



Electricity Supply Industry Expert Panel

Issues Paper: Summary of Submissions

August 2011

Introduction

On 24 June 2011, the Panel released its Issues Paper, which sought submissions from interested parties on the key issues that the Panel has identified in response to its Terms of Reference.

The Issues Paper posed more than 60 consultation questions across seven core theme areas as a way of facilitating further input and discussion to inform the Panel's deliberations and assist it in developing its findings, which it will be putting forward in its forthcoming Draft Report.

The Panel has received a total of 17 submissions from a broad range of industry stakeholders, peak bodies and other interested parties. One of these submissions has been made on a confidential basis, while the remaining 16 are public (listed below) and are now available to download from the Panel's website at www.electricity.tas.gov.au/issespaper. The Panel would like to thank all of those stakeholders who took the time to prepare a submission and engage in what is a critical component of the Review process.

This paper provides a brief, high-level thematic analysis of the key issues and responses raised in public submissions. It is designed to provide a 'snapshot' overview for those who wish to get a sense of what various stakeholders are saying on the key issues, without having to read each of the individual submissions in detail. The paper should also provide direction to those who wish to quickly identify the submissions that deal with issues and questions in which they have a specific interest.

Clearly, this summary cannot cover every issue raised across all submissions and should be treated as a supplement to, and not a replacement for, reading individual submissions in full. Please note too that this summary does not present any views or opinions on matters raised in the submissions, noting that the Panel's position on identified issues will be articulated in its forthcoming Draft Report.

List of Public Submissions

1. Tasmanian Council of Social Service (TasCOSS)
2. Office of the Tasmanian Energy Regulator (OTTER)
3. Hobart City Council (HCC)
4. Tasmanian Chamber of Commerce and Industry (TCCI)
5. The Australian Energy Regulator (AER)
6. Aurora Energy
7. Transend Networks
8. Hydro Tasmania
9. ERM Power
10. TasGas Networks
11. Rio Tinto Alcan (RTA)
12. Loy Yang Marketing Management Company (LYMMCo)
13. Eco-Energy Options
14. Ms Sandra Healy
15. Mr John Arneaud
16. Mr Greg Todd

Summary of Responses to Key Themes and Issues

1. Effectiveness of the Retail Market

1.1. Full Retail Contestability (FRC)

A number of submissions strongly support immediate the roll-out of FRC, while others offer various cautions.

The TCCI, for example, believes that FRC is critical and that the Panel should identify options to reduce barriers to its roll-out. Hydro Tasmania also believes that FRC is preferable to the current regime of regulated prices for small customers and suggests that there are insufficient incentives at present for other retailers to enter the market until final tranche of small customers becomes contestable. TasGas Networks believes that the introduction of further retail competition is desirable as it would encourage greater innovation, including dual-fuel convergence, and hasten moves towards more cost-reflective retail pricing. Ms Sandra Healy also strongly supports the introduction of contestability from her perspective as a small energy customer.

TasCOSS, however, is sceptical of the benefits of FRC for the majority of residential customers and suggests that it is likely that small customers would incur increased costs under FRC, including sales and marketing costs, increased retail margins, and increased network costs from Aurora Energy's distribution arm having to deal with more than one retailer. OTTER's view is that FRC will not automatically mean lower retail prices for consumers, with lower prices being reliant on alternative retailers being more efficient than Aurora Energy Retail while also being able to obtain wholesale energy prices that are lower than current regulated allowance.

Aurora Energy notes that it supports FRC where the change will clearly benefit consumers but expresses concerns that costs could outweigh benefits for a large number of customers. Similar to OTTER, Aurora Energy suggests that FRC alone will not automatically deliver significant benefits given the relatively small retail component in customers' overall bills. Aurora Energy notes that the existing regulatory framework has the same objectives as FRC and that there is no evidence that aggregate prices will fall under FRC any more than they would under the current framework.

Aurora Energy also contends that some customers could end up paying more, with higher-income, lower risk customers 'cherry picked' by retailers at the expense of less commercially attractive customers. It further notes that significant costs of establishing systems to allow for customer 'churn' between retailers are significant, and in Tasmania would be spread over a relatively small customer base.

