary driver of prices for *non-contestable* customers has been sustained increases in the wholesale energy allowances that make up part of the regulated prices. This has been a result of the nature of the Tasmanian regulatory framework and is discussed further below, and in detail in Chapter 13 of the Draft Report.

For *contestable* customers, in addition to the network cost drivers, a key determinant the costs of electricity is wholesale energy costs. Since contestability commenced, wholesale prices have been, and will continue to be, influenced by the direction of prices elsewhere in the NEM, particularly Victoria, together with changing hydrological circumstance, and the overall supply/demand balance. These factors have led to variable wholesale energy costs for *contestable* customers.

The Terms of Reference also require the Panel to investigate and report on the impact of major investment decisions on *non-contestable* customer prices. The Panel has interpreted those investment decisions to include Basslink and the TVPS.

- The Panel has concluded that as a result of the regulatory framework for determining *non-contestable* customer prices, these customers are not paying for the costs of Basslink, either directly or indirectly. Moreover, interconnection has provided additional electricity supply to Tasmania over the period 2006-07 to 2010-11 at a lower cost than would otherwise have been achievable from on-island sources. This is discussed further below, and in Chapter 9 of the Draft Report.

- The regulatory arrangements for determining *non-contestable* customers prices in 2010 continues the methodology for setting the wholesale energy allowance used in 2007, pre-dating the Government's decision to acquire the TVPS.

Drivers of Future Electricity Prices

Forecast increases in demand across the NEM regions and a consequential tightening of the supply balance, combined with expected increases in fuel costs are expected to contribute to increase NEM wholesale energy prices, including in Tasmania.

A major driver of changes in delivered energy costs to Tasmanian customers will be the impacts of carbon pricing. Carbon pricing will: increase the costs of thermal generation in the NEM generally; increase the costs of the operation of the TVPS; and increase the value of hydro-electricity.

For *non-contestable* customers, under the current regulatory arrangements, the quantum of any change in retail prices will be determined by the TER and will not be directly linked to changes in the wholesale market price of electricity in Tasmania.²⁴

In the case of *contestable* customers, where wholesale contracts have a 'carbon pass through', the delivered price of electricity will increase in proportion to the impacts of carbon pricing on market wholesale electricity prices.

The Panel commissioned modelling of the potential impact of a price on carbon on wholesale electricity prices throughout the NEM, including Tasmania, over the period 2012 to 2016. In the case of Tasmania, carbon pricing is forecast to add around \$17/MWh on average to wholesale electricity prices over the period 2012 to 2016 and that increment is the lowest forecast for any region of the NEM.

In relation to the network elements of the sector, the rate of growth in new investment is moderating, with corresponding decreases in the rate of growth in network costs. However, the historically high capital expenditure that has been observed over the past decade is now reflected in the asset bases of the networks. This will continue to be the major driver of the level of network costs, and therefore, prices, into the foreseeable future.

²⁴ The wholesale energy allowance that is factored into retail tariffs is based on estimates of the costs of a notional new entrant generator. The Price Control Regulations require that this cost must take into consideration carbon emission costs. At the time the wholesale allowance was determined, the potential impact of a price on carbon emissions was excluded, as the carbon pricing arrangements were uncertain and were not in effect. It is expected that the wholesale allowance will be 'reopened' by the TER to take into account carbon emission costs.

The AER is currently considering Aurora Energy's regulatory proposal for its distribution business. The AER's draft determination has reduced Aurora Energy's proposed operating expenditure by 8.6 per cent, capital expenditure by 21 per cent and has proposed a cost of capital (or WACC) of 8.08 per cent, below Aurora Energy's proposed WACC of 10.33 per cent. If implemented, these will moderate upwards pressure on distribution prices.

Tasmanian electricity price and reliability outcomes remain broadly comparable with those in other regions of the NEM. However, the Panel's view is that there is considerable potential for higher efficiency and improved pricing outcomes in Tasmania.

The Performance of the TESI

One of the most discussed outcomes in the Tasmanian electricity market is electricity prices. In this regard, the key issue is the confidence electricity customers can have that prices are efficient – that is as low as possible on a sustainable basis.

