



17 February 2012

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

Lodged by email: contact@electricity.tas.gov.au

Electricity Supply Industry Expert Panel – Draft Report

The Energy Supply Association of Australia (esaa) welcomes the opportunity to make a submission to the Electricity Supply Industry Expert Panel's draft report for its review of the Tasmanian energy sector.

esaa is the peak industry body for the stationary energy sector in Australia and represents the policy positions of the Chief Executives of 38 electricity and downstream natural gas businesses. These businesses own and operate some \$120 billion in assets, employ more than 61,000 people and contribute \$19.3 billion directly to the nation's Gross Domestic Product. Our member businesses include all three Tasmanian state owned energy businesses (SOEBs) and the other licensed retailers.

A well-functioning energy sector is critical to underpin Tasmania's economy and community, as well as making a valuable contribution in its own right. Tasmania's energy market has features similar to its National Electricity Market (NEM) counterparts and indeed Western Australia's South West Interconnected System. It also has its own characteristics that create unique challenges for energy policy to navigate.

As a national association, esaa takes a keen interest in energy policy developments in all of Australia's markets. We consider that the Panel's work has made an important contribution to both the Tasmanian and wider Australian energy policy debate.

The Panel has made a number of recommendations for consideration in its draft report. Many of these propose changes to industry structure while some of these recommendations require decisions by the Government that overlap its dual responsibilities as policymaker and the major shareholder of the Tasmanian SOEBs. This submission will not express a preference among the particular wholesale, retail and network reform options proposed in the draft report but below we make a number of more general comments for the Panel's consideration.

The review has shed some light on important questions

Given the significant developments in Tasmania's energy market over the last decade, the Panel's review is a timely opportunity to take stock of Tasmania's energy sector. We consider it a detailed and wide-ranging body of evidence for informing the Tasmanian Parliament, government and community before the next steps in energy reform are taken.

In particular, we welcome the clarity it has provided on some long standing questions. For example, the Panel's finding that non-contestable customers are not paying for Basslink through their electricity prices and its finding that major industrial customers are not being subsidised by other electricity users. Shedding light on these types of issues is helpful as it enhances understanding of the energy market, which should in turn provide the basis for support for any future energy reforms. We encourage the Panel and the Government to actively communicate the Panel's findings to the broader Tasmanian community.

Wider implications

The focus of the terms of reference for the Panel's work is improving outcomes for Tasmania. While this is an understandable focus, given Tasmania is part of the NEM, it is important to bear in mind any wider implications for the NEM and to maintain consistency with market-wide frameworks where possible.

Market reforms

The centrepiece of the draft report is a set of wholesale and retail reform options. Together these reforms aim to catalyse greater competition in the wholesale sector as a precondition for greater competition in the retail sector.

We welcome the focus in the review on competitive markets. esaa considers that open, competitive energy markets free from distortions should be the cornerstone of Australia's stationary energy supply system.

The review highlights the current concentration of both the generation and retail sector in Tasmania. We note, however, that this is a historical legacy and not a product of decisions of the incumbents. Indeed, electricity systems in all of Australia's states have all been highly concentrated at various stages in their development. However, competition has been promoted in these markets through the emergence of a range of market participants, some of who are now vertically integrated in both generation and retail.

We note that the Panel's chief concern with concentration in the generation sector relates to the concept of "latent market power" and its impact on the long term dynamic efficiency of the market and not the sustained exercise of market power. Indeed, the Panel's analysis of spot and contract price outcomes finds there is no evidence that Hydro Tasmania exercised sustained market power in the spot market over the period studied.

The Panel therefore takes a different approach to market power issues to the Australian Energy Market Commission (AEMC) in its current Market Power Rule

change process. The AEMC's process focuses on the exercise of substantial market power as demonstrated by actual price outcomes and the existence of barriers to entry. In part this difference reflects that the Panel is examining a fundamentally different question to the AEMC. That is, the AEMC is focusing on wholesale market competition in its own right. In contrast, the Panel's focus on the wholesale market stems from its concerns about the implications for retail competition and the ability of the industry to produce economically efficient outcomes over time and to respond and adapt to change.

Our view is that energy reform throughout Australia should ultimately aim for a fully contestable retail energy market free from the distortion of price regulation. Vulnerable consumers should be protected by appropriate, government-funded support. This would bring energy in line with the arrangements for the majority of goods and services in the Australian economy.