Given the above issues – and the potential for a loss of shareholder value in Aurora’s energy business under FRC - Aurora Energy suggests the Panel should conduct a full cost-benefit analysis of FRC as part of its Review.

ERM Power suggests that FRC roll-out should not be rushed based on its observation that some recently contestable (Tranche 5a) customers have ‘struggled’ with the change. The HCC offers a similar view, noting that the assessment of available contractual options can be resource intensive and that standard guides or other forms of consumer support could be beneficial for smaller customers in particular.

1.2. Roll-out of Contestability – Experiences and Observations

ERM’s position as a new-entrant retailer to Tasmania is that the structure of the market is not a barrier to entry generally and that the market is operating efficiently. However, ERM identifies a number of areas where it feels Aurora Energy as the incumbent holds a competitive advantage, for example access to names and contact details of existing customers. ERM notes that if any generation assets were provided to a state-owned energy retailer then this would provide a barrier to entry.

Aurora Energy, however, suggests that issues of scale, along with a lack of competition in the wholesale market are likely barriers to entry for retailers under FRC. Both Aurora Energy and ERM also note that the application of consumer protection requirements under the new National Energy Customer Framework (NECF) will likely act to deter some retailers from offering products to smaller customers in Tasmania.

From its perspective as a relatively new contestable customer, the HCC suggests that the main changes relate to better information to inform usage and potential savings and options offered by retailers for voluntary load shedding. The HCC notes that pricing is more stable and predictable where it has contractual arrangements, as compared to the regulated prices for its non-contestable sites.

The HCC and ERM make brief contributions on what motivates contestable consumers to switch retailers, with both suggesting that switching behaviour is largely driven by price, but that other factors - such as more flexible terms and conditions, branding and customer service experiences - can also play a significant role.

2. Effectiveness of the Wholesale Market

The perceived effectiveness (or lack thereof) of Tasmania's wholesale energy market is a key theme in a number of submissions.

2.1. Competition and Market Power

Hydro Tasmania suggests that the wholesale market (both spot and contract) in Tasmania is operating efficiently and effectively, delivering competitive prices for contestable customers. Hydro Tasmania therefore believes that the Panel is focusing too much on the wholesale market, when price increases have primarily been driven by increases in network charges between and the way the regulatory framework determines wholesale energy prices (i.e. the long run marginal cost of new generator entry).

Hydro Tasmania further maintains that it does not have market power, latent or otherwise, nor the ability to set spot prices, due to operational constraints, including the threat of new entrant generation and hydrological risk management. It also notes that if latent power 'might exist', then there many other examples of oligopoly markets in Australia and the Panel has not yet identified the benefit of intervening in a regulatory sense.

Presenting the converse view, Aurora Energy suggests that the current wholesale market arrangements are unsustainable and that the fundamental task for the Panel should be addressing the operation and structure of the market. Aurora Energy argues that current inefficiencies are self-evident in both economic theory and in practical experience and contends that reform has the greatest potential to increase incentives for efficient operation, which will flow through to customers in the form of lower prices.

Aurora Energy notes that significant volatility in Tasmanian spot prices has had an impact on Aurora Energy as a retailer and generator and would be expected to be an issue for others looking to enter the market. Risk management against market volatility is noted a particular challenge in Tasmania, as Aurora Energy suggests that Hydro Tasmania is the only party offering risk management products and also has the ability to set spot prices through its market dominance. Aurora Energy considers an outcome of this is a requirement to put in place 'excessive' hedge cover to manage risk, with Aurora Energy noting that this is also likely to be an issue for any potential new entrants.

Aurora Energy therefore believes that effective competition in the wholesale market the most important pre-condition for effective retail competition, noting that real pricing benefits to consumers will come from retailers being able to strike alternative wholesale energy purchasing, hedging and risk management arrangements.

The TCCI is also of the view that, *prima facie*, there is insufficient competition in the wholesale energy market. The AER goes further in suggesting that current market outcomes do not reflect efficient supply costs and that inefficiencies and risks in the wholesale market are also hindering development of retail competition.

The AER provides some detail with regard to how it believes Hydro Tasmania uses its market power to set prices ‘almost at will’ through its control of non-scheduled generation and use of Basslink. Lending support to Aurora Energy’s contention, the AER suggests that there is evidence that Hydro Tasmania can, and has in the past, structured its offers in the spot market to cause financial harm to Aurora Energy Tamar Valley (AETV).