The electricity industry will make the best contribution to the growth and development of Tasmania and to the economic welfare of Tasmanians if it is operated on the most economically efficient basis possible.

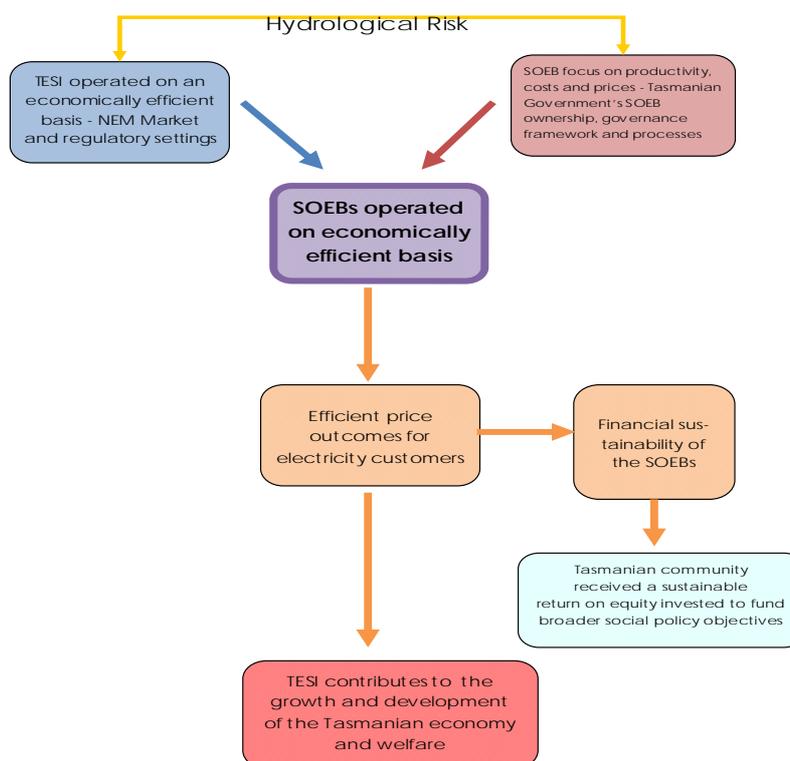
As such, the interests of Tasmanian electricity customers are best served by pursuing efficiency in the operation of all participants in the TESI, and particularly the SOEBs, which comprise the great majority of the industry in Tasmania. Efficiently performing SOEBs will deliver sustainable financial returns to the Tasmanian community as the ultimate owners of the businesses that are not generated 'at the cost' of electricity customers. Both objectives require that other related objectives of government should be pursued in ways that are consistent with the efficient operation of the market.

Sustained SOEB performance requires the combination of a framework of incentives and obligations on the SOEBs, by the market and/or regulatory settings on the one hand, and strong governance and accountability processes between the Shareholding Ministers and the SOEBs on the other.

It is the incentives for improved performance created when these two forces act in concert that drives genuine productivity improvements within the SOEBs which underpins price levels.

This framework of incentives is illustrated in Figure 2 and is discussed below.

Figure 2 – Drivers of outcomes in the TESI



Observations on the Efficiency and Effectiveness of the SOEBs

'**Effectiveness**' in the context of the Panel's Terms of Reference is the extent to which SOEBs are contributing towards the continuity and quality of electricity supply – or, in other words **technical performance**.

Chapter 8 of the Draft Report provides more detail on efficiency and effectiveness, and the Panel has produced a supporting Information Paper on this topic, which includes specific measures and performance statistics.²⁵ In general terms, the Panel has concluded that the effectiveness, of the industry is generally comparable to that of other states. In particular:

- The technical performance of Hydro Tasmania's generating plant currently meets the risk management requirements that arise from its participation in the NEM, particular its ability to asset-back its trading position. However any ongoing significant deterioration of performance could be an indicator that the current asset management strategy was risking long term asset value.

²⁵ A Review of the Efficiency and Effectiveness of the State Owned Electricity Businesses.

