

Electricity Industry Panel - Secretariat
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24 February 2012

Dear Mr Christian

Bell Bay Aluminium (Bell Bay) welcomes the opportunity to comment on the draft report into the Tasmanian Electricity Supply Industry (TESI), published by the Expert Panel on 16 December 2011. Bell Bay's response is framed around those recommendations made by the panel which are considered to be most relevant to the long term sustainability of its own business

Recommendation 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.

Bell Bay notes that the proposal is to replace a method that only takes into account costs of new entrant generation, in a market where new entrant generation is not required for many years, with an approach that also takes into account the prevailing supply-demand conditions. This seems a sensible approach in principle.

Bell Bay notes that the Panel cannot say how much non-contestable prices will fall under the new approach, but estimates it could be five to ten per cent. Bell Bay notes that this will necessarily result in a loss of revenue to the State Owned Electricity Businesses (SOEBs), whose financial performance had already not been found to be efficient.

Bell Bay's concern is how the Government proposes to manage this deterioration in revenue. Should the Government wish to adopt this recommendation as policy, there should be transparency regarding how the Government will manage the revenue shortfall and what the implications will be for the Tasmanian community.

Recommendation 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.

This is a matter for the Tasmanian Government, as the sole shareholder, to decide. However, the draft report highlights that one motive for establishing the standalone financial position of the Tamar Valley Power Station (TVPS) is to identify the funding shortfall, which the Panel has suggested could be funded from a levy on Tasmanian customers.

The Panel has identified what appear to be some serious shortcomings in the performance of the SOEBs, particularly in relation to the returns from diversification investments and the sustainability of TVPS.

Bell Bay has always taken the view that the performance of the SOEBs is a matter for the shareholding state government generally and not one in which the consumer should interfere,

except to the extent that inefficiency or ineffectiveness impacts on prices are passed to consumers of electricity.

In relation to TVPS, Bell Bay did not raise any concerns about the Government's investment, as the decision was rightly one for the Government, as a shareholder of Aurora and hence the investor in the asset, to make. It is now of considerable concern to find the Panel suggesting that the asset should potentially be funded by a levy to customers. Bell Bay considers that this would set a very poor precedent, where customers can be expected to be the ultimate underwriter of investments in SOEBs if they fail. This introduces an additional sovereign risk of operating in Tasmania.

The Panel has characterised this asset as providing a non-market service not contemplated in the National Electricity Rules (NER), yet the power station will continue to offer its load into the market in the normal way. If the Tasmanian Government believes that the NER does not properly address the service it considers is delivered by the TVPS, the proper course of action is to seek a change to the NER through the appropriate channels. This is what electricity customers and other market participants are required to do if the Rules are not considered to operate as they believe they should.

Recommendation 3: Reforms be implemented to address the absence of effective competition under the current structure of the wholesale market.

Of all the recommendations, this is the one given primary focus within the draft report. The Panel has articulated that this reform is required to provide the conditions for the following recommendation - the implementation for full retail competition - having been advised by nationally based retailers that the latent market power of Hydro Tasmania is a deterrent to entry into the Tasmanian wholesale market and that, without the ability to manage their wholesale position, they are unwilling to participate in the retail market.

The Panel has also stated that the current wholesale market arrangements are not sustainable in the longer term.

The Panel has taken the view that Hydro Tasmania's latent market power should be reduced and proposed three options:

1. Compelling Hydro Tasmania to auction hedge contracts
2. Combining Tasmania and Victoria into a single region
3. Transfer Hydro Tasmania's trading rights to a number of Traders, each of whom would have rights over a portion of Hydro Tasmania's capacity.

Bell Bay notes that details on the implementation of any of these recommendations are yet to be developed.

Bell Bay has the following comments regarding the Panel's recommendation:

1. The Panel assumes that competition will benefit consumers in Tasmania, and therefore focuses on how to create the right conditions for competition to occur. However, Bell Bay notes that all reform is costly to implement and that it is important to have confidence that the benefits it will bring will outweigh those costs. Bell Bay would like to see greater focus on quantifying the costs and benefits of reform.
2. The Panel has not provided enough detailed analysis on how any of the three proposals to reform the wholesale market would be implemented. Poorly implemented reform can lead to costs that outweigh the benefits of reform and have significant and irreparable negative impacts on customers and the SOEBs. Bell Bay cautions that reform should not be a leap of faith, but must be very carefully thought through and implemented.
3. Changes to the wholesale market will impact different customers differently. For customers with long-term contracts, like Bell Bay, reform necessarily impacts the commercial arrangements agreed between the parties. The ultimate effect cannot be predicted without a detailed understanding of the commercial arrangements and is often subject to different

legal interpretations, which can lead to dispute. Until more detail of the proposed reforms is available, Bell Bay is not in a position to speculate on the impact it could have on the viability of the smelter. Bell Bay has entered into commercial arrangements with SOEBs in good faith. If the Government wishes to significantly change the rules of the game, policies should be put in place to mitigate sovereign risk by ensuring that customers on pre-existing contracts are not adversely impacted.

Recommendation 4: Following implementation of wholesale market reform, full retail contestability, be introduced.

The Panel has assumed that the benefits of full retail competition outweigh the costs of implementation. The Panel has identified flaws in the regulated retail price setting framework, and the first of the Panel's recommendations is aimed at addressing this. While the Panel cannot say what the impact will be on prices, it is estimated they could be reduced by five to ten per cent. The benefit of full retail competition for non-contestable customers should be assessed against the benchmark of what customers can expect to achieve from the implementation of this first recommendation, and not against the price paid today.

Recommendation 5-7

These are matters for the Tasmanian Government.

Additional comments

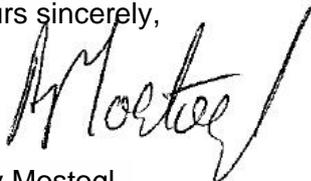
Assumed effectiveness of the NER and National Electricity Market (NEM) regulatory framework

In relation to the Panel's findings on the efficiency of the regulated monopoly network businesses, the Panel notes the significant and deliberate overspend incurred relative to the regulated revenue allowances and the apparent lack of discipline within the governance framework to drive efficiency. However, the Panel concludes that consumers have not been disadvantaged because all prices are set relative to regulated revenue allowances and all the expenditure was approved (albeit significant portions of capital expenditure were approved for inclusion in the network businesses' Regulated Asset Base ex-post). However, this conclusion is based on the assumption that the NER and the regulatory processes operate perfectly effectively in setting efficient revenue allowances. While Bell Bay accepts that review of the effectiveness of the NER and regulatory processes are outside the scope of this Tasmania specific review, Bell Bay consider that current reviews of the Rules relating to network revenue regulation are evidence of broad concern that these Rules may not already be perfectly effective. Therefore, Bell Bay consider the Panel must contemplate that consumers may have been short changed.

Given the Panel's findings that the SOEBs cannot be said to have performed efficiently in the past and its concerns relating to the effectiveness of governance, Bell Bay fully supports the Panel's suggestion that there should be an independent review of the measures the businesses have put in place to improve efficiency and accountability going forward.

If you would like to discuss these findings any further, please do not hesitate to contact Lesley Silverwood (telephone: 07 3625 5425, email: lesley.silverwood@riotinto.com).

Yours sincerely,



Ray Mostogl
General Manager, Bell Bay Aluminium