While Hydro Tasmania claims that Tasmania’s spot prices are comparable to Victoria, both the AER and Aurora Energy suggest that this claim does not bear scrutiny when looking beyond high-level averages, noting that there are clear examples where Tasmanian prices have been significantly higher for sustained periods.

RTA notes that where there is a market with few competitors, as is the case in Tasmania, the perception of market power may influence the behaviour of market participants. RTA highlights its belief in the importance of effective regulatory oversight and governance if increasing the level of competition in the market is not practical or feasible.

2.2. Hydro Tasmania’s Utilisation of Basslink and Non-Scheduled Generation

The AER and LYMMCo both raise issues with Hydro Tasmania’s current utilisation of Basslink, which they suggest is to the detriment of competition in the wholesale market. The AER contends that Hydro Tasmania has the ability through its energy and Frequency Control Ancillary Service (FCAS) offers to drive counter price flows across Basslink, limiting the ability of competitors to manage their spot market risk through inter-regional revenues (IRRs). The AER also suggests that pre-NEM entry commitments regarding the purchasing of IRRs have not been fulfilled. Combined, it is argued that these factors increase the difficulty for potential new retailers to manage risk.

LYMMCo further suggests that the arrangements between Hydro Tasmania and Basslink (BPL) may breach competition and consumer laws as they essentially result in a ‘price fixing’ regime. LYMMCo’s view is that BPL should cease to give effect to its agreement with Hydro Tasmania and instead operate as an independent commercial agent in the NEM, suggesting that if Basslink is uncommercial without the services agreement in place then it could become a regulated interconnector, similar to the links that operate between other Australian jurisdictions.

The AER also raises specific concerns with the way in which it believes Hydro Tasmania reduces supply from its non-scheduled (smaller-scale hydro) plant to ‘spike’ the spot price without warning, resulting in inefficient price outcomes and suggests that Hydro Tasmania should be required by Government to re-register its non-scheduled plant as scheduled as a “simple, immediate and inexpensive” solution this problem.

2.3. Structural Reform of the Wholesale Market

Both the TCCI and AER’s submissions call for significant structural reform to address what they see as fundamental issues with a lack of competition in the wholesale market. The TCCI makes a general comment in this regard, suggesting that the Panel should consider changes to market structure, the regulation and operation of Basslink, ownership of IRRs and any other changes to support competition at the wholesale level. The AER goes further and nominates several potential reform options, including the separation of Basslink from Hydro Tasmania.

Aurora Energy also calls for change, suggesting a two-stage ‘reform pathway’, with Stage 1 focusing on regulatory changes to the wholesale market and potentially a move to FRC if these initial changes at the wholesale level were proven effective. Stage 2 would be the move to a fully competitive market, assuming that any competitive wholesale market solution is found to be both achievable and shown to provide tangible customers benefits.

In order to improve competition at the retail level, the AER also floats the potential option for Hydro Tasmania to be required to make wholesale energy contracts available to new entrant retailers at a price determined by OTTER.

Hydro Tasmania’s view is that FRC does not require regulatory intervention in the wholesale market, as it already has sufficient incentives to offer efficiently priced and appropriately structured products to retailers. Lending support to this position, ERM suggests that derivative pricing provided by Hydro Tasmania enables it to compete in the Tasmanian market on a ‘level playing field’.

In its submission, RTA raises the more fundamental question of whether the size of the Tasmanian market is sufficient to provide fully functioning competition and suggests that this be considered before any restructuring is considered. RTA further notes that any proposed restructure should be able to demonstrate clear benefits.

3. Wholesale Energy Allowance for Non-contestable Customers

3.1. Long Run Marginal Cost

The current methodology for determining the wholesale energy component of non-contestable customers' power prices is critiqued in a number of submissions. OTTER suggests that the 'long-run marginal cost' (LRMC) of new entrant generation "...may not be the best measure of efficiency in the Tasmanian market", given that supply currently exceeds demand. Hydro Tasmania notes that LRMC is a poor measure of efficiency and does not reflect wholesale prices or Hydro Tasmania's production costs or overheads. RTA agrees that the methodology lacks credibility in a region where new investment in generation is not required in the near term and suggests that an alternative approach is to consider the marginal value of the last megawatt of energy supplied.