- The transmission network operated by Transend is performing in line with industry standards and is improving by comparison with peer entities. There remains scope for further improvement, although this is an economic question relating to the cost of increased reliability levels, compared to the value customers place on incremental reliability improvements.
- Aurora Energy's distribution network effectiveness has exhibited mixed performance relative to regulatory benchmarks. Community-based targets for improvements are in place and it remains to be seen if this approach results in average performance improvements. There is a declining trend in service levels for urban areas and improvements in rural performance.
- Aurora Energy's retail's performance in terms of customer service measures appears to be relatively stable, and may require additional focus in the event that full retail contestability is introduced.

'Efficiency' in the context of the Panel's first Terms of Reference **is a measure of the extent to which activities are carried out at least cost.** Due to difficulties benchmarking the SOEBs with industry peers, the Panel's assessment of efficiency is less clear cut. However, the Panel has observed the following:

- Hydro Tasmania has had a sustained focus on reducing operating costs, with three efficiency programs implemented over the past eight years, the latest of which aims to reduce operating expenses to around 80 per cent of current levels. The primary driver of efficiency improvements has been the constraints on the supply of capital to fund capital investment and growth strategies. Capital constraints have also incentivised Hydro Tasmania to seek more efficient delivery of major capital expenditure projects.
- Transend's operating costs are higher than its peers and have grown at a higher rate over the period 2005 to 2009. In part this reflects scale-diseconomies in Tasmania. However, for the period of the 2003 regulatory determination, Transend made a considered decision to spend above its regulatory allowances, based on its view that the regulatory determination was unsustainable. Transend's performance relative to its operating allowances has improved with its 2009 regulatory determination, which saw a 40 per cent increase in its operating cost allowance. Transend has operated within the allowance for the past two years.
- In relation to capital spending, Transend's capital program exceeded its regulatory capital allowance by around 10 per cent over the period 2005 to 2009. The AER subsequently undertook a detailed ex-post review of capital projects over that period and found that the capital expenditure was prudent.

- Aurora Energy's distribution business has also had a history of overspending regulatory allowances, but to a lesser degree than Transend. Aurora Energy's regulatory proposal currently being considered by the AER indicates that the business is seeking to deliver real operating cost decreases over the 2013 to 2017 period. Significant changes are emerging within the distribution business, which indicates there is a commitment to deliver on the productivity savings that underpin the regulatory proposal. In its Draft Determination on Aurora Energy's regulatory proposal, the AER has determined to reduce the proposed level of operating expenditure by \$36.5m (nominal) over the forthcoming regulatory period.
- Aurora Energy's retail business has been unable to operate within its regulatory operating allowance with respect to the *non-contestable* customer base. The Panel understands that in the competitive contestable market, there have been strong pressures on retail margins to maintain market share. Aurora Energy has developed a strategy to reduce costs in line with regulated "cost to serve" levels, and the first phases of that strategy have been implemented.

The apparent willingness of the network businesses to regularly overspend regulatory allowances in the past and the preparedness of Boards and the Shareholders to accept the financial consequences of this through poor returns on investment and lower returns to the Budget has not created an environment consistent with driving business performance.

The Panel notes that recent changes in regulatory incentives and governance arrangements have sought to address these issues. Consistent with the discussion above, they will require consistent application to ensure that there is a 'clear line of sight' between Shareholder expectations and the regulatory framework on the one hand, and Board, management and staff performance on the other.

Observations on the Financial Performance of the SOEBs

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 to shareholders/taxpayers.

Given the dominant positions of Hydro Tasmania and Aurora Energy's retail business in the market-facing sectors and the regulated monopoly network of Transend and Aurora Energy's distribution businesses, it is not unreasonable to expect the businesses to generate a commercial rate of return, commensurate with the risks that public owners are willing to bear, while other capital needs are also adequately managed.