Different states in Australia are at different stages along this competitive reform path. Most, but not all, states and territories have introduced full retail contestability but only Victoria has fully deregulated energy prices. Tasmania has made many positive steps, including joining the NEM, progressively introducing contestability and using an independent body and a transparent methodology to apply price regulation.

As a general principle we support Tasmania continuing along the reform process towards competitive markets. Considerably more detailed analysis of the costs, benefits and risks of all options is required before any decision could be taken on any wholesale or retail reform option. This analysis should include consideration of the interactions with the regulated network sector.

The link between retail competition and price regulation

A key theme in the Panel's report is the methodology for retail price regulation for non-contestable customers. In particular, it recommends an adjustment to the methodology for setting the wholesale energy allowance that it considers could lead to a reduction in retail prices for small users.

Given the pressure placed on some consumers by recent electricity price rises, any regulatory change that could deliver price reductions is welcome, provided that it does not have adverse unintended consequences. As such, we caution that any consideration of methodology changes should take into account the Panel's broader reform objectives such as the emergence of a competitive retail sector in the future.

Both the existence of retail price regulation and the manner in which it is applied are inhibitors of competition in Australia's energy markets. The risk of being squeezed between the cost of supply and a regulated retail price is a deterrent to new entrant retailers. This was demonstrated in the Australian Energy Market Commission's 2010 report into retail competition in the Australian Capital Territory (ACT). The report found that price regulation is a barrier to competition and has directly contributed to the low levels of competitive activity in that market.¹

¹ See Australian Energy Market Commission *Review of the effectiveness of competition in the electricity retail market of the ACT*, Stage 1 Final Report, 24 November 2010.

We encourage the Panel to consider the impact of any changes to price regulation on the incentives for new entrants in the event that full retail contestability is introduced in Tasmania.

The Association supports retail price deregulation in contestable energy markets. As such, we also consider the Panel should include a broader critique of continued price regulation in its final report. This can serve as a basis for articulating how and when it sees full price deregulation fitting into its possible reform paths. While there are a number of steps required before price deregulation for non-contestable customers would be possible in Tasmania, it is important that the Panel identifies it upfront as an ultimate objective.

It would be a lost opportunity for Tasmania if reforms to spur retail competition for small users were undermined due to price regulation – either its existence or the specific methodology – effectively closing the market to new entrants (as is occurring in the ACT).

Achieving welfare objectives

A long-standing esaa principle is that the price of energy and the achievement of the community's social objectives should be kept separate. This preserves price signals for consumers and producers, facilitating efficient consumption and production decisions. Delinking subsidies from energy prices also facilitates retail competition as it prevents a situation where incumbent retailers can be seen to offer a price advantage over new entrants.

As such, we strongly support the Panel's recommendation that all CSO activities are transparently identified and funded through the Budget process rather than the energy market.

Governance

A mixture of public and private ownership is a common feature in Australia's energy markets. However, where this occurs in the competitive market it creates a more challenging investment environment given the government's multiple roles as policy maker, regulator and asset owner. Application of competitive neutrality principles and transparent and clear governance arrangements for publicly owned energy businesses are essential to supporting the environment for new investors. We therefore support clear articulation of strategic objectives for the SOEBs as proposed by the Panel. We also consider that to ensure effective governance of the energy market and avoid conflict of interest in the efficient operation of energy businesses there should be clear separation of responsibilities between the functions of the shareholding Minister and the Minister responsible for energy policy.

Review of financial performance

We note that the Panel draws attention to "the tendency for Aurora Energy and Transend to overspend regulated allowances for both operating and capital expenditure" until recent years. This assessment of the financial performance of the SOEBs implies an *a priori* assumption that the regulated allowances were correct judgments. Given the difficulties regulators have in predicting the expenditures a

network business will need to incur to meet its service obligations and targets, we do not consider that such an assumption necessarily holds. Indeed, the Panel itself elsewhere suggests that the regulatory framework may have contributed to these financial outcomes, noting that, “Revisions to the regulatory framework in 2008 and 2009 provide more comfort that regulatory allowances permit network businesses to recover their efficient costs, and provide stronger incentives to outperform expenditure and service targets.”

Any questions about our submission should be addressed to Kieran Donoghue, by email to kieran.donoghue@esaa.com.au or by telephone on (03) 9205 3100.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Matthew Warren', with a long horizontal flourish extending to the right.

Matthew Warren
Chief Executive Officer