OTTER notes that Regulators in other jurisdictions have the flexibility to apply other methodologies including market prices or the weighted average between market prices and LRMC and that only NSW has adopted Tasmania's current approach of 'the higher of LRMC or market prices'. Comparisons provided by OTTER between LRMC and market prices during the 2010 Price Investigation show LRMC estimates to be substantially higher.

4. Transmission and Distribution Network Regulatory Outcomes

4.1. Current Investment Incentives

A significant number of stakeholders raise issues with regard to the operation of the current regulatory framework and its perceived impact on increasing network (transmission and distribution) prices. TasGas Networks suggests that, given deficiencies in the current framework, network costs being passed onto consumers do not represent good value for money.

TasGas Networks, the TCCI and Hydro Tasmania all believe that the current framework rewards network service providers commercially for building assets to ensure reliability, potentially beyond efficient levels, and providers are subsequently not focusing on low-cost operational issues affecting the transmission system, nor potential demand-side alternatives to network augmentation. John Arneaud also suggests that there is little in the current Framework to encourage the deferral of capital expenditure. RTA's position on this issue is that network service providers should face the same performance incentives as private sector entities.

OTTER also notes that in submitting capital programs for approval under the most recent Pricing Investigation, less-cost distribution or non-network solutions could potentially have been pursued by Transend Networks under the processes specified in the existing regulatory test.

TasGas Networks argues that gas has the potential to provide a competitive alternative to further investment in Tasmania's electricity networks and that the current regulatory framework does not allow non-network options to be appropriately considered.

With regard to demand-side participation (DSP) Aurora Energy suggests that the potential benefits from 'smart grid' technologies, in terms of price reductions from reduced network capital expenditure, could far outweigh benefits to customers under FRC.

4.2. Review of the Network Regulatory Framework

The AER notes that it will be shortly making a number of recommendations to the Australian Energy Market Commission (AEMC) with regard to changes to the network regulatory framework. Support for the AER Review is noted by a significant number of stakeholders who have made submissions to the Panel. Transend Networks suggests that, given that the network regulatory framework is the remit of the AEMC, the Panel should focus on Tasmania-specific issues that can either be addressed independently or feed into national discussion.

Transend Networks also notes that it has worked with OTTER to minimise duplication between obligations imposed by the national and Tasmanian Regulator and current reliability obligations therefore reflect jurisdictional decisions regarding arrangements that are most appropriate for Tasmania.

5. Pricing

5.1. Fixed and Variable Charges

The issue of electricity tariff structures – specifically the quantum of fixed daily charges – is the subject of a number of representations to the Panel in response to the Issues Paper.

OTTER notes in its submission that it regularly receives complaints and inquiries from the general public with regard to fixed daily charges.

TasCOSS and Eco Energy Solutions both raise concerns that the relatively high fixed charge component makes it difficult for low usage (non-concession) customers to achieve significant savings through reduced energy usage and therefore there is a lack of incentive for energy efficiency. The HCC also notes that, from a policy perspective, lower fixed charges (and therefore higher energy charges) would likely encourage greater energy efficiency by customers.

5.2. Cross-Subsidies

A number of submissions also address the issue of whether cross-subsidies currently exist across individual customers or customer classes in Tasmania. There is a broad awareness of (and support for) the application of 'postage stamp' pricing to network charges as the most obvious cross-subsidy in the market (that is, between urban and rural customers).

TasGas Networks also considers there to be substantial cross-subsidies between users with different demand profiles, given its position that retail prices do not currently reflect the true cost of peak electricity consumption.

With regard to the issue of Major Industrial (MI) pricing, the TCCI urges the Panel to make an assessment of contracts to ensure they represent fair market value and are neither over nor under priced, but notes that appropriate pricing should reflect value to Tasmania of the MIs flat and interruptible load. The HCC notes that there is a general perception that the MIs pay lower energy prices, but that this does not necessarily constitute a cross-subsidy.

Hydro Tasmania suggests that its provision of competitively priced power to MIs has helped keep them operating within the State, with resulting benefits to the Tasmanian economy, but emphasises there is no element of cross-subsidy or below-cost pricing in its contracts with the MIs. RTA comments that it does not believe that there are any cross-subsidies in its purchase of electricity for its smelter.