The core sources of financial value in the SOEB portfolio are hydro-generation and the asset bases of the transmission and distribution networks. Electricity retailing generates relatively small financial value by comparison with the aforementioned activities and involves considerable risk, while gas-fired electricity is, under current market conditions, not delivering any financial value. Financial returns to the Tasmanian community from diversification/growth activities have yet to eventuate.

The regulatory framework for setting wholesale energy allowances creates a source of value that has historically been captured by Hydro Tasmania, but is now utilised by Aurora Energy to support the financial viability of the TVPS.

There is significant scope to improve the SOEBs' financial performance. Historically, both Aurora Energy's distribution business and Transend have overspent regulated allowances for operating expenditure; and Aurora Energy's retail cost to serve is significantly above its regulated allowance for that function. As discussed above, governance changes that drive accountability for performance are starting to emerge. If sustained, these can be expected to improve the financial performance of the SOEBs.

Financial returns to the community by way of dividend payments have been low. Over the six year period 2004 to 2010, dividends have totalled \$309 million²⁶, representing around 3 per cent of revenue; or 18 per cent of net cash from operations, over the same period. In the last 3 years of that period, returns represented around one per cent of revenue. This is fundamentally the result of three key drivers²⁷:

- for Hydro Tasmania, the 2007 to 2009 drought;
- relatively weak profit performance and the need to improve the accountability of Boards and management to Shareholders with regard to financial performance;
- the need for reinvestment in core business activities to rebuild the asset base and improve reliability standards (particularly in the network businesses), which has led to decisions to reinvest returns within the SOEBs; and
- the pursuit by Hydro Tasmania and to a lesser extent Aurora Energy, supported by the Government, of diversification/growth activities, which has required the application of capital, rather than a return to the community by way of dividends.

Chapter 8 of the Draft Report provides more detail on the SOEB's financial performance and the Panel has produced a supporting Information Paper on this topic.²⁸

²⁶ This includes \$52 million of special dividends paid by Hydro Tasmania, which represents a withdrawal of equity.

²⁷ In the case of Hydro Tasmania, another key driver was the drought during 2007 and 2008 and the need for it to back its contract position in Tasmania with limited capacity to pass through higher costs arising from 'purchases' of electricity from the market.

²⁸ *A Review of the Financial Position of the State Owned Electricity Businesses*

Next Steps

This Draft Report contains the Panel's findings and recommendations for actions that would inform the development of an Energy Strategy. These have been developed on the basis of information made available to the Panel, particularly through its information gathering powers, and also through interactions with stakeholders. Much of the Panel's thinking has been guided by analysis undertaken by the Secretariat and the Panel's financial, economic and technical advisors.

The Panel recognises that interested parties may have available supplementary information that it has not taken into consideration in developing these findings and in considering the areas for reform.

As such, the Panel remains open to additional information and evidence being provided to further develop and refine its understanding of the material issues that have given rise to the current position of the Tasmanian energy sector, particularly where there is a connection to the potential reform paths.

The Panel places a particular importance of gathering feedback and input on the reform paths - both the structural reform elements associated with the competitive market segments and in relation to governance. Both are important in shaping the future of the Tasmanian energy sector.

The two key steps for garnering this input are:

- Public hearings, which will be held in Tasmania on 1 and 2 February 2012; and
- Lodging submissions with the Panel before 17 February 2012.

Consistent with its Terms of Reference, the Panel will, amongst other things, provide the Tasmanian Parliament with a set of actions that would inform the development of an Energy Strategy. A key driver in the refinement of the reform paths suggested in this Draft Report will be input from interested parties on the Draft Report.