6. Value Creation, Benefit and Cost Allocation of Major Investment and Policy Decisions

6.1. Basslink

Hydro Tasmania contends that its decision to enter into the Basslink arrangements has proven to be a sound financial move for both the Company and the State, noting that its last five of operations have resulted in a positive return for the Company.

It notes that value sources from Basslink include interregional trading, cost minimisation during drought, increased ability to capture high inflows and a NEM market price for generation. Hydro Tasmania notes that the annual net benefit from Basslink varies from year to year but notes that the annual net benefit averages in excess of \$40 million between 2006-07 and 2010-11.

LYMMCo, however, suggests that the benefits of Basslink accrue only to Hydro Tasmania, with no flow-on benefits to Tasmanian retail consumers or external generators in terms of offering an additional source of competition.

Coming from a different perspective, the HCC contends that the full value of Basslink yet to be realised and will only happen when significant additional on-island generation is installed.

6.2. Tamar Valley Power Station

TasCOSS raises concerns around the fact that non-contestable customers may be supporting the viability of AETV via regulated tariffs. The HCC's view is that, to the extent that customers benefit from having the TVPS available as a buffer against hydrological risk, all beneficiaries should bear this cost equally.

RTA concludes that, in the NEM, there are no guarantees that a generator will recover its full costs. RTA suggests that the case should be established the Tasmanian electricity market has failed (not that the price paid for the TVPS was too high) and that Government intervention is necessary to provide a fair return to the TVPS.

6.3. Carbon Pricing – Distribution of Additional Value Flowing to Hydro Tasmania

Hydro Tasmania notes that it will likely benefit from a competitive advantage under a carbon price and that this will flow through in the form of increased value in the business and higher returns to its shareholders. Hydro Tasmania's position is that the way in which any benefit from increased dividends is passed onto the community is a matter for the Government to determine.

TasCOSS suggests that while Hydro Tasmania will benefit from the introduction of a carbon tax, Tasmanian electricity customers will still face higher prices.

TasCOSS proposes the 'earmarking' of a portion of increased Hydro Tasmania dividends to improve thermal efficiency of current housing stock.

RTA proposes an alternative approach that would distribute any benefits accruing equitably across Tasmanian businesses and taxpayers who have funded Hydro Tasmania's assets.

The TCCI opposes a carbon tax in absence of international agreement, suggesting that current design will particularly hurt small and medium sized businesses as they will not benefit from changes to income tax thresholds aimed at households, nor will they have access to transitional arrangements available to the major emitters.

6.4. Natural Gas

TasGas Networks notes that the Tasmanian Government's substantial investment in the natural gas distribution network represented a significant investment in a more diverse and therefore more reliable and secure energy sector. However, it suggests that, with only around 9000 customers currently connected to natural gas, the gain from the 'diversity premium' is lower than it should be, while the majority of the funders of this premium (taxpayers) do not receive any potential benefits. TasGas Networks contends that even a moderate increase in gas penetration would bring with it significant gains for household and business energy customers and suggests a range of reforms to existing regulatory and governance frameworks (at both the State and national levels) to deliver the benefits of increased gas consumption.

While cautioning that it does not wish to advocate the Government 'picking winners', the TCCI also supports further development of natural gas network and calls on the Panel to investigate merits of further Government investment in roll-out.

7. Governance

7.1. Objective for the Sector

Transend Networks and TasCOSS both respond to the electricity sector objective proposed in the Issues Paper. TasCOSS suggests that electricity needs to be considered as an 'essential service' and the objective therefore should take into account broader issues beyond the safe, reliable and efficient operation of the market and include affordability, accessibility and consumer rights. Transend Networks considers it appropriate that any state-based objective does not supplant or replace the existing National Electricity Objective.

7.2. Separation of Market Outcomes from Broader Policy Objectives

There is a high level of consensus across several stakeholders' submissions – including the HCC, Transend Networks, Hydro Tasmania, the TCCI and Mr John Arneaud - in support of the Panel's contention that "compromising efficient electricity sector outcomes to achieve financial outcomes for the SOEBs or taxpayers would not be in the community's long-term interest".

The relevant SOEBs in particular feel that social and other policy objectives should be dealt with separately and transparently from their commercial objectives. The HCC and RTA also agree that the setting of SOEB objectives should be such they do not impede the improvement of business performance and achieving economic efficiency.

TasCOSS appears to approach this issue from a different perspective by suggesting that as an 'essential service', the wider social implications of a reliable and affordable electricity supply cannot be easily separated from market outcomes.

Both Hydro Tasmania and Transend Networks advocate a 'hands off' ownership model of ownership, where Government sets high-level strategic direction but does not then exert control over the SOEBs in such a way that would usurp the roles of the Board and management. Transend Networks suggests that if Government wishes in the future to exert greater financial/operational control over the businesses, then it needs to consider which corporatisation model is most appropriate to achieve this.

Taking a broader perspective, RTA suggests that the Government should consider whether it is a 'transitional' owner, with the businesses to be eventually privatised, or whether it intends to remain a long-term owner for strategic/policy reasons, as its position in this regard will fundamentally influence the direction and focus that the Government sets for the SOEBs.

7.3. Government's Conflicting Roles in the Sector

The broader issue of the Government's potentially conflicting roles as shareholder, policymaker and regulator are raised in a number of submissions. For example, Mr John Arneaud suggests that there is currently the potential for long-term energy market efficiency to be sacrificed for short-term political/electoral gain. The TCCI's broad position on governance is that the inherent conflict between the Government's various roles in the sector can only be adequately resolved once the SOEBs are privatised.

From a regulatory perspective, OTTER suggests that the high level framework - once appropriately set by Government - should remain consistent between regulatory periods as far as is possible and permit the Regulator to with sufficient independence. OTTER also highlights the importance of national consistency, where possible and appropriate. TasCOSS supports the notion that the regulatory price setting function should operate independently from Government.

7.4. Competitive Neutrality

The TCCI and TasGas Networks both raise the importance of a 'fuel neutral' energy policy (that is, no bias towards electricity or any other fuel source) to encourage investment in lowest cost solutions. TasGas Networks is concerned that the SOEBs currently receive favourable treatment by virtue of being publicly owned and draws attention to Tasmania's decision to opt out of the recent nationally-agreed phase-out of electric resistance hot water heaters as a potential example of how policy outcomes are influenced by an 'electricity-centric' outlook. Mr Greg Todd also suggests that state ownership affords the SOEBs privileged political access to the point that this may be impacting on competitive neutrality between public and privately owned energy suppliers.

7.5. SOEBs' Financial Returns

The TCCI suggests that Tasmania's SOEBs are currently underperforming, achieving a rate of return on assets of less than the six per cent minimum recommended by the Auditor-General, with 2009-10 returns at 3 per cent for Hydro Tasmania, 1.4 per cent for Aurora Energy and 5.2 per cent for Transend Networks. The TCCI's position is that privatisation is the best way for the Government to capture the full commercial value of all its investments.

Hydro Tasmania acknowledges that returns to Government have been below commercial benchmarks, but is looking to the introduction of the carbon tax to redress current inability to earn a sustainable return when competing against coal-based generation. Transend Networks notes that it has improved its profitability and return to shareholders but suggests that its returns 'could not be described as excessive'.

7.6. SOEB Reporting and Scrutiny

Responses to the Panel's question as to whether the SOEBs might be required to adopt continuous disclosure requirements (akin to ASX listed companies) are mixed. RTA offers support to the concept, arguing that ASX disclosure requirements would be a sound benchmark for the SOEBs to adopt. Hydro Tasmania suggests that continuous disclosure provisions are not theoretically relevant to SOEBs given that there is no market involvement in the application of capital and that as a company it is already subject to greater scrutiny (e.g. Fol, GBE Scrutiny Hearings) than private sector companies. Transend Networks also questions the relevance of the model to SOEBs on these grounds, but offers in-principle support for continuous disclosure requirements, provided that it effectively replaces, rather than adds to, the existing suite of reporting requirements.

Mr Greg Todd raises some broader issues with what he considers to be the inadequacy of SOEB scrutiny and oversight, including relevant Parliamentary processes (e.g. GBE Scrutiny Hearings) and suggests that members of Parliament are not currently provided with the capacity or ability to discover important information relevant to the operation of the businesses.