Key Findings and Recommendations

Key Findings

Competition – the wholesale and retail markets in Tasmania

- Large retailers that are not currently active in Tasmania have indicated that the State presents potentially attractive commercial opportunities.
- Hydro Tasmania possesses and periodically signals significant latent market power through the spot and contract markets. This is a deterrent to entry into the retail market by efficient, large scale, national retailers.
- While ever Hydro Tasmania remains the dominant spot market participant *and* the principal supplier of contracts, major national retailers will not enter the Tasmanian market and choice for households and small businesses will be stymied. Unlocking greater retail competition in Tasmania, and with it, effective customer choice, hinges on addressing this problem.
- The Panel has identified three reform paths which would create a more competitive environment for spot and contract market trading in the future. They can be represented firstly as a regulatory path, secondly, a means of introducing effective competition within the Tasmanian region and thirdly, as a means of increasing the size of the market available to Tasmanian consumers. These are:
 - ❖ Reform Path 1: An independent, regular auction of standard contracts from Hydro Tasmania to conduct a regular auction to provide retailers with confidence that appropriately priced hedging contracts will be available in the Tasmanian market on an ongoing basis on reasonable terms;
 - ❖ Reform Path 2: Creating competition in the trading of energy produced by Hydro Tasmania by establishing independent trading entities while retaining Hydro Tasmania as an integrated generating business; and
 - ❖ Reform Path 3: Increasing competition for Hydro Tasmania by combining the Victorian and Tasmanian NEM regions.
- On balance, the Panel prefers reform path 2.
- If wholesale market problems are properly addressed, there could be significant benefits in undertaking retail reforms that would deliver new entry in the retail market by making the customer base available through a competitive sale process.

The price-setting framework

- The arrangements for the determination of wholesale energy allowances for *non-contestable* customers should reflect current and prospective supply-demand balances.

The impact of major infrastructure projects

Basslink

- Tasmanian *non-contestable* (regulated) customers are not 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 than would have been the case under alternative scenarios.
- Since 2006, Basslink's net overall cost to Hydro Tasmania has been around \$134 million. This largely reflects the drought directly following commissioning. With the return to more typical inflows, between 2009 and 2010 Basslink has enabled Hydro Tasmania to generate net returns approaching \$30 million.

Tamar Valley Power Station

- 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 storage levels.
- The TVPS' viability is underpinned by contractual arrangements between Aurora Energy and Hydro Tasmania that are linked under the *Electricity Supply Industry (Price Control) Regulations 2003*. The arrangement effectively transfers the shortfall in market value for the TVPS to Hydro Tasmania. This is not sustainable.
- The valuation advice provided to the Government when it decided to buy the partially built 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'.

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 a 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 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.

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, with about 40 per cent driven by the wholesale price of energy.
- 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.
- The Panel has seen no evidence that residential and business customers are subsidising the major industrial customers.
- Electricity prices are expected to increase into the foreseeable future in every region of the National Electricity Market (NEM), including Tasmania, with carbon pricing being a new driver.
- For *non-contestable* customers, under the current regulatory arrangements, any change in retail prices will be determined by the Tasmanian Economic Regulator (TER) and will not be directly linked to changes in the wholesale market price of electricity in Tasmania but will still reflect the introduction of a price on carbon.

The 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. Between 2004 and 2010 the SOEBs returned \$309 million in dividends, or just 18 per cent of net cash from operations.
- Poor returns have been partly due to the SOEBs investing in non-core business activities. Between 2004 and 2010, \$100 million has been invested outside Tasmania, and, to date, has yielded very little in the way of financial return.
- Until recently Aurora Energy and Transend have regularly overspent their regulated allowances for both operating and capital expenditure. Aurora Energy's retail cost to serve is also significantly above its regulated allowance.

Key Recommendations

The Panel recommends that:

1. The current regulatory framework for the determination of wholesale energy allowances for *non-contestable* customers be adjusted in future pricing determinations so that it reflects the prevailing and prospective supply-demand balance.
2. The TVPS be funded transparently and put on a commercially sustainable footing by re-valuing and recapitalising the power station to reflect its current place in the market and the sustainable revenues available to it.
3. Reforms be implemented to address the absence of effective competition under the current structure of the wholesale market.
4. Following implementation of wholesale market reform, full retail contestability, be introduced.
5. The Tasmanian Government commence a scoping study for the sale of Aurora Energy's retail business to determine an appropriate number of tranches for sale in the market.
6. The Tasmanian Government develops a publicly available Energy Business Ownership Policy that more clearly articulates its overarching, strategic objectives for the SOEBs.
7. SOEB oversight continues to be refined to 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.